ERA OF UNCERTAINTY

Bryce Gill
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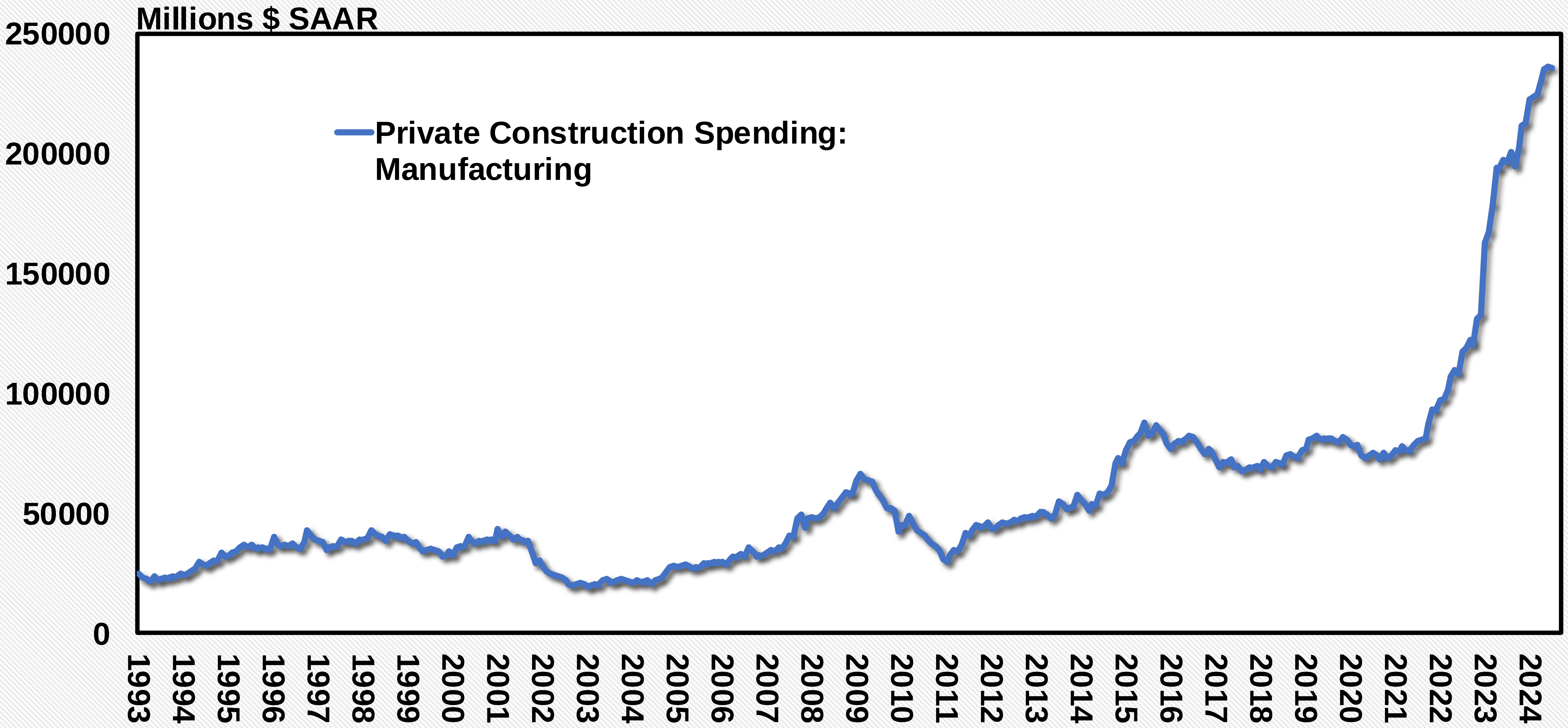
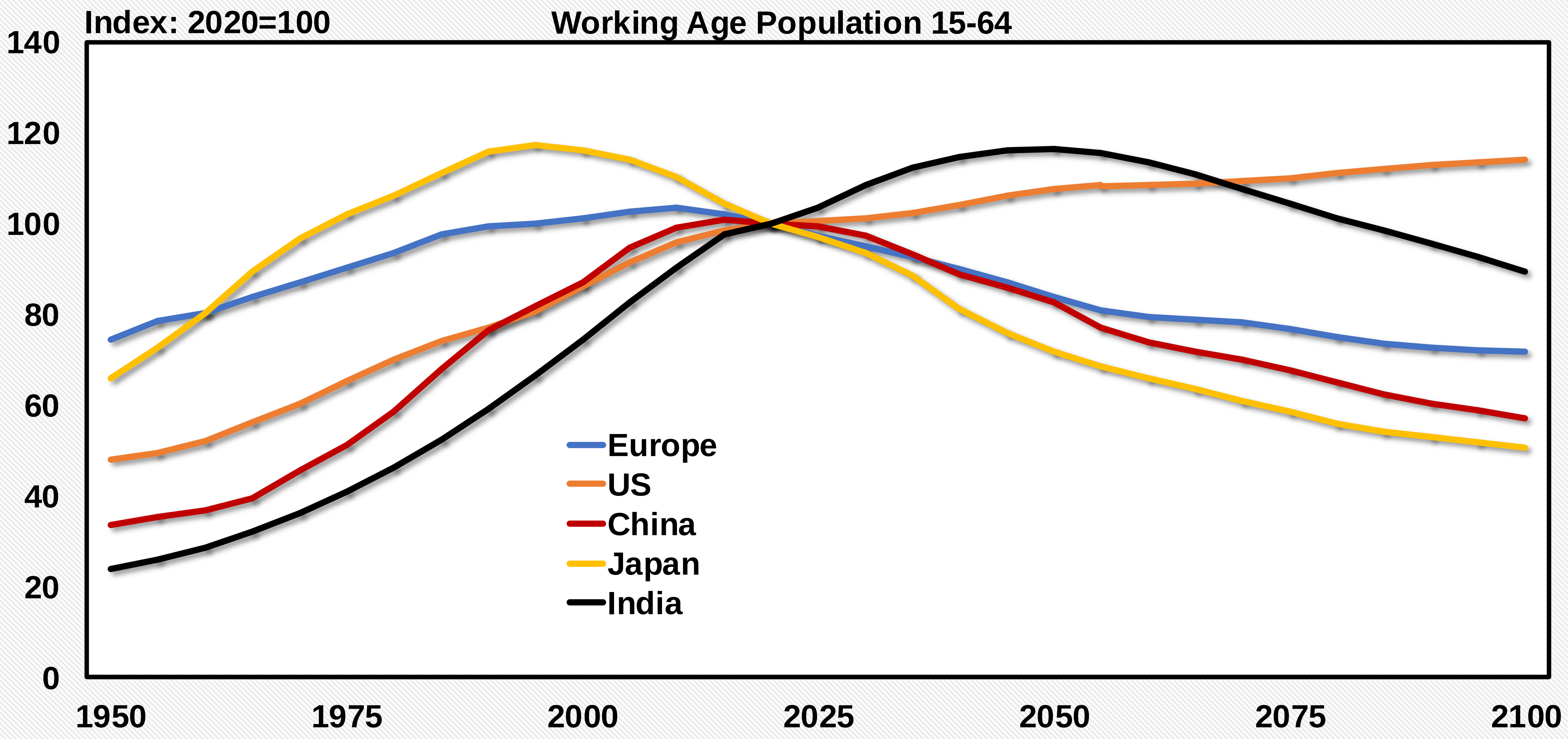
The Reshoring Boom



Source: US Census Bureau, Monthly Data Jan 1993 - May 2024

The Big Picture

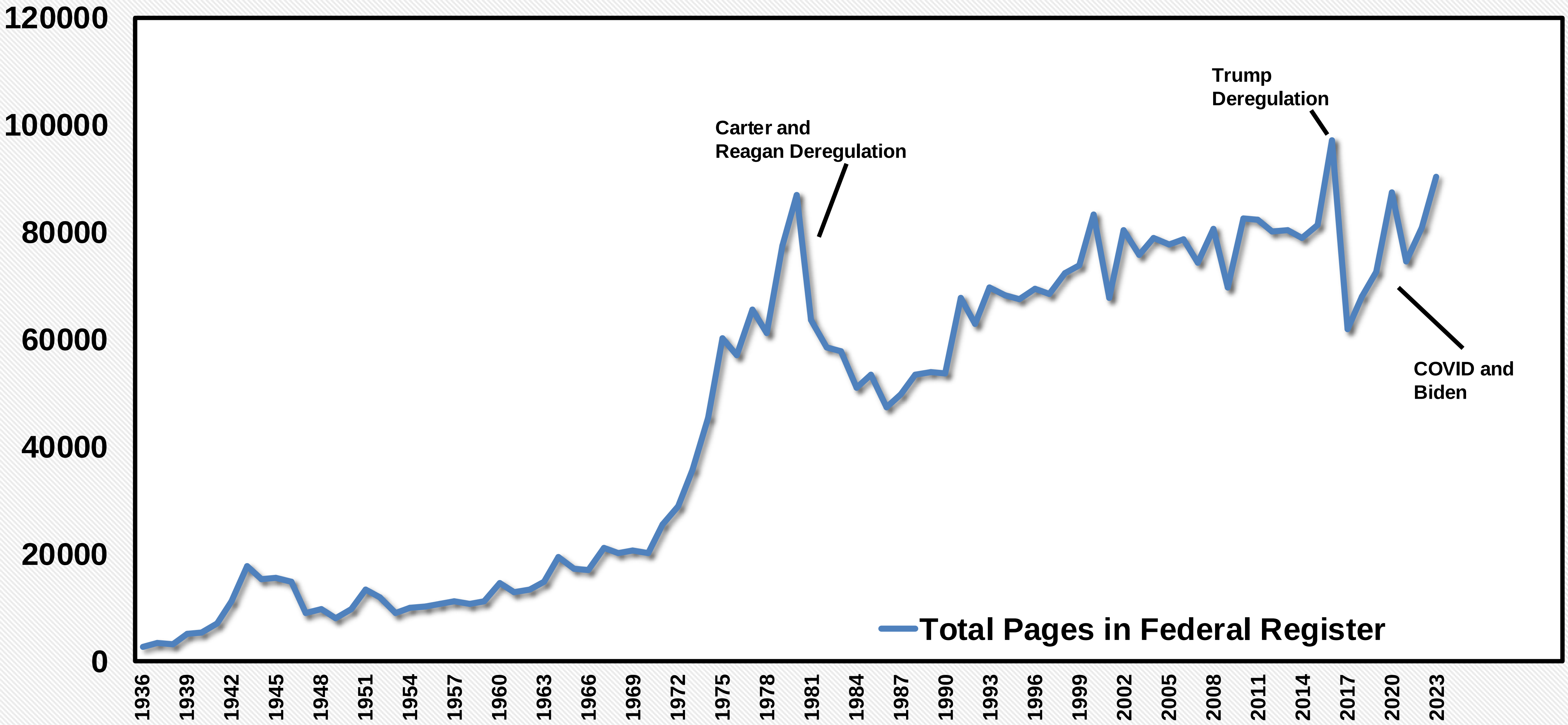


Source: United Nations, Annual Data 1950-2100

Plenty of Room to Increase Tariffs

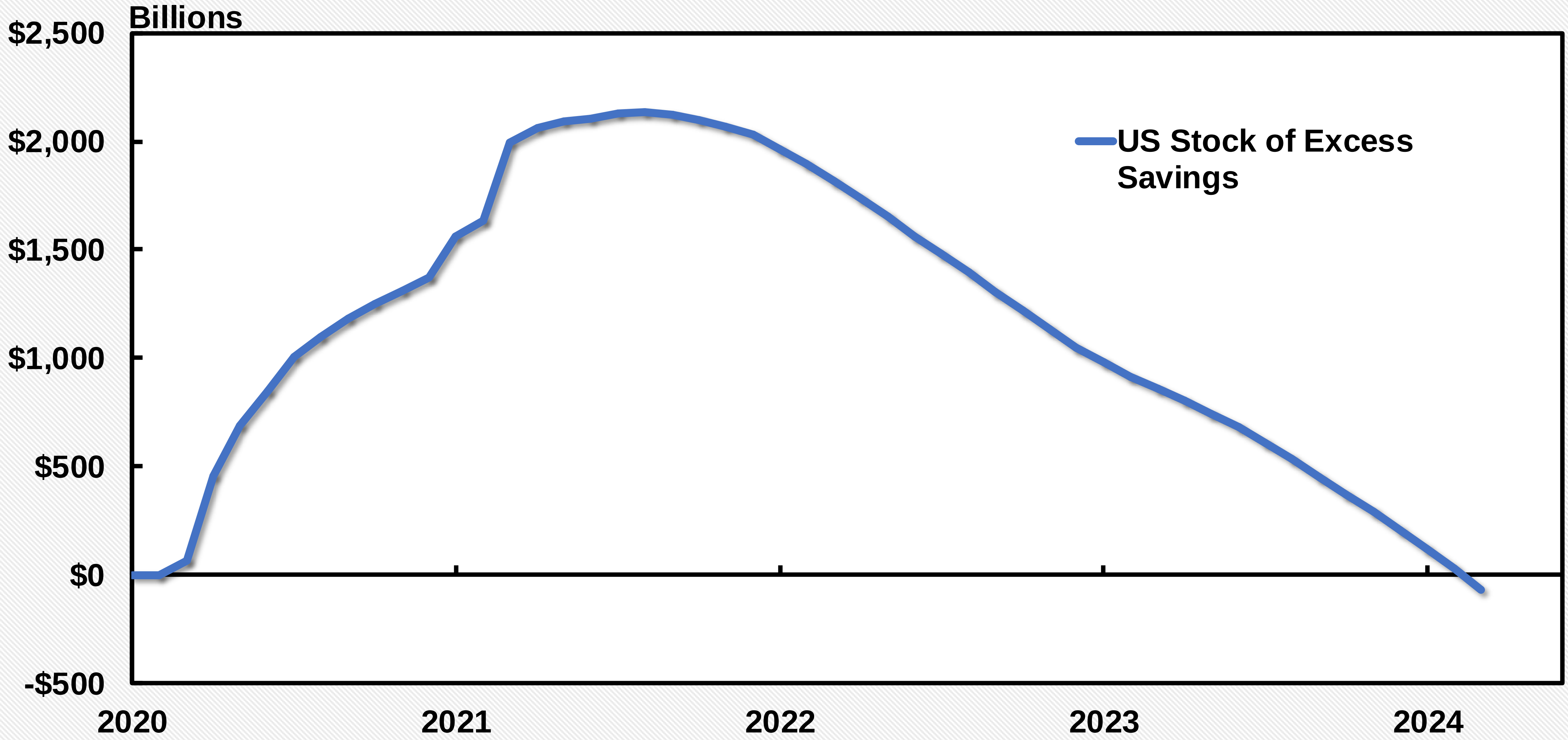
Source: US Treasury, US Customs, Annual Data 1901-2022

US Regulatory Burden



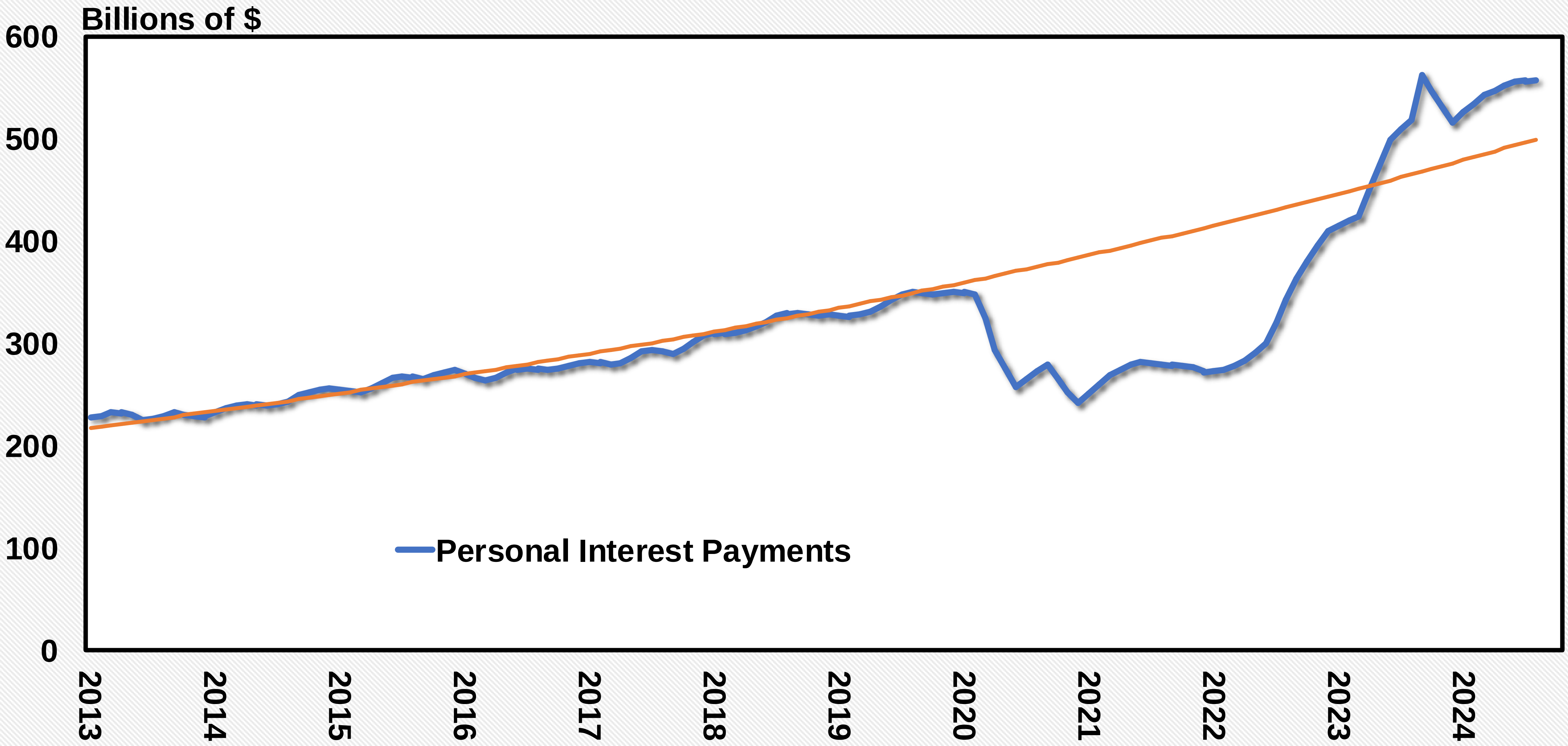
Source: Office of the Federal Register, First Trust Advisors, Annual Data 1936-2023

Excess Savings Has Dried Up



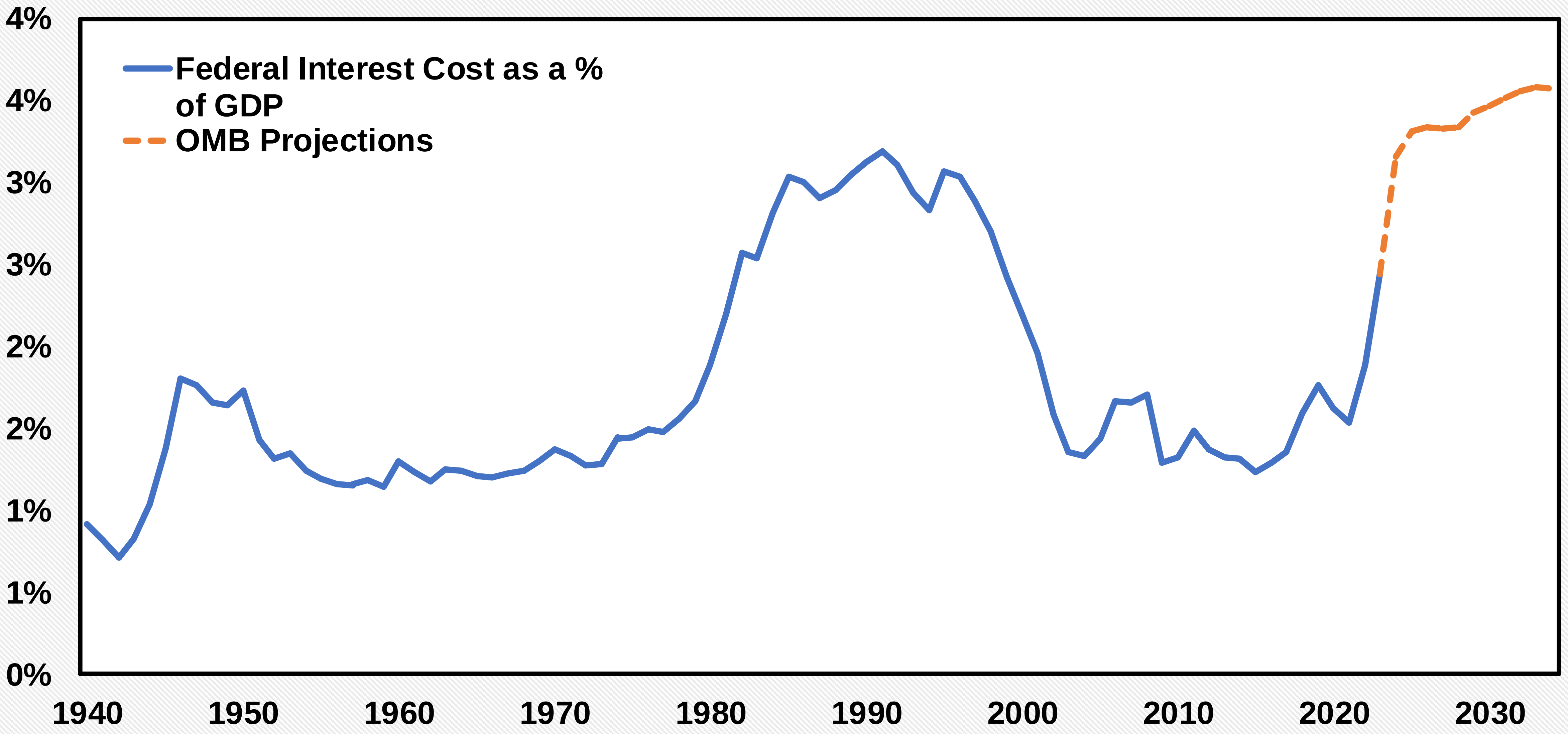
Source: Bureau of Economic Analysis, San Francisco Federal Reserve, First Trust Advisors, Jan 2020-Mar 2024

Headwinds to Consumer Spending



Source: Bureau of Economic Analysis, Monthly Data Jan 2013-Aug 2024

Interest Costs are the Highest in US History



Source: Office of Management and Budget, Annual Data 1940-2023 (Projections 2024-2034)

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Monday Morning OUTLOOK

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Dep. Chief Economist*
Strider Elass – *Senior Economist*
Andrew Opdyke, CFA – *Senior Economist*
Bryce Gill – *Economist*
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February 20, 2024

January Stagflation

A key economic mistake people make is thinking growth leads inflation. One reason they do that is because inflation is a monetary phenomenon. When money is too easy, first growth rises, and then inflation rises with a longer lag due to excess dollars in the system. This process reverses when money is tight, first growth slows, then with a longer lag inflation does too.

That makes 2023 an anomaly. The economy has remained resilient, but year-over-year consumer price inflation has moderated from a peak of 9.1% in mid-2022 to 3.4% in December 2023.

One theory is that the high inflation was all due to economic bottlenecks and supply constraints during COVID, so the end of lockdowns and the process of getting back to normal has expanded supply, leading to both faster growth and lower inflation. There's no doubt that the imposition of lockdowns and then the re-opening from those lockdowns had "supply-side" effects – first negative, then positive – and are consistent with this explanation.

But it's a flawed explanation. If supply constraints and their loosening were the key drivers of inflation, we would expect pandemic driven inflation to be followed by outright deflation as the economy reopened and returned to normal. That clearly hasn't happened, and inflation remains stubbornly high.

Instead, we believe monetary policy played the key role. The M2 measure of the money supply soared 41% in 2020-21, the fastest since World War II. This measure of the money supply then declined 3.2% in 2022-23, the largest two-year drop since the Great Depression. These swings in M2, the relative sizes of the swings (larger up than down), and the long lags between shifts in M2 and inflation do a much better job explaining the inflation pattern of the past few years.

The problem with this theory of "monetary dominance" is that classical liberals like Milton Friedman and the Austrians would expect economic growth to take a hit before inflation were brought back down to normal. And yet Real GDP grew 3.1% in 2023, which is above the 2.0% long-term trend.

So what gives? Our belief is that the US injected so much money, so rapidly, that the economy couldn't absorb it instantaneously. So, now, what we have seen is that even though M2 has declined, we still haven't absorbed all the money that was added. Some call it excess savings, we call it excess M2.

But the US has finally absorbed the excess money, and fiscal stimulus is waning as well. And guess what? Recent reports for January show an economy that may be weakening faster than most investors realize. Retail sales fell 0.8% for the month and have declined in three of the past four months. Manufacturing production fell 0.5% in January and manufacturing excluding the auto sector (the auto sector is volatile) has declined four months in a row.

Meanwhile, home building got hammered in January, with both housing starts (-14.8%) and completions (-8.1%) dropping sharply. It's possible that colder than normal January temperatures were a factor, as well as unusually high precipitation, but the drop in starts was in every major region of the country, the drop in completions happened in most regions (except for the West), and while weather was bad, quantitative measures of national heating requirements were not unusually high in January.

We've had bad weather before – and apocalyptic weather reports are clearly clickbait for some in the news media – but housing starts in January were the second lowest for any month since mid-2020, during the onset of COVID when lockdowns still prevailed in much of the country. In other words, we see these data potentially signaling broader economic weakness, consistent with the drop in retail sales and decline in manufacturing production in January.

And yet inflation was also a problem in January, with both consumer and producer prices rising 0.3%, faster than the consensus expected and inconsistent with the Federal Reserve's 2.0% target inflation.

A weakening US economy with inflation remaining (temporarily) stubbornly high would be consistent with the monetary dominance story of inflation's rise and fall and would also be a problem for the stock market. Using our Capitalized Profits Model, with a 10-year Treasury yield at about 4.25%, economy-wide corporate profits would need to rise 30%+ to justify an S&P 500 at 5,000. But there's no way profits (ex-Fed), which are already high relative to GDP would surge that much higher in a soft economy. The current consensus puts profit growth at roughly 10% this year.

Time will tell if the weakness in January becomes more widespread. On the surface, the job market still looks fine, with payrolls up more than 300,000 in both December and January. But the labor market can be a lagging indicator.

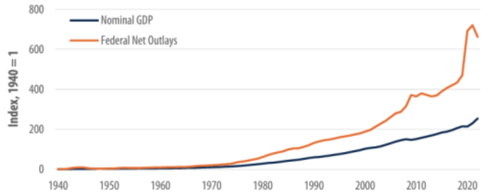
Unprecedented policies during COVID have created noise in the data. But underneath it all, we still believe Milton Friedman had it right. A decline in money will lead to recession, and *then* a decline in inflation.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
2-22 / 7:30 am	Initial Claims – Feb 17	216K	**216K**		220K
9:00 am	Existing Home Sales – Jan	3.960 Mil	**3.990 Mil**		3.780 Mil

THREE ON THURSDAY
First Trust
FIRST TRUST ECONOMICS
February 29, 2024

In this week's edition of "Three on Thursday" we look at the composition and evolution of federal spending over history. In conjunction with the Office of Management and Budget ("OMB"), the White House releases the "Historical Tables" – a comprehensive array of data on Federal Government finances spanning as far back as 1789 and extending to the most recent data available for Fiscal Year 2022, with projections included for the President's Budget for 2023-2028. An examination of this data unveil remarkable findings: in Fiscal Year 2022, a staggering 72.1% of federal spending was allocated to payments to individuals, matching the highest share ever recorded. The Federal Government has become not much more than the world's largest money transferring machine. So much spending going directly to individuals makes cutting the budget very difficult politically. For deeper insights into this matter, explore the three charts below.

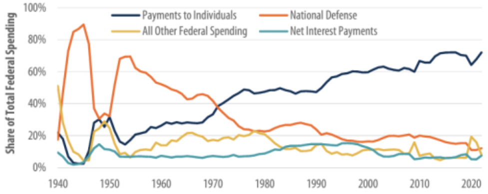
Government Spending Towers Above GDP Growth



Source: Office of Management and Budget, First Trust Advisors. Fiscal year data 1940-2022.

Since 1940, Nominal GDP has surged nearly 255-fold, while federal spending has skyrocketed by a staggering 663-fold over the same period. Regardless of the party in power, it's evident that government spending consistently expands. WWII marked a clear dividing line in U.S. budget history. Before the war, in 1940, federal spending was 9.6% of GDP. During the war, spending peaked at 42.7% of GDP, and although it decreased post-war, it never fell below 10% of GDP again, growing significantly in each successive decade. As of 2022, it sits at 25.1% of GDP. A major portion of this surge in federal spending stems from a massive 2,184-fold increase in payments for individuals since 1940.

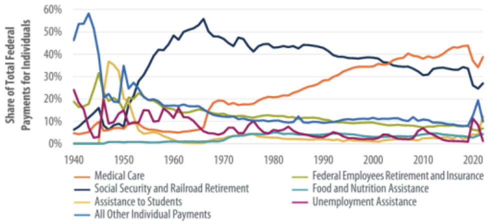
The Composition of Federal Spending



Source: Office of Management and Budget, First Trust Advisors. Fiscal year data 1940-2022.

The U.S. Federal Government has turned the U.S. into a transfer society, with an incredible $3.7 trillion or 72.1% of spending in 2022 allocated towards payments for individuals—a record high that matches the share seen just a few years prior in 2016 and 2017. These payments encompass various government programs aimed at providing income support to individuals and families, whether in the form of cash or other benefits. This trend has notably impacted National Defense spending, which has dwindled to a mere 12.2% share of federal spending, marking a steady decline since the mid-1950s. Following closely behind is the category of All Other Federal Spending, accounting for a modest 8.1% of the federal budget. Last, but certainly not least is Federal Net Interest Payments, which made up 7.6% of federal spending in 2022 and is notably projected to climb to 12.0% of spending by 2028 according to the OMB.

Composition of Federal Payments for Individuals



Source: Office of Management and Budget, First Trust Advisors. Fiscal year data 1940-2022.

So what is causing the massively higher trend in payments for individuals? Medical Care takes the number one spot, accounting for $1.76 trillion of federal spending in 2022. In 1940, Medical Care made up around 5% of federal payments for individuals, but that has now ballooned to 38.8% as of 2022. Next in line is Social Security and Railroad Retirement, which accounted for $1.2 trillion of federal spending, or 27% of federal payments for individuals. Just these two areas alone now make up over 65% of federal payments for individuals! Rounding out the top 3 is assistance to students, accounting for $553 billion of spending in 2022. This category exploded in 2022, rising from 4.0% of spending in 2021 to 12.2% in 2022, much of this having to do with student loan forgiveness.

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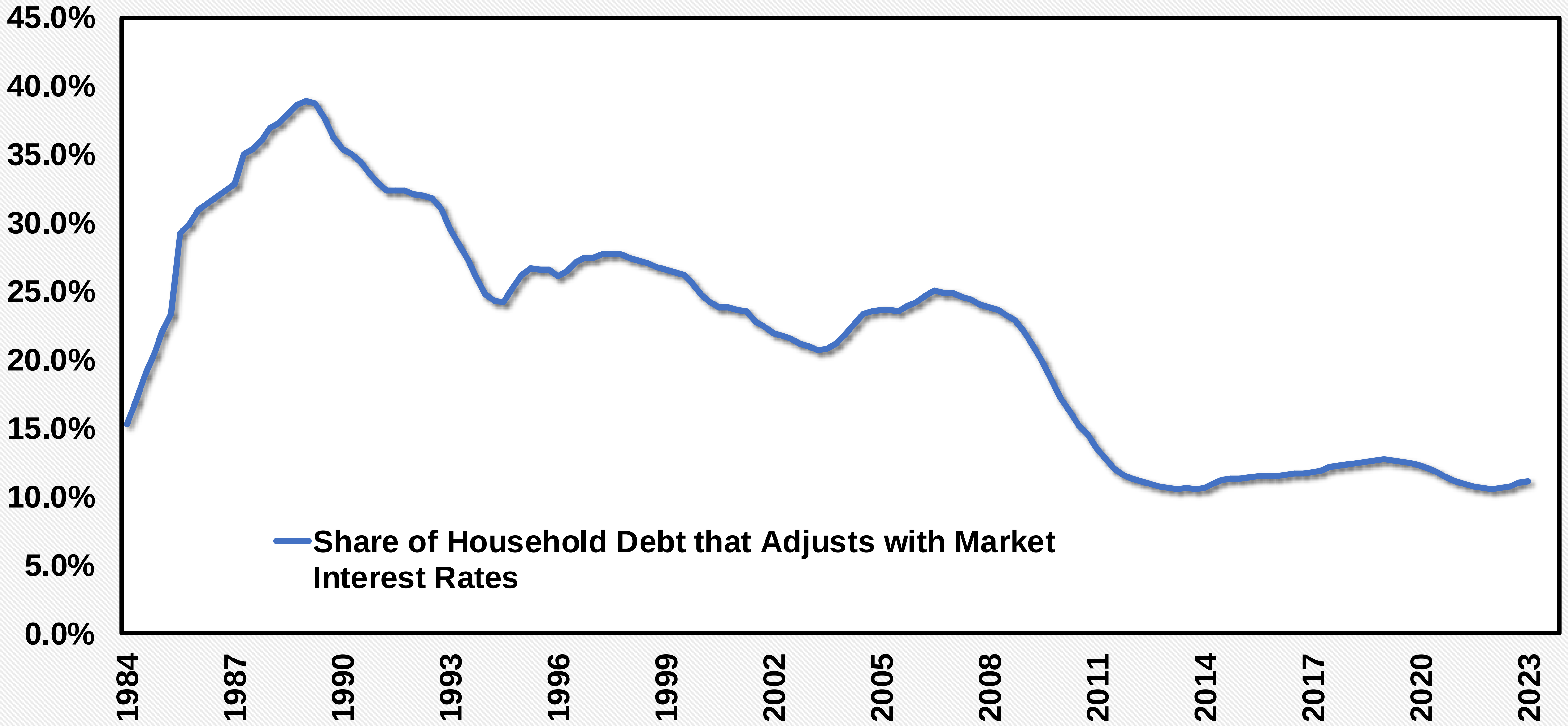
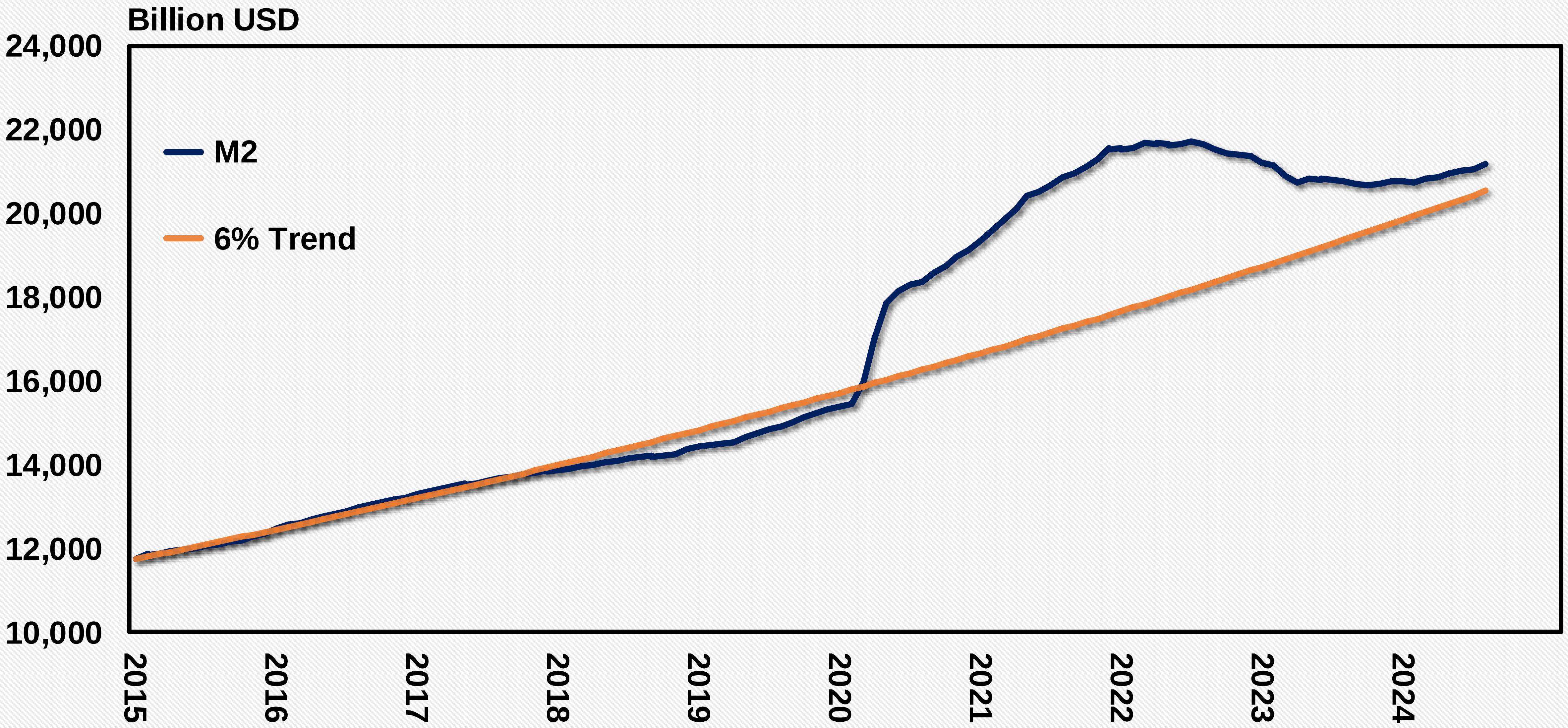
Monetary Policy Less Effective Against Inflation



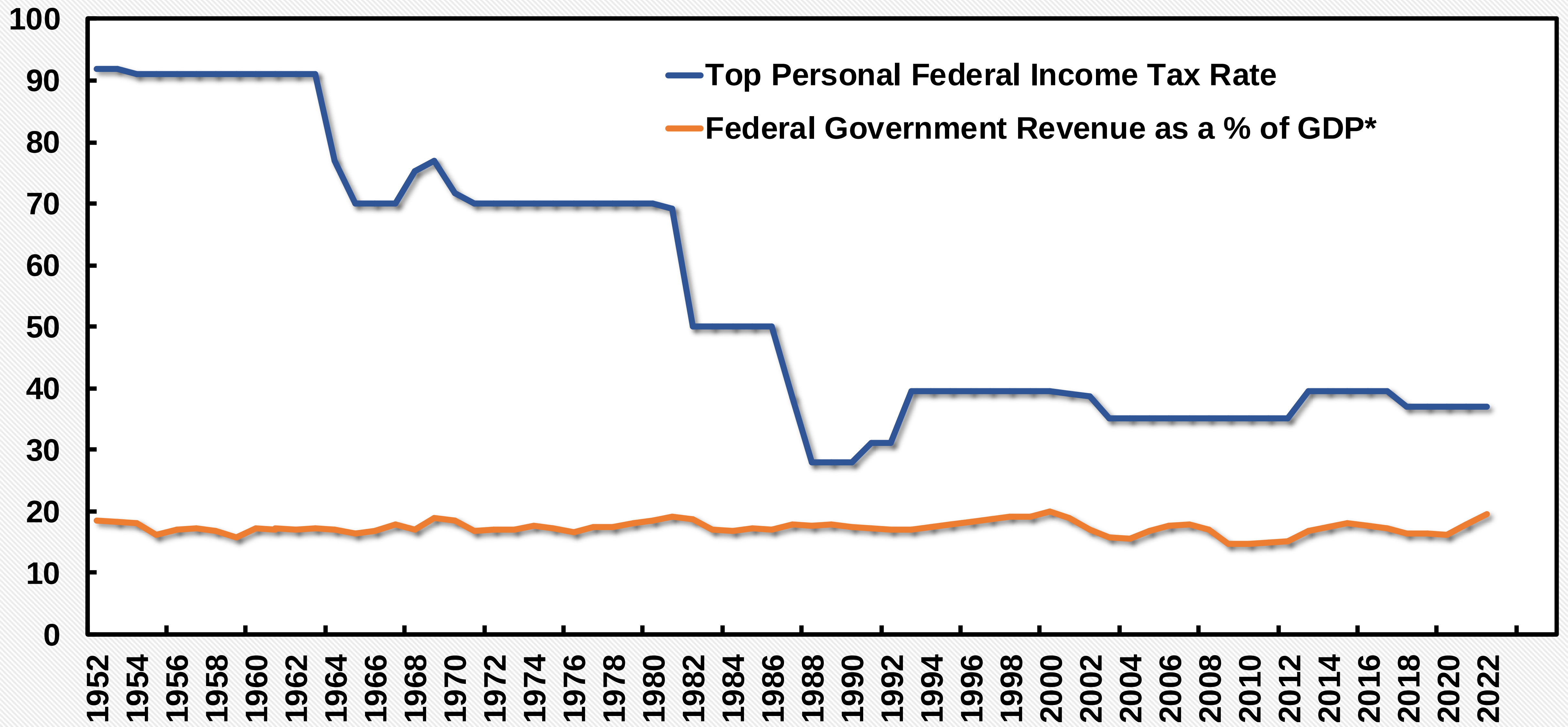
Source: Moody's Analytics, Quarterly Data Q1 1984-Q1 2023

Money Supply Vs. Pre-Pandemic Trend



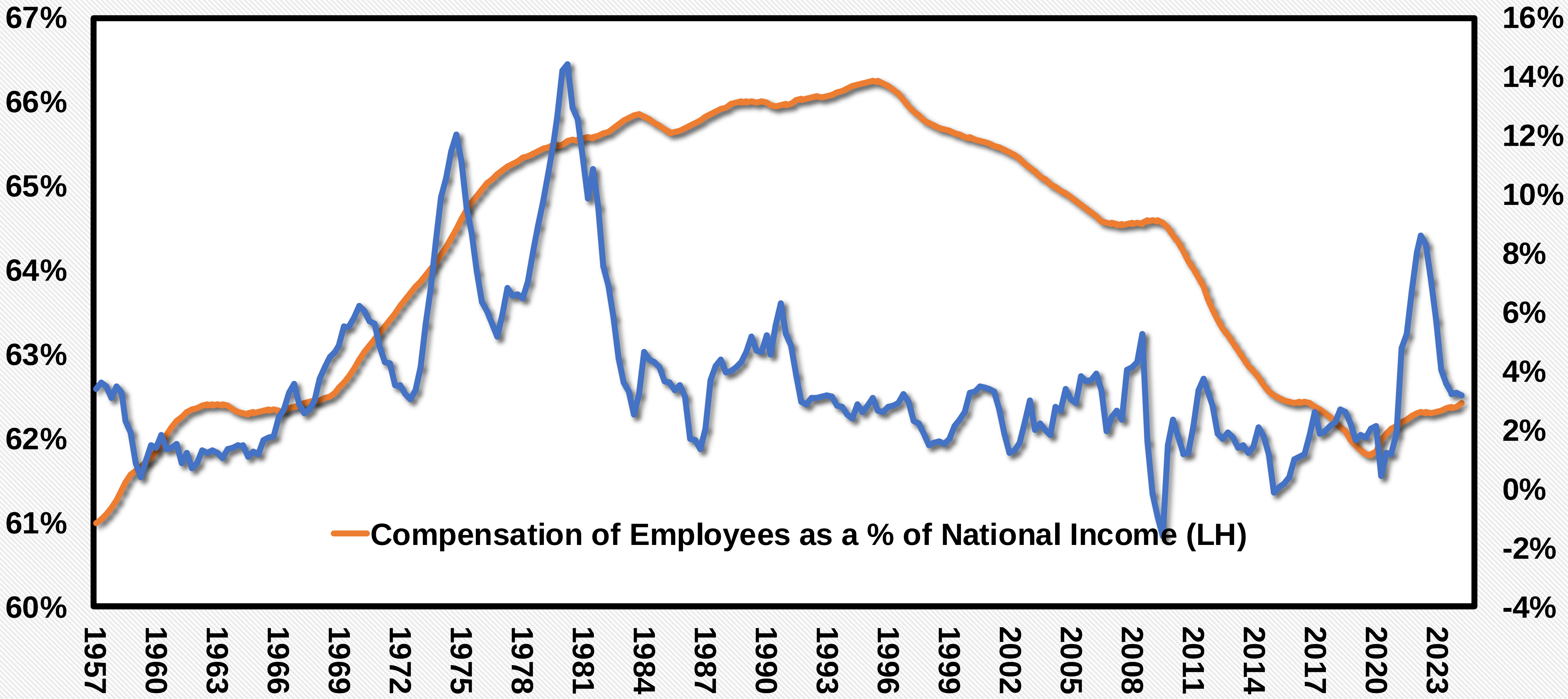
Source: Federal Reserve, Monthly Data Jan 2015- Aug 2024

Higher Taxes Won't Fix US Budget Problems



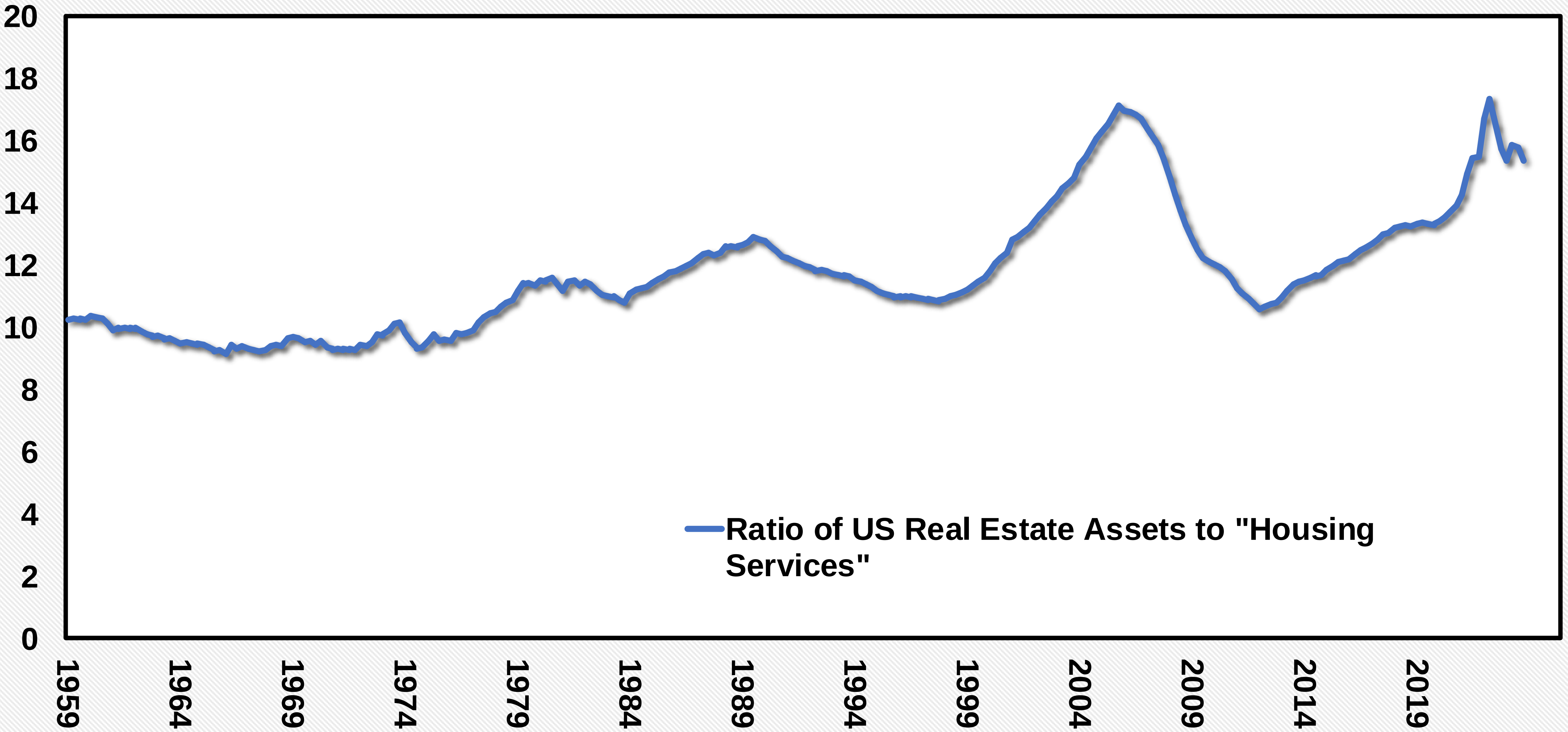
Source: Office of Management and Budget, Annual Data 1952-2022

Tide is Turning on Employee Bargaining Power



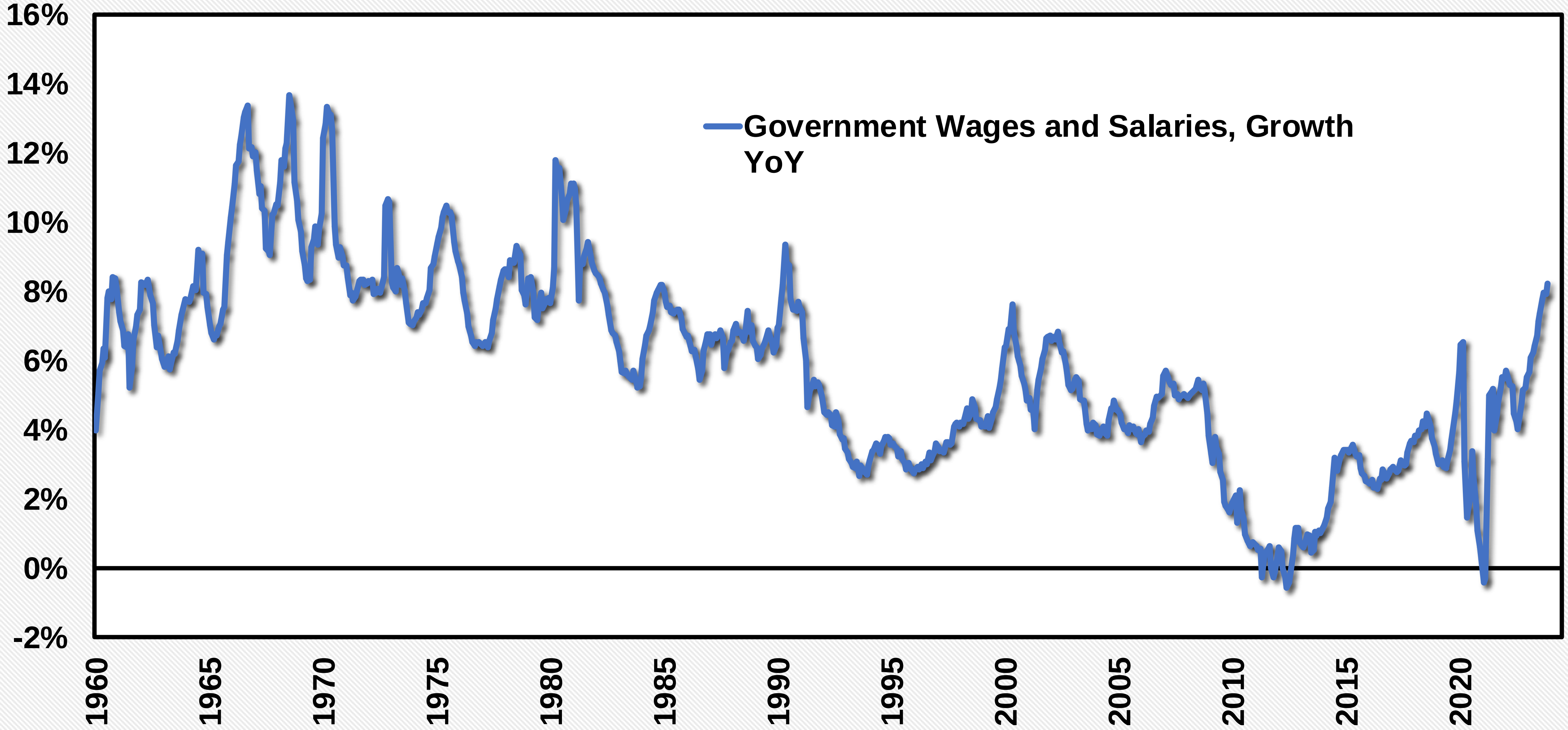
Source: US Census Bureau, Bureau of Economic Analysis, Quarterly Data Q1 1957- Q3 2023

Rent Won't Fix Inflation



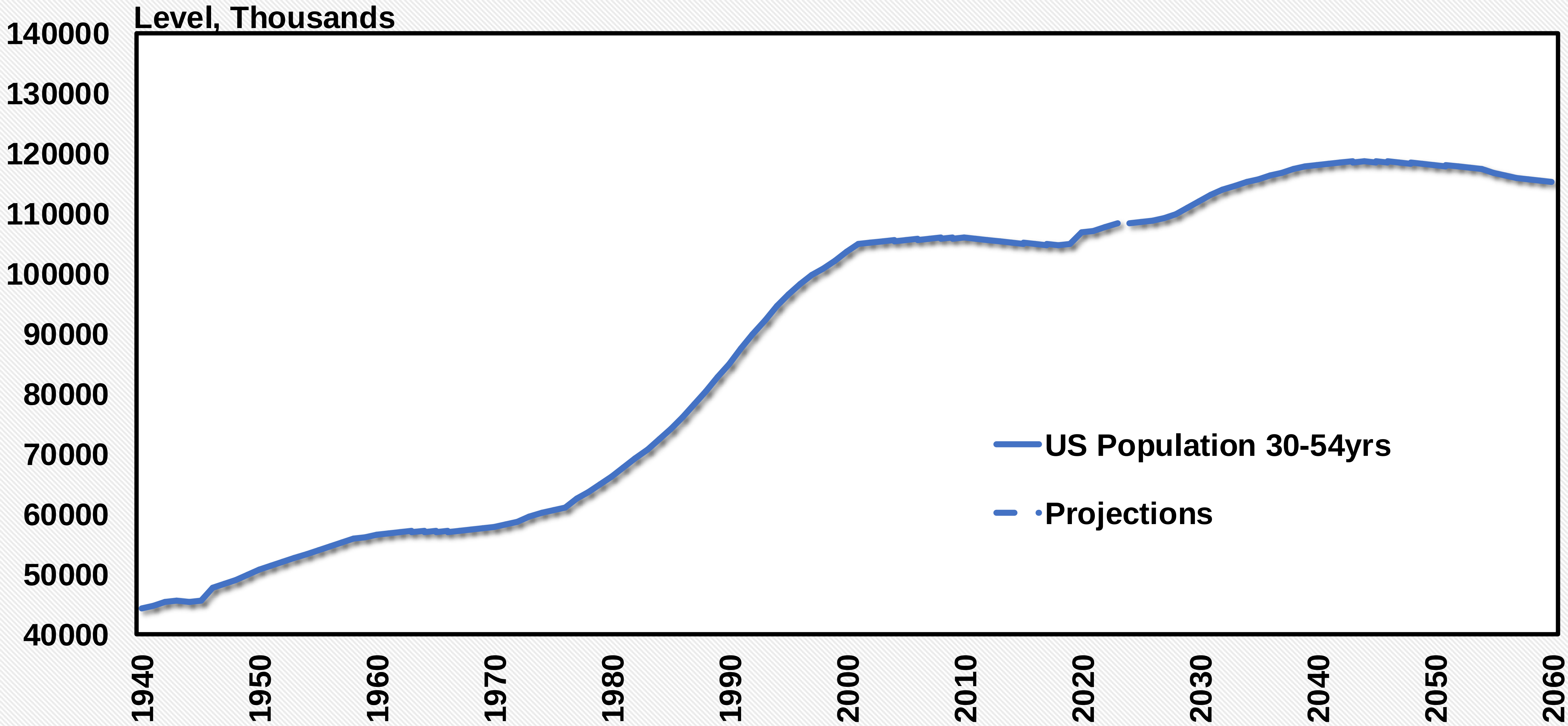
Source: BEA, Federal Reserve, Quarterly Data Q1 1959 – Q4 2023

Government Driving Growth



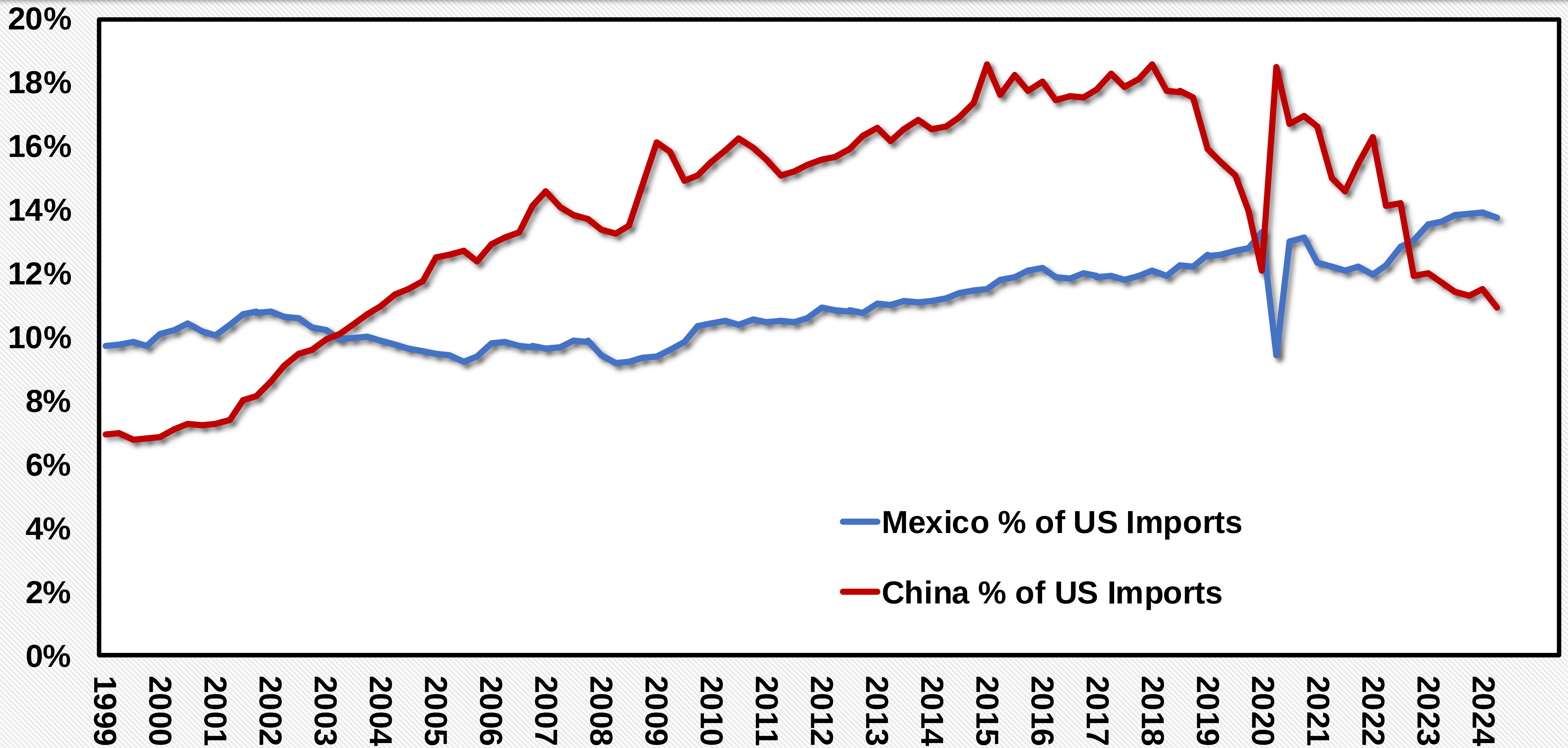
Source: Bureau of Labor Statistics, Monthly Data Jan 1960-Dec 2023

Millennials Set to Drive US Growth



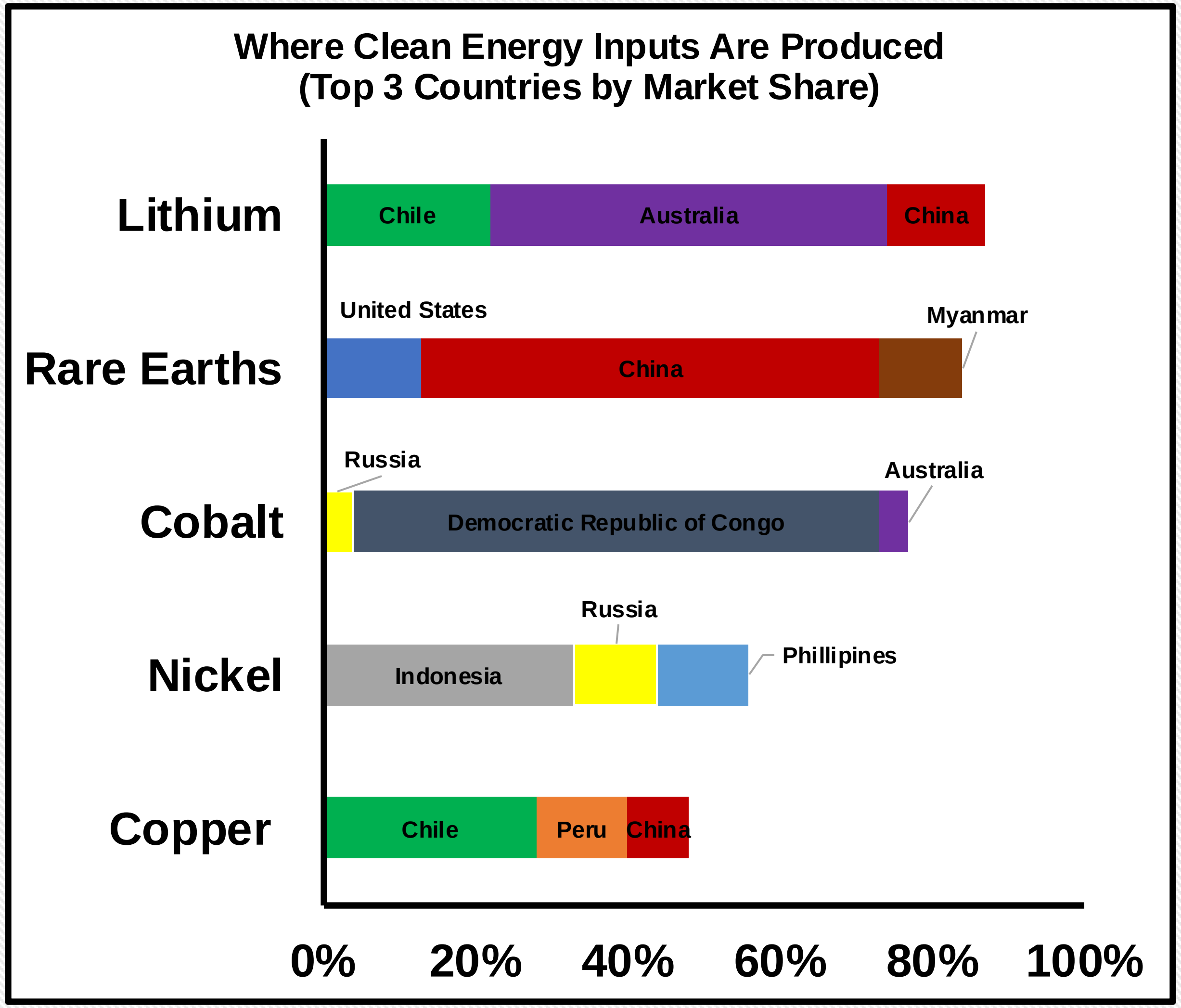
Source: US Census Bureau, Annual data 1940-2023, Projections 2024-2060

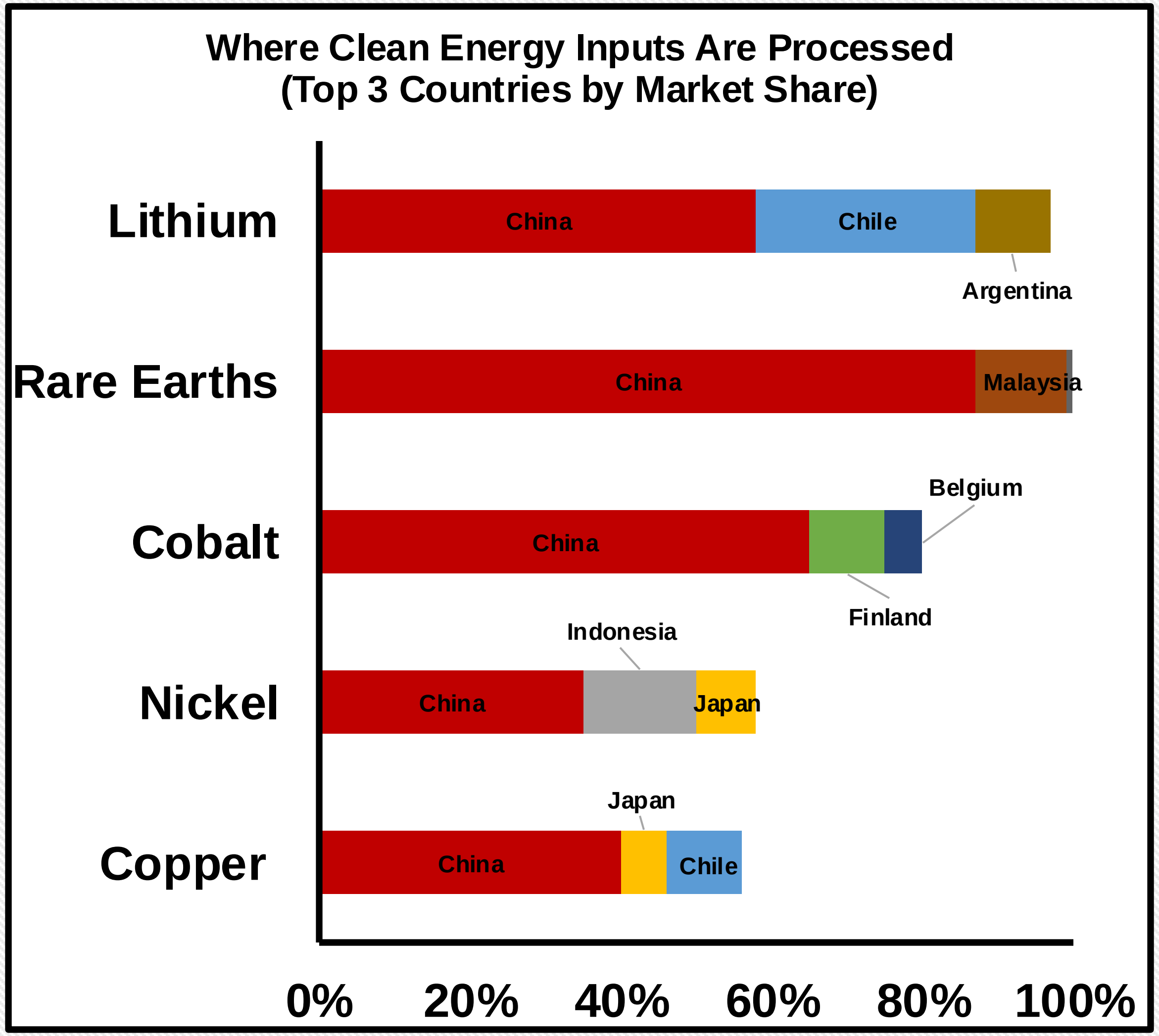
Decoupling From China



Source: US Census Bureau, Quarterly Data Q1 1999- Q2 2024

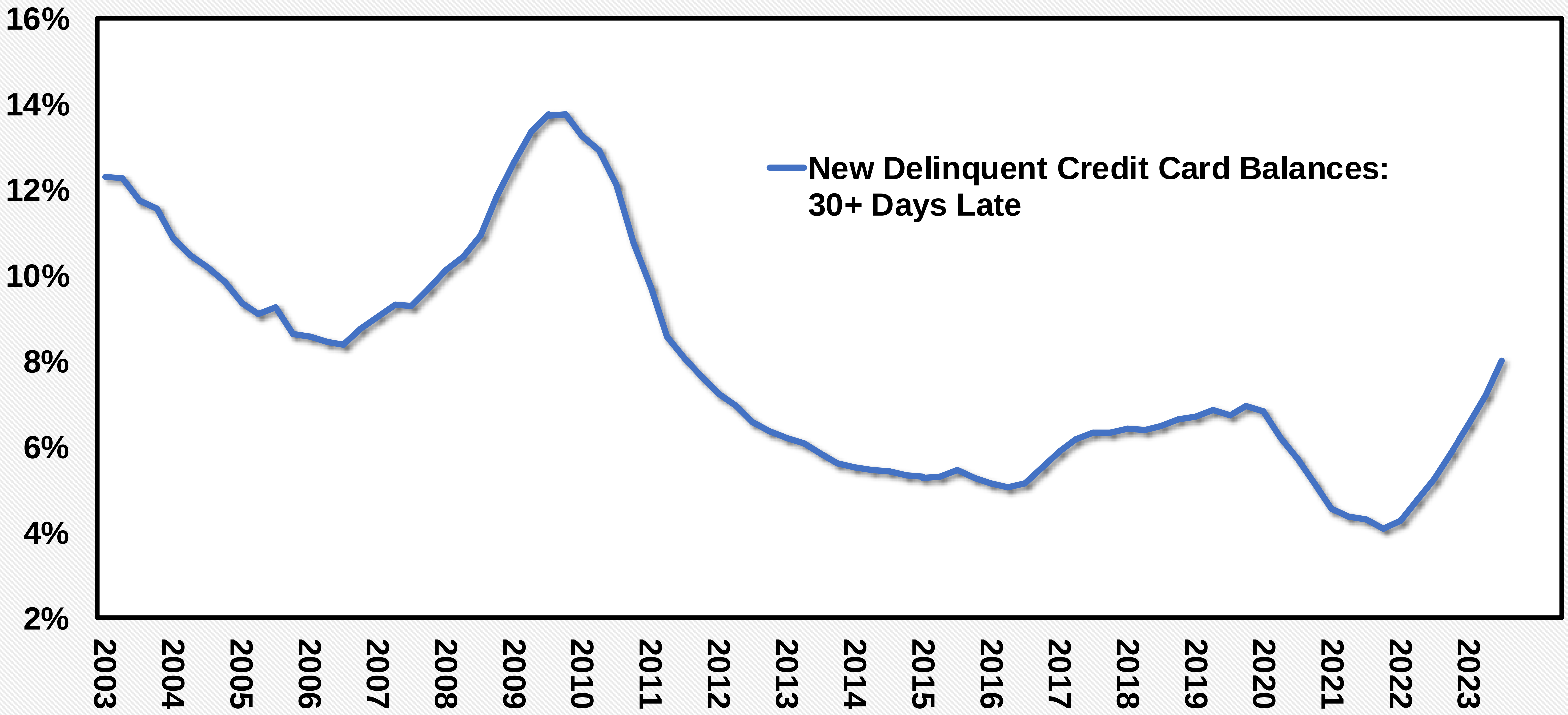
Realities of the Green Supply Chain





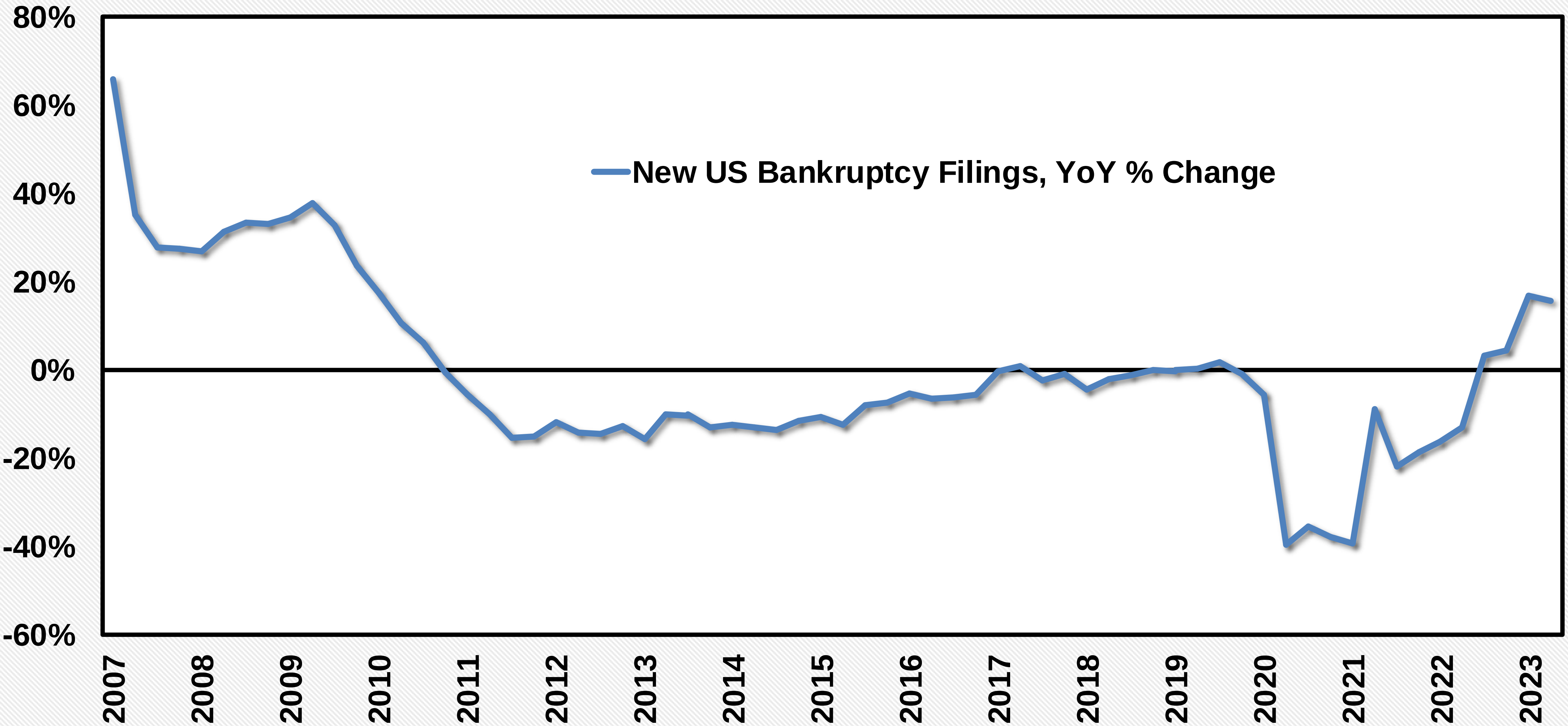
Source: International Energy Agency, 2019 Data

Credit Card Defaults Rising



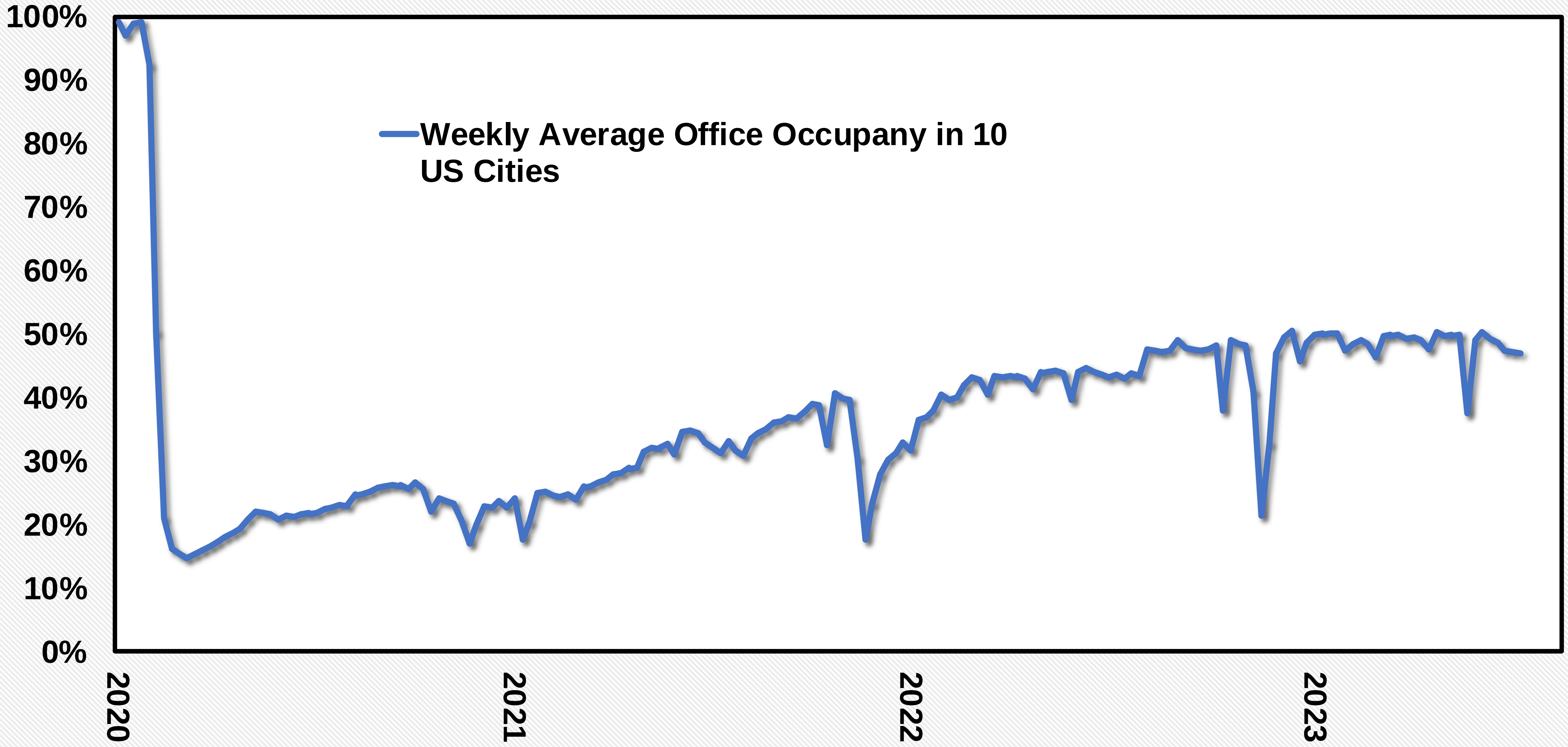
Source: FRBNY Consumer Credit Survey, Quarterly Data Q1 2003- Q3 2023

Bankruptcies Beginning to Rise



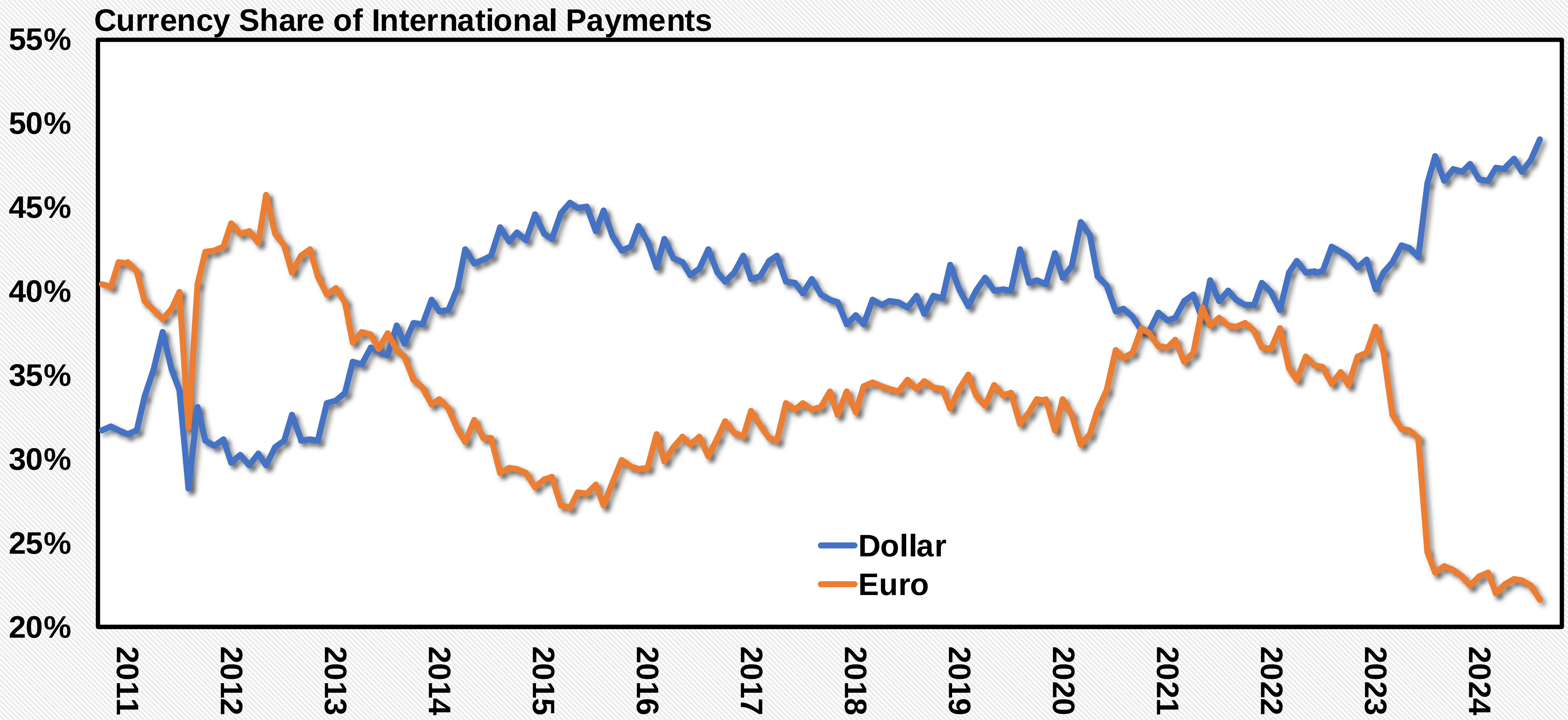
Source: Administrative Office of US Courts, Quarterly Data Q1 2007- Q3 2023

Trouble For Commercial Real Estate?



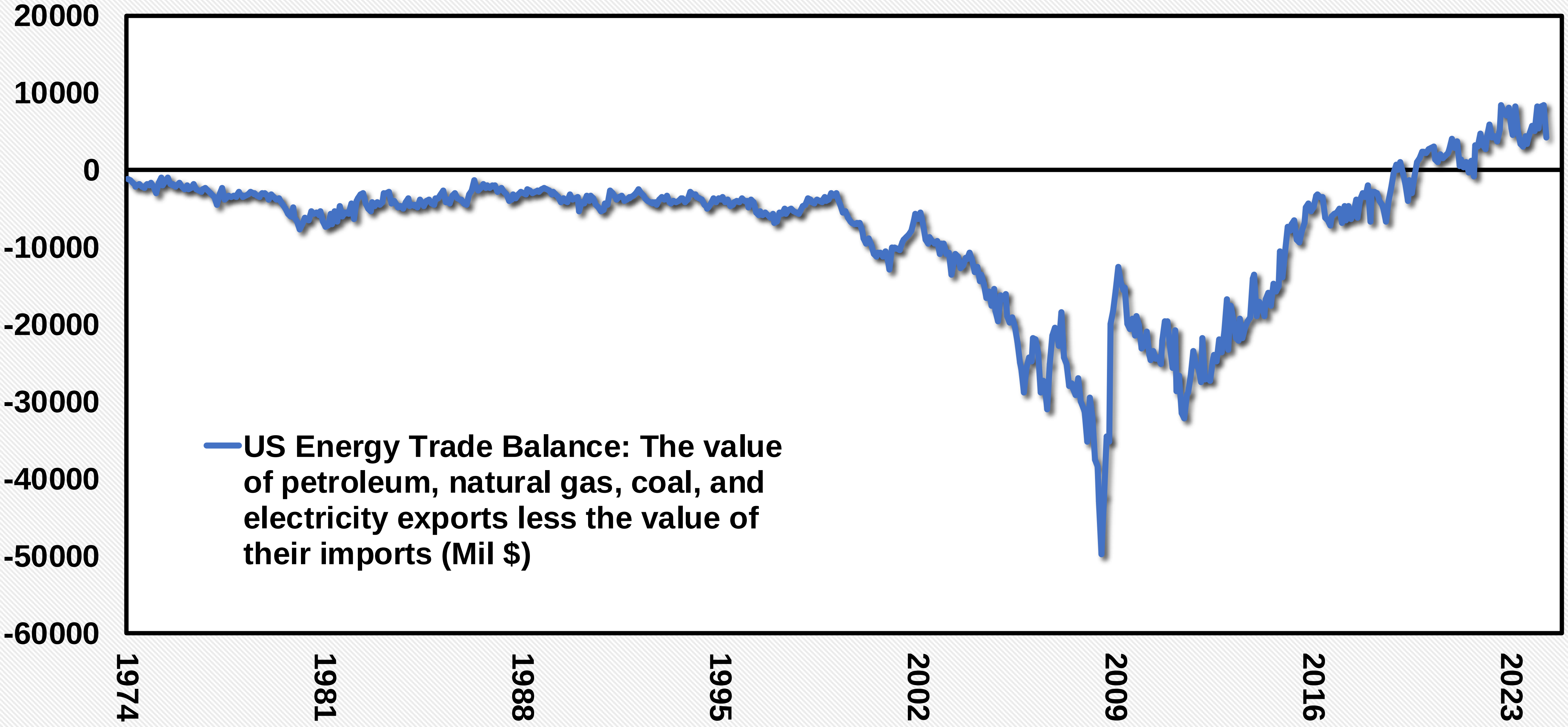
Source: Kastle Systems, Bloomberg, Quarterly Data Q1 2020- Q3 2023

Dollar Remains the Reserve Currency



Source: SWIFT, Bloomberg, Monthly Data Oct 2010- Aug 2024

Energy Independence: The End of the Petro-Dollar



Source: US Census Bureau, Monthly Data Q1 Jan 1974-Apr 2024