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Third Quarter 2022
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Unusual Downturn

Are we in a recession today? That's one of the key questions that investors and economists are asking, and there is no easy answer.

A recession is a period of time when the economy stops its usual long-term growth pattern and starts shrinking. The technical definition is a drop in the value of goods and services produced (the gross domestic product) for two consecutive quarters. This is often associated with declining incomes, employment, industrial production, and retail sales.

The U.S. experienced a shrinking GDP in the first six months of the year, but, unusually for a recession, employment was strong, incomes were rising, and prices of goods and services were going up rather than down. Corporate profits are expected to rise for the remainder of the year.

The conclusion is that if we are indeed experiencing a recession, it is an unusual one, triggered not by the usual decline in corporate activity and job losses but by a unique combination of supply chain disruptions, a war in Europe, rising energy prices, and the persistence of COVID. In what other recession in history could we say (as we can today) that the economy added 390,000 new jobs in May, the 17th straight monthly gain, and the unemployment rate is at 3.6%, the lowest in a half century?

Unusual recessions are actually not that unusual. As recently as 2020, the U.S. economy experienced a sharp two-month downturn, the shortest ever. The Great Recession, on the other hand, lasted for 18 months and was triggered not by the usual economic factors but by reckless Wall Street sales of sketchy bundles of mortgages with little underwriting, followed by a housing collapse.

Often, recessions are brought to heel by a central bank stimulus. In the case of the Great Recession and the more recent COVID downturn in 2020, the U.S. Fed flooded the economy with money at zero or near-zero interest rates and made itself a significant buyer of government and mortgage bonds. Both times, the medicine worked. We cannot expect the Fed to ride to the rescue while the inflation rate is as high as it has been, but eventually an economic downturn will depress prices, and stimulus will once again be possible, assuming that an economy with robust employment and corporate profits will actually need it.

From Our FSA Family

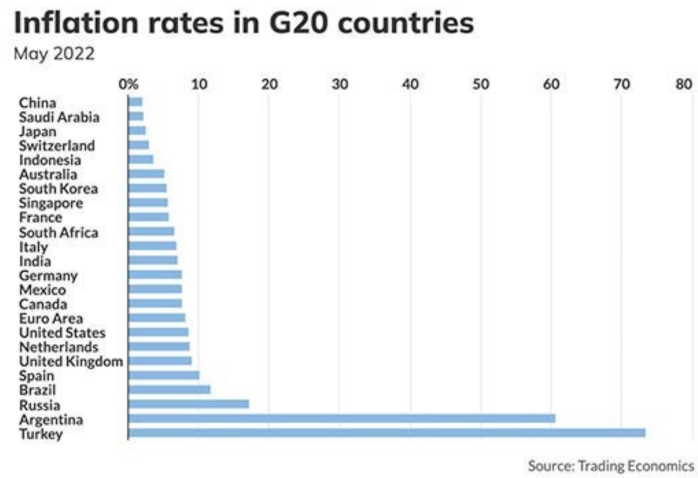
As you may know, FSA cares for our clients and employees, but what you may not know is how much we care about our community, big and small. We wanted to take a moment to highlight the contributions FSA has made this year.

- In April, FSA donated over $5,000 to the Center for Disaster Philanthropy (CDP) to help with the relief efforts in Ukraine.
- In May, we participated in the career day program for Wheaton Woods Elementary School.
- In June, our team came together to create 44 welcome and cabin baskets on behalf of Boulder Crest Foundation. Boulder Crest's mission is to aid veterans and first responders struggling with traumatic stress.
- In August, our team again came together to construct 120 backpacks full of back-to-school supplies. This project was on behalf of Wheaton Woods so that kids in need can be well prepared for their first day of school.
- Also this summer, our Social Committee challenged our employees to a six-week "kill 'em with kindness" challenge, putting together a list of nice things to do for others from which our employees can select and earn points.
- A new initiative FSA has taken on this year is to donate $500 quarterly to additional charities. The fun part about it is that one employee is randomly selected each quarter to choose which charity or charities receive that donation. To date, we've made donations to the American Diabetes Society, the American Cancer Society, the Alzheimer's Association, No Kid Hungry, and the Arlington Food Assistance Center.
- We also have plans later this year to do a winter weather gear drive for Wheaton Woods, participate in the Marine Corps Reserve's Toys for Tots program, and donate to more charitable organizations of our employees' choosing.

Giving back is vital to our company culture. It reminds us that we can all make an impact in this world, no matter how small the effort is.

FSA Cares

Inflation Across the World



The inflation rate, which was so moderate for so long, is now back in the news – and the news isn't good. The U.S. Consumer Price Index, the cost of a basket of items that are included in most monthly budgets, rose by 9.1% over the 12 months ending in June.

But is the U.S. alone in its inflationary misery? As you can see from this May inflation chart, many countries are seeing their monthly costs rising much faster than the 1-2% rate we've all grown accustomed to. And consumers in Turkey, Argentina, Russia, Brazil, Spain, and the UK are having a harder time battling inflation than Americans. What the chart doesn't tell you is that most countries calculate their inflation using measures closer to the personal consumption index. If you compare apples to apples, internationally, then the entire Euro area, Canada, Mexico, India, Italy, and South Africa are suffering higher price increases than we are in the States.

The point here is that inflation has become a global phenomenon, even though most of the press coverage focuses on the U.S. Federal Reserve Board's efforts to raise interest rates. If we're going to defeat the rising costs of living, it will require the coordinated efforts of the global community, which means you can expect other central banks to follow the Fed's lead and constrict liquidity and ultimately their economies.

Protection Against the Unexpected

One of the most frequent complaints about our medical care system is the unexpected (surprise) items on your medical bill after a procedure. Like the out-of-network anesthesiologist who bills thousands of additional dollars after you carefully scheduled a procedure at an in-network facility with an in-network surgeon. Or the expensive ambulance ride that turned out to be out of network. (If you need a ride in an ambulance, chances are you weren't in an ideal position to schedule it.) A recent survey found that for people in large employer plans, 18% of all emergency visits and 16% of in-network hospital stays had at least one out-of-network charge associated with the care.

That doesn't count so-called "balance billing" where a physician might bill a patient directly for services rendered. A more comprehensive survey found that 39% of insured non-elderly adults received an unexpected medical bill in the previous 12 months.

In an attempt to stem this flow of dollars out of consumers' pockets, Congress passed the No Surprises Act which went into effect on January 1. The bill would end many out-of-network surprise expenses and specify that if you choose to receive services from an out-of-network provider, or if an out-of-network provider happens to show up on your service team, you cannot be billed more than an in-network cost. The new law also requires health care providers and facilities to give you an easy-to-understand notice explaining whenever you are getting care out of network and your options to avoid balance bills. You are not required to sign that notice or get care out of network.

Beyond that, people can protect themselves by asking their insurance providers, directly what will be covered (or not) under the policy and to ask their doctor how a medical procedure will be coded for billing purposes. If you elect to have non-emergency surgery, make sure everyone with whom you interact and who participates in the procedure will be in network. You can also comparison shop prices for different procedures using the Healthcare Bluebook.

The Fed and the Bear

By now, you know that the U.S. Federal Reserve Board raised the so-called Fed funds rate by three quarters of a percent for the second time. The stated reason for the rate increase is to squeeze inflation out of the economy. The logic is somewhat complicated, but the simple explanation is that inflation occurs when too much money chases too few goods. Raising rates will make it more expensive to borrow, diminishing purchasing power on credit . . . which could (eventually) result in less borrowing . . . which could (eventually) slow down consumer spending.

But of course, consumer spending is a huge component of economic growth, so less spending will slow down the entire economy at a time when it has already recorded a full quarter of negative growth. And by making borrowing more expensive, the central bank is also reining in corporate spending, which is another contributor to economic growth. In fact, some economists believe that the economy was running "hot" for the past decade because companies could fund their operations with cheap money and unprofitable companies could stay afloat because they could always borrow enough to get by. The almost-free money allowed "distressed" companies to rack up $49 billion in obligations that might need to be structured or face default.

If you look at the bigger picture, the American economy has experienced something quite extraordinary – more than four decades of falling interest rates until they finally fell to zero (short term) or near zero (longer term) and had no more room to fall. The Fed action has built on a reversal of that trend, sending mortgage rates to their highest level in nearly 14 years.

If you want to second-guess the Fed economists with their Ph.D.s, you might wonder whether curbing inflation is worth the collateral damage of negative economic growth, diminished consumer spending, and reeling investment markets where confidence in the future is shaken. Their answer is likely to be that sooner or later they had to take away the punch bowl that led to the economic equivalent of drunken excesses – the stock market boom, meme stocks, special purpose acquisition companies, soaring housing prices, and the alarming rise in the cost of living. They might have been more gentle about it, but we all know that economic booms eventually lead to busts, which weed out unprofitable or poorly-run companies and ultimately deliver a healthier economy and, for investors, provide opportunities to buy stocks at a discount.

The Fed has challenged all of us, whether we run companies or manage our monthly budgets, to endure a painful transition that was probably inevitable and take our medicine all at once rather than gradually over a longer period of time. Yes, the medicine tastes terrible right now. Let's hope it provides the cure that the U.S. central bank is hoping for and that this will lead us into the next economic expansion and a new bull market.

Not Your Father's Retirement: Better

Inflation is up, the markets are down, and millions of Americans have, until recently, been forced to sit on the sidelines of the job market. Baby Boomers entering retirement have it a lot tougher than their parents did with their cushy pensions and cheap home prices. Right?

A recent article in the Bloomberg Press disputes this commonly held view. It notes that for most of human history, people worked until they were physically unable and then spent the remainder of their lives either poor or dependent on family for food and shelter. This changed in the mid-20th century with Social Security and various pension programs which created that purported golden age of retirement in the 1960s and 1970s.

The article notes that even at their peak, only about 38% of private sector workers had one of those cushy defined benefit plans, and they tended to be the highest earners who had the least need for them. One report estimated that 57% of U.S. workers have some form of retirement plan, and that may be a low estimate. A study by the National Bureau of Economic Research found that 56% of 65 year olds, 65% of 70 year olds, 69% of 75 year olds, and 69% of 80 year olds were receiving pension income.

When you factor in all retirement accounts, pension plans, bank accounts, stock portfolios, and Social Security, IRS records show that people today have more or almost the same income as previous cohorts of retirees. Beyond that, there are many more opportunities for part-time work years into retirement for people who want to improve their financial situation after their careers have ended. If there is a golden age to retire, it might be now.

Persistent Inflation

It wasn't so long ago that the economists at the U.S. Federal Reserve Board were reassuring all of us that the spike in inflation was "transitory," which most of us interpreted as "temporary, nothing to worry about, and we're handling it."

The rise in inflation since then has been anything but temporary, and you have to wonder if, at this point, our runaway cost of living increases are beyond the power of any federal agency to rein in. According to the latest figures, the Consumer Price Index, reflecting the cost of items that most of us pay for on a monthly basis, rose another half percent in June, reflecting prices that are a remarkable 9.1% higher than they were last year at this time. To put this in historical perspective, this is the fastest pace of inflation since December 1981, toward the end of the so-called "stagflation era."

You can probably guess where the inflation is coming from. Energy prices are 48.7% above where they were at this point a year ago. Shelter costs rose 5.5% over the past year, the fastest increase in that item since February 1991. Food prices overall are up 10.1% above last year's costs.

One of the most interesting (alarming?) implications of this sustaining surge in inflation is the potential impact on interest rates. Treasury bonds typically pay out roughly 1-2% more than inflation; otherwise, Treasury investors are losing value. Corporate and municipal bonds typically have a higher "real" return (coupon payments above inflation) because they carry a higher risk of default.

But if you look at the numbers, there's a huge discrepancy right now. Instead of paying 9.6% to 10.6%, 10-year Treasury yields are currently around 2.88%. The question of the hour is whether bond rates will, sooner or later, catch up with inflation in order to attract investors who presumably are not motivated to put their money into an investment that is losing money on a real return basis. And if they do, how would such a wrenching shift impact borrowers (higher costs), current bond investors (potentially sharp losses), the stock market (more competition from the bond market), and the U.S. economy as a whole (less easy money for corporate America)?

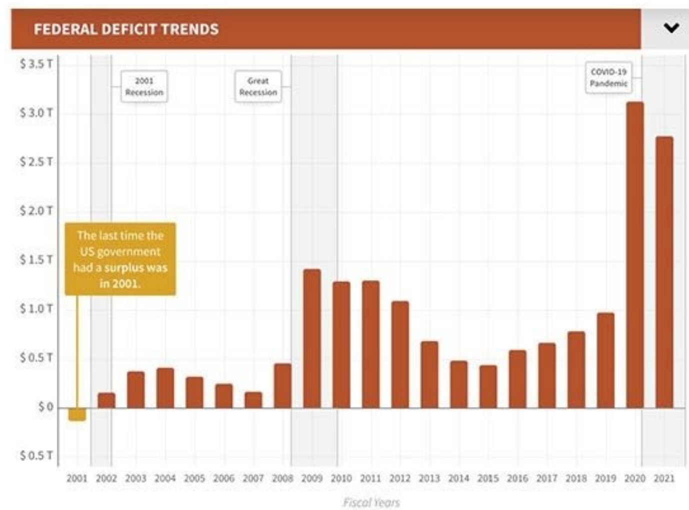
The obvious thing to hope for is that the Fed was right all along and this current inflationary spike is a temporary blip. But as the months of CPI increases go on, that is beginning to look less and less likely.

Deficit Update

The U.S. budget deficit is growing and out of control. Right?

In actual fact, the U.S. government has become rather thrifty of late, at least in comparison with its past profligacy. Last year, the government spent $2.775 trillion more than it took in in tax revenues; the year before that, the deficit reached $3.1 trillion. This year, that budget deficit will shrink dramatically to "just" $1.036 trillion.

The chart shows how, since 2001, the government has put more money into the economy and issued more IOUs (Treasury bills and bonds) than it took in, year by year. The Great Recession years were (most of us thought at the time) doozies with deficits over $1 trillion. But then came COVID, and the deficits exploded to unprecedented highs. The chart doesn't show 2022, but imagine the next bar returning to the 2019 level and you can see how Washington has been tightening the reins.



Going forward, there are several complicating factors. One is inflation . . . which is driving up interest rates . . . which drives up the rates that the government will have to pay on newly issued bonds.

Another is economic growth. When the economy is humming along, tax revenues rise and the deficit is reduced accordingly. If the economy were to contract, that would reduce tax revenues and widen the deficit a bit.

But the bigger question is how much does all this actually matter. When the economy runs a deficit, that means that the government is making more Treasury securities available to the investing public. We lend money to Uncle Sam and receive interest until the bond matures, at which point the government can find other borrowers or sell us a new bond.

There is certainly no shortage of things to worry about in the world, in our personal lives, pretty much everywhere. Taking on the worry of a budget deficit that is actually (finally) coming back down to earth should probably not be at or near the top of our list.

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