THE BEACON OUTLOOK

FROM THE DESK OF

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OVERVIEW

The pandemic-driven business cycle ended in the last half of 2021, when levels of aggregate consumption reached long run trend and unemployment dropped below 4% in the United States—all in less than First things first. The U.S. economy has fully recovered from the pandemic-driven recession.

This shouldn't be news, as the economy has been recovered for almost a full year. Yet in many circles, including the White House where the "Build Back Better" recovery plan is still being promoted, this fact doesn't seem to be getting through. While the structure of the current economy is different than it was two years ago, a 3.6% unemployment rate, record low inventories, and the highest pace of industrial production ever is clear evidence that the U.S economy is operating at full capacity. This means the recession, defined as a period in which an economy produces significantly less than its potential, is over. In fact, the U.S. economy is running red hot. You can almost hear Scotty saying, "the engines can't take any more of this, Captain!"

Still, despite clear evidentiary data to the contrary, pundits, politicians, and economists continue to behave as if the economy is in recovery mode and, even more, that it is fragile and will derail quickly in the event of an even modest negative shock. This narrative sits at the heart of the crisis the United States is facing today both economically (the stimulus bubble we're experiencing), and politically, as both parties become more and more driven by populism. From an economic standpoint the issue is simple: when you continue to "cure" a patient for an ailment they no longer have, eventually the cure becomes the ailment. There will be consequences for today's policy choices.

Given current public discourse, it's not surprising that the United States has a bad case of the jitters. Of late the stock market has swooned even as consumer confidence has fallen to its lowest level since the economy was in the midst of the Great Recession well over a decade ago. Suddenly, there is chatter in the news about another recession (a double dip?) and the Wall Street Journal's survey of economists suggests the chance of another downturn within the next 12 months is now at 30%. At issue is the surge in inflation and it's believed impact on consumers, combined with rising interest rates, which have been driven up in part by the Fed's moves to combat said inflation.

Beacon Economics does think there is a very high probability of a recession in the next few years (although not in 2022), but not because of current trends in prices and interest rates. A more accurate assertion would be that the Federal Reserve has already caused a recession, we just aren't sure when it will start. Of course, the Fed received significant help from Congress and the White House in the form of excessive government stimulus deployed over the last two years – $12 trillion and counting to deal with a large but short-term pandemic shock. The result has been an overheated economy marked by an unsustainable level of spending and investment, as evidenced by supply chain issues, the growing trade deficit, asset market frothiness, and record low inventory levels. The inevitable collapse back to normality will create a recession in its wake.

The trillion-dollar questions are when a recession will likely begin and how bad will it be. Timing wise, certainly not yet. The main concerns about the economy right now—inflation and rising interest rates—are the symptoms of an overheated economy, not signs of an economy about to tip into a downturn. Although U.S. output contracted in the first quarter of the year, it wasn't driven by weak spending—final demand in the nation grew at its fastest clip in three quarters, almost 3%.[1] Rather, it was driven by the recent enormous surge in imports that replaced domestic production—another sign of an overheated economy.

The current expansion still has a lot of momentum, driven by historically high household savings, low private sector debt levels, and the fact that policymakers have yet to truly withdraw stimulus funding. The Federal Reserve's moves to date will have minimal impact on demand, and therefore inflation. Indeed, the Federal government seems more intent on expanding deficit spending than on trying to pay down the $30,000 that was borrowed for every person in the nation over the past five years. Given all this, Beacon Economics does not see any basis reason for a recession in the near term outside of the very low probability that the Fed decides to get serious about inflation and dramatically accelerates the near-term schedule for quantitative tightening.

Ironically, the surge in public panic over the economy, although unwarranted, is liable to prevent the Fed and Congress from doing what they need to do to cool things off. This means the problems associated with an overheating economy will grow worse, and when the recession does arrive it will be more severe than if the issue had been tackled more quickly and assertively. Reality must inevitably catch up with the U.S. economy, and it's possible that the resultant downturn could either be mild or on par with the Great Recession, albeit with very different characteristics. In short, it's too soon to dive into your bunker, but it would be wise not to venture too far from it either.

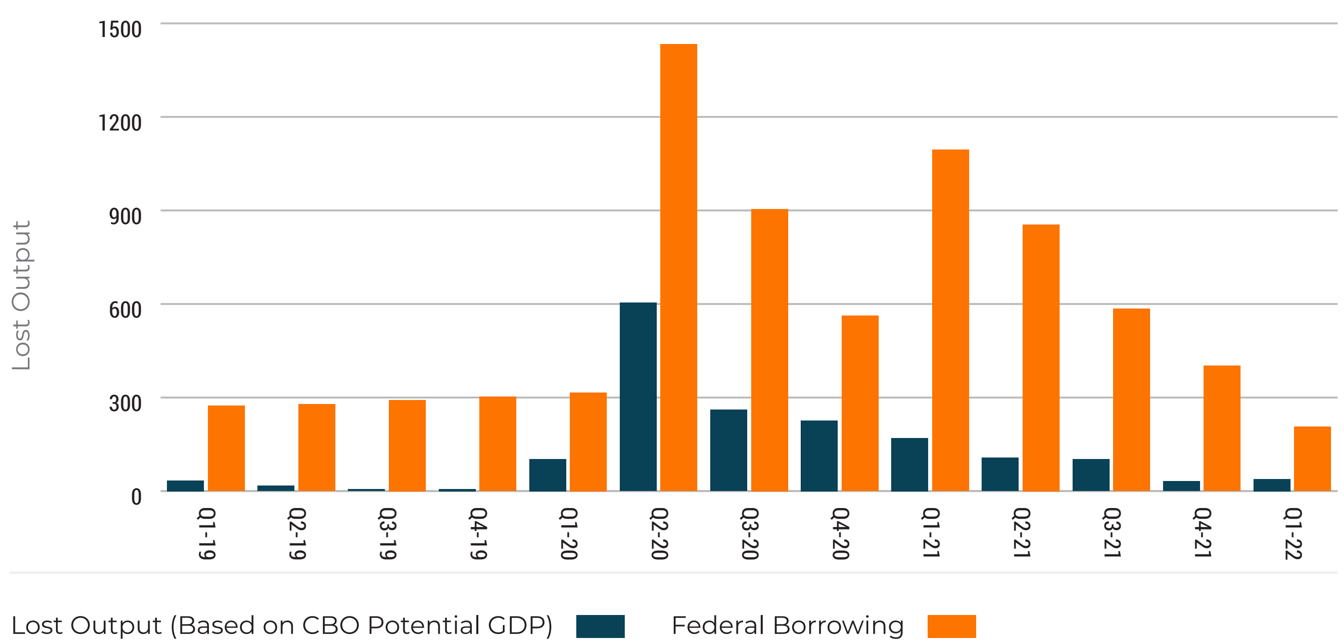
Of course, monetary and fiscal stimulus also played a role in the strong recovery, both in guiding the nation through the first few weeks of (clearly unwarranted) financial panic, as well as supporting businesses and workers who were truly hard hit. But the scale of the intervention in the economy was vastly more than what was needed under the circumstances. This is evident by the simple fact that other developed nations have followed similar V-shaped recoveries despite thrusting significantly less stimulus into their economies. Economic growth has now slowed, but most countries had larger economies at the end of 2021 than they did in pre-pandemic 2019, and those that didn't were typically facing issues going into the pandemic. Despite the massive amount of Federal government stimulus, the United States doesn't stand out globally in its rapid V-shaped bounce

1 Final demand is the sum of spending by consumers, businesses, and the government; or GDP with inventories and the trade deficit removed.

THE OVERHEATED U.S. ECONOMY

At issue in the U.S. economy today is the nearly $12 trillion in stimulus that the Federal government has injected into the system over the past two years; as noted in past editions of The Beacon Outlook, it is a vastly excessive sum. Consider that over the course of two pandemic years the Federal government borrowed $7 trillion in deficit spending, yet a reasonable estimate shows that the U.S. economy lost roughly $1.6 trillion in output, a disparity of over 4 to 1[2]. For every dollar in lost household income, government stimulus programs gave $2.60 back to U.S. households, leading to a perverse situation in which there was a huge surge in household disposable income and a massive buildup in household savings in the middle of a recession. And the Federal government is still in stimulus mode—the Congressional Budget Office is estimating the current deficit at $1 trillion per year.

FEDERAL DEFICIT & LOST GDP

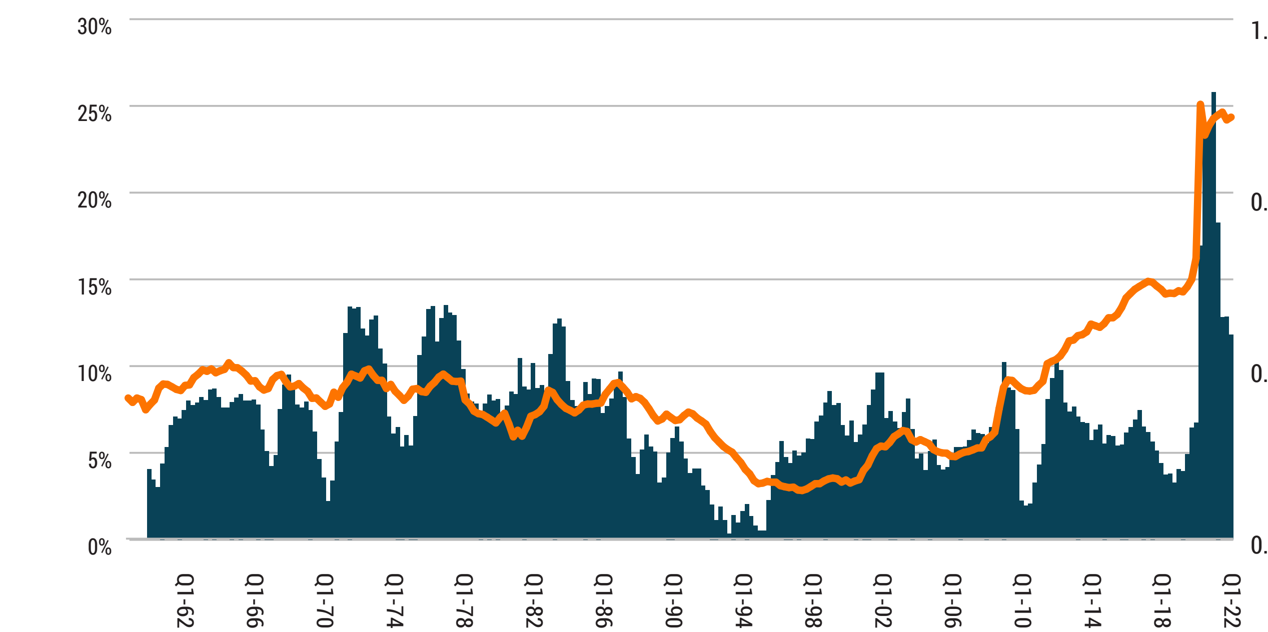


Source: U.S. Bureau of Economic Analysis; Congressional Budget Office; Analysis by Beacon Economics

2 This estimate is derived by taking the difference between the Congressional Budget Office's projection of nominal GDP and actual nominal GDP.

Monetary policy was similarly oversized. The Federal Reserve engaged in $5 trillion in quantitative easing in two years, compared to $3.6 trillion in quantitative easing enacted over six years in the wake of the Great Recession. They did this despite almost no sign of any major financial problem being generated by the pandemic – loan delinquencies, foreclosures, and bankruptcies all declined sharply over the last two years. Consequently, while M2 growth remained remarkably steady through the Great Recession, it grew by 40% over the past two years, one of the largest increases in money supply ever seen in modern U.S. history. The unit money supply, M2 relative to the size of the nominal economy, has never been higher which suggests the United States will see a lot more inflation unless something is done to shrink M2 back to size.[3] It is not an exaggeration to say that this will likely go down in history as some of the worst policymaking ever seen at the Federal Reserve since they decided to allow the banking system to implode after the collapse of the stock market in 1929.

M2 GROWTH AND UNIT MONEY SUPPLY (M2/GDP)



Source: Board of Governors of the Federal Reserve System (US), US Bureau of Economic Analysis; Analysis by Beacon Economics

3 Data nerds will recall that M*V = P*Y, which means that unit money supply = 1/V. But the velocity theory of money is a long run condition and can depart this long run equilibrium in the short run. In other words, the high unit money supply implies that right now M*V > P*Y, and an increase in P (inflation) is needed to get this ratio back into equilibrium.

The pandemic was a human tragedy but posed almost no medium- or long-term risk to the economy. It simply wasn't that kind of recession and was instead more akin to a natural disaster. Much less support would have been sufficient to deal with the supply shock driven by the health crisis. It is not surprising that Congress followed the angry populist narratives of our era and ended up overdoing it, politics, after all, is inherently myopic and focuses on the short run. But the Federal Reserve and its phalanxes of economists should have known better. Milton Friedman taught a generation of economists about monetary theory and the consequences of excess money supply growth, as evidenced by piles of research papers and books (and his Nobel Prize in economics). But despite this being a classic monetary error, the Fed still appear shockingly unconscious of the slow-motion steam roller they have let loose on the economy.

Even a brief review of Friedman's work illustrates the basic steps that occur when the money supply is excessively expanded. First the economy jumps as interest rates fall, asset markets sharply expand and real spending increases. But this is all an illusion of prosperity that can't last because the claims on the economy have risen beyond the economy's physical capacity to meet those claims. This initial stage of prosperity is inevitably followed by rising interest rates and an acceleration of price growth (inflation). It is important to understand that inflation does not cause a recession; a cooling economy will, by definition, cool inflationary pressures. The real problem is that inflation induces a slowdown in real spending and investment, which ultimately leads to economic stagnation—stagflation as the press coins it, driven by the unequal impact of inflation on the population combined with the difficulty of investing in an inflationary economy. And at this stage, the economy would be fragile—even small negative shocks can send it into a nasty recession as happened in the mid 1970s when the oil crisis drove an oversized economic contraction.

The United States is clearly near the end of the initial stage, the overheating. Consider asset prices. Home prices are up 30% in two years, equity P/E ratios for the stock market remain in the 30's (the second highest ever) despite recent declines in the market[4], and cap rates on all commercial real estate have fallen to record-low levels. This has led to the sharpest surge in household net worth ever seen on paper—an increase of 30% or almost $35 trillion in two years. And it didn't all go to the billionaires—net worth among the bottom 50% of earners has increased 90% in the last two years, although wealth inequality in the nation is still vastly too high. At the same time, Americans have paid off a great deal of debt or refinanced mortgages at ultra-low rates. The debt burden on U.S. households is much lower than it's ever been.

We are the wealthiest generation in history… that is if we ignore the $30 trillion in Federal debt we are carrying, $24 trillion of which was accumulated over the last two decades and $10 trillion over the last five. These numbers are so large, they're difficult to comprehend. Think of it this way: Over the past 20 years, the Federal government has borrowed $60,000 for each person in the nation. A full $30,000 (per person) of this borrowing was accumulated in the last five years. And that pace of borrowing now continues at about $3,000 per person per year. As alarming as this pace of debt accumulation is, the silence from policymakers, and even the media, is astonishing. People don't seem to care anymore. At some point reality will force its way through the bubble of denial, however, and the consequences will be severe.

Not surprisingly all this new private 'wealth' is driving a spending binge by U.S. households. Overall, real consumer spending has just returned to pre-pandemic levels, but that masks the inter-sectoral shift where spending on services has returned to pre-pandemic levels while real spending on goods has been running 5% to 15% above trend since July of 2020. Spending levels would be even higher but for the oft discussed supply chain problems the nation and globe are experiencing. A non-trivial example is new auto sales. There likely would have been one to two million more sales in the last year had supply been available. In the entire United States there have been fewer than 100,000 autos for sale for the last six months. A typical inventory is one million units of supply.

4 Shiller Cyclically Adjusted PE Ratio (CAPE Ratio).

The service sector is also suffering from supply chain problems in the form of labor shortages. The great retirement that occurred over the course of the pandemic saw almost three million U.S. workers drop out of the labor force. Now there are a record 11 million job openings and an unemployment rate of 3.6%. Some of the largest increases in job openings are in sectors that were shuttered during the pandemic and are finally ready to reopen as public concern surrounding the health crisis fades. Demand for workers is so frenetic that wages are rising at the fastest pace in thirty years according to data from the Atlanta Fed Wage Tracker. And it isn't just households earning more income. Business profits have also jumped sharply despite supply chain problems. Business investment has surged back, as has home production. Venture capital investments hit $350 billion in 2021, well over twice the level in 2019.

The nation was never built for this level of demand, and it can't keep up. One of the most worrisome trends is the trade deficit, which, as of the first quarter of this year, is running at 5% of GDP, another way of saying the nation is consuming 5% more than it is producing (5.5% in March alone). The United States "borrowed" a net $300 billion from the rest of the world in the first quarter alone to fuel this excess consumption. The global economy is littered with nations that have gone on similar spending binges – and they don't tend to have soft landings once the situation runs its course. The inevitable collapse of spending back to sustainable levels creates the kind of economic turmoil that quickly turns into a contraction. The increase in real borrowing costs, and what will likely be some level of fiscal tightening, will contribute to the pain.

US REAL TRADE DEFICIT

Source: U.S. Bureau of Economic Analysis; Analysis by Beacon Economics

But to be clear, the trade deficit is still opening, the housing market is still seeing tight inventories and rising prices, and households have just begun to dig into the $35 trillion of new wealth they have acquired. We are nowhere near the breaking point. As for worries about Ukraine, if anything, that tragic conflict has pushed the day of reckoning out, rather than bringing it forward. Despite negative real interest rates in the United States and a growing pace of borrowing, the dollar has been appreciating. This is an effect of the conflict. Uncertainty in global markets push investors towards safe havens, and the United States gets to free-ride on its status as a global reserve currency.

This huge increase in household wealth is not real, but a mirage generated by excessive stimulus. In other words, the nation's economy simply does not have the ability to physically produce goods and services at a level commensurate with the demand that has come from the jump in household net worth. The only way to rebalance the situation is through a large surge in prices and interest rates, exactly what is happening today because of the over-stimulation of the economy.

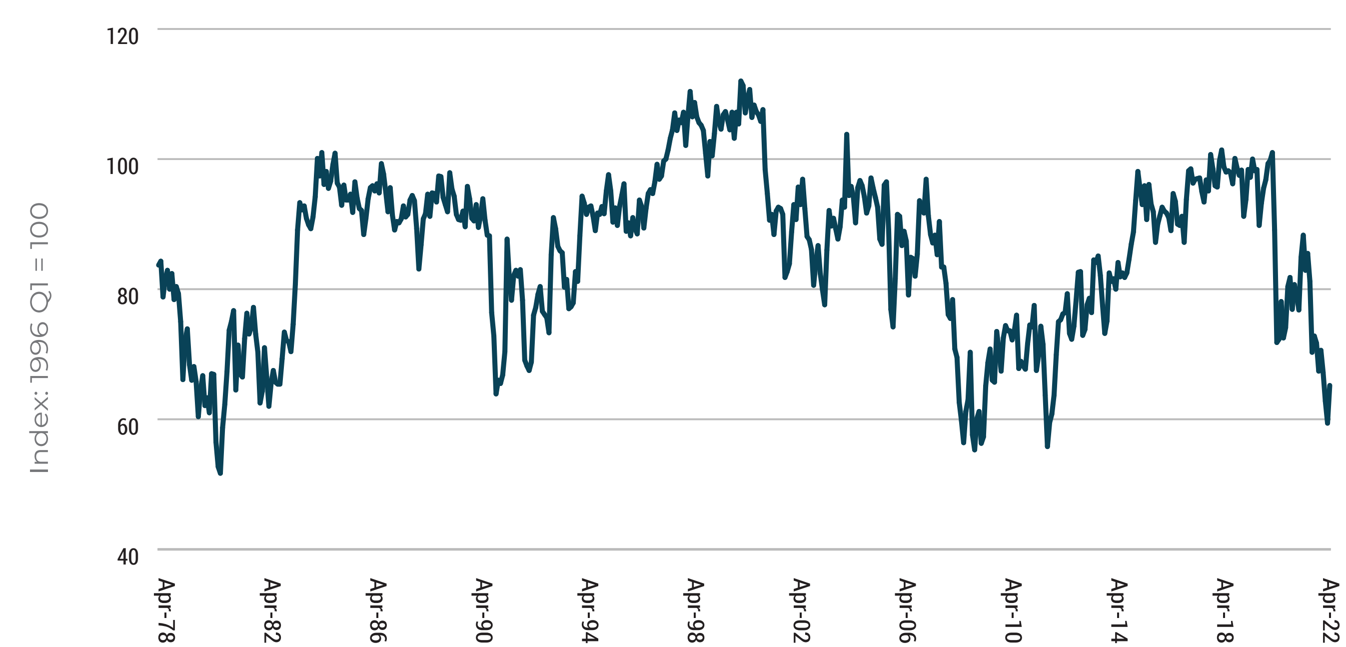
THE MYTH OF THE FRAGILE ECONOMY

One of the strangest elements of the current economy is the collapse in consumer confidence. After a partial recovery from the decline that occurred at the start of pandemic, consumer confidence in the United States is yet again plummeting. The latest few readings by the University of Michigan has it almost where it was when the nation was in the grips of the Great Recession in 2008 and 2009. The Conference Board's confidence metric is also dropping, although not as dramatically. This is very odd, given that confidence is typically strong in an over-heated economy. Indeed, confidence is often generated by that very overheating, as was the case in the runup to the Great Recession. But today confidence is falling, despite excess wealth and spending.

Needless to say, the economy couldn't look more different today than it did during the Great Recession. In 2008 and 2009, the unemployment rate was in double digits, the housing market was experiencing record foreclosures and rapid price declines, and economic output was falling. Currently, the unemployment rate is back to its 50-year low (3.6%) as job openings hit record-high levels, worker earnings are growing at the fastest pace in over two decades, and U.S. industrial output just reached a record-high.

While it's easy to suggest that today's collapsing confidence is being driven by inflation and supply chain problems, it's difficult to equate the hardships Americans were suffering from during the Great Recession with anything occurring today. If we are to believe that the consumer sentiment index can be roughly but accurately compared over time (and the data suggests that it can) then it tells us Americans have troublesomely lost context.

CONSUIMER SENTIMENT



Source: University of Michigan; Analysis by Beacon Economics

Of course, if they have, the blame lies largely with shrieking headlines from a wide variety of platforms that seem to dominate news about the economy. Indeed, a loss of context seems to be at the heart of the destructive populism that drives politics in the United States today. While the headlines scream about inflation "crushing" consumers and "evaporating" savings, the nation faces massive worker shortages, empty auto dealer lots, and too many boats vying to get into U.S. harbors to offload products. These two visions of the economy cannot be reconciled.

Indeed, some households are feeling the effects of inflation more than others, but at this point we are in the early stages of rising consumer prices – about a one year 6.6% increase according to the more accurate Bureau of Economic Analysis PCE index. Here comes the context: In the past five years consumer prices have risen about 15%, slightly over normal and the same as in 2008. And this is a far cry from the 50% increase seen in 1980 when Paul Volker took over the Federal Reserve. Contrasted against rising incomes, a tight labor market, and an enormous increase in household net worth, today's level of inflation isn't that consequential. But we don't seem to be allowing facts to get in the way of a good story.

5 YEAR INCREASE IN CONSUMER PRICES

Source: University of Michigan; Analysis by Beacon Economics

Beacon Economics is more worried about future inflation, not the inflation seen to date. If we look at the history of unit money supply (defined above) we can easily intuit that the nation is due to experience 30% inflation over the next few years, and probably more if velocity increases, as it typically does after a surge in inflation. And once inflation does kick in, it tends to have a feedback loop that makes it even more painful to stop. The solution to stopping inflation is fiscal and quantitative tightening. Yet, to date, policymakers have worried far more about the consequences of fighting inflation than about inflation itself.

Which brings us to rising interest rates. The 10-year bond hit 3% recently, and mortgage rates jumped past 5%, a significant increase from the ultra-low levels of two years ago. But again, context is needed. Rates are rising mainly because the Federal Reserve has stopped expanding its balance sheet, and suddenly credit is a bit scarcer. When combined with the increase in consumer borrowing and the ongoing $1 trillion Federal deficit, the real question is why rates haven't gone even higher. Interest rates are still significantly negative even with the recent rate hikes. The bond markets have been shockingly calm in the face of enormous inflationary pressures and seem to be operating on the illogical belief that much of the surge in inflation is being driven by temporary factors, something that trumps data and logic.

And when context is added, rates aren't really that high. From 1970 to 2010, rates never fell below 5% yet the nation had active real estate markets and plenty of booms and busts. If we want to worry about high interest rates, we should wait until the Fed starts to clear its balance sheet to shrink the money supply. But this hasn't stopped exaggerated headline pronouncements. Mark Zandi, Chief Economist with Moody's, just declared that U.S. housing is in a "correction" because of rising interest rates. Yes, the market has downshifted. It has to in order to deal with the shift in payments driven by the hike in rates. But the residential real estate market in the United States today has $26 trillion in equity, three times what it was a decade ago. The market also has the lowest mortgage debt to equity ratio since the 1980s and, equivalently, existing home inventories are still incredibly tight. Mind you, Moody's Zandi doesn't think prices will fall nationally, only in pockets here and there. The U.S. housing market is a long way from cooling off.

Current predictions for a near-term recession and for real estate corrections are far too early and point to the same issue that is largely to blame for the predicament we're in today—let's call it the myth of the fragile economy. It's a belief that the economy is delicate, easily broken, and has to be unduly buoyed by stimulative efforts. Ever since the waning days of the Great Recession, economic forecasters have been calling 'recession' at the drop of a hat – there were many incorrect double-dip recession calls throughout the recovery. In January 2019, 80% of economists who contribute to the Wall Street Journal's 'Next Recession Survey' said the United States would have a recession within two years; we did of course but that was due to the pandemic, not for any of the reasons the economists were worried about at the time. And of course, let's not forget the ridiculous calls of 'depression' that were made at the start of the pandemic, which, at least in part, caused the excessive use of government stimulus.

When will this all come to a head? As noted above, inflation is still more of a potential problem than an actuated one. Similarly, the nation's $30 trillion Federal debt and $1 trillion structural deficit are problems that haven't really been discussed by the public or the bond markets. The enormous and growing U.S. trade deficit is also being ignored. Instead, the narrative the public hears revolves around our 'fragile economy', the commodity impact of the conflict in Ukraine, prices at the pump, and other distractions. Congress needs to focus on balancing the U.S. budget. The Fed needs to get serious about shrinking its balance sheet. But this is unlikely on both fronts because public sentiment suggests we are on the edge of a cliff—and no policymaker wants to be the pusher.

Only we are nowhere near a cliff. The economy has plenty of momentum and will keep growing in the near term. But it is not sustainable and will eventually stagnate due to public debt and inflation's subversive impact on investing. At some point policymakers will have to go through the process of reversing course on stimulative measures, and when this happens reality will finally creep in. The combination of tight money, a falling dollar, and dramatic fiscal tightening will create a serious problem for the U.S. economy.

If you think the American public is angry now, just wait.