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Should the Past Always Be Treated as Prologue When Analyzing the Economy?

- by Dr. James E Newton, DCTO Chief Economic Advisor

Over the past year or so, a bevy of economists have pronounced numerous times that a recession is just around the next corner based, in part, upon their reading of the past performances of economic indicators prior to a recessions, and what they viewed as a nearly inevitable downturn given recent similarities to those past relationships. A reasonable person might wonder just how many "next corners" must be encountered before these economists determine that past performance is not necessarily a good predictor of the future when numerous once-in-a lifetime upheavals unexpectedly transform the economy.

Consider the multitude of disruptive factors that have impacted the world over the past few years: a global pandemic, a ground war in Europe, supply chain disruptions and a resulting shifting of economic alliances, aging populations in most developed nations, and sometimes massive monetary and fiscal policy interventions with resulting huge government debt levels. In short, people, businesses and governments are almost certainly dealing with an environment that is the most challenging since World War II. Is it any wonder that "traditional" economic indicators/analysis about how the future is likely to unfold seems so threadbare?

When inflation-adjusted GDP fell during the first two quarters of 2022, huge numbers of economists and policymakers proclaimed that a recession had arrived. In fact, no such thing was true. The onset of a recession is not determined by a single factor, real GDP, but rather by a simultaneous reading of a number of economic statistics. These include real GDP (down in the first half of last year but then rising about 3% in the second half), nonfarm employment levels (increasing during the entirety of last year with a barnburner performance in January of this year with over half-a-million new jobs), industrial production (a mixed performance, with weakness particularly at year's end in 2022), real wholesale/retail sales (acting in much the same manner as industrial production), and real income less government transfer payments (trending modestly upward through virtually the whole of last year). Taken together, at no time during 2022 did the economy experience a single month where all of these economic indicators fell, much less for the minimum of a few consecutive months needed to satisfy the definition of a recession.

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So, precisely where does that leave us in early 2023 and for the remainder of the year? Clearly, the economy is under some downward pressure due to the Federal Reserve increasing the targeted federal funds rate; now set in the range of 4.5%-4.75% in an attempt to bring the accelerating inflation rate they labeled "transitory" back in 2021 down to a more acceptable level. In fact, the inflation rate has, indeed, been falling since peaking last June at 9.1% as measured by the CPI; registering 6.4% in December, 2022 for the "all items" index. It should be realized, however, that this is still far above the Fed's desired inflation rate goal of 2%. It should also be noted that the Fed does not use CPI data when evaluating inflation, though it is certainly what most people think about as they try to live their lives and adjust to seemingly ever rising price levels.

As mentioned earlier, in January of this year nonfarm payroll levels exploded relative to economists' expectations, with a jump of 517,000 new jobs. This came just two days after the Fed raised the targeted federal funds rate by a very modest 0.25 percentage points (25 basis points), apparently under the belief that past increases (which were generally considerably bigger) had sufficiently set the stage for better controlled inflation, and thus the need for smaller federal funds rate increases. While this may turn out to be true (I don't personally happen to think so), the January employment gain has almost totally eliminated the possibility of a recession beginning in the first half of this year, with yet another "next corner" failing to arrive.

What I think this may well mean for the remainder of the year is the Federal Reserve will increase the targeted federal funds rate by an additional 25 basis points in at least their next two meetings (in March and May). Given that they have declared a number of times that they are basically "data-driven," what happens after that may well depend upon further changes in job gains (which I think should moderate very considerably from January's robust number) and inflation rates. With regard to the latter factor, it seems likely that the overall inflation rate (as well as the "core" level that excludes food and energy prices) will continue to trend downward through the first half of this year.

While the Fed may well be inclined to engage in some self-congratulatory efforts if this happens, they should refrain from doing so. The likely first half improvement in inflation is largely a function of just how rapidly price levels rose last year, thus making year-over-year comparisons this year considerably easier. Sadly, the second half of the year is likely to see inflation rates stabilizing and possibly rising, particularly in the final few months of the year. And if events generally unfold somewhat along these lines, the year-end inflation rate (and possibly the rate

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over the longer-term as well) could settle in the 3%-4% range on a year-over-year basis; far above the Fed's stated goal of 2%.

Clearly, this is not a particularly optimistic outlook and suggests a potentially unsettled environment as the U.S. enters an election year in 2024. On a positive note, it may mean the economy dodges a recession (my personal belief) or enters one that is exceedingly mild. Of course, only time will tell which corner we actually turn.

The views/opinions herein are Dr. Newton's and do not necessarily represent those of the Delaware County Treasurer's Office

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