FAIRPORT FLASH
AN INVESTMENT PODCAST

Episode #39: A Deep Dive into the Economy with Neil Dutta

Annika Traner:

Welcome to another episode of Fairport Flash. This is Annika Traner, Digital Marketing Manager, bringing you the latest insights from the Fairport investment team. Joining me in the studio today are Chief Investment Officer John Silvis, and our very special guest, Neil Dutta, a partner and Head of Economic Research from Renaissance Macro Research. As Head of Economic Research, Neil leads RenMac's macroeconomic research efforts with an emphasis on analyzing the US economy, Federal Reserve, global trends, and cross market investment themes. Thank you for joining us today, Neil.

Neil Dutta:

Thanks for having me on.

John Silvis:

Hey Neil, I appreciate you coming on and talking about the economy. Never a dull moment, but I thought before we start talking about where we're at today, we can kind of go back a little bit. So about this time last year in 2023, most economists were calling for a recession somewhere in the middle of '23, I would say it was an overwhelming majority of your colleagues, but you were one of the outliers. You didn't really think we'd see a recession. What made you make that call? And obviously, it turned out that you were right.

Neil Dutta:

Well, thanks for that. I think a few things. I mean, number one, it's important to remember why recession risks rose so much in the first place, and that was because we had a big spike in food and energy costs triggered by the Russian invasion of Ukraine. And at the same time it was aggressively hiking interest rates. I mean, remember they at first ruled out 75 then ended up going 75 basis points of meeting for several consecutive meetings. So that's the time to be very cautious is when you have rising food and energy prices alongside a tightening fed. And by the end of the year, this is the end of 2022. That was rapidly changing. Remember, by the end of 2022, gasoline prices had basically round tripped to where they were to start the year. So you went into the new year with a very strong tailwind for household incomes.

In other words, inflation was slowing more rapidly than the labor markets, and that boosted real incomes. And then guess what people did with that money? They went out and spent it. And then earlier in 2023, because inflation was coming off because the fed was kind of taking baby steps to the exits, the bond markets kind of repriced the fed somewhat. And you have all sorts of people, all sorts of trades being put on with the pause, fed pause, and you had a rally in the fixed income markets and that rally in fixed income drove a substantial pickup in the housing market. So you had mortgage rates going from seven to six and a half, and that unlocked a lot of housing market activities. So that was a big driver for a lot of the concern in 2022. And that kind of went away very quickly in 2023, at least in the early part of 2023.

And then finally remember that the government was a substantial tailwind, whether that was in local government spending and investment, the federal government was boosting GDP growth. So you had a variety of tailwinds out there that kind of kept the economy on even peel. So that was why I thought recession was unlikely. It really started with the consumer. It it's unusual to have real incomes expanding and the economy going into recession. So that's why I was sort of surprised about how firm everyone was on the call. And then by the third quarter of last year, it was clear that the fed's heart was no longer in it. I mean, initially they believed that recession was needed to quell inflation and now they no longer do. And that's a good thing because it's clear that inflation can moderate somewhat without the Fed having to induce a much higher rate of unemployment. So I think that's welcome and those are sort of the reasons why I didn't see a recession. Yeah.

John Silvis:

Well, no, your call was spot on. So one other thing from 2023, and then we'll move into the present here, but we also had a little banking hiccup in March of last year, starting to hear a little bit of conversation. Was it New York Community Bank they're talking about now with some of the commercial real estate? Do you see that as a hiccup or a repeat from what we saw last year and that crisis we had in 23, do you think that's worked its way through the economy and that's kind of a past event, or is that still lingering?

Neil Dutta:

Well, I think banks, I mean to the extent that it matters, it matters less, right? Sequentially, the shock from it is probably evading. We know that banks spent much of the last year beefing up their balance sheets, provisioning more for potential portfolio losses and so forth. But I think the larger banks in particular, they're provisioning for an unemployment rate that's supposedly going to go up to like 5% by the end of this year. I mean, I find that highly implausible. So we may be in a situation where they're actually a little bit too cautious on the outlook, and if the unemployment rate doesn't rise as much, then there might be reason for them to loosen lending standards over the course of the year. So I think that that'll be something to watch. And certainly if the Fed's cutting interest rates this year, that should normalize the yield curve, right?

I mean, if you're assuming let's say three to four 25 basis point cuts, I mean, that'll probably take care of the yield spread. And if the yield spread is positively sloped, again, you'd expect to see things like mortgage spreads compress and lending standards fees. So that's kind of where I'm at. I mean, certainly it's something that we watch. The regional banks have been a problem because of what's going on in the commercial real estate markets. But I think the Fed has also shown that it can very quickly deal with crises that pop up in the banking system, like coming up with some kind alphabet super program to basically allow banks to borrow cheap money from the Senate.

John Silvis:

So as we get into 2024 here, we're only about six weeks into the year already, but Chairman Powell's been all over the place. So we had the Fed meeting earlier, earlier in January. We had the jobs number come out stronger than expected, I think the opposite of last year. Most economists out there now kind of embracing the soft landing scenario as we get into what will eventually be some type of rate cut process. And then the biggie was Chairman Powell did his 60 minute comments, so maybe taken one by one. What was your thoughts on the job number? They obviously came out stronger. Was that a one-off? It looked like the revisions were stronger. Is that just another indication the economy really is picking up again? I mean, obviously the third quarter you mentioned was really, well, fourth quarter was above trend. Do you see that continuing? And you already mentioned the unemployment rates, so maybe you already tipped your hand, but do you think those numbers are stronger, stronger for a reason? Or was that just kind of an outlier?

Neil Dutta:

I mean, I think it's a little bit of both. It probably over January was a really sloppy month. I mean, you had lots of people out, normally employed, people that weren't at work due to bad weather. So that probably weighed on things like the work week. So the number, I mean, look in any month, there's no jobs number is perfect, right? I mean, even in the best labor markets, folks with a Bears predisposition can find some nook or cranny in the jobs number to kind highlight, oh, the birth death model. Oh, median duration of employment. It's like the list goes on and on, generally speaking, I mean, I think the best way to look at this is just take jobs, the work week and hourly earnings and what does that tell you? And if you look at that number, it's growing at about 5% at an annual rate over the last three months. So that's basically a rough proxy for the labor income that's being generated from the labor market, the income for the private sector, that's fine. I mean, that's more than enough to keep consumer spending on sort of an even keel. But I think you mentioned that the markets are kind of embracing the consensus.

I think the markets are sort of embracing the soft lending. Now that's become the consensus. But keep in mind, I mean there's a lot of upside to GDP growth expectations for the consensus. If you look at, I'll tell you, I'm looking at my Bloomberg screen right now. This is Q1 of this year through Q4 of this year, annual rates for real GDP growth in the us, 1.51, 1.5, I mean, so the consensus doesn't see growth stronger than 1.5% at an annual rate in any of the next four quarters. I mean, think about that for a second. That is a thirdly weak, especially considering if you look at now cast for the first quarter. I mean if you believe the Atlanta Fed we're north of three and a half, so it's a little bit, I think people are getting caught off sides on growth. Now, does that mean that the Fed is going to be hawkish?

Well at the margin, yes, but I don't think that stops rate cuts from happening. I mean, one of the ways I think what's going on is that the consensus is underestimating productivity growth, right? I mean, this is typically what happens when productivity is growing is that the consensus has a habit of going into the year very, very cautious on growth. And as by the time the year's over, they've revised up their expectations quite rapidly. This is something that was happening in the nineties also. Now, it might be too soon to tell whether that's the case here, but clearly people have underestimated productivity, which is why inflation's been falling more rapidly than people have thought, even with the strong growth. And I think that there's some room for that to continue. I mean, growth is okay. I kind of assume that it's going to be something around two to two and half percent, but I think inflation is continuing to moderate, and I think the markets have kind of lost sight of that recently. But when you look at things like used car prices, those are coming down, shelter prices, those are coming down, that's going to matter for core inflation, and the Fed can only ignore that for so long. So this is one of the reasons why I've said even if they don't hike in cut in March, sorry, they'll probably use March to set up a cut later mean, but the threshold is the bar is very, very high for them not to cut before June.

John Silvis:

I want to go back to the rate cut scenario, but you mentioned something, you mentioned the nineties, and then you mentioned productivity. So you'd have to be under a rock not to hear people talk about AI or artificial intelligence and how that's the new economic boom. I've heard it compared to the internet, internet taking off in the mid-nineties. Think is that an economic boom? Is that going to be the next productivity driver?

Neil Dutta:

It could be, but I would just say that that's probably not the reason why productivity is picking up right now. I mean, think there's the old quip about the solo paradox. I mean, productivity is everywhere except for the economic statistics. So my experience is that typically when you see these things happening around you, that's not when the peak productivity shows up in the economic data because it takes time for people to learn and understand and extract the most value out of all the new technologies that are out there. So if it's ai, I mean, we're not going to notice that until maybe a few years from now. I think what's driving the productivity right now is something a little bit more simplistic, which is that people aren't quitting their jobs to the same degree they were a year ago. I mean, if someone is quitting their jobs every two months in search of a new one that's paying them more, I mean, how can you establish labor productivity in that environment? You have to actually keep the seat warm in order to get productive in the job. Right?

John Silvis:

Yeah, that's a good point.

Neil Dutta:

Good point. And so I think now that that's happening, it's probably providing some dividend for productivity. And I think we're getting a little bit more used to our working from home arrangements and so forth, and maybe that's providing some tailwind for productivity, although there could be some kind of a mix shift there where you're kind of driving up the productivity of more mid-level and somewhat more experienced workers at the cost to lower skilled or newer workers. Because I think being in the office definitely helps younger workers more than middle aged or older workers. But generally speaking, I think it's because people haven't been quitting their jobs as much and they're occupying their roles for a longer period of time, and that's bound to have some effects on productivity in a positive way.

John Silvis:

So you mentioned the rates. I guess before we get into that CPI or the consumer price index came out recently. I know the Fed looks at PCE, which is personal consumption expenditure, a little different, but it seems like the three- and six-month numbers, if you just take those and annualize 'em are definitely trending towards that below 2%, which I think is where the Fed wants to go. It's been rumored or the Fed looks at those more than they look at the 12 month annualized numbers. So do you think, going back to when the fed cut comes, it seems like Chairman Powell ruled out March, and he pretty much said that during the 60-minute interview, although you did say in one in your piece earlier this week that it's not totally out of the question, but it seems unlikely. I look today it's

Neil Dutta:

20%. For me, it was as John, it was my base case earlier, and we kind of stuck our neck out at the end of last year on March, and it was working out pretty well until PA had to go open his mouth. But look, I mean, I wouldn't just say the data's already there. You know what I'm saying? I mean, the data's already there by his own admission because he is not even, I mean, inflation over the last three months on core PCE is 1.5% at an annual rate for the last three months. For the last six, it's 1.9. Okay, so basically we've It's there. Yeah, the data are cooperating, not even, I mean at the margin they've become somewhat less data dependent. They're just time dependent. March feels too soon. It's not the data, it's a little too soon. That's all he's saying. He wants to wait because he wants to take out some insurance on the prospect of inflation kicking back up again. I think the problem with that logic, quite frankly, is that if inflation were to kick back up, you wouldn't know it even by May. I mean because there's such a pipeline of disinflation from things like Rent, it's too soon to even think about it popping back up.

John Silvis:

So is that the one thing holding things back, the rent number that you hear that owner's equivalent rent a lot, and I guess it's showing up some places, but it takes longer to percolate through the official numbers?

Neil Dutta:

I don't even think it's that. No, I think what's holding them back, frankly, is the economy's growing really strongly in real terms that's holding them back. It's not the inflation data.

John Silvis:

I mean, in other words, the fear of being Alfred Miller, is that the idea?

Neil Dutta:

You could make the argument now that at some level, maybe the Fed put his back, right? Because it wouldn't take a lot in terms of growth, weakness or financial condition tightening for the Fed to come in and start cutting because they've basically achieved their inflation goals by their own admission. All they're really saying is we're confident. We just need to get a little more confident. It's very vague and opaque by design. So he hasn't, I mean, Powell's even said that inflation doesn't actually need to get better. We just need to see more or less, more of the same.

And so look, as I've said, there could be a big downside surprise in the inflation data at some point in the next two months, and the market could be pricing maybe a 40% chance of a march cut by then. I mean, it's hard to know. That's why I say you can't rule it out completely. But I do think that we're probably going to see some recalibration of policy this year. And I think the big story is whether that comes in May or June or March, you have sort of a ceiling on how many cuts the Fed will do. I don't think it'll be, frankly, more than four.

John Silvis:

So the dot plots earlier said six, right? And then March two weeks ago, March was 80%. Now I think it's 20%. So do you think it's a later start in probably three to five, but six is probably unlikely at this point, cuts?

Neil Dutta:

Yeah. I mean, if I look at the futures market, the futures market at the moment is coming more into line with the Fed's dots. I mean, the Fed currently sees three cuts and the market's at five. Now, I think I could see a scenario where the Fed is penciling in an additional cut this year because I think inflation's slowing a little bit more quickly than they think. But keep in mind that the bond market is always going to see more rate cuts than whatever the Fed is projecting because bond traders have a habit of, it's just the hedging story. You're basically, you need to hedge against the risk of a big slowdown. And if there's a recession, then obviously the Fed is going to be going more. So your modal outcome might be three your baseline, but it's the tail risks that drive those expectations if it looks like five cuts, six cuts or whatever. So if the fed ends up going three or four times, I mean, you'd still expect the bond market to be pricing in five. And as we get closer to those meetings, those expectations will get priced out.

John Silvis:

So looking forward, and you said earlier you can never rule things out. So if there was one signal out there that would maybe change your mind that, hey, maybe the recession is a higher probability than I'm thinking. I know credit card delinquencies have perked up here. I saw a headline recently. I know your colleague Jeff deGraaf talks about credit spreads and they seem to be pretty solid so far. But do you keep an eye on credit, generally speaking, and then delinquencies and non-performing loans and those things? Is that kind of the canary in the coal mine?

Neil Dutta:

Well, I know people are talking about it a lot. I mean, I would say a couple things with respect to credit. I mean, obviously during the pandemic you had a lot of people getting credit. It was easy to get. And during that time also, you had a lot of people moving up the credit ladder, like formerly subprime folks moving into higher tiers. So that credit step-up process means that the pool of subprime at the margin is less credit worthy. So, the delinquency rates have spiked for subprime borrowers because a lot of the better subprime borrowers have moved up in some respects, the credit chain in some respects, I would say the delinquency rates for subprime is overstated a little bit. I mean, it overstates the magnitude of the problem for that reason. And I mean, look, I think credit historically is something that's episodic. I mean, if the economy is slowing and employment is declining, then credit becomes a big problem that accelerates the downturn. But if that's not the case, then it'll be okay. And the last thing I would say is that you do have this sort of interesting thing where, because mortgage rates have been so low and people are locked in at like sub 3% paper on their 30-year, they're prioritizing paying those off, then their cars.

John Silvis:

I'm in that camp myself. So, I guess I know this is not your area of expertise. Your colleague Steve Pavlik covers policy and politics, but we do have an election coming up, and I know China seems to be always on people's minds. They were very slow as to reopen after the pandemic, and everybody thought there'd be kind of a bump there, and it hasn't really materialized. And then we're starting to hear more and more companies reshoring those jobs or bringing them back home or however you want to term that. Just maybe from the global economy perspective, is China kind of a declining factor out there?

Neil Dutta:

I mean, I think at the margin, yes, a lot of final assemblies already leaked out of China, and it's not having as much of an effect on the global economy, frankly, not even the regional economy. And if you look at some of the Asia economies, they're doing fine, even though China's a mess. I mean, if you look at activity from South Korea or Vietnam exports, Taiwan even, I mean, their export numbers are looking better, even as China's looking somewhat worse. Certainly India has kind of taken up some of the slack in that part of the world also. So do I think China's a problem for global growth? Yes, but it's not the catastrophe that it was like in 20 16, 20 17. I mean, you're not talking about a scenario where the fed's going to be backing off because China's devaluing their currency or anything that, I mean, that was sort of the 2015 that happened back in 2015. So I think it matters a lot for Europe. I mean, the fact that China's emerged as this big auto producer that's kind of taken a lot of the air out of Germans, the European manufacturing base, particularly in Germany. And so I think it's had much more of an effect on the Europeans and Germany, frankly, than it has on the us.

John Silvis:

So one other thing on politics, and then we can move on, but it looks like the general election has been kind of set. And four years ago, all you heard about was tariffs. And then we haven't heard much about tariffs in the last couple years, but I've heard that term pop up again. Does that have a long-term effect on the economy or has it since we, because I don't believe we've rolled any of those back. And is it just kind of something the economy is absorbed or is that something that will be a hindrance going forward if we actually do see more tariffs on China coming after the election?

Neil Dutta:

Well, at the margin, if you have more tariffs on China, you'll probably leak final assembly away from China. It doesn't necessarily mean that you'll be leaking that activity back to the us. I mean, in my work, what you've seen is whenever you have these big tariff announcements, usually what you see is countries like Mexico benefiting. So it's not necessarily that the activity spills back into the US and certainly it would be inflationary for US consumers at the margin. But I always think that trade generally, I think has, I mean there's no law in economics that says trade has to grow at some sort of exponential rate relative to GDP. I mean, back in the nineties, early two thousands, I mean, trade volumes were growing about twice as quickly as global GDP, and now it's basically one for one. That's okay.

It's probably a modest headwind, but I don't think that there's some kind of rule that says that trade has to be growing at some sort of exponential rate relative to GDP. And yeah, I mean, I think it's something that's been probably dramatically oversold in terms of what it means for the economy. Doesn't mean that tariffs are good, but let's see what happens. I mean, I wouldn't be lighting my hair on fire because of tariffs. Obviously, lots of things can happen. I mean, if you recall back during the Trump presidency, what happened, I mean, it was sort of a love hate relationship with the markets and Trump, I mean, the first year of his presidency was sort of a love fest, right? Because he was doing all sorts of things to stimulate the economy, provide relief for companies, corporate tax reform and so forth, lowering the rates, broadening the all sorts of things that companies said they wanted. And then basically Trump, by his own admission, he said, look, now I'm playing with the house money. So basically companies got this huge tailwind for their margins, and then the tariff thing started. And look, I mean, I think we have to kind of wait and see the headlines that you see probably aren't what will end up happening, but I do expect kind of a hawkish sort of approach with China and tariff will probably be one way that they deal with that.

John Silvis:

So we're almost done on time, but a couple of just kind of quick questions, more predictions. So CPI, do you think we get a two handle on it before the end of the year? We're pretty close already, but

Neil Dutta:

Yeah, I mean, I think certainly PCE will have a two handle on it. I mean, I think the Fed will be revising down their inflation forecast in March again. So yes, I think so.

John Silvis:

Okay.

Neil Dutta:

One thing I would point out, it is important for viewers to know that there is a, I mean, remember the Fed looks at PCE and the CPI number is also important. That's released earlier in the data cycle. But the reason the Fed focuses on PCE E, one of the reasons is because it's a wider scope of things, right? So the CPI only measures out-of-pocket expenses. The PCE also measures payments made on behalf of individuals, as an example, like education. Those payments are being made on behalf of people by their local school districts and so forth, or your health insurance, right? Health insurance is made by, in many cases, third party payment that's not included in CPI. And so that's why the Fed looks at PCE versus CPI and PCE for that reason, I think is because it has a wider scope. It means that some of the areas are going to look a little bit more sluggish. I mean, healthcare is a good example. I mean, healthcare inflation and PCE is likely to run much lower than healthcare inflation and CPI, and for that reason, it's probable that PCE converges onto 2% more quickly than CPI does.

John Silvis:

So my last question, a little tongue in cheek here, but so what's going to have a bigger influence on the 2024 economy, the artificial intelligence or Taylor Swift?

Neil Dutta:

That's a great question. Well, on the 2024 economy, it depends. We got the Super Bowl coming up next week. If the chiefs are able to pull it out and he gets on bended knee and proposes to it right there on the field, that could do it.

John Silvis:

That's 2% right there.

Neil Dutta:

You'll probably get a baby boom in the US starting at some point in 2025.

John Silvis:

Okay. All right. Well, hey Neil, I really appreciate the time. This has really been insightful. Our clients and viewers really appreciate this. I appreciate the time you have and best of luck to you guys between now and the end of the year, and we'll keep in touch.

Neil Dutta:

Alright, thank you.

John Silvis:

All right. Thank you very much.

Annika Traner:

And that concludes another episode of the Fairport Flash. Thank you again to Neil for being on the show today and for sharing your thoughts and insight. As always, if you have any questions on the topics discussed today, please don't hesitate to reach out to a member of your Fairport Wealth team. For the latest updates from our investment team, follow us on LinkedIn, Facebook, or Twitter, and look for the hashtag, #InvestingWithFairport. Thank you for listening, and we'll see you next time.