MORNING BRIEFING
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Dismissing The Dismal Definition Of Economics

Check out the accompanying chart collection.

Executive Summary: The conventional wisdom is that economics is the study of how best to allocate scarce resources—a dismal proposition. I disagree: Economics is all about using technology to create and spread abundance—a much more uplifting definition. The dismal framing taught in universities seems to have produced economists biased toward pessimism. Perhaps that's why most—after ample evidence that the economy is thriving—are just starting to accept that a recession is not about to happen. … Today, we examine the consensus views of economic forecasters, including within the Fed, and supply context to their outlooks in the form of what inflation has been doing, especially wage inflation.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

US Economy I: Scarcity vs Abundance. Economics is widely known as the "dismal science." Economists have tended to be pessimistic ever since Thomas Malthus predicted that population growth would exceed the rate of increase in food supplies, resulting in mass starvation.

Modern-day economists were mostly introduced to the dismal science by reading Paul Samuelson's famous *Economics* textbook, which also had a dismal spin. The latest (19th) edition of *Economics* (2010), by Samuelson and William Nordhaus, teaches students that economics "is the study of how societies use scarce resources to produce valuable goods and services and distribute them among different individuals." This definition hasn't changed since the first edition of this classic textbook was published in 1948.

That's a relatively depressing definition of economics: Resources are scarce, and economists must determine the best way to distribute them. That's led to lots of infighting within the profession between those who believe that the free market is the best way to divvy up the scarce resources and those who contend that the government should do it.

In my 2018 book *Predicting the Markets*, I objected to the dismal characterization of economics as follows:

"I've learned that economics isn't a zero-sum game, as implied by the definition. Economics is about using technology to increase everyone's standard of living. Technological innovations are driven by the profits that can be earned by solving the problems posed by scarce resources. Free markets provide the profit incentives to motivate innovators to solve this problem. As they do so, consumer prices tend to fall, driven by their innovations. The market distributes the resulting benefits to all consumers. From my perspective, economics is about creating and spreading abundance, not about distributing scarcity."

US Economy II: Today's Dismal Scientists. Over the past year or so, economists mostly have been very pessimistic about the economic outlook. The vast majority expected a recession as a result of the tightening of Fed policy in the face of mounting inflation. For a while during 2021 when inflation was starting to take off, it was widely perceived that inflation was a transitory problem. But during 2022, the consensus among economists shifted: Inflation was viewed as a more persistent and pernicious problem that could only be stopped with a Fed-engineered recession.

But the economy has defied its detractors, proving to be remarkably resilient. More recently, inflation has proven to be more transitory than persistent, as we wrote in yesterday's *Morning Briefing*. As a result, the consensus view among economists is turning less pessimistic.

Indeed, the July 15 *WSJ* included an *article* titled "Economists Are Cutting Back Their Recession Expectations." It is subtitled: "Forecasters still expect GDP to eventually contract, but later, and by less, than previously." Here's more:

(1) The article observes: "Easing inflation, a still-strong labor market and economic resilience led business and academic economists polled by *The Wall Street Journal* to lower the probability of a recession in the next 12 months to 54% from 61% in the prior two surveys.

"While that probability is still high by historical comparison, it represents the largest month-over-month percentage-point drop since August 2020, as the economy was recovering from a short but sharp recession induced by the Covid-19 pandemic. It reflects the fact that the economy has kept growing even as the Federal Reserve has raised interest rates and inflation declined."

Furthermore, the article explains: "Nearly 60% of economists said their main reason for optimism about the economic outlook is their expectation that inflation will continue to slow." The survey of 69 economists was conducted July 7-12. That was mostly before June's lower-than-expected CPI was released on July 12. It rose just 3.0% y/y last month, sharply lower than the peak of 9.1% in June 2022 and the slowest in more than two years.

(2) The *Philly Fed's Survey of Professional Forecasters*, which started in Q4-1968, includes the "Anxious Index," which is the probability of a decline in real GDP (*Fig. 1*). The survey asks panelists to estimate the probability that real GDP will decline in the quarter in which the survey is taken and in each of the following four quarters. The Anxious Index shows the probability they see of a decline in real GDP in the quarter after a survey is taken and the probability of a recession over the next four quarters (*Fig. 2*).

The Philly Fed's Q2 survey, dated May 12, showed that the forecasters saw less risk of negative growth during Q2 than previously estimated but higher risk during subsequent quarters. The estimate for Q2 was 38.8%, down from the previous estimate of 42.4%. The Q1-2024 estimate saw the largest revision in the risk of a contraction in real GDP. The forecasters pegged the risk at 39.3%, marking an upward revision from 31.8% in the previous survey three months earlier.

(3) The *Conference Board*, which compiles the Index of Leading Economic Indicators (LEI) and the Index of Coincident Economic Indicators (CEI), also maintains a US recession probability model. The latest version, dated April 12, 2023, calculated that the recession probability estimate was "near 99 percent pointing to the likelihood of a recession in the US within the next 12 months." The proprietors of the model observed: "Despite better-than-expected consumer spending recently, the Federal Reserve's interest rate hikes and tightening monetary policy will lead to a recession in 2023." This outlook is consistent with the LEI, which peaked at a record high during December 2021 and is down 9.4% since then through May (*Fig. 3*). On the other hand, the CEI increased 2.3% over this same period to a new record high (*Fig. 4*).

(4) Even the Fed's staff economists have been forecasting a recession. The *January FOMC minutes* noted: "The sluggish growth in real private domestic spending expected this year and the persistently tight financial conditions were seen as tilting the risks to the downside around the baseline projection for real economic activity, and the staff still viewed the possibility of a recession sometime this year as a plausible alternative to the baseline."

The *March FOMC minutes* indicated that a mild recession forecast was now the staff's baseline: "Given their assessment of the potential economic effects of the recent banking-sector developments, the staff's projection at the time of the March meeting included a mild recession starting later this year, with a recovery over the subsequent two years." That outlook was maintained in the *May FOMC minutes* and the *June FOMC minutes*.

US Economy III: Waller's Scenario. Among the Fed officials who spoke publicly before the Fed's blackout period started this past Saturday was Fed Governor Christopher Waller. He did so in a *speech* titled "Big Shocks Travel Fast: Why Policy Lags May Be Shorter Than You Think" on Thursday, July 13 at the Money Marketeers of New York University. That was a day after the release of June's lower-than-expected CPI report for June. Waller said:

"Yesterday, we received new data on consumer price index (CPI) inflation. After 5 consecutive monthly readings of core inflation of 0.4 percent or above, this rate dropped by half in June, to 0.2 percent. This is welcome news, but one data point does not make a trend. Inflation briefly slowed in the summer of 2021 before getting much worse, so I am going to need to see this improvement sustained before I am confident that inflation has decelerated. …

"While I expect inflation to eventually settle near our 2 percent target because of our policy actions, we have to make sure what we saw in yesterday's inflation report feeds through broadly across goods and services and that we do not revert back to what has been persistently high core inflation. The robust strength of the labor market and the solid overall performance of the U.S. economy gives us room to tighten policy further."

Waller sees a 25bps hike in the federal funds rate at next week's meeting of the FOMC. He sees another 25bps before year-end if the economy remains strong, the labor market remains tight, and inflation shows signs of heating up rather than cooling off.

US Economy IV: One of Powell's Favorite Charts. While the CPI inflation rate is showing more signs of being transitory for both goods and services, wage inflation remains relatively persistent. Fed Chair Jerome Powell addressed this issue in a November 30, 2022 *speech* titled "Inflation and the Labor Market."

Powell observed: "In the labor market, demand for workers far exceeds the supply of available workers, and nominal wages have been growing at a pace well above what would be consistent with 2 percent inflation over time. Thus, another condition we are looking for is the restoration of balance between supply and demand in the labor market."

He provided an interesting chart comparing supply and demand for labor. The former is simply the same as the size of the labor force, while the latter is the sum of household employment and job openings (*Fig. 5*). It shows that over the past two years or so, demand for labor has well exceeded its supply. That's boosting wage inflation.

The spread between labor demand and supply is reasonably well correlated with wage inflation, using either the average hourly earnings for all production and nonsupervisory workers (AHE-P&NS) or wages and salaries in the Employment Cost Index (ECI) (*Fig. 6* and *Fig. 7*). The former is available monthly since 1964 and accounts for about 80% of payroll employment, while the latter is quarterly and available since mid-1975 (*Fig. 8*). Here are their latest readings:

(1) AHE-P&NS rose 4.7% y/y through June. It is down from last year's peak of 7.0% during March.

(2) ECI wages and salaries rose 5.1% y/y during Q1-2023, down from last year's peak of 5.7% y/y during Q2-2022.

In his recent press conferences, Powell has said that he would like to see wage inflation down to around 3.0% y/y, consistent with 2.0% price inflation plus 1.0% growth in productivity. Then again, at his May 3 *presser*, he ambiguated as follows: "I do not think that wages are the principal driver of inflation. … I think there are many things. I think wages and prices tend to move together. And it's very hard to say what's causing what. … I've never said that … wages are really the principal driver, because I don't think that's really right."

Calendars

US: Tues: Headline & Core Retail Sales 0.5%/0.3%; Headline & Manufacturing Industrial Production -0.1%/-0.2%; Capacity Utilization 79.5%; Business Inventories 0.1%; NAHB Housing Market Index 55; TIC Net Long-Term Transaction; API Weekly Crude Oil Inventories; Barr. **Wed:** Housing Starts & Building Permits 1.450mu/1.495mu; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. (Bloomberg estimates)

Global: Tues: Canada CPI 0.3%m/m/2.9%y/y; Ramsden. ¥46.7b; Australia Employment Change 17.0k; Australia Unemployment & Participation Rates 3.6% & 66.9%; Mauderer; Ramsden. **Wed:** Eurozone Headline & Core CPI 0.3%m/m/5.5%y/y & 0.3%m/m/5.4%y/y; UK Headline & Core CPI 0.4%m/m/8.2%y/y & 0.4%m/m/6.8%y/y; UK PPI Input & Output Prices -3.3%y/y & 1.6%y/y; Japan Balance –¥46.7b; Australia Employment Change 17.0k; Australia Unemployment & Participation Rates 3.6% & 66.9%; Mauderer; Ramsden. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell last week for all three of these indexes simultaneously for the first time since the April 7 week. That typically occurs in the beginning of the quarterly reporting seasons. While none were at a record high for a 55th straight week, all three are up from their lows during February and March. Through the week ending July 14, LargeCap's forward earnings is 2.7% above its 54-week low during the week of February 10. MidCap's is 3.1% above its 55-week low during the week of March 10, and SmallCap's is 1.8% above its 72-week low during the March 17 week. The forward earnings downtrend since mid-2022 for these three indexes has been relatively modest this time around compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. LargeCap's is now 3.3% below its record high at the end of June 2022; MidCap's is 5.3% below its record high in early June 2022; and SmallCap's is 12.1% below its mid-June 2022 record. Forward earnings momentum remains near two-year lows. The yearly rate of change in LargeCap's forward earnings was negative for a 24th straight week, and up to -3.1% y/y from a 29-month low of -3.2% y/y during the June 23 week; that compares to a record-high 42.2% at the end of July 2021 and is up from -19.3% in May 2020, which was the lowest since October 2009. MidCap's rate of -4.5% y/y is up from a 31-month low of -5.9% in early June, which compares to a record high of 78.8% in May 2021 and a record low of -32.7% in May 2020. SmallCap's -9.6% y/y rate is up from a 32-month low of -12.9% a week earlier, down from a record high of 124.2% in June 2021; it compares to a record low of -41.5% in June 2020. Analysts' consensus earnings forecasts for 2023 and 2024 had been heading steadily lower since last June, but 2023's estimates briefly ticked higher during the Q1 reporting season as analysts incorporated the strong earnings beats into their forecasts. Here are the latest consensus earnings growth rates for 2023 and 2024: LargeCap (-0.4% and 12.6%), MidCap (-10.7, 13.2), and SmallCap (-9.9, 13.2).

S&P 500/400/600 Valuation (*link*): Valuations rose for these three indexes through the July 14 week. LargeCap's forward P/E gained 0.5pt w/w to 19.4 from a 15-month high of 18.9. It's up 3.9pts from its 30-month low of 15.1 at the end of September, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E rose 0.4pt to a 19-week high of 14.1, but remains 0.6pt below its recent 10-month high of 14.7 in early February. It's now up 3.0pts from its 30-month low of 11.1 at the end of September, which compares to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E rose 0.4pt to a 19-week high of 13.7, which compares to a 19-week low of 12.5 during the May 12 week and is now 0.6pt below its recent 12-month high of 14.3 in early

February. It's now 2.7pts above its 14-year low of 10.6 at the end of September and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's 27% discount to LargeCap's P/E remains near its 24-year-low 30% discount during the June 23 week. It had been at a 21% discount during the March 17 week, which was near its best reading since November 2021. SmallCap's 29% discount to LargeCap's P/E last week is not much above its 21-year low of 32% in April 2022. That compares to a 22% discount during the March 10 week, which was near its lowest discount since August 2021. SmallCap's P/E had been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for a 109th straight week; the current 3% discount is near its lowest since July 2021 and an improvement from its 20-year-low 9% discount in December 2021.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Following the Q3-2020 earnings season, when the US economy emerged from the Covid shutdown, analysts began raising their consensus forecasts for future quarters instead of lowering them as is the historical norm. That six-quarter streak of positive revisions throughout the quarter ended during Q1-2022, and the estimate declines accelerated considerably for the three quarters ending through Q4-2022 before easing for Q1-2023. Looking ahead to Q2-2023, analysts are forecasting that the S&P 500's y/y earnings growth rate will mark its cyclical bottom with an 12.0% decline, down from -2.8% y/y in Q1-2023. On a pro forma basis, they expect the y/y earnings decline to bottom at -8.1% in Q2, down from a 0.1% gain in Q1-2023. S&P 500 ex-Energy earnings are forecasted to be down 2.6% y/y in Q2-2023, down from the 1.6% decline in Q1-2023 and the 7.4% drop in Q4-2022. Six sectors are expected to record positive y/y percentage earnings growth in Q2-2023, up from five sectors doing so in Q1-2023 and only two in Q4-2022. Here are the S&P 500 sectors' expected earnings growth rates for Q2-2023 versus their final earnings growth rates for Q1-2023: Consumer Discretionary (28.5% in Q2-2023 versus 56.2% in Q1-2023), Communication Services (8.9, -8.9), Financials (8.5, 7.7), Industrials (7.4, 27.1), Consumer Staples (2.7, 0.4), Utilities (0.4, -21.8), S&P 500 ex-Energy (-2.6, -1.6), Information Technology (-2.9, -8.3), Real Estate (-5.0, -6.2), S&P 500 (-8.1, 0.1), Health Care (-28.8, -14.8), Materials (-30.8, -22.2), and Energy (-46.9, 21.0).

US Economic Indicators

Regional M-PMIs (*link*): The New York Fed has provided the first glimpse of manufacturing activity for July, which held relatively steady after big swings in activity during the first six months of this year. July's *composite index* slipped 5.5 points to 1.1—following wide monthly swings the first six months of this year, from January through June of -21.7, +27.1, -18.8, +35.4, -42.6, and +38.4. The new orders (to 3.3 from 3.1) component was little changed in July, while shipments (13.4 from 22.0) expanded at a slower pace than June. Meanwhile, *delivery times* (-6.9 from -1.0) continued to shorten in July, and inventories (-10.8 from -6.0) continued to contract. As for the labor market, the *employment* (4.7 from -3.6) measure showed factories hired workers for the first time in six months, while *hours worked* (0.3 from -5.8) was little changed. Turning to *prices,* the prices-paid (16.7 from 22.0) measure continued to ease, posting its slowest pace since August 2020, while prices-received (3.9 from 9.0) was the slowest since July 2020. Both price measures are down sharply from their record highs of 86.4 and 56.1, respectively, during April and March of last year. Looking ahead, *the index of future business conditions* remained on an upward trend, in expansionary territory, though edged down from 18.9 to 14.3; its recent bottom was -6.1 in November. Both new orders (11.0 from 13.8) and shipments (12.0 from 17.9) are expected to increase modestly, while delivery times (-10.8 from -12.0) are predicted to continue to shorten. Employment (13.2 from 15.1) should increase at a steady pace.

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