Review & Outlook

Second Quarter 2024

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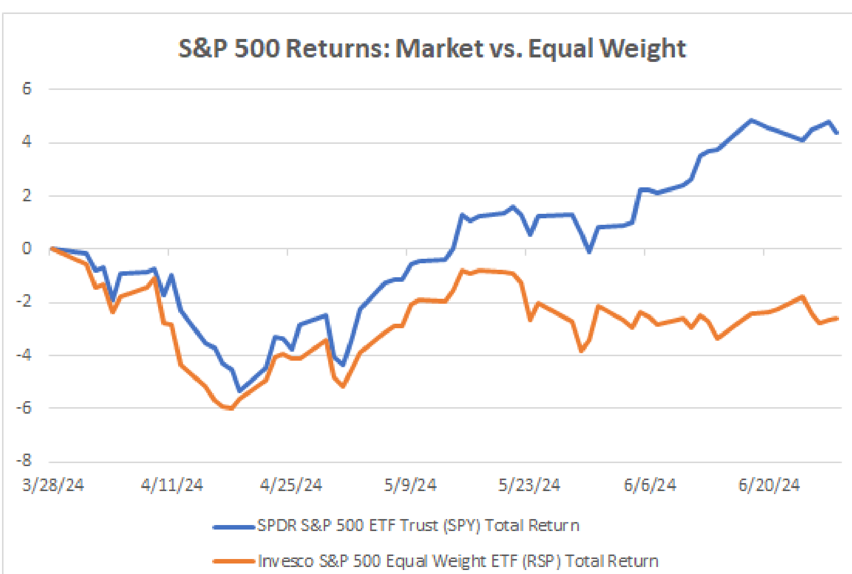
Review and Outlook

Through all of this year's uncertainty and challenges, the economy has continued its positive path forward. In the first quarter of 2024, the Bureau of Economic Analysis downwardly revised its estimate for GDP growth, placing it at 1.3% annualized, which, while noticeably slower than 2023's growth, is significantly better than the considerable slowdown expected by most economists. As of June 20th, the Federal Reserve Bank of Atlanta's GDPNow model estimates growth in the second quarter to be 3.0%, which is above the long term trend, and the U.S. economy continues to perform favorably relative to other major developed countries. So the fairy tale continues, with historically low unemployment, falling inflation, and no recession.

Index Performance Data
Total Return as of 6/30/2024

Indices[1]	Q2 2024	Trailing 12 Months
CRSP U.S. Total Market Index Total Return	3.25%	23.17%
MSCI ACWI Ex-U.S. Total Return	2.79%	13.46%
Bloomberg U.S. Aggregate Bond Index	0.07%	2.63%

With respect to inflation, the Blue Chip Consensus report shows the Consumer Price Index rose 4.2% in 2023, and is expected to drop to 2.7% this year. That decrease shows considerable progress, although 2.7% is still higher than the Federal Reserve's target of 2%. The Blue Chip Consensus calls for unemployment to increase from 3.7% in 2023 to 4.2% in 2024, however, we note considerable uncertainty in the data behind that number. Employment and unemployment estimates are based on survey results of businesses and households, and the response rate for those surveys is well below pre-Covid levels, so the surveys have been reporting very different messages lately. In a quarter or two, we may see revisions revealing that the labor market is not as strong as some of the data currently suggests.



In short, the national economy continues to defy expectations, keeping the long-predicted recession on hold. But debt is increasing for those in the lower half of the income spectrum, especially credit card debt and auto loan delinquencies. Inflation is also much more of a problem for lower income earners rather than those at the upper end of the spectrum. So, while the overall numbers are quite positive, there are nuances in the underlying data that should not be overlooked.

The financial markets continue to do well, no matter the news. We wrote in our last Review and Outlook about how the strong economy has allowed corporate earnings to increase, which in turn leads to stocks becoming more expensive. But bond prices have fluctuated with news about inflation, which, curiously, indicates something different. Current stock prices reflect a view that interest rates will be much lower in the near future, while bond prices suggest that interest rates will settle at a rate below where they are today, but higher than what we saw before the pandemic. We view this as a type of normalization in the bond market, and continue to think that stock prices may stagnate given the run-up they've had over the past nine months.

Stock market gains also continue to be driven by a small number very large companies. As a consequence, the S&P 500 Index (which is market weighted, so that the largest companies have the biggest impact) has outperformed the S&P 500 Equal Weight Index (in which all companies are weighted the same) by almost 13% over the past 12 months, and by almost 7% over the past quarter. In fact, in the second quarter of 2024, the return for the S&P 500 Equal Weight Index was actually negative: -2.62% vs. 4.38% for the S&P 500 Index (market weighted).

In Focus

Our In Focus this quarter highlights reasons for both concern and optimism. In May 2024, the U.S. Treasury reported that it has cost $728 billion to make interest payments on its debt, which was 16% of total federal spending.[2] And a CBS news report estimated that we will spend $870 billion in 2024, exceeding the expected $822 billion for defense.[3] We now spend more on interest to finance the national debt than we pay for Medicare and Social Security. Of course, it's easy to sensationalize these numbers, but the real question is what do our high interest payments actually mean?

Theory suggests that more government spending means higher taxes or more borrowing, with borrowing being the more popular choice in recent decades. More borrowing means upward pressure on interest rates: as we issue more bonds for more spending, the price of bonds should fall, which should result in higher interest rates. In general, the money that people save supports loans. More loans by the government pushes up interest rates, which means it is harder for individuals and businesses in the private sector to invest in new projects. As such, more government borrowing can crowd out private investment, and less private investment suggests slower growth. While it is a worry, the magnitude of impact is a point of some debate.

U.S. debt is now noticeably larger than our GDP, and many people consider a debt-to-GDP ratio of 100% to be quite worrisome. However, our debt-to-GDP ratio at the end of WWII was similar to what it is today and we did not encounter problems then. Moreover, Japan has a much higher debt-to-GDP ratio than the U.S., and they have been able to maintain a very high debt-to-GDP ratio for decades, without any type of public debt crisis, which is no small feat with a rapidly aging population. But cultural and other differences suggest that Japan may not offer the best lesson for how the U.S. might navigate the future with higher and higher debt payments.[4] Additionally, the next few decades may not look like the few that followed WWII. Dealing with the debt we have today may not be as easy as it was in 1948.

While dire predictions of imminent bankruptcy may be both premature and overstated, there should be no doubt that more money spent on interest payments means less money for social programs, so those higher interest rates will have real consequences. It's a chronic and slowly building problem that, unfortunately, will likely be pushed aside for now, since policy makers usually react to more pressing issues, suggesting that no solution will be found until it truly becomes a crisis.

A second area of concern is looking beyond the most recent era of globalization. Some view the 1960s as the start of a particular era in globalization, when modern communication satellites allowed the 1964 Olympic Games in Tokyo to be televised in the U.S. More important to us is the way trade increased, and costs for many products declined over the decades at the end of the 20th century and early parts of the 21st century. While the creation of wealth and dampening effects on inflation due to trade are not in dispute, there were clear winners and losers, and gains from trade were not managed as well as they could have been, or shared with those who lost their jobs. This poor management has led to an understandable backlash and a certain type of nationalism that, in many countries, is fueling populist demands for curbs on immigration, and new tariffs on imported goods and services.

Proposed tariffs, deportations, and other strategies designed to strengthen a given country look problematic from an economic perspective. Tariffs would be inflationary, and deportations or stricter immigration controls would tighten labor markets, likely adding to wage driven inflation. Recently, 16 Nobel economists expressed concern about such proposed actions.[5]

On the optimistic side, we see much opportunity for economic growth, including productivity gains, as the U.S. will be forced to develop our electric grid due to increased power demand and decarbonization required to mitigate climate change. Without significant investment in the electrical grid, we anticipate significantly higher power costs for both production and distribution. A report in Bloomberg News suggests electricity demand could increase 40% over the next 20 years.[6] Adding capacity for A.I. search engines is part of the increase in demand, but so is the transition to electric vehicles, and a growing demand for heat pumps and air conditioning in many parts of the country.

Consequently, we expect continued investment in renewable energy, but also more reliance on nuclear power based on more modern technology.

The power grid needs dependable base load power to complement solar and wind, which means something needs to replace coal and natural gas plants. Equally, there will be investment in power storage, so that wind and solar produced energy can be used even when the sun is not shining and the wind is not blowing.

Because the need for, and potential benefit of, a modernized electric grid is so great, we are optimistic that market forces will respond with solutions, even if government might drag its feet. It might surprise many to learn that the state currently producing the most renewable energy is Texas, which has seen massive additions of solar and wind power generation in recent years.

So, even with the gathering clouds, we continue to see the sun: a relentless economic force pushing the buildout of renewable power production and an enhanced power grid. As such, it's an area that we continue to look at more carefully with respect to successful long-term investment.

1. Index performance data provided by ICE Data Services, and calculated by Black Diamond, an SS&C Advent company.
2. U.S. Treasury. (n.d.). Fiscal Data explains the National Debt. Understanding the National Debt. U.S. Treasury Fiscal Data. https://fiscaldata.treasury.gov/americas-finance-guide/national-debt/
3. CBS News. (2024, March 1). U.S. interest payments on its debt are set to exceed defense spending. should we be worried?. CBS News. https://www.cbsnews.com/news/federal-debt-interest-payments-defense-medicare-children/
4. Chien, Y., & Stewart, A. H. (2023, November 14). What lessons can be drawn from Japan's high debt-to-GDP ratio? Federal Reserve Bank of St. Louis. https://www.stlouisfed.org/on-the-economy/2023/nov/what-lessons-drawn-japans-high-debt-gdp-ratio/
5. Yahoo! (2024, June 25). 16 Nobel economists warn Second Donald Trump term would mean 1 thing. Yahoo! News. https://news.yahoo.com/news/16-nobel-economists-warn-second-115342496.html
6. Bloomberg Business Week. (2024, June 21). AI Is Already Wreaking Havoc on Global Power Systems. Bloomberg.com. https://www.bloomberg.com/graphics/2024-ai-data-centers-power-grids/