PAYCHEX THRIVE
A BUSINESS PODCAST

Season 4 | Episode 32

The 2023 Economy: Deficits, Debt Ceiling, Demand Suppression, and More

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Announcer:
Welcome to Paychex THRIVE, a Business Podcast, where you'll hear timely insights to help you navigate marketplace dynamics and propel your business forward. Here's your host, Gene Marks.

Gene Marks:
Hey everybody and welcome back to another episode of THRIVE. My name is Gene Marks. Thanks so much for joining us today. With me today, my guest is Lyn Alden. Lyn's the founder of Lyn Alden Investment Strategy. I am an avid follower of her on Twitter.

Gene Marks:
Lyn, I have to say, if I ever respond or anything to any of your tweets, it always gets a ton of engagement. I mean, I don't know who your followers are, but they're either a loyal bunch or they're a crazy bunch, which you probably don't even want to figure that out. But, it's a great Twitter account, you do great work, you analyze the economy. Tell us a little bit about yourself and what you do and what your company does.

Lyn Alden:
Sure. So, my background's actually initially in engineering, but I've been interested in finance my whole life and I eventually transitioned towards in the financial side of engineering. So overseeing the budget, technical budget, head engineer of a facility, but eventually I transitioned out of that to actually focus on macroeconomic research.

Lyn Alden:
It's kind of an interesting pivot, but it's something that actually I started investing even before I was an engineer, and I kind of kept it up all along. My master's degree was in engineering management with a focus on financial modeling and engineering economics and that kind of thing. So, I kind of just combined a lot of the background I had to start looking at the macroeconomy from the lens of systems analysis, and so I kind of just come at it from a different angle.

Lyn Alden:
So, I've been publishing research for both institutional and retail audiences since 2016 in various capacities, and so that's primarily what I do. Basically there's been a trend where a lot of investment firms, they outsource some of their analysis. Instead of having tons of analysts in-house, they can use economies of scale to have certain analysts that they subscribe to, basically in addition to all the inside analysts they have to form their investment pictures. So, I try to add my piece of the puzzle, you could say.

Gene Marks:
That is amazing. Do you specialize in any industry per se? You said you take a macroeconomic approach, so I guess that's the economy on the whole?

Lyn Alden:
I do. There's a couple areas that I've specialized in and a couple areas that I avoid just having no edge. So, the areas that I tend to focus on are macroeconomics, anything money-related, energy, commodities. Whereas for example, anything related to biotech or certain sectors I tend to avoid. I also have gotten into digital assets to varying degrees, basically understanding how the technology there can influence some of the ways that things operate now. So, those are kind of my areas of focus.

Gene Marks:
I mean, you don't have to disclose any of your clients, but would you say that most of your clients are investment managers, investment type of companies? Or do you have clients that are actually regular B2B or in private industry themselves that has somebody like you on retainer to tell them where things are going?

Lyn Alden:
Yeah, it's actually both. The sweet spot that I tend to aim for is institutional type of research, but in plain English. The benefit of that is that institutional people like it, because it's the content they need in plain English. Then also, businesses or more sophisticated investors. Let's say you're a lawyer, you're a doctor, you're an engineer, you're a small business owner, you want to know what's going on, but you're full-time focused on your work and you want to have tabs on what's going on with your investments or things out there, that's the kind of people that would generally subscribe to my research. So, a pretty big range.

Gene Marks:
You've been doing this you said since 2016, and I realize, okay, so that's not decades worth of work, but I got to get your thoughts just initially. You and I are talking now, it's the middle of February. Is this economy just a really difficult thing to read for somebody like yourself?

Gene Marks:
I mean, when I speak to other economists, I hear again and again that it's a very unique situation we're in, and there are all sorts of conflicting data about where the economy is going. We have historically low unemployment and yet here we have an inflationary environment and interest rates rising, and we have some retail sales bottoming out a little bit, but the construction industry, very busy right now. It's a very, very difficult economy to predict. Do you find it that way or do you feel that it's clearer than most?

Lyn Alden:
I do find it very difficult. There are periods of time where it's clearer than others. There's certain inflection points where I feel like I have greater clarity on what's going on, and then other times where there's pivots and I'm kind of in this period of reassessment. So, my level of confidence for any given analysis will fluctuate over the course of quarters and years depending on the nuances.

Lyn Alden:
Generally what I've found is that a lot of what's happened in the past few years has been relatively unprecedented in terms of obviously shutting down an economy, having massive amounts of stimulus, all this kind of stuff working through the system.

Lyn Alden:
One kind of starter kit or cheat code you could say I've had for making sense of some of this is looking back at the 1940s. As it started to unfold back in even actually in 2019, but also then especially in 2020 when it actually started to happen, I did a lot of research on the 1940s and the end of the 1930s, and that's the last time we had this large fiscal-driven type of inflation.

Lyn Alden:
So, when people think of inflation, they think of the 1970s, where there actually has been other inflationary periods in history and a lot of these characteristics that we're seeing happened in similar ways in the 1940s. Obviously instead of a pandemic, you had a war, a lot of things were happening on a bigger scale, but actually a lot of the macroeconomic indicators and factors that were happening were kind of similar between those two periods. I found that that's an interesting analog to at least be aware of, because then things seem a little bit less crazy when you look at it through that lens.

Gene Marks:
You wrote in your December newsletter, and I'm going to quote out, you said, this is back in December, "My base case, unless or until I see evidence of the contrary is for worsening economic conditions in the first half of 2023, continuing the trend of disinflation versus demand suppression." I'm going to ask you about that in a minute. "US corporate profit margins are likely to go sideways or down and economic activity is likely to be sluggish and potentially recessionary."

Gene Marks:
Now, we've already seen as results have been released for end of the year, corporate profits have been sideways or down, but do you still hold to that prediction that you made back in December that you are looking at a down, a worsening of economic conditions in 2023?

Lyn Alden:
Roughly speaking, I've kind of pushed back my base case a little bit. When we look back at the last cycle of the last 10 years, you had these three mini cycles actually in it. You had your periods of accelerating economy and then decelerating economic growth, with the difference being that those decelerating periods never turned into actual recessions, right? So you had a slower growth, a near recession you could call it, rather than outright recession.

Lyn Alden:
It usually has some sort of mild pivot in terms of fiscal monetary policy that kind of kickstarted the next cycle. What we've been seeing in the past few months is that we are at the border there where it looks like one of those mid-cycle decelerations, you're kind of at stall speed.

Gene Marks:
Yeah.

Lyn Alden:
Then the big question is whether or not that's going to fall into recession or whether that can actually pivot back up into another mini cycle of growth in this economic cycle. I think a lot of that's going to come down to this year due to liquidity dynamics.

Lyn Alden:
And so, on one hand, obviously you have deceleration of most economic indicators, you have a Federal Reserve that's tightening interest rates and reducing their balance sheet. The high interest rates have squeezed out interest rate sensitive industries, so housing, technology stocks that were based on very high valuations and constantly issuing equity at those valuations. So, those kinds of things have been more impaired than other parts of the economy.

Lyn Alden:
This is offset somewhat by just the sheer amount of fiscal deficits that are happening. So, if you think of fiscal deficits as essentially a form of stimulus at the cost of inflation and other costs down the line, but when they're happening they're essentially stimulus. Right now, we're kind of running $1.4, $1.5 trillion annualized fiscal deficits, and so you kind of have that structural backdrop that's somewhat nominally, at least, bullish. So, those are the two conflicting things.

Lyn Alden:
I think a challenge is that from here until the debt ceiling issue, which is roughly the middle of the year, third quarter, you have the treasury offsetting a lot of the Federal Reserve's liquidity drain. So, the Federal Reserve is decreased in their balance sheet raising interest rates. The Treasury General Account has actually been draining their cash balance, which is actually positive for liquidity, because they kind of have their money locked away in a void, they tax and issue debt to bring in money that they haven't spent yet.

Lyn Alden:
So, kind of like if you were a household and suddenly your ability to issue new debt or income went away, but you still had cash savings, you could keep paying your bills for a while, the treasury's kind of in that phase right now. And so, that's actually positive for liquidity, it's offsetting some of the Fed quantitative tightening. So, I think things still look decent for the next several months, and I think the big question is what happens in the back half of this year when you don't have the treasury offsetting the Fed anymore?

Gene Marks:
You had mentioned about demand suppression sometime during 2023. I mean, household wealth, you wrote a chart that shows that household wealth, as a percentage, it's still historically strong, but it's been declining since the height that it hit during the pandemic. Credit card spending is up as well.

Gene Marks:
I just saw this past week that mortgage delinquencies are starting to trickle up as well or tick up in the wrong direction. Because we have continuing inflation wages not keeping up with inflation and interest rates still relatively high with the threat and very strong probability that the Fed will raise them even more. When does that demand suppression kick in? I mean, in the end it is about the consumer, isn't it? You feel like the consumer doesn't have long to go before they really start putting on the breaks, but we're not seeing it yet, are we?

Lyn Alden:
Yeah, I think we've seen it around the margins, we've seen it in certain industries, and so that's actually what complicates this, it's a very industry-specific thing. So, you've seen it in housing, you've seen it in tech and a couple other areas, that can obviously eventually ripple through to other things.

Lyn Alden:
I mean, basically people that lost their tech jobs, are going to go out to eat less, for example, that can ripple through everything else. But so far the things that are not directly heavily impacted by interest rates, things like restaurants or travel in general, those areas still look quite strong. I don't really see much of a deceleration in the data there.

Lyn Alden:
If you look at labor, obviously the labor market is the strongest part of this current market-

Gene Marks:
It is.

Lyn Alden:
So, in my client reports, I have a grid where I look at all the different areas of the economy, kind of a heat map for what's accelerating or decelerating, but also what's strong or weak versus other things at the same time. Right now labor's the key area, but even if you look around the margins there like overtime hours or temporary help services, those have been decelerating. Those are these slightly more volatile leading indicators of labor.

Lyn Alden:
So, we have early signs of labor softening, but really if you're currently in some of those non-heavily impacted industries, it's still quite unclear whether or not they're going to have a significant downturn. I mean, I think there's a lot of pent-up demand still-

Gene Marks:
There is.

Lyn Alden:
For things that were essentially under-bought for a two plus year period that are now being consumed pretty readily.

Gene Marks:
You talk about that heat map of industries that are doing better than others, and it's been very, very tough over the past year or two to say is the U.S. in a recession. It just kind of depends on what industry you're talking about and where you are. There are other factors that determine, it's a big country.

Gene Marks:
So, what does your heat map tell you? What industries are you seeing still strong? I'm curious, because we have a lot of listeners that are operating businesses in those industries and I'm curious to see if they would validate that.

Lyn Alden:
Yeah, so basically across the board you have a deceleration and rate of change terms compared to what you saw say the peak of say 2021 stimulus, for example. So, you do see a deceleration mostly across the board, except for a handful of industries that are very travel- or dining-oriented.

Gene Marks:
Right.

Lyn Alden:
So, those are the strongest areas. Labor in general is quite strong. The weakest areas are housing or tech that's unprofitable, either in private equity or in public markets. A reason for that, people often think of tech as less interest rate sensitive than housing, but if you have an environment where a company's designed to be unprofitable for a foreseeable future and you're just constantly focused on growth, growth, growth, growth, you're issuing very expensive equity to fund the fact that you're not actually profitable. That's reliant on investors continuing to mop up that expensive equity issue, that's also how you're paying part of your employee salaries in many cases, just ongoing equity there.

Lyn Alden:
And so, when a higher interest rate, a higher hurdle rate slams down the valuations for those, suddenly that compensation and investor mechanism goes away. So, those companies actually have to raise prices and try to be a little bit less unprofitable or kind of err towards profitability at an earlier date, but that actually then slows down their growth, because part of the prior growth they had was unsustainable, it was based on unsustainable pricing.

Gene Marks:
Sure.

Lyn Alden:
And so, when they actually get back to a more sustainable pricing trend, their real rate of growth is slower and then that further hurts the valuation. So, I think we're seeing a big reset there, a reset of expectations in growth and figuring out what percentage of that was actually malinvestment.

Lyn Alden:
So basically, it's those interest rate sensitive ones, the housing, the tech, areas that were in many cases over-invested in in the 2010s decade. I mean, just tons of software stuff was made.

Gene Marks:
Yeah.

Lyn Alden:
I think we're seeing consolidation there, whereas a lot of stuff that kind of stagnated due to financial services, banks, travel, things like that, they're still, as far as my indicators are concerned, doing quite well.

Gene Marks:
Yeah, the banks released earnings this last quarter and none of them are raising any red flags, and they're still saying that spending is still good and their customers are still in good shape. They're stocking away reserves, because they're concerned about the future, but even Jamie Dimon who is not necessarily the most optimistic guy about the economy still can't say at Citigroup whether or not they're having issues. It seems like things are still rolling along.

Gene Marks:
But you do talk about interest rate sensitivity, so here's what I'm seeing. My practice, we have about 600 clients all up and down the East Coast near Philly, near where you live in Jersey and Pennsylvania, and a lot of them are already telling me that they're starting to feel a little bit of a pinch when it comes to interest. The interest that they're paying for working capital loans, for equipment loans, for loans for property, for some of them that are less creditworthy, it's going into the double-digit area.

Gene Marks:
That's a concern and I see that impacting them and their ability to get additional financing and grow, buy inventory, buy equipment, operate their businesses. I see that as potential problems. So number one, I'd like to ask if you agree or if you're seeing the same thing?

Gene Marks:
Then the second part to that question, again on interest rates, is that the consumer businesses that you mentioned, the retail, restaurants, travel, the ones that are not as interest rate sensitive, if I make an argument that if credit card debt continues to spiral as it is right now and as rising interest rates impact credit cards as well, could that have an impact on those consumers making those non-interest rate industries more sensitive to interest rate increases? If that makes sense.

Gene Marks:
Let's go to the first part first about my clients that are operating in a manufacturing and distribution environment. Do you have those same concerns about their availability of capital and the cost they have to pay?

Lyn Alden:
Absolutely. So, industry sensitivity's kind of a spectrum, right? There's ones where it impacts bigger and faster, but at the end of the day, almost anything that involves equity or debt is going to be somewhat interest rate sensitive, it's just a matter of degrees. So we see it first show up either in industries that are very, very debt heavy, so you get into real estate, or ones that are very, very equity heavy, which is technology constantly issuing new equity rather than earning profits. So, those are the canaries in the coal mine.

Lyn Alden:
Then you have a couple things that trickle up from there. So, one is part of the reason a monetary policy operates with a lag is that some debt is fixed rate, either on a short-term or medium term, longer term. So as that over time starts to come due and get refinanced, that eventually pushes up the average interest expense of a business.

Lyn Alden:
Then if you are in those businesses that have various credit lines or various things that adjust pretty quickly, you're also impacted as well, and so that depends on how big that is relative to the size of your business.

Gene Marks:
Sure.

Lyn Alden:
Right? So, that can impact almost everyone and it depends how big that is. So, if that's a very large percentage of a business, then obviously that comes down to the bottom line pretty quickly and then that affects hiring and everything else. Then for the second part of your question, that then trickles into the consumer.

Lyn Alden:
If we look back at the recession after the dot com bubble, that was actually a pretty mild recession and you can see where it emanated from. It obviously emanated from tech. A lot of these things that people thought they had wealth, people thought they had sustainable businesses, it turns out didn't. You started to get layoffs from there and that kind of trickled out to make everything else soft over time. Even if they weren't in a bubble themselves, if you're a restaurant that's serving people that are in a bubble, you're obviously going to be impaired as well.

Lyn Alden:
I think we're seeing a similar thing here where you start from certain areas, in this case, it's tech again, but it's also real estate and it's also if your business relies on access to cheap credit, obviously you're going to be impaired as well, and I think we start trickling out from there.

Lyn Alden:
I'm a little bit less worried than some seem to be about credit card debt, because we are moving up very quickly, but if you look at the amount of credit card debt relative to say the amount of incomes or the amount of GDP, whatever kind of metric you want to use that actually puts it relative to something else, it's still actually below the average of the 2010s decade.

Lyn Alden:
So, it's not as though they're getting really, really in debt, they're just going back up from what was a pretty low basis in the past few years. Also, that's still a pretty small percentage of the economy. That obviously impacts certain people very, very significantly, but in an overall economic environment, that's kind of around the margins. So, I do think that over time it is starting to gradually trickle through and could lead to softness, and you can kind of see it emanating out from those most sensitive industries to the less sensitive ones over time.

Gene Marks:
For those of you listening and watching, I'm talking to Lyn Alden on her Twitter account, LynAldenContact. Lyn just mentioned the percentage of credit card debt. On February 8th, she made a really interesting post showing how credit card debt is a percentage of assets. If you're going to make it relative to something, it's still below what it was back in the 2010s. So, there's room for that to move and no one should be panicking about that yet. It's all relative, we all have to put this in a historical perspective, and Lyn does an amazing job of doing that.

Gene Marks:
Lyn, in the final few minutes that we have, let's talk a little bit about the national debt. We're going to come up to this whole debt ceiling debate. We're going to hit that limit sometime in mid-2023, it's going to be all over the news. So, prepare us for that. What are the implications of that? Why should we care as business owners? We've been hearing this fight going on in Washington literally for decades, going back to George W. Bush. So, tell me why we should even care at this point?

Lyn Alden:
So, there's the near-term question and the long-term question. So, the near-term, the actual debt ceiling debate itself, that can be thought of as a volatility event. I mean, if you get close to that deadline unresolved, you could get shutdowns in government, so that can affect federal workers. That's another thing that can ripple out if your business serves federal customers, or their families or just their contractors downstream from there, you can get that trickle event of incomes that are at least temporarily dried up.

Lyn Alden:
Also, just obviously challenges to liquidity in general, you actually start to get a very mild pricing in for the potential for temporary default on certain treasuries, which gets weird. So, basically it's a volatility event to navigate and be aware of depending on how affected your business might be by that.

Lyn Alden:
Longer-term the question of the debt, the challenge there is I think in the '90s and the 2000s we had a little bit of a reprieve that I think made people complacent. So, if you look back over the past four decades, ever since the early '80s we've transitioned from falling public debt to GDP to rising public debt to GDP. That was somewhat offset by the fact that interest rates were on a 40-year down trend. So you had higher and higher debt to GDP, but interest expense relative to GDP wasn't really going up.

Gene Marks:
Right. Not anymore.

Lyn Alden:
Yeah, not anymore. Exactly. So, in the late '80s and early '90s, actually you kind of hit peak moral panic around the debt, right? That's when the famous debt clock went up, that's when we had had a third party candidate, one of the most successful in history, a big part of the thing he ran on was the debt. Those people were in some sense were early, because they weren't wrong about the problem, but then you had peak demographics in the late '90s, tech boom, you had, again, falling interest rates that offset a lot of that debt.

Lyn Alden:
But in the past few years, we hit bedrock in interest rates and kind of go sideways to up now while you still have accumulating deficits and debts. Now, the industry expense is actually going structurally up.

Gene Marks:
Right.

Lyn Alden:
So, I think that some of the aspects that maybe lulled us into complacency over the past two decades are no longer there, so I think we're probably going to return to a period, much like to say the late '80s or the early '90s where that debt actually becomes relevant again. Because if you have just ongoing increasing debt to GDP, ongoing deficits, and then you actually get a meaningful interest rate on that, that actually causes a fiscal spiral. You get even larger deficits to pay for those, and then there's very little agreement on what you're going to cut.

Lyn Alden:
I mean, basically you're not going to cut near-term social security Medicare type of things. They might do reforms around the margins to save on medical expenses.

Gene Marks:
Right.

Lyn Alden:
They're probably not going to cut the military much considering what's happening geopolitically, and so you kind of get this gridlock that happens. I think the biggest way that that can affect people long-term is that that can add to a structural inflation component, because if you have very, very large deficits, again, that's kind of like a stimulus for the private sector, but not always in a good way. Because if you're just printing that difference, which they're not doing right now, but if this level of deficits and debt continues, you probably would get back to a period of central bank or commercial bank financing.

Gene Marks:
Yeah.

Lyn Alden:
That's actually quite inflationary, that's more money entering the economy. It's basically just pouring out into the private sector, which can give you a structurally inflationary backdrop. One of the challenges with inflation, especially if it's above average or it's variable, some years you have higher inflation, some years you have lower inflation, is that it makes it harder to do longer term contracts.

Gene Marks:
Yeah.

Lyn Alden:
So, in stable periods, the ease of doing business goes up, you can make longer-term contracts, you can plan out your business longer. When you have these more fluctuating inflationary periods, it's harder to do those long-term contracts. You have to think more short-term, which obviously adds friction and expense to a business, and so that's how it can impact, I think, real people.

Gene Marks:
So really, to put it in the terms of a lot of business people like myself would understand is that when we go for financing from a traditional bank, our debt maintenance is part of that calculation and how we're able to pay that debt back. You're right, over the past 20, 30 years, even as our national debt has gone up, I mean, as long as we could pay it and we could cover the interest and it wasn't really making a big difference, who cared? Now, suddenly we're in a higher interest rate environment, and so that interest portion cuts into a much, much bigger part of the budget.

Gene Marks:
Unless they're willing to cut expenses somewhere, which nobody is willing to do, it's going to have to be paid for somehow. That would've to be paid for through printing more money, which like you just said, would cause more inflation. When you have more inflation, that impacts a lot of business decisions, particularly long-term business decisions. Did I say all that right? Did I get what you just said?

Lyn Alden:
Yeah, that's accurate. The way I would kind of summarize that is that I think on average the 2020s decade is going to have higher inflation than the 2010s decade. It won't be a straight line. It wasn't a straight line in the '70s, wasn't a straight line in the '40s. You kind of had these bursts of inflation, then things settled down, but I think we're probably going to see further bursts of inflation this decade and that just makes business planning more challenging.

Lyn Alden:
Right now they're in a period of tightening, right now banks aren't buying treasuries, the Federal Reserve's not buying treasuries, it's really the retail public that is buying treasuries. But if you get back into another couple years of just massive treasury issuance at this rate, you might have to see the Federal Reserve or commercial banks come back in as buyers. That's pretty inflationary when you're running $1.5 trillion deficits on a just year, after year, after year basis. So, I think that's kind of a key trend to at least be aware of.

Gene Marks:
Lyn Alden is the founder of Lyn Alden Investment Strategy, a former engineer. Electrical engineer, mechanical?

Lyn Alden:
Yes, electrical.

Gene Marks:
Electrical engineer, okay. It's a pleasure to have you, Lyn. First of all, what is your website?

Lyn Alden:
Lynalden.com.

Gene Marks:
Your Twitter account is @LynAldenContact, that's L-Y-N-A-L-D-E-N. Please, if you guys are watching or listening to this, Lyn's newsletter is fantastic, her Twitter account is also great. Super resource to help you follow the economy. I always try to advise my clients to follow certain economists and analysts that can at least give you somewhat of a picture of where things are going, and Lyn is definitely high on my list. So Lyn, thank you very much for joining. I'm thrilled to have you and hopefully we can talk again in the future.

Lyn Alden:
Thanks for having me. Happy to be here.

Gene Marks:
Great. Everybody, you've been listening to THRIVE, a Paychex Podcast. My name is Gene Marks. Thank you so much for paying attention and following along with us. If you need any help or tips or if you'd like to suggest a guest to come on the podcast, please visit our webpage at payx.me/thrivetopics. That's payx.me/thrivetopics. Again, my name is Gene Marks. Thanks so much for listening and watching. We will see you again soon. Take care.

Gene Marks:
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Speaker 1:
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