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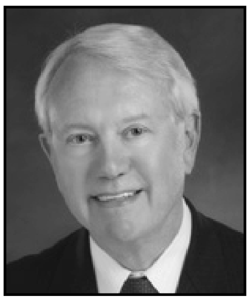
ECONOMY

Political economics: mixed data for a new year

By Jim Flinchum

What a quarter! War broke out in Europe, and inflation broke out in America. COVID infections declined in America but increased in China. Despite nagging supply chain problems, the stock market hit an air pocket during the quarter but has almost recovered. Consumer confidence even rose slightly.



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The stock market: With all that worry, the S&P 500 only lost 4.6%. Small-cap stocks did slightly worse, losing 5.62%. Growth stocks lost 8.59%, compared with value stocks, which were flat. It was interesting that consumer staples beat consumer discretionary, down 1% compared with 9%, suggesting a more "risk-off" mentality. The best performing sectors were energy (up 39%) and utilities. The worst performing was communications, down almost 12%. The Nasdaq briefly touched bear territory (down 20%) but recovered to an 8% loss. Agriculture stocks rose 22%, as Wall Street sees food shortages and hunger increasing worldwide.

Internationally, Latin America caught fire, with stocks rising 29.5%. Investors in Europe ran for cover, with stocks losing 7.33%. Oddly, Australian stocks were up 7.4%, while Asia was down 9.27%.

After years of double-digit increases in the stock market, investors are now spoiled. Most analysts see another up-year but only single-digit growth.

Inflation: We think of inflation as being a result of either monetary policy or fiscal policy — a mistake by the Federal Reserve or by Congress. While both have contributed to inflation, the huge jump in the budget deficit during the pandemic "filled in the hole" from greatly reduced consumer and business spending. It prevented a drop in consumer demand, which could have become deflationary and is much more difficult to control than inflation.

Some analysts are placing more blame for inflation on the supply-chain problems, which defy simple solutions. Although residential construction was up a robust 1.1% in February, home values still increased 19% year over year — at least partially due to supply chain shortages. China's shutdown of whole cities, blamed on their zero-COVID policy, has also exacerbated the problem. Of course, the biggest supply shortage is the shortage of labor.

Another cause is inflationary expectations, which has suddenly reached an all-time high. If we assume prices will rise, it becomes self-fulfilling. We hear constant complaints about gas prices, but that is only 3% of household spending and has never exceeded 5%. Seeing inflated prices at every corner gas station hardens the expectation.

I am not overly concerned about long-term inflation, as the Fed has already started quantitative tightening or "reducing their balance sheet" by selling bonds and reducing money supply. Combined with rising interest rates, the Fed now has a two-fisted approach, unlike past bouts of inflation.

The labor force: Strong! There were 431,000 new jobs last month. The unemployment rate dropped to only 3.6%, and the Fed expects it will drop to 3.5% by the year's end. Total employment is now very near pre-pandemic levels.

Employees don't usually quit jobs unless they feel confident getting another. With 10.6 million job openings last month, 4.5 million workers felt confident enough to quit their jobs, which is a record high of 2.9% of the labor force, likely causing the 0.6% increase in average hourly earnings during the month of March. Year over year,

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wages increased 5.6%, less than inflation for that period of 7.9%.

It is good news that the labor force has started expanding again, as workers return, even "retired" workers. The labor force participation rate reached a fresh cycle high of 62.4%. Over 300,000 women returned to the labor force last month, suggesting that the heavy caregiving duties during the pandemic are finally subsiding.

Interest rates: The Fed knows they are behind the curve in curbing inflation. They have kept interest rates unnaturally low since the global financial crisis of 2008-2009. In March, they raised short-term rates by a quarter-point and are expected to do that again several times this year.

Because the Fed has good control over short-term rates and minimal control over long-term rates, they risk pushing up short-term rates above long-term rates, which is called an inversion. Pundits joke that inversions have predicted eight of the last six recessions. We currently have a minor inversion, but I don't think it predicts anything, except the Fed is behind the curve.

The only question is whether they will increase rates by a half-point or another quarter-point on May 4.

Taxes: While I understand the need for additional tax revenue, taxing privately held assets is not a workable solution and will be a subsidy to America's accountants, appraisers and lawyers. Different capital gains rates for privately held and publicly traded assets would be more workable and reduce some of the tax advantages currently held by privately held assets.

R.I.P.: The world's largest asset manager is Blackrock. Last month, their CEO said that Putin's war on Ukraine is the beginning of the end for globalization, but I disagree. Globalization has been dying for several years already. It was flawed from the beginning, as Congress took the economic benefits without paying the economic costs, such as re-education and relocation. Short-term political needs overwhelmed long-term economic gains. The lower-middle class has suffered, and America became hollowed out. There has been an enormous long-term political cost to this. It is like watching a beautiful home slowly sliding down a hill.

Free-floating angst: Recessions come and go and need not be feared. If you think a recession is approaching, you should increase your savings. A financial crisis like The Great Recession in 2008-2009 is entirely different and should be feared, but I see little likelihood of that. American banks are some of the best-capitalized in the world and have been subjected to numerous "stress tests" in recent years.

I do worry somewhat about stagflation, which is a period of low economic growth and high inflation. If the Fed does not have any early success controlling inflation, consumers will slow spending, which slows the economy. (After inflation, consumer spending dropped 0.4% in February.) However, because the American consumer enters this slowdown in better financial shape than any previous slowdown, I am not overly worried about stagflation.

Seduced by the beauty of blockchains, bitcoin and other cryptocurrencies have achieved "escape velocity" and are remaking the world of financial technology. However, with an infinite number of such cryptocurrencies, picking the winning currency will be more difficult than picking a winning stock.

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