Inside Business

The Hampton Roads Business Journal | Insidebiz.com

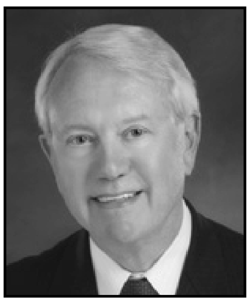
JULY 18, 2022 $1.00

ECONOMY

Is this a garden-variety recession?

By Jim Flinchum

Make no mistake — the economy is in recession. The traditional, nonofficial definition of recession is two consecutive quarters of shrinking gross domestic product. The first quarter was revised downward to negative 1.9%. Obviously, GDP was already contracting as it entered the second quarter, and I know of no economist who thinks GDP grew during Q2. But how severe will this recession be — a routine recession or another Great Recession?



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The stock market: The S&P 500 was down 20% year-to-date, but 16% of that was in Q2, not Q1. Growth stocks were down 28% year to date compared with value stocks losing 11%, suggesting a new "risk-off" mentality or flight-from-risk. Energy stocks did the best, up 32%, and consumer discretionary stocks did the worst, losing 33%.

It is a rare year that both stocks and bonds decline. Most financial plans assume bonds go up when stocks go down. Traditional asset allocation hasn't worked this year.

Worldwide, most stocks followed the U.S. into bear markets. Asia lost 18% year-to-date. Europe and Japan each lost about 20%. Canada and Australia lost about 11%. Latin America was flat year-to-date, although it lost 17% in Q2.

The cost of Russian President Vladimir Putin's war on Ukraine will continue to be very costly for both Russia and Europe. Given that cost, one wonders what Putin will do with that pile of rubble formerly known as the nation of Ukraine? The United Nations estimates that 71 million additional people have already been pushed into poverty by Putin with higher food and gas prices.

Inflation: Congress did the right thing by approving massive deficit spending to offset the pandemic-flash-recession in early 2020, but they did too much — spending too-many dollars to fill a too-small hole. The classic cause of inflation is "too many dollars chasing too few goods."

There is some reason to believe we have passed peak-inflation. After bursting out of the gate, inflation seems to be slowing down. Higher interest costs naturally slow the economy, plus the stronger dollar tamps inflation in commodities. It is often said that "the cure for high prices … is high prices." People cannot demand what they cannot afford. We're seeing some "demand-destruction" for gas, lumber, copper and other commodities. A deflationary factor is the high level of retail inventories, as retailers cut prices to reduce the expense of holding inventory.

One worry is inflationary expectations, which has suddenly reached an all-time high. If we assume prices will rise, it becomes self-fulfilling. Behavioral economists know that expecting higher prices causes higher prices.

The labor force: There were 372,000 new jobs created last month and 2.7 million jobs this year. The unemployment rate has held steady at 3.6% for four straight months. Total employment is now very near pre-pandemic levels.

Employees don't usually quit jobs unless they feel confident getting another. With 11.3 million job openings last month, there are now 1.9 job openings per job seeker. Jobseekers should feel confident today.

It is good news that the labor force has started expanding again, as workers return, even "retired" workers. The labor force participation rate dropped very slightly last month from a cycle high of 62%. It is estimated that an extra 800,000 senior workers quit or retired because of the pandemic. Now, they are caught between inflation and falling individual retirement accounts and are starting to return to the labor force. Some are just bored with retirement being less than exciting. We need them to return!

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Interest rates: When you lend money to someone, there is a greater risk of something going wrong over 30 years than over the next two years, for example. Therefore, long term rates should be higher than short-term rates. If not, it is called an "inverted yield curve" and sometimes predicts a recession. Today two-year and five-year rates are higher than 10-years. However, that has not been a useful indicator since pre-2008 when the Fed took tighter control over short-term rates but still have little control over long-term rates.

Some investors think the movement of interest rates — long-term interest rates — predict economic growth. Since mid-June, those rates have been dropping, suggesting further weakness in the economy.

The dollar: With the rest of the world hurting, the U.S. is a safer place to hold the money of foreigners. To do so, they buy dollars, and that drives up the strength of our currency, but — here's the problem — the dollar is just too strong, especially for emerging market debt that is payable in dollars. While it is a great time to visit Europe, the strong dollar hurts our exporters. The British pound and European Union euro look cheap. The dollar could soon reach triple parity with the euro and the pound, whereby one dollar = one euro = one pound.

In a textbook, Americans would order more foreign-made goods when the dollar is strong but not this time, as they've already ordered many foreign goods while on lockdown during the pandemic. As a result, the ISM manufacturing index has been falling worse than expected (while the ISM services index is doing better than expected), contributing to our reduced trade deficit.

Crypto-winter: It has been a bad quarter for all cryptocurrencies, which have lost as much as two-thirds of their value. Many crypto-related companies, especially lenders, have already been bankrupted. Few older investors will miss them, having never understood what a cryptocurrency can do that the dollar cannot. Of course, it would be unfortunate if the blockchain baby got thrown out with the "currencies."

Perspective: There are recessions, and there are recessions. Consumer spending is 65-70% of GDP, and consumers have never entered a recession with such a strong job market. Our collective memory is burdened with 1970s inflation and the 2009 recession. 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 by reducing money supply. Combined with rapidly rising interest rates, albeit tardy, the Fed now has a two-fisted approach, unlike past bouts of inflation. This is not your father's inflation!

I do not expect this recession to be severe. 2009 was a global financial crisis, and this is not. Our banks and financial system are a fortress in the world of global finance. This recession is just another garden-variety recession that we've seen too many times to remember. This is not your grandfather's Great Depression.

Free-floating anxiety: I do worry that the Fed might raise interest rates too much, or that the food crisis in Africa becomes inevitable, or that the energy crisis in Europe this winter will be even worse than feared, or that Putin sinks further into madness.

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