Bell Institutional

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ECONOMIC OUTLOOK

Underlying influences, mentioned in our last several monthly outlooks, are now manifesting themselves in hard data – as economic markers appearing in the overall economy and markets, and noted by more academic-minded observers. Unemployment has increased more than forecasts anticipated, and the stock market is seeing rotation out of the elevated-valuation tech stocks that provided outsized returns year to date. On the surface, the most recent report showing an increase in unemployment suggests the economy could be cooling. It should be noted that productivity increased at a 2.3% annualized rate in the second quarter. This productivity improvement suggests fewer employees are required to produce a consistent amount of output.

Where to from here? By definition, data reflects something that has already happened. Focusing on data does not help anyone be proactive about economic or market turning points. To be proactive, we must make a guess – an educated guess, but a guess nonetheless. A guess is a forecast – and as I like to say, a forecast has two potential outcomes: lucky or wrong.

In economic theory, there are relationships among employment, inflation, wages, job openings, economic growth and all sorts of other data points. Unfortunately, those relationships do not tend to remain constant, which presents challenges in trying to interpret them. In theory, theory and practice are the same; in practice, they are not.

One of the areas we believe has been a sticking point in the Federal Reserve's communication to the markets is the Fed's focus on inflation returning to 2%. Historically, except for the post-financial crisis period, inflation has seldom been consistently near 2%. The average inflation rate over the last 50 years has been 3.13%. If the Fed remains focused on its 2% inflation number before addressing adjustments to the target fed fund rate, we believe it will be too late for the Fed to avoid missing the goal of a soft landing (in which inflation declines, unemployment doesn't deteriorate too much, wages cool and economic growth slows but does not go negative – therefore avoiding a recession).

Federal Reserve economists may realize too late that relationships among economic indicators have drifted. If this is the case, they may be late to adjust policy. Even when policy is adjusted, it is still subject to long and variable lags between monetary policy and its effects on the economy. >>>

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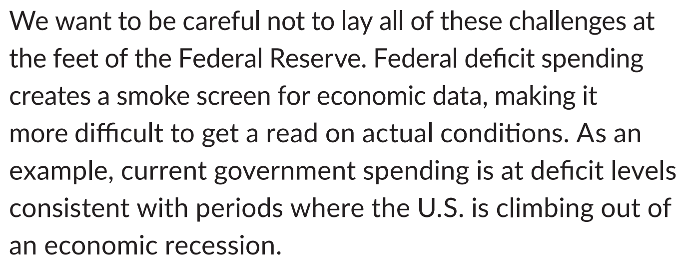

We want to be careful not to lay all of these challenges at the feet of the Federal Reserve. Federal deficit spending creates a smoke screen for economic data, making it more difficult to get a read on actual conditions. As an example, current government spending is at deficit levels consistent with periods where the U.S. is climbing out of an economic recession.

It appears that economic uncertainty, the inverted yield curve, stock market concentrations and now rising unemployment have introduced a level of nervousness that is showing up as volatility in the markets. When things are going well, investors tend to take more risk than is otherwise suggested by their personal investment profiles. It is these sudden changes that bring us back to focusing on our long-term goals.