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What Outcome Did You Have in Mind?

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In a Nutshell

The economic landscape is so convoluted today. All the traditional recession gauges have proven worthless, and consumers do not feel like they are keeping up with inflation. Meanwhile, broad spending indicators remain robust, and the economy keeps chugging along. I believe the confusion is owed to the unique fiscal and monetary policies over the past five years. With no path forward better than a coin flip, it is necessary to remain vigilant as the once white-hot economy cools. This is not the "everything is awesome" economy we have all grown accustomed to over the past five years. I am not suggesting we are heading for a cliff, but I believe the economy will continue cooling. Consumers must shift their thinking from the now-gone carefree, cheap money environment to more normalized lending conditions where everything is expensive and wage growth reverts to the trend. This is not the end of the world, but rather, a return to a more typical economic environment. Financial conditions have been exceptional for five years, and asset owners have benefited tremendously, so it should not be surprising that we may need to endure some discomfort on the way back to normal.

What Outcome Did You Have in Mind?

A large corporation was looking to hire a new CFO and interviewed three candidates. Each candidate was asked, "What is one plus one?" The first two candidates responded with "two" and were not offered the job. However, the third candidate responded with "What number did you have in mind?" and was subsequently offered the job. I believe this captures the economic landscape today quite well, which is very convoluted and full of exceptions. One can easily make a compelling case for whatever outcome you have in mind.

Consumers have had vastly different experiences over the past five years. There are so many unique dynamics at play, making it hard to assess the path forward. Some may pretend, but no one really knows what is going on. At this time, no path forward for the economy is better than coin-flip odds, and it would be disingenuous to assert otherwise. Looking at certain data tells one story, while on the other hand, talking to consumers paints a much different picture. And you will get an even different picture when talking to another group of consumers.

Considering the complex forces at play, we can attempt to highlight what makes assessing the path forward difficult. If we take a 60% stock and 40% bond portfolio with $1,000,000 at the end of 2019, that portfolio would be worth $1,476,060 by the end of the second quarter of this year. Assuming the underlying holdings pay income yielding 3% on the portfolio, that equates to $30,000 in income at the beginning of the period and increasing to $44,282 by the end. Over this period, the income received from this portfolio increased by 47.6%. On an inflation-adjusted basis, the income received is worth $36,524 in 2019 dollars, equating to a 21.8% increase in income after accounting for inflation. Now,

consider a portfolio of rental properties valued at $1,000,000, charging the median rent and generating $43,538 in rental income at the end of 2019. Today, the portfolio is valued at $1,562,100 and produces $63,639 in rental income, assuming median home price and rent growth. However, the income is worth $52,490 after adjusting to 2019 dollars, representing a 20.6% increase from the income received in 2019. In the two scenarios presented, the income received by the owner of each portfolio would have not only kept up with inflation but increased their standard of living by more than 20%. Finally, consider a typical household earning $80,000 in 2019. The household will earn $98,728 this year, assuming growth in line with average hourly earnings. However, after adjusting for inflation, the income is worth $81,432 in 2019 dollars. So, this household only increased their standard of living by 1.8% in five years.

Herein lies the problem: most people do not have a seven-figure retirement account or a portfolio of rental properties. The median retirement savings balance across all age groups is $87,000, while those aged 65 to 74 have a median balance of $200,000. As long as the median household can hang in there, consumers in the top income quintile will do the heavy lifting. For example, the top 20% of households by income account for just over 40% of total consumer spending. This helps explain how the economy keeps chugging along even though 78% of households say their financial situation is about the same or worse off than a year ago. And almost 70% expect their financial situation to be about the same or worse off one year from now. On balance, consumers can be widely downbeat about their financial situation while the economy continues to post strong growth numbers. The economy is leveraged to those top earners, and as long as they continue to spend, they will prop up the broader economy.

This provides a timely segway to tax policy. The Tax Cuts and Jobs Act (TCJA) enacted in 2018 lowered individual income tax rates, among other changes to the tax code. The legislation expires next year and could have a major impact on individuals and small businesses. The timing could not be more consequential. With so many consumers already feeling the pinch from high inflation and the economy largely reliant on high-income consumers continuing to spend, perhaps now is not the time to increase taxes. In the same vein, going after high earners is probably not wise either, as they punch well above their weight in terms of consumption. The top 5% of households account for 19% of total spending, while the bottom 40% of households account for 22%. While the TCJA measures will likely be extended in some form, it is worth paying attention to as the bill was passed along party lines, and the temperature in Washington has been dialed up significantly since then. Do not underestimate the propensity of elected officials to act in a politically expedient and self-fulfilling manner.

At this point, my faithful readers likely think I just put my foot in my mouth with the suggestion not to increase taxes. In my first quarter letter this year, I said the government may need to increase revenue through higher taxes to afford the soaring interest payments to service the national debt. While this is true and remains a critical issue that must be addressed, an economic downturn would cause more significant damage to the economy than extending the provisions of the TCJA for a couple more years. If the economy were to fall into a recession, incomes would decline, resulting in lower tax receipts, and the government would have to borrow even more money to stimulate the economy.

So, what happens now? Where do we go from here? If I knew the answer to those questions, I would be writing this letter on a beach somewhere in the Caribbean where the temperature is 80 degrees, rather than sitting in an ice bath trying to stay cool in the unrelenting Phoenix heat. But I digress. Once-faithful recession indicators are on thin ice today, making the path forward hard to predict. Historically,

when the U.S. Treasury yield curve inverts, meaning the yield on short-term Treasuries is higher than longer-dated Treasuries, a recession often occurs within six to 18 months. Over the six recessions in the U.S. since 1980, the yield curve inverted before the recession started each time. In the current business cycle, the yield curve first inverted in April 2022, and based on historical precedent, a recession should have occurred between October 2022 and October 2023. The yield curve remains inverted, marking the longest-running inversion without a recession.

Similarly, the Leading Economic Index (LEI), a composite of leading economic indicators, has historically been a reliable recession indicator, anticipating business cycle changes about 7-months in advance. Since 1980, a recession has occurred each time the LEI's signal was met. In the current cycle, the LEI first signaled a recession in July 2022, indicating the onset of a recession in the first quarter of 2023. Again, here we are two years later, and the accuracy of an indicator with significant predictability is being called into question.

The final indicator with a tremendous track record is the Sahm Rule, named after a former Federal Reserve economist, which signals the onset of a recession. According to the Sahm Rule, the economy is in a recession when the three-month moving average of the unemployment rate rises at least 0.5% above the minimum reading over the previous 12 months. Since 1949, the Sahm Rule has signaled the economy is in a recession with 100% accuracy. According to the July reading, the recession signal was met. However, the creator of the Sahm Rule said we are not in a recession and that the indicator may not be accurate this time. To my point at the start of this letter, no one really knows what is going on. This is just how wacky the situation has become; the founder of a recession signal with perfect accuracy is doubting its validity.

I remain concerned about the path forward, and I believe consumers are on shakier ground than what is implied by the data. I am not suggesting impending doom is around the corner. Instead, the economy will continue cooling, and conditions will become uncomfortable for consumers. No more of the "everything is awesome" sentiment enjoyed for much of the past five years. However, staying honest with ourselves, any outcome for the economy is no better than a coin flip, and a reasonable case can be made for a wide range of outcomes. Just look at the Sahm Rule; the indicator signals recession, but its creator says not so fast. So, what does all this mean? Well, what outcome did you have in mind?

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