Current Economic Conditions

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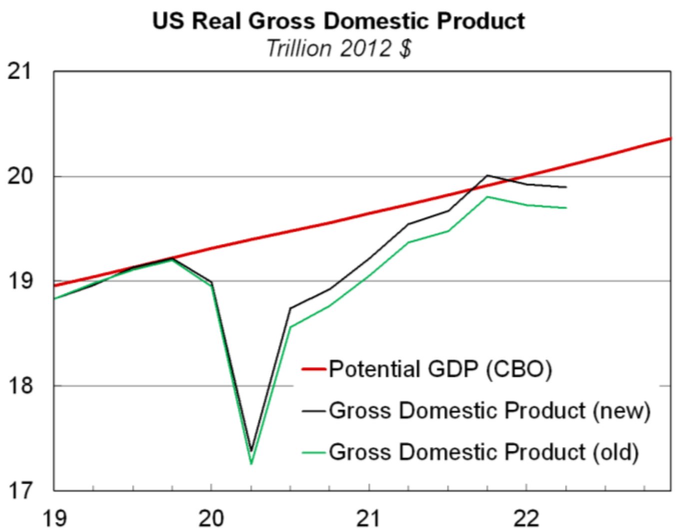
A LITTLE MORE BOOM, A LITTLE MORE BUST

The U.S. Bureau of Economic Analysis (BEA) released its annual revision of the National Income Accounts on September 29. Historical estimates of Gross Domestic Product and its components were revised to reflect more-complete information. Quarterly growth rates were revised up in most quarters of 2020 and 2021, making the 2020 recession a little shallower and the 2020-21 recovery a little stronger. The annual growth rate for 2021 was revised up from 5.7% to 6.7%.



Before this year's annual revision, GDP stayed below the Congressional Budget Office's estimate of potential GDP, the highest level of GDP that can be sustained without an acceleration in inflation, throughout 2021 and 2022. That made it hard to explain the big increase in inflation based on the relationship between GDP and potential GDP. Revised data show GDP rising above potential GDP in the second half of 2021. That's much more consistent with the big increase in inflation we've seen since early 2021. Growth rates for the first two quarters of 2022 were not revised this year, but I expect that next year's annual revision will show that growth was stronger than the quarterly declines shown in current data. (I think BEA has understated inventory accumulation, which adds to GDP.) Current estimates of third-quarter GDP growth, to be reported later this month, are in the 2.5-3.0% range. When we get next year's annual revision, we may find that GDP has been above potential GDP for five straight quarters (or more), especially if the Congressional Budget Office revises down their estimate of potential GDP.

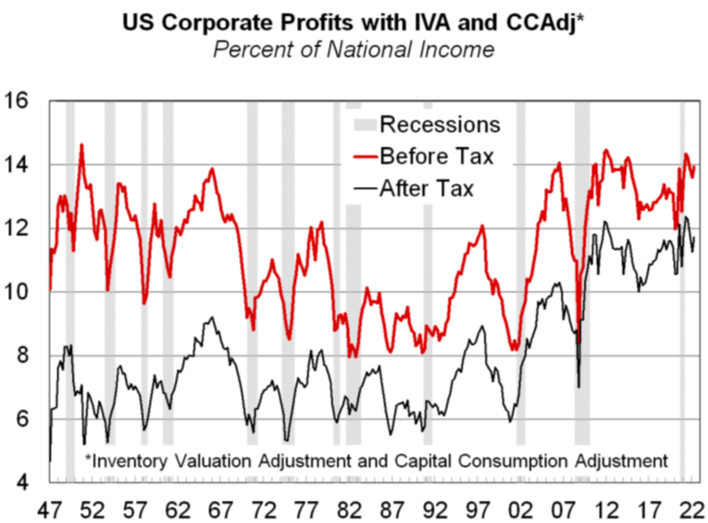
Other measures of economic activity were already showing a booming economy. The unemployment rate fell back to 3.5% in September, equaling the 53-year low hit in July and in late 2019 and early 2020. Payroll employment rose by 263,000 in September. While this is much less than the average monthly gain of 562,000 in 2021, it is still much more than what is needed to absorb growth in the working-age population. Year-to-date, employment has grown by an average of 420,000 a month in 2022. Industrial production in U.S. manufacturing grew at annualized rates of 3.7% in the first quarter and 3.2% in the second quarter, totally out of sync with the reported declines in GDP. Growth slowed to a 1.9% rate in the third quarter, but that reflected declines in May and June. Manufacturing output posted solid gains in July, August, and September, growing at a 5.7% annualized rate from June to September! Housing starts have fallen sharply in recent months, but we shouldn't forget that they hit a 16-year high in April.

Low unemployment, GDP above potential, and – more generally – demand that has grown faster than supply have pushed inflation to 40-year highs. The Consumer Price Index, excluding volatile food and energy prices, rose 0.6% in September, much more than expected. This lifted the year-over-year "core" inflation rate to 6.7%, the highest since 1982. The headline (total) CPI and headline Producer Price

Index also rose more than expected. However, the Producer Price Index for finished goods excluding food and energy, my favorite measure of underlying inflation, rose just 0.2% in September. That was the smallest increase since 2020 and suggests that inflation might finally be peaking, although construction of the rent and owners' equivalent rent components of the CPI and the Personal Consumption Expenditures price index almost guarantees that these indexes will be very slow to show declining inflation.

If the big increase in the September CPI is reflected in the PCE price index – the Federal Reserve's preferred inflation measure – the Fed is almost certain to raise its federal funds rate target by another 75 basis points at its November meeting. Because price indexes will reflect slowing inflation with a considerable lag, another rate hike is likely in December. If history is any indication, the Fed will keep hiking rates until something breaks. The best-case scenario is that inflation comes down relatively soon, and the Fed stops hiking rates before too much damage is done. The Fed could also stop hiking rates in response to financial stress somewhere in the world. More likely, it will keep hiking until it's clear that the U.S. economy has fallen into a recession. Leading indicators continue to point to a coming recession, but coincident indicators show that it hadn't arrived by the end of September.

The magnitude of the recession will depend primarily on three factors: (1) how much the Fed hikes interest rates and how long they wait until they start cutting rates; (2) how high energy prices go in coming months; and (3) how quickly businesses switch from raising prices to cutting them (or at least not raising them further). The recession will be worse if businesses try to maintain profit margins and pass higher labor costs on to customers. The profits share of national income – the macroeconomic analog of profit margins – remains near all-time highs. Historically, a high profits share has been a leading indicator of coups and revolutions in developing countries and a leading indicator of bad economic policies in developed countries. Shareholders won't like it, and businesses won't like reporting it, but a decline in profit margins would be better for getting inflation down, for social cohesion, and for the avoidance of bad economic policies. In the short term, however, a decline in profit margins would put further downward pressure on stock prices. Declines in stock prices since January and declines in house prices starting more recently are reducing household net worth. That will ultimately put downward pressure on consumer spending, which accounts for 70% of GDP.



Because GDP is higher relative to potential GDP than previously estimated and because stubbornly high **measured** inflation will lead the Fed to hold interest rates too high for too long, I've made the 2023 recession in my forecast a little deeper. For those of you with long memories, the recession in my forecast is similar in depth and duration to the 1990-91 recession. The impact of the recession will be concentrated on housing and related industries (e.g., building materials, floor coverings, appliances, furniture, and furnishings) and, because of the strong dollar and economic weakness abroad, on U.S. exporters. I expect a recession in China, although it will probably never show up in official data. That recession may have already started, but the release of third-quarter GDP has been delayed, presumably because the National Bureau of Statistics did not want to embarrass President Xi by releasing a negative number during the quinquennial Communist Party Congress. I expect a much deeper recession in Europe as businesses shut down to conserve natural gas for home heating purposes. Emerging markets, especially in the Middle East and Africa, are likely to be hit hard by the strong U.S. dollar and high food prices. As former Fed Chairman Alan Greenspan said in 1998, "it is just not credible that the United States can remain an oasis of prosperity unaffected by a world that is experiencing greatly increased stress."