Capital Markets Group

Points to Ponder

September 9, 2022

The First Tee...

Cruising at 40,000 Feet…the Fed will probably move the benchmark rate close to 4% by year-end…some Fed officials are talking about sustaining higher rates for as long as the next four years:

- Fed Chairman Powell stated last month, to bring inflation back to the 2% target rate the FOMC needs to raise rates enough to push growth below trend for a sustained period:
  - The economy has been over-heated since 2021…this occurs when GDP exceeds potential growth:
    - Potential GDP growth is the expansion rate an economy can sustain over the medium term without creating excess inflation…potential growth has declined in advanced economies the past few decades due the slower growth in labor, capital, and productivity
      - The hot economy was created by outsized fiscal and monetary spending (money creation) in response to the COVID pandemic:
        - This all boils-down to a declining probability the Fed is able to engineer a soft economic landing while fighting 40-year high inflation.
    - Powell is promoting the idea the pain that businesses and households will have to endure is preferable to the Fed failing to restore price stability now, forcing an infliction of even more damage to the economy down the road.
  - Potential GDP growth is estimated to have declined during the pandemic to below zero, down from an average 1.8% growth rate seen in the decade leading up to the pandemic (GDP averaged 2.25% during this period)
    - The potential growth rate will remain below its pre-pandemic pace in the near term due the shortage of labor:
      - The worker shortage has been exacerbated by long COVID illnesses and the need to care for sick family members or children.
        - The Brookings Institute estimates long-term COVID symptoms has kept 1.6 million workers from re-joining the U.S. labor market.
      - Labor shortages have also been impacted by the aging population, workers retiring early, and the falling pace of birthrates.
    - It's estimated future labor force growth will be dependent on immigration…the Congressional Budget Office projects immigration will account for about three-quarters of U.S. population expansion over the next decade (and all population growth by 2043)
- **Some like it Soft**…keeping the economy out of recession-land could depend on labor participation:
  - There are forecast the labor force participation rate will rise as individuals who quit working during the pandemic return to the job market…just as employers are reducing hiring due to rising interest rates:
    - This scenario could result in downward pressure on incomes and spending without causing a severe GDP contraction:
      - The unemployment rate would rise, not due to workers losing their jobs, but because more individuals are looking for work:
        - The number of prime working age individuals **(aged 25 to 54) who are employed remains below pre-COVID levels.**
    - Lagging worker productivity is also a problem, efficiency has declined to a 75-year low during the first half of 2022.
- **Sahm like it Hot**…a recession indicator called the Sahm Rule (developed by former Fed official Claudia Sahm)…signals the start of a recession occurs when the 3-month moving average of the unemployment rate rises half a percentage point above its previous 12-month low.
- **Growth Recession** (an oxymoron?)…forget about a soft economic landing, some analysts are predicting the economy could go through an extended period of meager growth and rising unemployment:
  - A growth recession stops short of an outright contraction in the economy…but places growth below its potential:
    - If good jobs start to become more-scarce, household spending would start to diminish…creating a downturn in GDP.
  - History has shown the downturn in the housing market could spell trouble for the economy:
    - Since World War II, there has only been three occasions when a falling housing market did not result in a recession:
      - This occurred in 1965, 1984, and 1994…in each of these cases the Fed had started raising rates before inflation had gotten out of hand.
- **Neutral or Not?**...the elusive interest rate level that neither stimulates nor restrains growth:
  - The Fed's long-term median estimate of the neutral rate is 2.5% (a level that seems low in the current environment):
    - How Fed officials interpret the neutral rate will go a long way in determining how high they raise benchmark levels:
      - If the Fed can tighten monetary policy to marginally restrictive (slightly above the neutral rate), chances of a severe economic slowdown would remain low…although, the Fed is unanimous the economy must moderate before inflation starts to decline.
- **Synchronize your Watches**…historically, reducing growth to slow inflation is a time consuming exercise (typically, a least a couple of years)…but, the pandemic has created a faster timeframe for certain economic phenomenon:
  - As Atlanta Fed President Raphael Bostic has stated, "The reality is, we don't know what's going to happen."

At the turn...

The Back Nine…

Food Fight…war and weather have wrecked havoc on the global grain markets:
- The food fall-out has caused a spike in grain prices and shortages of supplies:
  - It is estimated there is 49 million people in 43 countries currently facing famine conditions.
- **Russian Revenue**…Russia has played a key role in disrupting the grain supply-chain with its invasion of Ukraine, while continuing to export its wheat at elevated prices (using food as a weapon):
  - Global grain trade accounts for $120 billion in annual revenues…global wheat prices are up 50% this year:
    - Russia has already collected $1.9 billion in revenues from wheat export taxes so far this season…while many wheat producing countries are struggling with lower harvest yields; Russia is projecting a bumper-crop this year:
      - Russian's blockade of Ukrainian ports has reduced grain shipments from Ukraine to about 25% of their normal capacity:
        - Russia and Ukraine are major suppliers of wheat and sunflower oil to the world…Ukraine ranks in the top 6 countries for corn exports:
          - Ukraine earns about 10% of its GDP from the agriculture and food sectors *(not surprising that Russia is mining Ukrainian farm fields!)*
    - Russia sidelining Ukraine has removed a key competitor, opening the door for more grain sales to favored countries:
      - Favored nations include those who are not pushing back on Russia's invasion…including China, India, North Korea, and Iran:
        - U.S. and European sanctions do not explicitly target food exports…although, restriction placed on Russian banks has made financing more difficult.
    - Despite increased crop output, the Russian populous is having to cope with the highest food costs since 2004.
- **Rice Rationing**…India is constricting exports of the food staple for half the world's population:
  - India is the single largest exporter of rice, with a 40% share of the global market (white, brown, and broken rice):
    - The Indian government has imposed a 20% duty on all shipments of white and brown rice…and banned exports of broken rice:
      - A majority of these rice varieties are shipped to Asia and Africa, impacting about 60% of total Indian rice exports.
    - Thailand and Vietnam will hopefully fill the void in rice exports…currently shipping 11 million and 7 million tons respectively this year):
      - China and European rice crops are damaged from heat and drought…Europe's crop is expected to be the smallest in 27 years.
  - Rice had been able to avoid a most of the price hikes seen from the Russian invasion…that is changing:
    - Thailand's benchmark white rice is selling for $431 per ton, the same Vietnam grade at $395, India at $340:
      - During the global food crisis in 2007, India and Vietnam restricted rice exports, the price spiked to over $1000 per ton.
- **Corn Pone**…severe drought is negatively impacting U.S. corn output (the world's largest producer and exporter):
  - Crop yields are down as 39% of the country is in a moderate to exceptional drought (especially in the west):
    - The crop damage is pushing up the price of corn, currently trading 39% higher than the price seen a year ago:
      - At the current price of $6.82 per bushel, corn is now 50% above its 10-year average price (oil is also trading 50% above its 10-year avg).
    - With the high price of oil, more of the corn crop is going to road fuel…about half the U.S. crop is used for ethanol production:
      - Ethanol has traded at a 28% discount to gasoline since March, compared to the 3.7% premium seen in 2021…still cheaper than oil:
        - The volume of corn-based ethanol is up 800 million gallons versus a last year…equivalent to about 2% of the entire corn crop.
- **War Games**…weaponizing food has become a popular political tactic *(as typical, the innocents suffer!)*

19th Hole...

Nonsense is good only because common sense if so limited. George Santayana

Ross Elford, Senior Vice President

Direct: 314.746.3679 | Mobile: 314.223.9739 | Fax: 314.746.8737