ECONOMIC OUTLINE – GULF COAST ESTATE PLANNING CONFERNCE – JOHN NORRIS
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- **Recap/Analysis of Recent Gross Domestic Product (GDP) Data:**
  - First Half of 2022
    - Headline numbers were worse than the underlying data; two consecutive quarters of negative GDP
    - Wild swings in inventories and trade deficit skewed the equation and made it look like economic activity was worse than it actually was.
    - True growth was closer to 1.5-2.0%
  - Second Half of 2022
    - Headline numbers were better than the underlying data; two consecutive quarters of relatively robust GDP
    - The reversal of the wild swings in inventories and trade deficit skewed the equation and made it look like economic activity was better than it actually was.
    - True growth was closer to 2.0%.
  - First Half of 2023
    - Headline numbers and underlying data are starting to converge, presenting a more even economic picture
    - The wild swings in the automatic stabilizers in the equation, namely inventories and the trade deficit, have stabilized significantly.
    - True growth is close to 2.0%.

At the start of 2022, analysts were worried about 2 things: inflation and the Federal Reserve. At the start of 2023, analysts were still worried about those 2 things: inflation and the Federal Reserve. Where are we?

The official inflation gauges are coming down, but might not get to the Federal Reserve's preferred 2.0% level for a while.

- **Reasons why inflation is coming down:**
  - The money supply has fallen roughly $800 billion over the last 12-months. While there is still a lot of liquidity in the economy, it would be a neat trick to see inflation continue run at 7-9% levels while the money supply is shrinking.
  - The yield curve remains inverted. This has always slowed the extension of credit in the US economy, as an inverted yield curve typically squeezes net interest margins. Thus far in 2023, through 8/23, 'US commercial bank assets loans & leases' had grown at an annualized 2.62% clip. The 10-year historical average is close to 5.65%.
  - Inventories continue to shrink as wholesalers and retailers are busy trying to get everything they ordered last year off the shelves. The best way of doing that is discounting and slashing prices.
  - The labor market is showing some signs of cooling. This would/could/should throw some water on wage inflation.

- Reasons why inflation isn't going to get to the Fed's magic 2.0% number soon:

   - There is still a massive amount of cash sloshing around the global economy.
   - There is no end in sight to Washington's annual deficits.
   - Green restrictions and regulations ensure the US economy will spend an awesome amount of money in order to generate the same absolute level of capacity or potentially less. There is no way that isn't inflationary over the long haul.
   - The global supply chain is too dependent on China. At some point, it will be able to dictate prices, as opposed to the other way around.
   - Housing inventory is incredibly low. As a result, home prices haven't fallen the way they should as interest rates rise. This has kept, and will keep, more people renting for longer. As a result, the housing component of the inflation gauges should remain slightly more elevated than it/they should be.
   - Energy prices remain curiously elevated given the US dollar's continued strength. What happens when the dollar starts to weaken, which it should when the markets are convinced the tightening cycle is over?
   - Prices for goods will remain under some control due to the reasons outlined. However, prices for services will continue to remain sticky for a simple reason: despite some recent softening, mild, employers are still having trouble finding workers.

- **So, what is the Fed going to do?**
   - Unless something dramatic happens, the Fed has no more than one 25 basis point rate hike left in this tightening cycle. At this point in time, it is likely finished (at 5.50%) unless something extremely unusual happens in the economic data.
   - If the CME futures (Chicago Mercantile Exchange) is anywhere close to being accurate, the Fed will start CUTTING the overnight rate at some point during the 2nd Quarter of 2024. By the end of the next year, the overnight rate could be as low as 4.50%.

- **Potential Threats – Real & Concerning**
   - No end to massive annual deficits;
      - According to the White House's budget estimate for 2024, the US Treasury would/should/could run up an additional $17.05 trillion in debt over the next decade. Further, net interest will mushroom to about 13% of the total budget.
      - Over the last decade, the Federal Reserve and the Chinese absorbed a lot of Washington's debt. Moving forward, it appears Beijing has a somewhat reduced appetite for it. Further, the Fed is actually trying to shrink its balance sheet, not add to it. So, who buys it? We will….just not at these current levels. As a result, longer-term interest rates could remain much higher than they were from 2011-2021, when the Treasury racked up roughly $14-15 trillion in debt. This leads to higher interest rates, which will lead to…
   - The creation of a bunch of zombie banks
      - The US still has something like 2,400 banks with total assets less than $500 million. Due to the depressing impact recent (and continued) higher rates have had on their bond portfolios, many banks this size (and even larger) have seen their capital levels shrink, somewhat dramatically. As a result, they will not have the ability to extend credit, to any meaningful

degree, for the foreseeable future. As a result, we should see an acceleration in bank consolidation over the next 5-10 years. That is the only way some of these firms will be able to make a go of it….combined with someone else and slash the redundancies.

    - This could likely have a disparate impact on smaller communities, which rely on banks this size much more so than the money center banks. It means jobs lost, charitable giving decreased, etc.
  - The "attack" on the energy sector continues, pushing us to closely dependency on China
    - Since 2019, the year before the pandemic, crude oil production in the US has increased at roughly a 1.4% annualized clips. This is simply the math of millions of barrels produced during the first 6-months of 2023 divided by the number of barrels produced during the first 6-months of 2019 and raised to one-fourth power. Just the math. By comparison, the annualized number for 2019 relative to 2015 (another 4-year time frame) was 6.0%.
    - Quite simply, the US economy/infrastructure is not well-suited to such a quick shift to EV and "renewable" forms of energy. We don't produce enough EV batteries domestically to even make a dent in the number needed. We don't produce enough rare earth minerals, lithium and copper, and probably don't intend to do so either. This means the US economy will become even more heavily reliant on its biggest threat, China…which dominates rare earths and EV battery production, and is a significant producer of both lithium and copper.
    - Lots of jobs will vanish and the government won't have the necessary cash flow to subsidize the necessary buildout for what it wants. BYW, that would inflationary if it somehow did.
    - Replacing cheap, reliable and efficient fossil fuels like natural gas with comparatively more expensive and less reliable (and therefore more inefficient) so-called renewables will be an expensive and inflationary exercise.

- **Potential Threats – Real & Not Concerning**
  - The US will eventually have to default on its debt
    - Don't believe a word of it. The US borrows in its own currency. This means, if it ever comes to it, the Treasury can simply print money to pay back its creditors. Essentially, the US doesn't have to go out into the global currency markets to get its own currency. It can turn on the presses. Inflationary? Higher interest rates? Sure, but the Treasury won't default.
    - The US collects plenty of money through a number of different means, easily enough to service its debt, easily. If the US decides to default on its debt, it will be completely voluntary and counter-productive. After all, it won't be able to borrow money moving forward.
  - The US dollar will no longer be the world's primary reserve currency
    - Don't believe a word of it. What is going to replace it? Nothing other foreign currency has the necessary size and liquidity to replace it. The euro would be the closest. However, the prospects for long-term Eurozone growth and its distant second-place standing make it a very unlikely contender. Couple that with potential breakup of the zone, and the euro remains second.
    - The only other potential contender is the Chinese currency. However, its financial system doesn't have the necessary transparency and liquidity. Also, the currency still isn't completely

convertible, and Beijing manipulates it to boot. Finally, are you willing to bet on the Chinese Communist Party's commitment to individual property rights.

    - Gold? There isn't enough of it, and it would be too cumbersome for contemporary international trade. Why do you think everyone got away from it in the first place?

- World War III over either Ukraine or Taiwan
    - Given the enthusiasm most of Europe has for getting involved in the conflict between Ukraine and Russia, it is hard to imagine the conflicting spreading significantly. Further, the so-called Global South largely views it as a war between two white countries a long way away from them. Not a ton of interest there.
    - Given the sheer size of the Chinese People's Liberation Army and Navy, it could overwhelm Taiwan if it really wanted. No one in the Pacific, absent perhaps India, could stop them, and New Delhi doesn't want THAT fight. Only the United States could provide enough of a deterrent. However, it is questionable the US could get the necessary men and material over to that theater in sufficient quantities in the time allowed. Further, it remains to be seen the appetite the American public will have to deploy sons & daughters to fight and die for Taiwan. Once the bullets start flying, that will be anyone's best guess.
        - Beijing's apparent, and best, tactic is to continue to beef up its army and navy, and wait (somewhat) patiently for US resolve to dissolve. Given the estimated US defense budget over the next decade and the Pentagon's inability to recruit sufficient numbers, it is hard to imagine China not eventually taking over Taiwan through 'diplomatic' means without having to fire a shot against the Americans.

- **Recap**

- **Questions & Answers**