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MAY MARKET AND ECONOMIC INSIGHTS

June 2023

Introduction and Overview

Welcome to the May installment of our monthly report, where we aim to highlight topical matters and assess their potential impact on financial markets.

In this report, we will consider recent economic data in the context of our continuing thesis vis-a-vis the heightened risk of economic recession in the US and Europe. In particular, we will argue that the data—seen against the backdrop of a holistic view of the economy—is not as rosy as the headline numbers seemed to imply. Additionally, we will argue that some of the data released, although apparently positive, is driven by unsustainable increases in government spending and fiscal stimulus, each of which will eventually require a "payback" that will trigger periods of reduced growth.

Even as we draft this report, financial markets are experiencing yet another case of an "almost everything rally" (noted in our February 2023 monthly commentary as Bed Bath & Beyond surged just prior to its bankruptcy filings), this time driven by exuberance around AI, the housing market, and payroll gains.

We believe systemic increases in deficit spending by the US government, which have risen to ~7% of GDP from a historical average of ~3% of GDP, is also culpable in determining why Federal reserve interest rate increases have neither materially cooled labor markets nor stemmed inflation.

In our view, the worsening tradeoff between growth and inflation is still a dominant theme, one that will soon implicate capital markets in the form of even higher interest rates. We see this as inevitable, regardless of the current low level of economic growth and stresses in the private economy.

May 2023 — Total Hours Worked Declined while Total Nonfarm Payrolls Increased and Beat Expectations

As the chart below shows, the seasonally adjusted index of aggregate "weekly hours worked" by all employees in the private sector has stagnated in 2023, punctuated by a modest decline in the month of May.

Despite this condition, nonfarm and private payrolls (both seasonally adjusted) actually *increased* in May by 339k and 283k, respectively, with both soundly smashing expectations.

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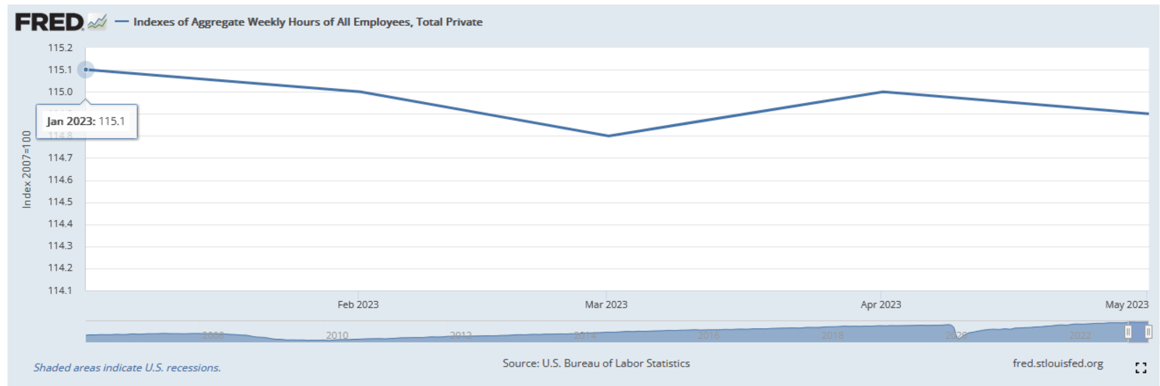

It is notable, we believe, that these data sets are inconsistent, barring a measurement error or a workforce shift that would have resulted in increasing payroll numbers even as employees worked fewer hours per week. At this point, we believe that either error or such a workforce shift is possible, or that both are somehow affecting the data. In any event, it seems premature to take the data at face value in any assessment of future market outlook for the workforce.

Is The Changing Nature of the US Workforce the Explanation for the Apparent Inconsistency Betrayed by the Decline of "Hours Worked Per Week"?

If we assume that both data sets are accurate, their compatibility would indicate that there are more people on payrolls but that they are working fewer hours, potentially resulting from increases in part-time work and the rise of the so-called "Gig Economy". If we accept this thesis, we would have to also question whether the traditional use of nonfarm payroll data as a proxy for labor demand and, as such, as a measure of the health of US economy, may have outlived its utility.

Self-employed persons, which include a sizable portion of gig economy workers, are not included in the US Bureau of Labor Statistics nonfarm payrolls. Similarly, the self-employed are not included in the dataset measuring aggregate hours worked. Increases in other forms of part-time employment, however, combined with fewer hours worked per employee, may help to explain this outcome. In this scenario, there is simply an overall decrease in demand for labor, thus supporting the theory of weaker level of economic activity.

Deficit Spending and Increases in Government Transfers are Driving Growth

As laid out in earlier monthly commentaries, our thesis continues to be that currently observed economic growth is primarily driven by government deficit spending. Unsurprisingly, if the level of government deficit spending returned to historical norms, the US economy would be shrinking. Growth in government spending, however, is NOT a sustainable growth strategy. The inevitable payback will come in form of either higher interest rates or higher inflation, or in higher inflation requiring higher interest rates.

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To provide a topical case in point, we believe certain forms of government expenditure—including providing foreign military aid—do not necessarily result in higher output in the future.

In our view, deficit spending is also creating challenges for the Federal Government as wage growth has lagged their base rate increases while deficits are moving labor demand relatively higher.

The net result of this phenomenon may push the Fed to increase rates above 6%, which would likely create further headwinds for the private sector. Essentially, the private sector may need to reduce its size in order to accommodate higher levels of government spending. The transition mechanism(s) for this will be higher interest rates for a longer period or, alternatively, higher levels of inflation.

Looking Ahead and Economic Outlook

In our view, attention must be paid to labor productivity numbers moving forward. If deficit spending is accompanied by reduced gains in productivity, the path for the economy to return to equilibrium becomes more challenging.

Conversely, productivity gains could make it possible for the US economy to achieve better tradeoffs between inflation and growth.

Either way, we believe current conditions—which support higher interest rates—are going to continue to put pressure on equity valuations.

Ali Meli

Lead Portfolio Manager

Monachil Credit Income Fund

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