Episode 07

Economy going at the speed of light – what could go wrong?

Kara O'Halloran (00:00):

Welcome back to Fireside, a podcast from FS Investments. I'm Kara O'Halloran. I'm a director on our investment research team here, and I think I'm going to start calling this the Kara and Lara show because we are once again, joined by Lara Rhame, our chief US economist. Lara, how are you?

Lara Rhame (00:20):

I'm great. Oh my God, we have so many amazing people to bring into our podcast, but I have to say, I've been enjoying our one-on-one conversations. These have been so much fun.

Kara O'Halloran (00:29):

I know. We'll spread the wealth a little bit soon, but it's been great. So given what we're talking about today, it does make sense that we've had you on for the last few episodes. The economy is moving so quickly, it's changing really rapidly, so we have needed a lot of updates from you recently to really help us sift through all of the noise and all of the data. But today we want to take a step back and look at the fact that we are moving so quickly and really what that speed means, and then more specifically, the risks that come with an economy that is moving this quickly.

Lara Rhame (01:00):

Yeah. Something that I try to put across so clearly to people is the consensus forecast of 2021 growth of over 6%, and then 2022 growing at 4%, these are growth rates that are three times higher than where our economy is sort of built to grow. I compare it to my 12-year-old Volvo, it's a workhorse, it's a great car, but no matter what kind of gas you put in it, no matter what kind of road you lay before, it does not like to go above 95 miles an hour, full stop. I mean, if you're on a slanted racetrack with high premium fuel, it can maybe get up to a little bit more speed, but it's not going to be able to sustain that.

Lara Rhame (01:56):

When I think of our economy right now, I just am writing a chartbook that's going to go out at the end of the week, and I'm really talking about the fact that our economy is traveling at light speed. Our economic cycle is moving at light speed. Our financial cycle has already moved at light speed. Not only are things getting faster, but the fact that our economy is growing so fast, I think you're going to start to see some structural constraints, and just to really remind people that for our economy, this is such a terrific speed of growth.

Kara O'Halloran (02:35):

Right. So I'm looking at this list that you sent over and as you said, you'll be publishing it. So maybe first you can not quite at light speed, but rapid fire, list the five things that you see that could go wrong with the economy moving this quickly, and then we will dig into them for the rest of the episode.

Lara Rhame (02:52):

Totally. I mean, the first thing that we really look out for closely is labor markets, and sort of that job gap closing. The second thing that can really happen when the economy is moving so fast, at possible risk of

overheating, are frothy markets, and that can come in a couple of different places. And I think alongside of that, the third thing is keeping a close eye on leverage. And I think today, I'm focusing on corporate leverage. And the fourth thing obviously, I mean, is inflation. It's a tremendous issue right now, and it is sort of the target of where all of the attention goes when the economy is racing at such a strong level above our potential growth.

Lara Rhame (03:40):

And finally, of course, policy error. It's way too early to start talking about a recession but when you look historically at prior recessions, what has preceded them? Rate hikes that have gone too far, some kind of other policy misstep that has caused our economy to really sort of break and contract a little bit. So those are, I think the five things that we need to start thinking about now, even though our economic growth right now is very solid and very strong.

Kara O'Halloran (04:15):

Right. All right, so let's dig in a little bit. So today is May 18th, so we are just one week past the big job's miss about a week and a half ago. The economy only added 266,000 jobs in April, instead of the 1 million that were expected. We would constantly hear how hard it is for certain businesses, especially restaurants or leisure and hospitality, I have family in the restaurant business and they cannot get anybody to work, we hear how hard it is for people to get staffing. So maybe we can talk a little bit about that, that mismatch there.

Lara Rhame (04:46):

Absolutely. I think this is a good example of when we try to push our economy to such a strong growth rate, there are natural constraints that happen, and you layer onto that the fact that COVID and the pandemic caused a huge shift in labor market demands, trends, preferences. We've seen this huge mismatch be created with we see job wanted, the JOLTS data shows that there are over 8 million job openings right now. That's a record high, and coincidentally is about the same amount of jobs that we have still lost and have yet to recover.

Lara Rhame (05:31):

On the other side, you have low labor force participation, you still have people with health concerns. You have more demand for truck drivers and less demand for concert workers. There are a lot of shifts in the labor market, which I like to remind people is the least efficient market in the US, that are just going to take time. And that is a good example of where the pace of our growth could really be hindered just by some of these structural constraints and changes on the back of COVID.

Kara O'Halloran (06:05):

Yeah. I mean, I think the past year has really fundamentally changed the way so many of us live our lives. And even, I think we saw so many people leaving big cities, I imagine that there's an issue there. People left New York City and they can't go back to work at the restaurant there.

Lara Rhame (06:22):

That's right.

Kara O'Halloran (06:23):

Yeah. I'm actually going to a restaurant this weekend that hired a... Not even hired, has a robot server because they couldn't get people to work.

Lara Rhame (06:31):

Whoa.

Kara O'Halloran (06:32):

I know. I'll have to report back.

Lara Rhame (06:34):

Exactly. We're doing a podcast on that. [crosstalk 00:06:37].

Kara O'Halloran (06:37):

I know, I know. I'll livestream from there. Anyway, so moving on, I think the next one that you cited was frothy markets. Valuations are high, no matter where you look really, across markets, equity, fixed income everywhere. So what are your thoughts there?

Lara Rhame (06:55):

Yeah. I think this is an issue because in addition to the frothy markets, we've seen several other facets evolve within the household and household finances. Households now have a greater percentage of their wealth invested in equity markets than they have historically. So obviously, sort of the 50th percentile is very, very elevated. The 10th percentile and the 1 percentile of wealthy households hold by far and away the most equities, and you're seeing their concentration inequities be at record highs.

Lara Rhame (07:41):

In addition, you have an enormous cohort, the baby boomers, that have saved and have a lot of their savings in equities. So all of this speaks to number one, the fact that we've had so much liquidity, so much growth and such strong earnings performance over the last four quarters, that I think we really see these markets just racing ahead. But looking forward, the earnings profile growth rate is expected to moderate. Again, staying strong, but decelerating, and that is an uncomfortable place for markets to be.

Lara Rhame (08:19):

I think it's one of the reasons why we've really struggled to make new highs over the last couple of weeks. And I think it really speaks to broad economic vulnerability to valuations that are as high, we haven't seen valuations as high since the dotcom bubble. Very different markets, I'll grant you, but it's something that can go wrong when the economy is this strong.

Kara O'Halloran (08:44):

Yeah. Especially if, as you talked about, the growth forecast that we have for this quarter and we're halfway through the second quarter, this is as good as it's going to get, basically. The forecasts are going to go down from here and, and markets are forward-looking.

Lara Rhame (08:58):

That's such a good point.

Kara O'Halloran (09:00):

Yeah. Let's move onto corporate leverage. We wouldn't be surprised to see corporate leverage increase really in the middle of a recession, especially as we get that hit to earnings. But maybe you could talk a little bit about where we are now, why you're really closely watching corporate leverage.

Lara Rhame (09:15):

Yes. I think corporate leverage shows an interesting trend throughout the business cycle. Typically, corporate leverage falls throughout, and you sort of think about it, right? The top line is total debt outstanding, and then the denominator is operating profits. So typically, as we have an expansion, leverage falls throughout the expansion and that often happens because profits grow. The denominator's growing, so the whole thing is falling and you see it really rise sharply as we go. As a business cycle winds down, corporate leverage usually rises and during a recession, it really rises. And that makes a lot of sense, right? During a recession profits usually fall more significantly, and so you get leverage higher.

Lara Rhame (10:08):

Well, we're about 7X right now, seven times leverage, which is again, the highest that we've seen, really sort of matching the all-time high that we saw in the 2001 recession. And I think what is noteworthy is that this time around it's really been driven, that higher leverage was driven by a different set of factors. Profits have been solid throughout this episode, but debt has risen so much. Corporate debt has just exploded, and that has what has driven this higher leverage.

Lara Rhame (10:49):

So think about what that means going forward. First of all, debt, interest payments are very manageable because interest rates are so low, but it leaves corporations highly vulnerable to any change or step back in credit markets, which is your area of expertise. I know that's not something that's in your forecast, Kara, but it still is a growing vulnerability that is really different than anything that we have seen historically in recessions or at the beginning of a new recovery.

Kara O'Halloran (11:24):

No, I was just going to say in credit markets, I think we're definitely watching this. I think kind of our view is that given where rates are, we're not surprised that companies did issue a lot of debt over the last year. I think also, they needed to shore up their liquidity in the height of the crisis last year. And for now ,it's really extended maturities. We've kind of pushed back that maturity wall a good deal, but I think it's definitely something that we are watching, paying very close attention to.

Lara Rhame (11:51):

Well, yeah, and especially we need business investment to be a part of really continuing to drive our economy forward over the next several years. Right now it's being driven by consumption because of stimulus payments, because of amplified unemployment insurance, because people have been saving because they couldn't go out and spend. But looking forward, one year, two years, three years, we really need business investment to really pick up the baton. And I think that's a place where maybe as the fed contemplates possibly raising rates, or as growth decelerates, any number of things can move credit markets off of these pretty significant tights that we're at right now. And I think that to me, is really something that I want people to have on their radar, that the leverage cycle this time around has been really unique and different from prior leverage cycles.

Kara O'Halloran (12:52):

Yeah. Definitely something to pay attention to. Okay. So I wanted to save a lot of time for our next one. It's inflation. Really hot topic, especially, we talked about the labor market, possibly some wage pressures there. I'm seeing reports often. I think McDonald's is raising their wages. Amazon was offering signing bonuses. That on the consumer side, the inflation data was certainly a hot topic last week. We saw CPI jump more than expected. So walk us through what we should be paying attention to right now with inflation, or the risks that you see when it comes to inflation.

Lara Rhame (13:26):

I mean, interestingly, such a hot topic and I feel like very little consensus around inflation going forward, which is kind of exciting as the economists. You got to really watch it all evolve and, of course, I have my opinion. The way I really break it down, Kara, is that higher inflation right now, inflation is rising, full stop. Is higher inflation right now, technical due to base effects? This time last year, inflation plunged, so really even a trend-like monthly gain is going to cause it to surge higher, just to offset that calculation. Is it transitory? We know that there've been supply chain disruptions in semiconductors, as an example, which really limited new car production, which meant that everybody has now pivoted to used cars because everyone also has cash and all of a sudden people need to drive to work again. They may not want to take public transportation. And all of that pushed used car prices in just one month up 10%.

Lara Rhame (14:31):

I mean, it's a small part of the overall index, but just a few of these small sub-indices saw extraordinary leaps that really pushed monthly CPI and core CPI rose 0.9%. I think that was the highest month of gain in 40 years. So that's an example of a transitory cause of inflation. I think a lot of people look at that and say, used prices are not going to go up 10% every month. That's not going to be a sustained increase. It's painful right now. Tt's causing everybody to really, I think worry about the monthly numbers, what it looks like annually, but it's transitory.

Lara Rhame (15:15):

The next issue really is structural, and I think that is where there is not as much consensus. Inflation has been on a structural deceleration. We've had disinflation for decades now driven by low growth, by low demographic growth, a lot of things, globalization, a lot of these enormous structural forces have caused inflation to fall. Has that reversed? My view is more that we're kind of in this mini cycle where we are going to get inflation for the next couple of years, but it's unclear to me what that looks like, if that's really going to move the needle on these sort of tectonic, I like to call, structural forces that are just kind of immovable. They're moving on their own and you can't really impact them very easily.

Lara Rhame (16:10):

Among all of that, I think it's important to notice that inflation expectations have risen to depending on what you like to look at, some of them are at 2.5%, the ten-year breakeven. We haven't been there in 10 years. The five-year five-year forward, my favorite market measure, it's at 2.3%. That's a seven year high. So I think that's something that we're going to continue to be watching because it's not just sort of what your monthly CPI forecast is. It's what markets are really starting to price in and anticipate for the long run. That has really important implications for real yields, for the 10-year treasury, for a lot of other parts of the market. And wages, to your point, are also rising. I think that's part of the labor supply demand mismatch, but is that temporary or is it permanent? I think these are the questions that have caused such disagreement among the consensus, which is healthy in my opinion.

Kara O'Halloran (17:19):

When we're getting all excited about disagreements over inflation, we know we have not been out much over the last year. We did a full episode a few weeks ago, talking about inflation and agreed that there would be some near-term based effects working themselves out, but it kind of sounds like the longer-term is still extremely muddled. So the final thing that you have listed that can go wrong is policy. The economy is so strong right now, growing really rapidly, but there are some signs that we're overheating. So what can go wrong in terms of policy?

Lara Rhame (17:52):

Well, of course that is the thing that can go wrong. And I think in the publication I'm putting out at the end of this week, I think looking at historically, at prior recessions, episodes where the fed has raised rates too fast, too far, have been mistakes that have interrupted our business cycle. I mean, we have very recent examples of this. In 2017, the fed kept on raising rates and in 2018, had to bend a knee and acknowledged that they had overreached, and they quickly cut interest rates. That was a rare example of I think really walking back a policy mistake in the nick of time. But that's kind of the reason often why we experience recessions.

Lara Rhame (18:55):

I'll say this fiscal policy has a role to play here too, because we're talking about enacting a lot of infrastructure spending. I have come on this podcast many times and talked about the need for infrastructure spending, that the need to add to productivity to our economy by smart investment spending. And the problem is the timing couldn't be worse. We know we're having a labor demand mismatch. A lot of these projects take, for example, refurbishing water systems in cities, which

Philadelphia badly needs, by the way, that is a labor intensive project. Where are you going to find the people? Home builders can't find people, manufacturing, they can't find people. So you're just seeing job shortages all over.

Lara Rhame (19:50):

Say you do get massive infrastructure spending. It causes wages to rise even more. Again, I think when we're at a place right now where the economy is so strong and there's really clear consensus that that is going to continue, what we need to do now is to look beyond. What are the consequences of this strong growth? And that's where I sort of come back to the worst case scenario, where it could cycle back on itself and actually end up prematurely ending our business cycle. That I think is at the end. It's the number fifth thing that can go wrong, but on the tier of concerns, it's number one.

Kara O'Halloran (20:37):

Lara, thank you again for joining us. I think that was a great conversation. I think we all know that the economy is moving quickly and there's a lot of optimism out there, but important to always be paying attention to some of the risks that are lurking. So thank you. Thank you so much.

Lara Rhame (20:54):

Absolutely. Enjoy your robot dinner. I can't wait to hear about that. [crosstalk 00:20:57].

Kara O'Halloran (20:56):

I certainly will. I imagine I'm going to get a drink or two dumped in my lap somehow. I don't know, we'll see.

Lara Rhame (21:02):

That could be our productivity solution.

Kara O'Halloran (21:04):

I'll report back.

Lara Rhame (21:07):

Thanks, Kara.

Kara O'Halloran (21:08):

Thanks, Lara.

Speaker 3 (21:14):

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