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Does The Economy Need A KISS?

Economists that attempt to forecast the direction of the U.S. economy tend to be less than stellar. Are their models wrong, and if so, is economic forecasting a fool's errand?

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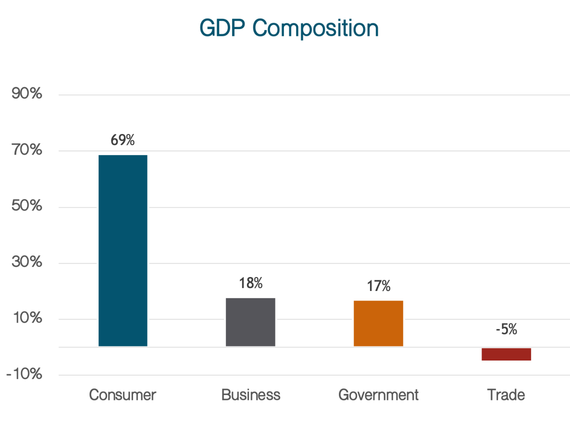
Keeping It Simple

KISS is an acronym for "keep it simple stupid" and was coined by the U.S. Navy in the 1960s. It is a design principle asserting that most systems work best when kept simple by avoiding needless complexity. Few industries have ignored such sage advice more than financial services.

There is no shortage of investment funds that advertise some proprietary economic model run by a team of PhDs comprised of tens or even hundreds of economic factors. The complexity of their model is marketed as a competitive advantage, when in reality, it is often the opposite.

To see why, let's keep it simple and assess the current state and future direction of the economy. The first step is to define the primary drivers of the economy. Gross Domestic Product (GDP) is a commonly used measure of economic growth, and the chart below breaks apart GDP to show its current composition.



Almost 70% of U.S. economic activity comes from consumer spending. Meaning, when we go out to dinner, visit a carwash, or get a haircut, the economy is growing. Add in business spending, and these two represent 88% of the $21 trillion economy. One way to forecast spending is to assess both the *ability* and *willingness* of consumers, and to a lesser extent businesses, to part with their money.

Can We Spend?

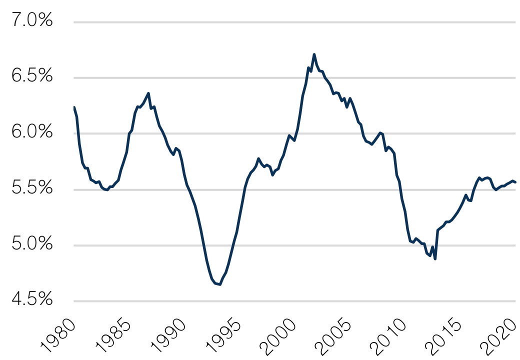
Three factors help determine the ability to spend. The first is access to capital because most large purchases are done on "credit." Consumers buy homes using mortgages and businesses acquire machinery with bank loans. The easier it is to borrow cheap money, the more incentive to buy stuff.

As of June 2020, access to capital has arguably never been better. Interest rates are at historic lows, and banks have plenty of capital to lend. In fact, due to recent stimulus programs, there is a record $3 trillion in excess reserves in the banking system waiting to be tapped[1].

The second factor is the ease at which consumers and businesses can afford debt. For example, if two neighbors have the same $1 million mortgage, but one makes $500,000 a year and the other $50,000, then the neighbor with the higher income should have an easier time making the mortgage payments.

The chart below shows that the amount of disposable income going toward interest payments is rising but still far from a level that would signal imminent danger. Additionally, interest expense, or the amount of earnings used to pay interest on debt, for S&P 500 companies rose slowly since 2015 but remained near all-time lows prior to the recession earlier this year[2].

Consumer Debt Service Payments as a Percent of Disposable Personal Income



Source: The Federal Reserve

The aftermath of the recession will most certainly impact these ratios, but cheap capital is so abundant (per the first point above) that any deterioration in debt affordability should be temporary. For example, consumers with good credit can refinance their mortgage(s) at historically low rates, and companies that want to issue bonds to lock in lower financing costs are being met with an insatiable demand from buyers of all shapes and sizes.

The third factor is profitability. For consumers, wage growth tends to matter most because there must be money coming in the door in order to spend. The economy tends to accelerate when wage growth exceeds inflation because consumers are acquiring purchasing power at a rate faster than inflation is taking it away.

As of June 2020, real wage growth fell 1.7%[3]. That's not good because it indicates consumers are losing wealth, but this may also prove to be temporary. Employment and retail sales have already rebounded sharply since April[4], so the hit to consumer wealth may already be reversing.

Estimates of corporate earnings for the second quarter signal a decline of 45%[5]. This is an almost unfathomable drop in such a short time frame. Even if these estimates prove to be overly pessimistic, the reality is that corporate earnings are bad right now.

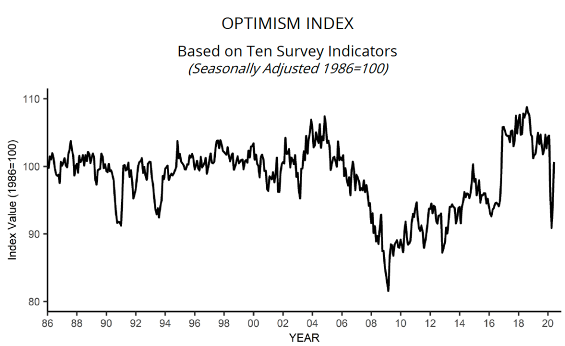
The good news is that earnings should recover faster than prior recessions. Going into the downturn, years of technology upgrades, lower corporate taxes, and better cost controls fueled record high operating margins. This strength should facilitate a speedier recovery in profitability.

Willingness To Spend

Just because we have money does not mean we will part with it. There are three factors that help gauge the willingness to spend, but they must be taken with a big grain of salt.

The first is consumer confidence. The more confident consumers are about today and tomorrow, the more willing they are to spend. As of June 2020, the University of Michigan Consumer Sentiment indicator rebounded sharply from the lows in April (although still down over 20% from this time last year)[6].

The second factor is small business confidence. While the media likes to report stories on the millions of employees at Amazon and Walmart, small businesses drive the majority of employment in the U.S[7]. Therefore, if small business owners feel confident about their future, then they tend to spend more to grow their business, hire more people, and pay them more. The chart below shows that optimism among small business owners was decimated back in April but rebounded almost immediately.



Source: NFIB, June 2020 (https://www.nfib.com/assets/SBET-June-2020.pdf)

The third factor is the recent performance of financial assets (stocks, bonds, real estate, etc.). Wealthy consumers drive the majority of spending in the U.S., and they also own most of the financial assets. Hence, their attitude towards spending tends to be highly correlated with what they already own. If asset prices are rising, so should their net worth and confidence about future prospects.

Asset prices were whipsawed earlier this year, and although many have already recovered, this extreme volatility will likely remain engrained in investors' minds. This could remain a headwind for consumer spending for quite some time.

Add It All Up

The factors used to determine the ability to spend are all ***quantitative***. They use "hard" data (things that can be counted) and tend to be reliable.

The factors for the willingness to spend are ***qualitative***. They rely on "soft" data (often just surveys) and are less reliable. We have to determine what's going on in the minds of consumers and executives and how long they are going to think like this. That is tough to do consistently, and soft data is prone to statistical errors and inconsistent emotional responses that can change fast.

Fortunately, of the two, the ability to spend is most important because this almost always lays the groundwork for longer term trends. For example, if a consumer wants to spend but can't because their credit cards are maxed out, their desire to spend is moot. But if a wealthy consumer chooses not to spend, they at least have the option down the road.

That being said, there is a harmony to how the hard and soft data work together. These six factors are inextricably linked and can paint a picture of where the economy stands today and where it is headed tomorrow. It goes something like this…

> *If small business owners are confident about their future, they pay more to acquire workers. Wage growth rises as employers compete for talent. As consumers' paychecks rise alongside the value of their homes and stock portfolios, so does their confidence. If we feel better about our future and have access to capital, we tend to spend more money, which combined with spending from small businesses, drives the U.S. economy forward.*

Currently, these six factors suggest the U.S. is in the early stages of an economic recovery. The sharp reversal in many of the data supporting these factors explain why we've seen a V-shape recovery since May. But others suggest that this V will probably not continue unabated until the economy has fully recovered. Meaning, it's probably going to be a choppy recovery from here.

The Bottom Line

A reporter once asked why forecasts from the Fed, Congressional Budget Office (CBO), and other government agencies and thinktanks are almost always wrong. The answer consisted of two theories. First, these agencies have access to way too much information. This leads to creating overly complex models, incorporating redundant data, and falling down the rabbit hole into "analysis paralysis."

Second, they are burdened with the "law of the instrument." The economists at these institutions are extremely intelligent. While this sounds advantageous, if all they have is a hammer, everything becomes a nail.

It is a classic mistake that brilliant people make ever so consistently. They know they are smart, others know they are smart, so they feel they must formulate a smart solution for something that probably just needs a KISS.

It's also why Wall Street is packed with salespeople who know all too well that complexity and sophistication translate to quality in the minds of investors (coincidentally driving big profits and fat commission checks).

That being said, simple is not the same as easy. Amazon's website may seem simple to use, but that's because they spent billions of dollars making it that way. There is nothing easy about investing, but the more an investor can simplify the process and remove unnecessary complexity, the better the chances of achieving financial goals.

The bottom line is that not every ant hill requires an atomic bomb. The analysis above used little math, was not created in some fancy spreadsheet, and didn't require a PhD in economics to operate. All we did was observe and estimate a select group of factors that control the singular behavior that drives the U.S. economy, which is spending.

Sincerely,

Mike Sorrentino, CFA

Chief Investment Officer

Sources

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