The Economy in 2023 and Beyond

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Summary

The economy is actually solid, particularly from the perspective of climbing gym owners. While there are always imbalances in the economy, they are larger right now than what we are used to dealing with. The major imbalance is between the labor market and the rest of the economy, with the labor market remaining much more constrained than almost any other sector, leading to increased competition for labor and higher wages. In the goods economy, inflation has largely cooled off, and there are increasing signs that some areas may already be exhibiting deflation. With the Federal Reserve and FDIC still playing whack-a-mole with bank failures, plus slowing inflation, we've probably seen the top in Federal Funds rates. However, I don't expect to see short rates declining any time soon.

Labor Markets

The most important factor to understand in the labor market is the change in demographics of the US labor force. Baby Boomers were born from 1945 to 1965, meaning that the youngest baby boomers are 58, and the majority are over 65. The generation entering the labor force (Gen Z) are a relatively small generation, like generation X. Figure 1 shows the current shape of the population pyramid. The size of the Millenial (aged 25-44) generation is clear, as is the small size of Gen X (45-60). In this figure, Gen Z looks similar to Boomers, but this is exagerated by the fact that Baby Boomers are already at an age where death rates have increased. Figure 2 is the population pyramid as of 2013, and the relative size of the four generations is clear.

The reason that this change matters so much in this moment is visible from the labor force participation rates by age group. Figure 3 plots the age 25-54 group and the 55+ group, and the change before and after COVID is noticeable. Even as the 55+ group continues to grow in size relative to the 25-54 group due to demographics, its participation rate has fallen by 1.75% or so while the rate for ages 25-54 has returned to pre-COVID levels.

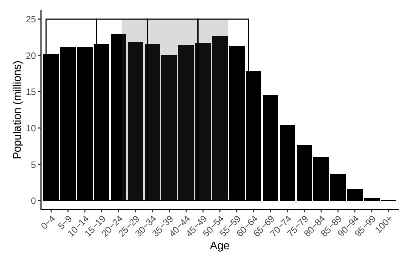
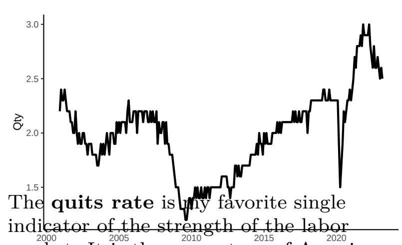


Figure 2: US Population by Age: 2023



The **quits rate** is my favorite single indicator of the strength of the labor market. It is the percentage of Americans who voluntarily quit their job each month. It *does not* include retirements. So in March of 2023 (the most recent data available) 2.5% of workers quit their job. While this is down from the peak of 3% hit in November 2021 and April 2022, it is still quite high compared to the previous 20 years.

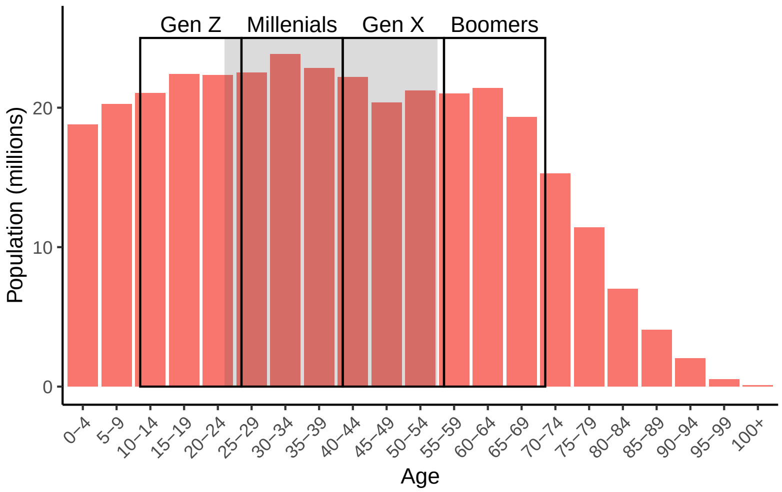


Figure 1: US Population by Age: 2023

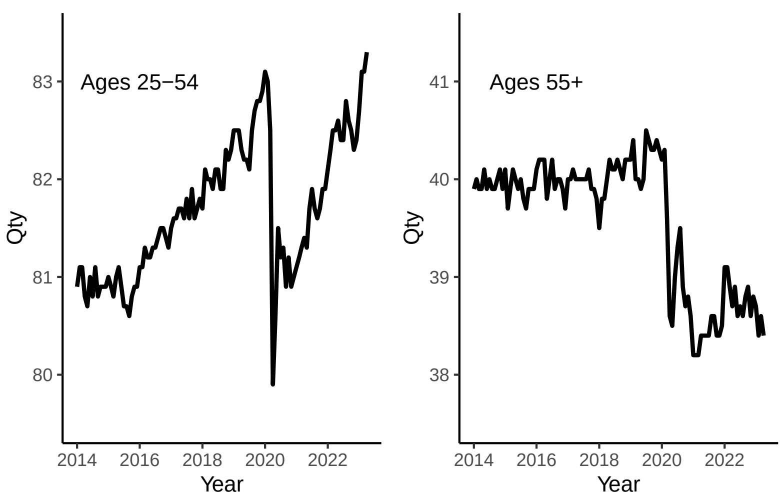


Figure 3: Figure 3: Labor Force Participation

The key takeaway for the labor market are that the changes we've all experienced–more difficult hiring, higher wages, increased expectations from workers–are not temporary, ***this is the new normal***. The pendulum between management and labor has swung toward labor. Even as we are seeing unemployment ticking up with a slowing economy, the shrinking workforce will keep higher unemployment rates from having much impact on actual labor tightness. Practically, this means that we all need to be spending more time on how to be better managers, and keeping our current employees happy and fulfilled. While every generation complains about various characteristics of 'the young' particularly their work ethic, Generation Z has an advantage that labor is in short supply, so they can demand more out of their workplaces. Over time, we will see more and more firms and industries attempt to reduce their dependence on labor, such as kiosks in airports and McDonalds and firms either offshoring or virtualizing support. As we budget, wages will not be declining, and the more skilled the position, the higher the wage growth, though not at the levels that we've seen over the past three years.

Inflation

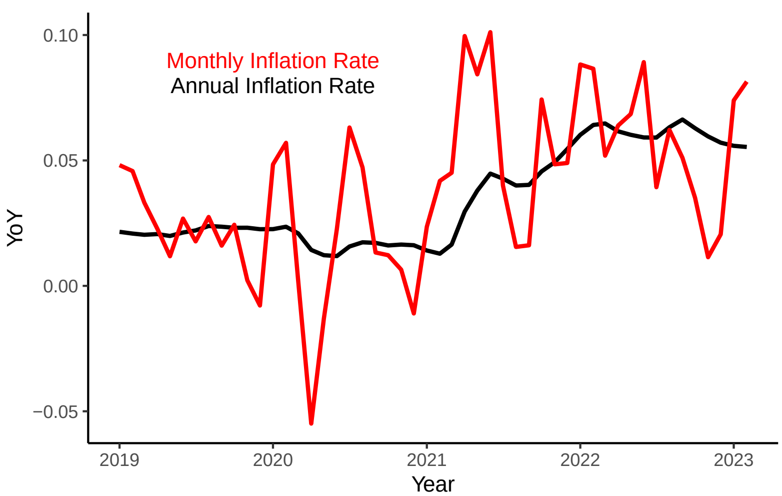


Figure 4: Figure 4: Labor Force Participation

Lots of ink has been spilled about the

Interest Rates

In the 14 months since the first increase in the Federal Funds rate on 17 March 2022, the funds rate has gone from 0% to 5%--an incredible rate of increase not seen since early 1980. Meanwhile, the rates that we care about, the Prime Rate and the 10 Year Treasury rate, have increased from 3.25% to 8.25% and 2.14% to 3.38% (and above 4% at a few points). These two rates matter because they are what loans to small businesses are actually priced against. The 'off the shelf' rate for a 7a Small Business Loan is Prime+2.75%. SBA 504 or other long-term, fixed rate loans are typically priced against the 10 year Treasury Bond.

Short term interest rates have risen much more as the market has continued to believe that the high inflation rates, and therefore interest rates, are transitory. At present, the financial markets are predicting that the Federal Reserve will start cutting interest rates as soon as late 2023 due to a slowing economy and pressure on the banking system.

At this time, I think that this is overly optimistic and underestimates just how traumatized the Federal Reserve is about the level to which interest rates rose. Further, while the bank failures are also a problem for the Fed, minor reductions to interest rates will not staunch the issues, which are tied to poor risk management for the banks and weak supervision on the part of the Federal Reserve itself. The good news is that there should be little affect on main street borrowers as a result of the failures, as credit risk (i.e. risk from loans going bad) hasn't played a part in any of the failures.

For those who utilize conventional (non-SBA) financing for projects, the way that interest rates vary over maturities right now means that loans that have 3 year lockouts will be even more advantageous on yields, as interest rates for loans under 3 years are higher than for those over 3 years. By guaranteeing the bank that you won't refinance before them, they can more readily use those longer term rates.

Finally, a question that I'm hearing more and more is whether very low or zero interest rates will ever return. Ever is of course quite a long horizon, but I don't expect to see 0% interest rates from the Federal Reserve, or 2.5% mortgages, again. The financial system is now having to work through the problems created by those policies, and they will take time. That isn't to mean that 5% short term interest rates are the new normal. I simply would expect the Federal Reserve to treat short term interest rates in the 2-2.5% range as the bottom going forward, and also not to return to Quantitative Easing policies that drove long-term (and mortgage) interest rates so low. There are definitely problems with the course I think that they are on, too. Many of us find ourselves trapped by extremely low-interest rate mortgages, and that will hamper the ability of workers to relocate for better jobs. Work from home will offset some of that, but it is still a change.

Consumer Demand

Even as interest rates and unemployment have risen, consumer spending has remained robust.

Matthew C Roberts, PhD is Senior Grains and Oilseed Economist for Terrain. From 2001-2016, Roberts was Associate Professor in Agricultural, Environmental and Development Economics at The Ohio State University. From 2017 to 2022, Roberts was CEO of 5.Life, a climbing gym chain in Ohio and Pennsylvania, as well as a consultant and speaker to the grains industry. During this period, he also served as a Board Member for Sutton Bank, a $1.4Bn FinTech partner bank in Ohio.

Agriculture is harder than ever before, and to help producers navigate this new and ever-changing landscape, three leading Farm Credit Associations partnered to create Terrain-a team of market analysts and industry experts here to help our farmer-members find more success.