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WEEKLY ECONOMIC COMMENTARY

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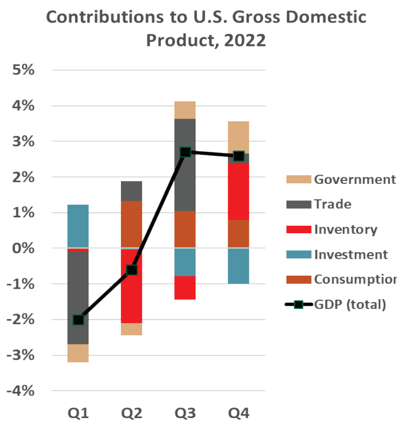
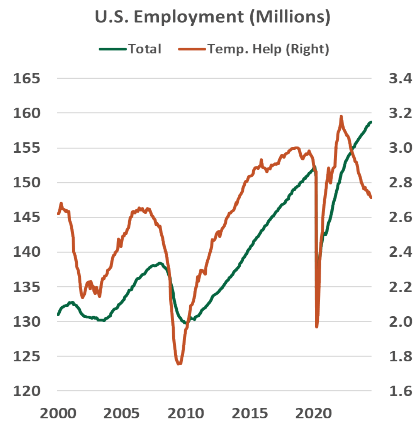
We spend our days immersed in data: digesting news, identifying trends and studying past episodes. Historically, many variables move together in predictable ways. Extrapolating these trends is one way to anticipate what lies ahead.

However, the pandemic cycle broke a number of past relationships, making it more difficult than ever to identify turning points in the cycle. The list of failed rules of thumb includes:

Two quarters of decline define a downturn. How do we determine when a recession has started? The complete answer is a nuanced review of a wide band of economic data, determined in arrears by the National Bureau of Economic Research (NBER). In practice, recessions are usually characterized by two consecutive quarters of economic contraction, which is the simple test that analysts often apply.

The U.S. economy declined during the first two quarters of 2022. But despite widespread fears, no recession took root. Amid unprecedented government support, job gains continued, consumer demand was sustained and business investment stayed buoyant.





Sources: BEA, BLS, Haver Analytics

Details are important when analyzing economic growth. The decline in the first half of 2022 was driven by unusually large shifts in highly variable components: inventory accumulation and net trade. Both of those series were whipsawed by pandemic disruptions. Final private domestic demand, which includes only consumption and investment, has grown throughout the cycle. This had happened only once before, in 1947, as the economy recalibrated after the global disruption of World War II.

Declines in temporary employment foreshadow broad job losses. As employers prepare to reduce headcount, they will usually start by cutting their temporary staff, who

work on a contingent basis. In a normal cycle, those reductions spread to full-time staff reductions. In this cycle, temporary workers declined, but regular employment gains have held steady.

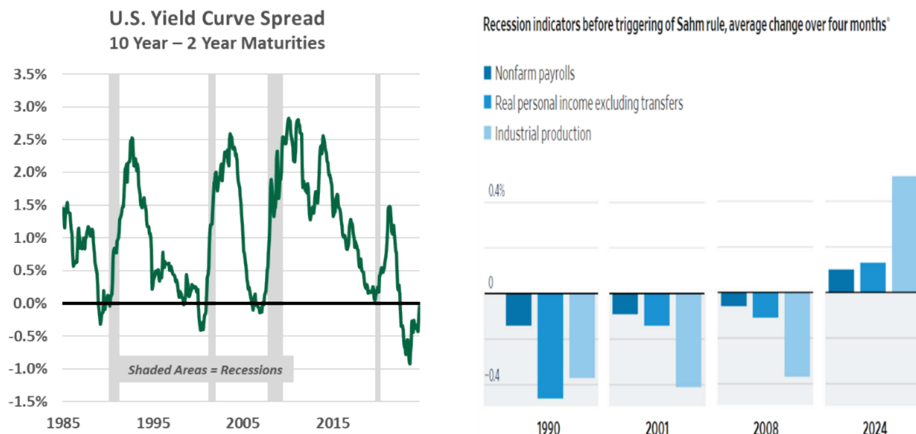
More than anything, this may illustrate a changing dynamic of the workforce. Employers are more likely to offer full-time employment, while gig workers may take sporadic assignments without the formality of working through a temporary staffing agency.

When the yield curve inverts, the economy is in trouble. We expect short-term yields to offer a lower return than long-term yields, reflecting the term premium required by investors to lock their money up for a longer time. When this relationship inverts, it can indicate that something is amiss.

We last discussed the limitations of the yield curve as a leading indicator in January 2023. While inversions have preceded most recessions, the curve gives us no clues as to the timing, cause or severity of the recession to follow. Since then, we have had a record-long curve inversion, but the economy and the equity markets have prospered throughout.

We love simple rules, but they can mislead us.

The challenge in using the yield curve as a cycle indicator is identifying what aspects of the fixed income market are out of equilibrium. If the short end falls because the Fed is lowering rates due to lower inflation, then the inversion can be corrected without a recession. What sounded like a tall tale in early 2023 has now become the base forecast.



Sources: Federal Reserve, Haver Analytics, WSJ

The "Sahm Rule" is in play. Economist Claudia Sahm sought a more timely way to diagnose the onset of a recession than waiting for NBER's expert judgment. Historically, when the three-month moving average unemployment rate rises by 0.5% from its prior-year low, a recession is unfolding. July's 4.3% unemployment rate crossed this threshold.

Fortunately for us, Claudia Sahm is still a practicing economist, offering real-time commentary. She has frequently disclaimed she only identified a coincident pattern in the data, not a predictive or absolute rule. The unemployment rate is not at a worrisome level, having risen from a 50-year low, and its rise has been driven by greater participation. Other indicators of activity do not suggest an imminent recession. So many relationships have failed in this cycle, and her rule may be the next to fall.

The anomalies of the pandemic cycle (lockdowns, shortages, inflation, excess savings, revenge spending) have led to a series of failed economic relationships. I'm hoping that steadier times will allow us to find new rules to love.

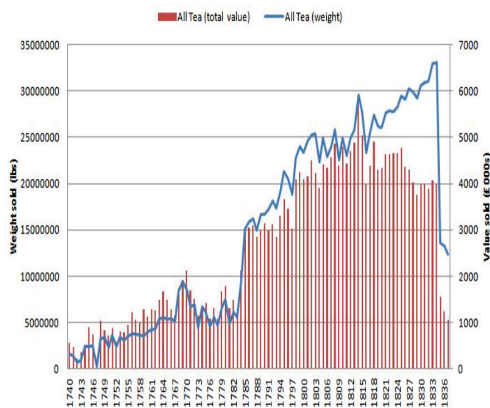
History In A Cup

My father expressed his distaste for unpleasant tasks by saying: "I wouldn't do that for all of the tea in China." Tea has historically been one of the world's most valuable commodities, and China has long been the world's foremost producer.

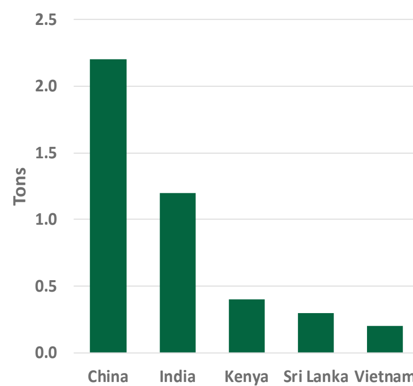
I learned quite a bit about the story of tea, and other beverages, in "A History of the World in 6 Glasses" by Tom Standage. My summer reading list is designed to take my mind away from business, but there were some important economic insights hidden within this book about the drinking habits of human beings.

Consumption of tea apparently began by accident nearly 5,000 years ago. Legend has it that a Chinese emperor was about to drink some boiled water when leaves fell into his cup. The taste was to his liking, and the beverage produced a heightened sense of well-being (which we now understand to be the result of caffeine). Tea was ascribed medicinal properties long before biologists established its ability to kill a range of bacteria and promote healthy digestion.

Tea Sales in the U.K.



Top Producers of Tea, 2023



Sources: Queen Mary University, Camellios

Tea played a subtle role in the Industrial Revolution...and the American Revolution.

Those of us in developed markets think little about the quality and supply of drinking water, but we haven't always been able to take them for granted. Waste management is a significant challenge for densely-populated areas; insufficient sewage treatment can allow diseases like typhoid and cholera to flourish. This remains an issue for many emerging markets to this day.

Tea consumption produces a noticeable reduction in water-borne afflictions. This allowed populations to live and work in close quarters, which supported the Industrial Revolution. Reduced levels of illness increased both productivity and the quality of life for early factory workers.

Thanks to its sensory and prophylactic qualities, tea-drinking became widespread. Britain got bitten by the bug in the middle of the seventeenth century, and its thirst grew rapidly. That led it to China, which grew more tea than any other nation. China was a formidable world power at that time; its industries were world leaders that provided for almost all of the country's needs. The British, having little in trade that the Chinese valued, were forced to pay for their tea in silver.

The British were anxious to find an export to China that would allow them to preserve their hard currency. And they found one: opium. The British East India Company handled trading in both tea and the narcotic, which was causing unwanted addiction in China. When the ruling emperor banned its import, the British intervened militarily to keep Chinese ports open to drug imports. At that time, Hong Kong became a British colony.

The "Opium Wars" were one of several unfortunate experiences that emerged from China's dealings with foreign traders in the 19th century. It bred a suspicion of the West that continues to this day. It also weakened the economic fabric of the nation and paved the way for the political upheavals that China endured during the last century. All of this for want of a cup of tea.

The tea trade has lessons for today's global commerce.

Many readers will also be familiar with the role that tea played in the American revolution. The colonies had established a network of smuggling routes to avoid paying taxes to the crown on imported tea; when these avenues were abolished, a group of Bostonians (dressed as native Americans) dumped an entire shipment of the stuff into the harbor in protest. Less than two years later, the War for Independence had begun. More than two centuries later, the "Tea Party" movement coalesced to inveigh against government interference in markets.

The story of tea is instructive for the present day. The use of tariffs, rebellion against taxes and the potential for military intervention to preserve access to critical materials are all features of the current environment.

When I selected Standage's book, I was hoping to enjoy a celebration of imbibements free from commercial considerations. Instead, I got a history lesson. Liquidity is, indeed, critical to economic development.

No Rush

After decades of economic stagnation, the Japanese economy appears to have rooted out deflation, albeit with some help from external forces. But the recent bout of market volatility suggests that Japan's exit from easy money might not be that easy.

Last week, the Bank of Japan (BoJ) raised its policy rate by 15 basis points to 0.25%, the highest level since October 2008. The central bank also unveiled a roadmap for reducing its investment holdings, another step toward policy normalization. But the decision to start quantitative tightening and hike interest rates at the same meeting has drawn the ire of markets.

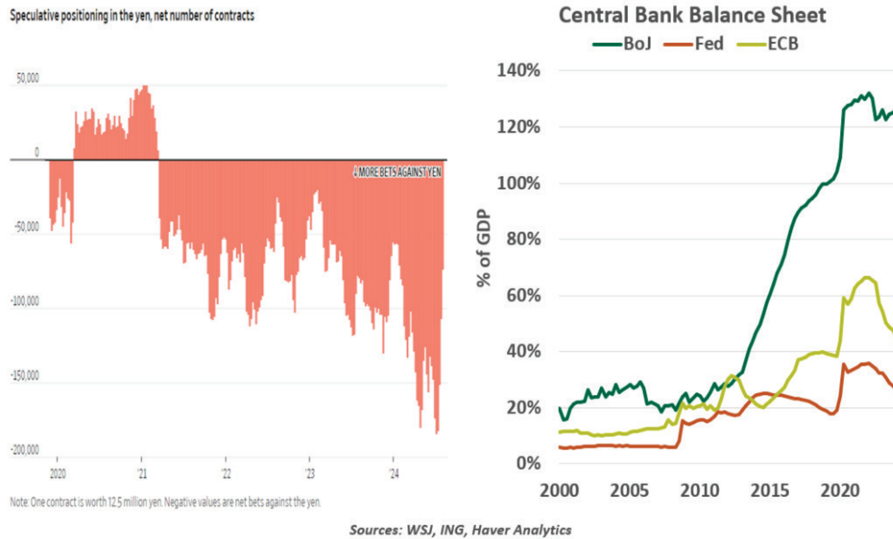
The Japanese Nikkei 225 stock market index closed down more than 12% on Monday, the most since Black Monday in 1987. The index covering Japanese banks recorded its biggest one-day plunge in history. Futures trading was suspended for the first time since the Fukushima nuclear plant incident in 2011. The yield on 10-year Japanese government bonds slid by the most in two decades.

The Japanese yen (JPY) has been appreciating in recent weeks in anticipation of further policy normalization. After the July meeting, the currency rallied further, rising sharply to levels not seen since the start of the year. The gain led to a rapid unwinding of yen "carry trades."

A carry trade involves borrowing in a currency with a low interest rate, then reinvesting the principal in another country's assets that offer higher returns. The strategy has been one of the biggest sources of flows in the global currency market. In fact, ultra-low interest rates and low volatility had made the yen the most popular funding currency in recent years.

But when Japanese interest rates rise and the yen appreciates, the economics of carry trades fade. Investors rushed to the exits to avoid losses. According to Commodity Futures Trading Commission data, hedge funds and other speculative investors were holding over 180,000 contracts betting on a weaker yen on a net basis, worth over $14 billion, at the start of July. By the end of the month, those positions fell to around $6 billion.

While market volatility has put the BoJ's plans for tightening on ice for now, the roadmap for trimming the bond buying program will likely remain unaffected. After an extraordinary expansion of its balance sheet over the past decade, the BoJ has decided to halve its pace of Japanese government bond (JGB) purchases by early 2026. The plan will reduce the central bank's share of outstanding government bonds to 45% from 48% in two years.



Sources: WSJ, ING, Haver Analytics

The Bank of Japan shouldn't rush to normalization.

The BoJ will have to tread cautiously in normalizing policy. The central bank not only needs to take into account market stability concerns, but also the macroeconomic fundamentals. Growth lacks legs to run, with real gross domestic product contracting in two of the last three quarters on an annualized basis. While summer bonuses helped real wages to turn positive for the first time in more than two years, consumption remained weak in June. Consumer spending, in real terms, has shrunk for four quarters in a row. The "core-core" inflation, which excludes fresh food and energy, has decelerated from a peak of 4.3% year over year in mid-2023 to 2.2% in June 2024.

Considering Japan's decades-long experience with deflation, the BoJ should accept the risk of higher-than-target inflation. Aggressive tightening that jeopardizes the long-awaited normalization would be snatching defeat from the jaws of victory.

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