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Watching & Waiting:
The Return to the 2% World?

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Remember the good old days before the Covid pandemic? The U.S. economy was performing well. In essence, it was in balance and performing up to its potential. Real Gross Domestic Product (GDP) was trending upward at around 2%, the 10-year benchmark U.S. Treasury note was fluctuating around 2%, and inflation was running at about 2%. We labeled this the "2% world," a complimentary description because, in large part due to the balance within the economy, we experienced the longest recovery/expansion period in U.S. economic history. Importantly, corporate America found this environment to be conducive to business. Companies were performing well in terms of both earnings and dividend growth, and of course, investors in common stocks were benefitting handsomely. It was indeed a good time.

This benign environment was suddenly interrupted when Covid hit and the U.S. and global economies were shut down. While the environment before the pandemic was characterized by balance, ever since, we have been suffering economic and market disruptions. Everything has been out of whack as extreme conditions have been the norm. Consider the following: 15% unemployment and GDP of -35% followed by +35%; six trillion dollars of Covid relief in a two-year span; zero interest rates and massive quantitative easing; inflation of 9%; the sharpest increase in federal funds in the shortest period in history; dramatic stock market declines and then recoveries and then declines again of bear market proportions; and the worst bear market in bonds in history. Needless to say, it has been a harrowing period, one of extremes. Whatever happened to the 2% world, and will it ever come back?

Once economies take on a different shape it is hard to reclaim the former. That said, it is not impossible. In fact, that is what the Federal Reserve (Fed) is attempting to do. All one has to do is look at their September economic projections. Their longer-term projection is for 1.8% real GDP, 2% inflation as measured by Personal Consumption Expenditures (CPE), and federal funds of 2.5%. This is not exactly the 2% world, but it is pretty close. Note, these are longer-term projections, set for after 2025, some three years hence. And nobody expects these targets to be met precisely. They are there more or less as a target and the best estimate of what the economy is capable of when conditions are balanced. In other words, these should be the "normal" conditions of our economy.

If the 2% world is considered to be the normal world, why are we so far off the mark, and what are the underlying conditions that would make it normal again? It all begins and ends with the fact that the economy is only capable of something in the area of 2% growth in real GDP (before inflation) on a sustained basis. GDP is a function of growth in the labor force (assumed to be around 1%) and growth in productivity (also assumed to be around 1%). Basically, GDP is created by getting more people working and having them work more productively. Because the trends in fertility and immigration are weak, and because of the lack of transforming technologies, this 2% real GDP growth rate seems set in place.

The basic condition of 2% growth should return, but what about the other two: inflation and interest rates? In a normal environment, these two should naturally follow from the growth rate. Within a condition of economic balance, a 2% growth rate should not support high interest rates and inflation. Right now, inflation is THE major economic problem as it represents a major imbalance in supply and demand, and the Fed is going after this problem with higher interest rates. The goal is to reduce demand and bring it back into balance with supply in order to keep longer-term inflation expectations under control. We are assuming that the Fed will ultimately be successful in their efforts, but it will not be an easy fight. This battle against inflation entails the risk of a recession and further disruption, but for sure, the return of the 2% world will not occur until the inflation problem is solved.

Some observers posit that the economy has been structurally or fundamentally changed by the whole Covid period and that we are in a permanently altered economy. We have difficulty identifying truly altered circumstances within the economy but acknowledge that there are some that are potentially altering. Globalization, one of the main contributors to low inflation is thought to be on the wane. World trade figures have flattened, but globalization as a phenomenon is more than trade alone, and like other secular trends, is hard to turn back. Within the globalization category, however, supply chain management is undergoing change as companies attempt to diversify their sources to include multiple suppliers, some closer to home. This trend could possibly lead to higher costs. Another possible structural change is the shortage of labor. This could well be the true legacy of Covid as it affected the work paradigm among all demographic groups. Shortages of labor are always a factor of inflation. Time will tell if these changes are truly structural or if, with the passing of the Covid era, they turn out to be merely cyclical rather than structural.

Our view is that we are likely to eventually return to an economic condition that resembles the 2% world. The economy doesn't have to be exactly the same as before, but if it generally falls within a framework of low inflation and interest rates combined with steady growth, it will be a favorable environment for investment. This outlook hinges on the fact that interest rates, globally as well as domestically, have been falling consistently for decades. This is not because the Fed has been leading them down with monetary policy. To the contrary, the Fed has been a follower as fundamental conditions of 1) shortage of demand relative to supply and 2) failure of investment to absorb an abundance of savings has required a low level of interest rates to keep the economy moving forward. Have these fundamental conditions reversed? We tend to think not, but we shall see in the years ahead.

We are prepared for the process of getting back to the 2% world to take some time, and this will be a challenging transition. It has already lasted longer than we thought it would. Our belief rests on the assumption that economic fundamentals always win out; sometimes it just takes longer than expected. Restoring balance in the economy is never easy, but as we noted earlier, it is not impossible. We remain cautiously optimistic that this transition period will eventually yield to a more constructive environment, one of economic balance and stability.

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