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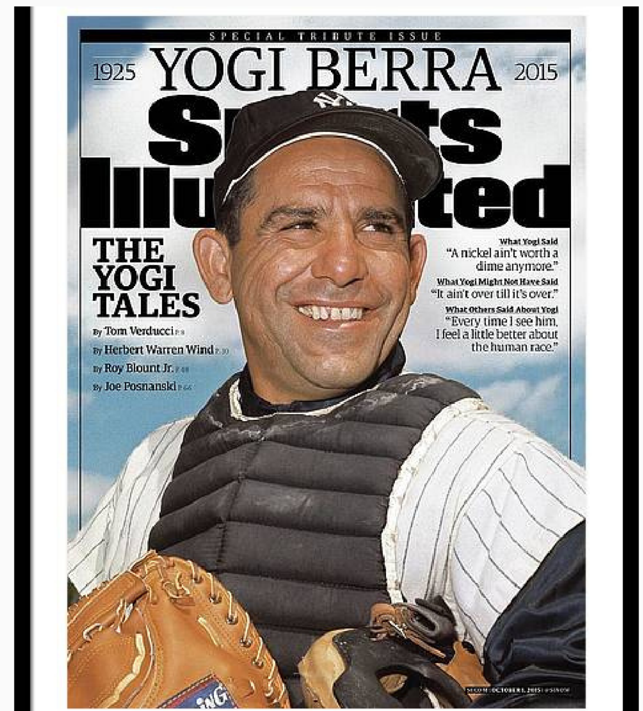
“It’s like déjà vu all over again.”

BY TERRY NAGER

This phrase is attributed to the famous humorous baseball philosopher: Yogi Berra, referring to something that is happening now which is very similar to something that happened previously. In this case we are referring to the year-old debate as to whether the economy is going into a recession or a Fed induced soft-landing. It is hard to believe that this question is still unresolved. Yet, valid arguments remain on both sides of this issue. We will look at both arguments: first, a recession looming, and second the Fed has engineered the soft landing.



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USA TODAY

A Recession is Looming.

1. The yield curve is still very much inverted. In the April 2023 newsletter, we explained that a yield curve is a graph that shows the interest yields for the same quality of bond (example: US government bonds) for different periods of time (example 30 days to 30 years).

- A normal yield curve is one in which longer maturity bonds have a higher yield compared to shorter-term bonds due to the risks associated with time.
- An inverted yield curve is one in which the shorter-term yields are higher than the longer-term yields which can be the sign of an upcoming recession.

2. Delayed effects of rate hikes

- "Legendary economist Milton Friedman once said Fed rate increases affect the economy with 'long and variable lags.' In other words, it could take a year or two before the higher borrowing costs work their way into the economy. Consumer and business spending may still be chugging along but they'll peter out at some point, Oxford's Schwartz says, "Our view is the lagged effects haven't kicked in yet,' he says. He expects to see a bigger impact by early next year, with a scaleback in both consumer and business spending and a rise in layoffs." (USA Today).

3. About 61% of Americans are living paycheck to paycheck.

- "Low-wage earners are most likely to live paycheck to paycheck, with almost 8 in 10 consumers earning less than $50,000 a year unable to cover their future bills until their next paycheck arrives. Yet even 4 in 10 high-income Americans, or those earning more than $100,000, say they're in the same position, the research found. Such a situation is viewed as financially risky …" (CBS News)
- According to Forbes, "… the average credit card interest rate in the US on accounts with balances that assessed interest was 22.16%, according to the Federal Reserve." The average credit card rate has now risen to 24.45%.
- Credit card debt hit a new all-time high of over $1 trillion. This combination of a cash-strapped consumer, high credit card debt at 20+% interest rates is an ominous sign for an economy that is heavily dependent (70%) on consumer purchases.

4. Inflation has not declined as quickly or as much as the Fed would like. Getting back to a 2% inflation rate (the Fed's goal) will take more time and require more pressure to be placed on the economy. The Fed's mantra is that rates will have to be "higher for longer." Some of the contributors to inflation are:

- Excessive government spending - the 2023 federal budget deficit is expected to be $2 trillion.
- Energy costs – It is expected that the oil price will rise to over $100 per barrel, resulting from: restrictive US energy policy that curtails production and announced cutbacks by the Russians and Saudis designed to keep prices high.
- Rising labor costs – the inflation over the last couple of years has caused US workers to fall behind in being able to afford their standard of living. This has led to labor unrest – the United Auto Workers (UAW), the actors and writers strikes.

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5. "Shrinkage" which is the term used by businesses to describe the effects of mob shoplifting and theft. This adds to the cost of doing business which inevitably gets passed along to the consumers in higher prices and producing a negative impact on the economy.

A Fed Engineered Soft Landing

1. The inverted yield curve is beginning to normalize. In July the 2-year treasury yielded 4.94% versus a 3.86% yield on the 10-year bond. That was the greatest disparity in 42 years.

- Presently, the 2-year treasury yields 4.99%, and the
- 10-year treasury yields 4.63%.
- The inversion in July was (4.94% - 3.86%) = 1.08%. Now the inversion is (4.99% - 4.63%) = .36%. It is now only about one third of a percent from being flat.

2. The annual inflation rate is easing. in June of 2022, it was 9.1% and in August of 2023 it was down to 3.7%. It is still a long way from the Fed's 2.00% goal but making progress.

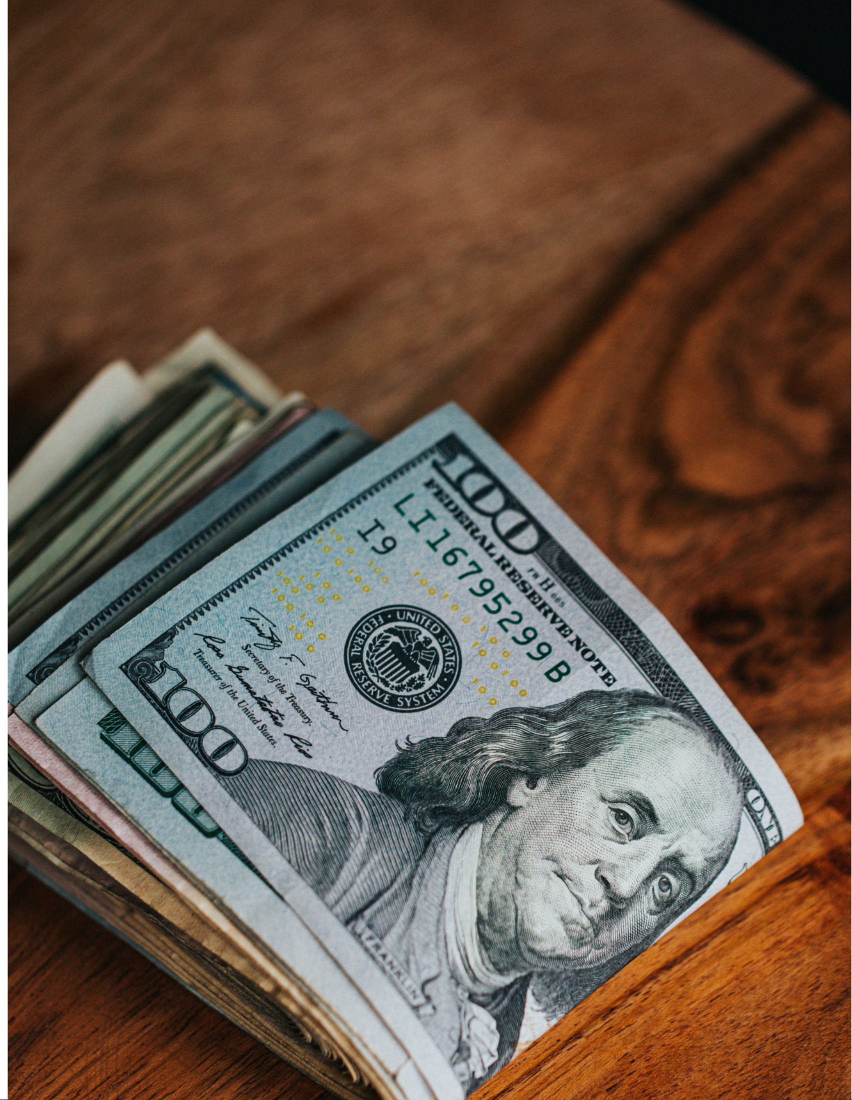
3. High employment numbers enable the consumer to continue spending despite the high credit card debt. According to McKinsey & Company, "Consumer optimism in the United States remained steady over the summer, while consumer spending saw a modest uptick across most categories."

Even though people are living paycheck to paycheck, they keep spending those paychecks.

4. The Fed is likely near the end of interest rate increases. Even though the Fed governors say that they think rates are going to “be higher for longer,” they also say that they are close to ending the increases. Keeping rates high, that is, not cutting them in the near future seems to be what they are really saying. In their estimation, keeping rates about where they are will eventually choke off inflation.

5. More federal spending – “The CHIPS Act, the Infrastructure Investment and Jobs Act and the Inflation Reduction Act set aside nearly $2 trillion to improve highways, broadband, and clean energy production, among other projects. These measures should modestly support economic growth next year.” (USA Today)

6. The conclusion is that the direction of the economy and the market is too close to call.



The Outlook

The first half of 2023, the stock market advanced on the backs of a few large-cap tech stocks based on their prospects from their participation in artificial intelligence (AI). However, August and September witnessed a pullback. As of the writing of this newsletter, the correction has been shallow (less than 10%). Thus far, the market is following a typical seasonal pattern of correcting in September, bottoming out in October and rallying into the end of the year. This pattern may be typical, but it is far from certain.

In addition to the economic factors listed above, we have two wars raging and one of the most unusual elections season this nation has ever experienced. Because of these unusual and unpredictable circumstances, we have placed 25% to 50% of assets into buffered ETFs. In previous newsletters we described these investments as providing 15% downside protection while enabling 15% to 16% of upside potential on a yearly basis. These investment vehicles seem ideally suited for the unpredictable times that we are experiencing. We plan to phase these investments out as we return to more normal circumstances. As always plans can change as events unfold.

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