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Weekly Economic Update

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The recession that the consensus did not expect to start until 2023 or 2024 is upon us – with real GDP down at a -1.4% annual rate in the first quarter. We have been arguing for months that the fiscal cliff was robbing consumers of nominal buying power, while inflation was exacerbating the effect on real spending. Now, the price spikes in food and energy sparked by the war in Ukraine have slashed spending power and profits even more. The financial markets know, with bonds signaling recession for months and the equity markets catching up late, like before the Great Financial Crisis. If we were the NBER, we would mark the start of the recession to December 2021, after the Fed pivoted on monetary policy, President Manchin cut off child care credits, inflation flared up from an already elevated pace and December retail sales plunged because the holiday season had been pulled forward by fear of supply shortages and inflation.

That said, we suggest we are now 5 months into what is normally a full year process. The next several months will provide the correction in hiring and inventory building needed to bring profits back into positive territory. As we have long said – the key lead indicator of a capitalist economy is profits – and our guesstimate on first quarter profits is -35% at an annual rate, up just 4% from a year ago on 11% corporate revenue growth. Non-farm proprietors' income – a nominal number – has been virtually flat for the past six months, confirming the weakness in profits.

We believe that firms have been warehousing employees in anticipation of a shortage during the peak summer months. Now, the economic outlook has changed dramatically and they are likely to be laying off -- relative to very strong seasonals, reflecting strong summers both pre-COVID in 2018 & 2019 and on re-openings in 2020 and 2021. Given wages are likely to remain sticky, we expect most of the correction will come from less than anticipated hiring, and reductions in hours, augmented by wage gains that are less than inflation. This process has started – from January through April, wages did lag inflation and hours worked were declining – but we expect the labor force correction will be most profound late in the second and into the third quarter, further depressing real spending and GDP growth.

Our most meaningful observation is that the bullwhip has cracked. Fourth quarter real GDP soared as firms took advantage of softer real demand and returning labor (attracted by higher wages) to rebuild badly depleted inventories. In the first quarter, an inventory slowdown had been expected – but it largely did not happen. Inventories continued to pour in from Asia, as earlier orders had been delayed by port bottlenecks. Meanwhile, outbound shipments were stalled, because real export demand fell -5.9% in the first quarter after a 22% pop in the fourth quarter. The result is inventories are no longer short – especially relative to slowing demand. Firms that over-ordered to ensure supply at any price are now shifting to cancelations. A slump in goods traffic has obvious in the US trucking industry for many weeks. It is highly likely that the inventory correction which was expected in the first quarter will hit in the second. Real final sales fell at an -0.6% annual rate in the first quarter and are up roughly 1.5% over the previous three quarters -- in total, not annualized! With slower inventory growth likely to carve at least 1% off Q2 real GDP growth, a second quarter of negative real GDP – one definition of recession – is certainly possible. The Atlanta Fed called the first quarter at 0.4% -- both at the start and end of the quarter. They have an initial estimate of 1.9% for Q2. We will take the under.

We smell a lot of capitulation in the air. Equity markets have been adjusting to weaker earnings outlooks, rather than to reports of strong revenues that show the economy in the rear-view mirror. Economist have been dropping their forecasts -- fast – with a handful now willing to use the R word for 2022. Still, it takes much longer for the adjustments to be made in the real world. Both the war in Ukraine and COVID in China only started in March, and both will make the necessary adjustments harder to accomplish, as they promise to keep supply chains under stress and prices sticky. Thus, policymakers are like to be faced with even lower valuation for financial markets that are starved of savings, reinforced by declining sales volume as price increases – even if they slow – continue to weaken real disposable income.

We do not expect the negative first quarter to deter the Federal Reserve from its expected fifty basis point tightening in May – or June. They are simply too far behind the curve. Failure to aggressively rein in what has been excessive accommodation would likely push long rates even higher – steepening the yield curve and sustaining banks incentive to expand money supply and inflation. Indeed, a short, sharp, largely unexpected recession in the US would help return supply and demand to a better balance. For now, we expect they will continue to steer the already proposed course.

Reality is that the US is not the epi-center of this global recession. Both Europe and China are currently in far worse shape than the US – as reflected in dollar appreciation against euro, yuan, yen, pound and virtually every other currency. Europe is most exposed, with the threat of an energy cutoff revealed this week. Austria has already caved into Russian demands for payment in rubles, because they depend on them for 100% of their gas. German sources have discussed a recession of -2.5% if energy was cut off. Clearly, their will be weakness even if gas continues to flow, as imports of Russian oil and coal are abandoned by European decisionmakers. Bottom line, no one can know how deep the European recession will be given the extreme uncertainty about their access to energy – never mind at what price. The only certainty is that Europe – particularly Germany and Italy -- will bear the brunt of what is likely to be a global slump.

Meanwhile, China is adjusting quickly to what has become an embarrassment for Xi Jinping as he prepares for his third term. Like their own original COVID shutdown, and those in the US and Europe, the last several weeks have seen the Chinese economy collapse from a promising reopening in January and February to a deep slump in March and April. In a classic example of Chinese incrementalism, they started their policy response with very muted decreases in interest rates and reserve requirements. In the past couple of weeks, they have become more forceful, allowing the yuan to depreciate by 5% against the dollar to remain competitive in Europe and Japan – which have seen their currencies fall by 10% to 15%. We saw this as a move to reduce capital flight. Now, Xi Jinping has indicated that private capital does have a role in China – under heavy regulation. (Sounds a bit like Europe -- or DeSantis in Florida.) This appears to have been directed particularly at the recently faltering technology industry. China has also started to ease up on restrictions on the housing sector – from very depressed levels. We have little doubt that a strong rebound is coming as COVID fades in Shanghai, allowing port activity to reopen. Nevertheless, they are exposed to an EU recession -- as their major trade partner -- and as the world's largest importer of food and energy, with prices soaring due to the war.

The US position in this global slowdown is like a highly paid professional during a round of layoffs – they are at risk, but far less than those lower on the economic ladder. During a recession, the risk is greatest when uncertainty is highest. Right now, financial markets around the world are in flux, because it is not clear yet how significant or permanent the impact will be from the war. Thus, every nation, business and individual is shifting to a more cautious economic stance – and it is reflected in asset values. Once some players have gotten the all clear, because they have avoided layoffs or collapses in profits – or, as in many economic crises, found a way to benefit – markets will adjust to that reality as well. We expect the news will only get worse for Europe – but that may prove to be a boon for some US firms that have greater concern about global supply shortages than direct exposure to the effects of the war.

Bottom line, the current US slump is likely to be a glancing blow, not a direct hit. The war in Ukraine may have an effect like the 2011 tsunami in Japan – which marked the top of the commodity cycle after China entered the global economy. Even the Great Financial Crisis was not enough to blunt rising commodity prices, as China rebounded quickly because the rest of the world sought cheaper imports following the GFC. As the global economy reopened in 2010, commodity suppliers responded to still high prices by expanding capacity rapidly to meet renewed demand – but remained behind the curve. However, when the tsunami devastated Japanese energy supply pushing them into recession, global commodity supplies finally caught up to ebbing demand. (Flooding in Thailand, another major part of the Japanese supply chain, exacerbated their regional recession making commodities more available elsewhere.) Europe's recovery from the GFC surged when their Japanese competitor faltered. However, because policymakers perceived the gains as permanent – rather than transitory – Europe was back in crisis in 2012, as Japan recovered.

We have seen some very optimistic forecast for the US economy in Q2 – some as high as 5%! They simply defy mathematical reality. For three quarters, declining real disposable income has sapped real final sales, and the economy has only expanded due to truly massive inventory building. In the fourth quarter of 2021, inventories rose 1.07% of GDP, and in the first quarter 0.94%. The norm over the past twenty years is 0.26%. As inventories' contribution to real GDP is from the change in the change, this 0.14% decline between quarters cut -0.8% on top of the -0.6% in final sales to generate a -1.4% first quarter. Reversion to the mean suggests that inventory building will be a drag on US GDP in coming quarters – as it was in late 2015 during the last growth recession. If final sales surged enough to produce a 5% jump (or even 3%) in real final sales – we do not see how it would come without substantial further inflation and a deeper inventory drawdown given the tight US labor markets.

Because we are less optimistic on US growth than the consensus, we are far more optimistic on inflation. Our broader interpretation of inflation to include money relative to all transactions, including asset prices, suggests to us that inflation is already rapidly ebbing. Asset prices have acted as a shock absorber relative to goods and service prices – rising rapidly on the initial money drop in March 2020 while PCE inflation remained low, and plunging on the shift in Fed and fiscal policy since November 2021 while PCE inflation remained high. To us, suggesting that PCE inflation will remain high while the Fed is stomping hard on the money brake implies that asset markets will still be falling a year from now. If so, we doubt that it will be in the financial markets, which can adapt to new expectations very quickly. It would have to be from falling – not just cooling – home prices. Just as high food prices were a key factor in Tiananmen Square and the Arab Spring, falling home prices were central to the Great Financial Crisis. We believe the Fed would be far more sensitive to another round of home depreciation than it has been to a far from a not unexpected correction in equities – which still have avoided a bear market for the S&P500.

Thus, our current global outlook is based on a recession in Europe, which may be very deep if energy access is cut. A strong rebound in China in the second half of the year, which helps clear supply chains -- but not until then, as the US still has to live through a sixty-to-ninety-day slump in imports from recent Chinese port issues. The US economy working its way out of a modest recession (maybe even a growth recession, like late 2015), which translates into slower, more sustainable growth with far lower inflation heading into 2023. The Fed full steam ahead for two meetings and then taking a look at what should be a changing economic landscape. Financial markets finding a bottom soon, as the uncertainty of war clears – for better or worse. Housing being the major casualty of the economic slump – as usual, but this time more on price than volume. And winners, like the auto industry and perhaps defense, who find that war in Europe improves their competitive position and alleviates supply constraints.

Bottom line, we want to remain focused on the cycle and not fall into the trap of drawing straight lines from developing trends. Technology stocks are in a bear market and interest rates have soared. Thus, they are not likely to be as negative for the economy in coming months as they have been recently. Corporations have been losing money because they misread the economic outlook for 2022 even before the war – and now find themselves scrambling to adapt. They will, by shifting their problems onto labor and other suppliers of inputs – which should rebuild margins, especially as many try to maintain price increases. This is where we expect the real shake-out to come. NFIB says that 60% of their members will raise prices more than 10% this year. Well, 60% will try, but there is not enough income out there for all to succeed. Some will succeed, others will fail – and some will close when they can't widen margins. Their workers will become available to those still seeking employees even as the economy cools – perhaps because they could raise prices.

The invisible hand will be busy in coming months. As noted above, a significant part of a recession is the identification of who has been swimming naked and putting them out of the game. This improves confidence among survivors and sets the stage for rebound. We are in economic winter. We believe we have been for five months. But as Chauncey Gardener opined, after winter comes the spring. We expect spring will come first for China, as their slump is related to disease, not economics – which had been improving before COVID hit again. Winter will last longest in Europe – testing their ties again. We are headed to Paris on Wednesday for the Global Interdependence Center's meetings with the Banque de France at the Louvre. We then head to Germany for the National Association for Business Economics' meetings with the Bundesbank. We have not been abroad in two years, and look forward to spirited conversations with those from a different locale – and in this case from those closest to the economic fire. We will be travelling over the coming weekend, so this note may not appear until our return. Thanks for reading.