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*In this week's recap: Confidence in Fed helps spark market rally.*

# Weekly Economic Update

*Presented by Ed Papier, May 30, 2022*

## THE WEEK ON WALL STREET

Stocks posted solid gains for the week, buoyed by the release of Fed meeting minutes and upbeat earnings from mid-size and discount retailers.

The Dow Jones Industrial Average jumped 6.24%, while the Standard & Poor's 500 advanced 6.58%. The Nasdaq Composite index gained 6.84% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, rose 2.09%. [1,2,3]

## A GOOD WEEK

The stock market staged a broad rally last week, ignited by the release of minutes from the May's Federal Open Market Committee (FOMC) meeting. The meeting notes eased concerns that the Fed might pursue a more aggressive monetary tightening stance than the Street had anticipated.

Investor sentiment rose owing to solid earnings and encouraging guidance from several mid-size and discount retailers, which eased concerns about the health of the American consumer. A smaller rise in the personal consumption expenditures price index, the Fed's preferred measure of inflation, triggered a strong rally on Friday. The powerful move ended seven straight weeks of stock losses. [4]

## FED MINUTES

The minutes from May's FOMC meeting were released last week. They confirmed the likelihood of at least two successive 50 basis point interest rate hikes. The minutes also indicated they might need to raise rates to a level that acts to restrict economic growth, something that Fed Chair Jerome Powell acknowledged might be a painful process. [5]

Not all Fed members are fully committed to the more aggressive rate hikes. Last week, Atlanta Fed president Raphael Bostic wrote that a pause in rate increases in September might be appropriate. He joined other members in suggesting that economic conditions may warrant reconsideration of additional rate hikes beyond those already signaled by Powell. [6]

## THE WEEK AHEAD: KEY ECONOMIC DATA

Tuesday: Consumer Confidence.

Wednesday: Institute for Supply Management (ISM) Manufacturing Index. Jobs Openings and Labor Turnover Survey (JOLTS).

Thursday: Automated Data Processing (ADP) Employment Report. Jobless Claims. Factory Orders.

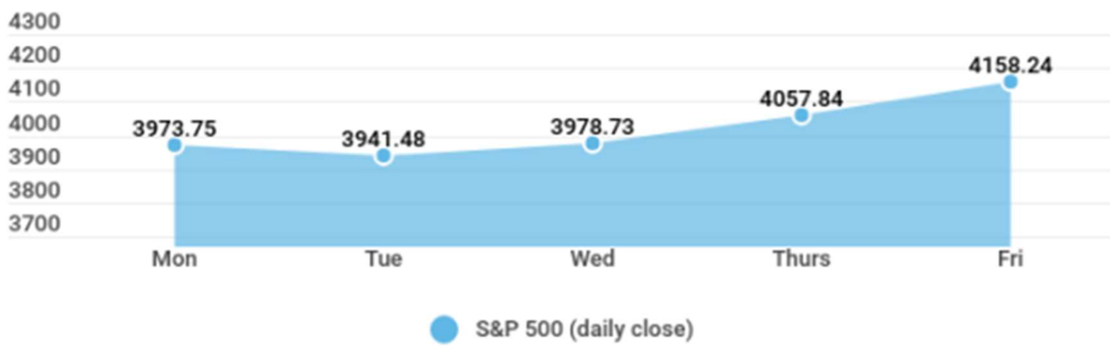
Friday: Employment Situation. Institute for Supply Management (ISM) Services Index.

## QUOTE OF THE WEEK

*"Stupidity has a knack of getting its way."*

*ALBERT CAMUS*

| Market Index | Close | Week | Y-T-D |
| --- | --- | --- | --- |
| DJIA | 33,212.96 | +6.24% | -8.60% |
| NASDAQ | 12,131.13 | +6.84% | -22.46% |
| MSCI-EAFE | 2,010.46 | +2.09% | -13.94% |
| S&P 500 | 4,158.24 | +6.58% | -12.76% |




| | Treasury | Close | Week | Y-T-D |
| --- | --- | --- | --- | --- |
| | 10-Year Note | 2.74% | -0.04% | +1.22% |

Sources: The Wall Street Journal, May 27, 2022; Treasury.gov, May 27, 2022
Weekly performance for the Dow Jones Industrial Average, Standard & Poor's 500 Index, and NASDAQ Composite Index is measured from the close of trading on Friday, May 20, to Friday, May 27, close. Weekly performance for the MSCI-EAFE is measured from Friday, May 20, open to Thursday, May 26, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

## OF NOTE

As the government sector grows larger, real economic growth declines. Not every quarter or every year, but the trend level of economic growth is continuously suppressed by increased government spending. This statement does not come from a dogmatic political view but rather from academic research, the logic of incentives, and data that has proved this thesis over the last several decades.

We can measure government size in various ways, but one reliable method is to look at the rolling average of non-defense government spending as a percentage of GDP. We look at the rolling average because the persistent encroachment of government is the main issue rather than one-time increases that are quickly reversed.

Government size has increased from 8% of GDP in the early 1960s to 22% as of 2021. In other words, government size has increased by 14%.

Economists Andreas Bergh and Magnus Henrekson published a paper in 2011 titled "Government Size ad Growth" which highlighted that a 10% increase in government size reduces real economic growth by 0.5% to 1.0%.

Based on this research, this 14% increase in government size should have resulted in a long-term decline of US real GDP growth in the range of 0.7% to 1.4%. If we look at the very long-term trend in US real GDP growth, a 20-year rolling average, we can see that economic growth averaged 2.25% from the 1960s to the 1990s, with much of the earlier part of those years well above 2.5%. Over the last 20 years, economic growth has increased at a 1.2% annualized rate, a decline of slightly more than 1.0%, perfectly in line with the research of Bergh and Henrekson.

The increased size of government or the persistent rise in government spending erodes the productivity of an economy through a rearrangement of incentives.

When you combine declining population growth with increased government size, thereby reducing long-term productivity, you create a potent cocktail of weaker economic growth.

In the book "Free to Choose" by Milton and Rose Friedman, the changing incentive structure created by government spending is revealed, highlighting why persistently higher government outlays reduce overall workforce productivity and leads to lower long-term economic prospects.

In "Free To Choose," we are presented with a four-option table about spending money.
When you spend money, you can spend your own money or someone's money, and you can spend money on yourselves or spend on someone else. The table is presented as follows:

Category I refers to spending your own money on yourself. The incentive is clear. You will always try to maximize the value you get for each dollar spent. You have a strong incentive to minimize waste and maximize "output."

Category II refers to spending your own money on someone else. The example given is a Christmas gift or birthday present. Although perhaps not quite as strong as category I, your incentive to maximize value is still clear. There will be some loss in value because your preferences and the recipient's preferences are not identical, so while you may think you are maximizing value, it may not be as efficient as transferring cash to the recipient for them to spend, placing them back in a category I situation.

Category III involves spending someone else's money on yourself. This is a wonderful situation where you have no incentive to maximize value at all. The example given is that you are eating lunch on someone else's expense account. You want to get enough value to satisfy your needs, but there's clearly a lack of incentive to stretch each dollar as there is in category I.

Category IV involves spending someone else's money on someone else. The example given is that you are buying someone's lunch on someone else's expense account. There is almost no incentive at all to maximize the value of each dollar spent. Category IV spending will clearly lead to significant waste and much less efficiency compared to category I spending.

All government spending creates category III or category IV spending, which radically reduces the productive value of each dollar spent in the economy not even including the deadweight loss of salaries and administrative costs for the people in the middle conducting the spending.

While most government spending is done with good intentions, there is virtually no way to ensure that the efficiency and productivity of the spending will be equal to category I or category II-type spending. Of course, there are some functions that government needs to carry out, but the point here is that as government size grows, we are marginally converting category I or category II spending into category III or category IV spending.

Each transaction we convert from I or II to III or IV may have a negligible effect that is invisible to the naked eye, but like compound interest, small changes accumulated over many decades create massive transformations. As government size in the United States has increased from 8% to 22%, we have shifted 14% of our economy to category III or category IV spending, which cannot have the same efficiency as category I or II spendings.

The collapse in per capita growth is clear evidence of these inefficiencies manifesting over time, corroborating the research of Bergh and Henrekson.

It's virtually assured that population growth in the United States will continue to decline as demographic forecasts are slow moving and relatively accurate. It's also virtually assured that government size will grow in the future due to Social Security, Medicare, and Medicaid, combined with the political reality that shrinking government size is a historical anomaly.

Through the logic of incentives, productivity growth will erode over time. When coupled with declining demographics, the two factors that comprise trend growth imply a continuous decline in per capita GDP growth.

The 2.5% growth that faded to 1.5% growth will soon be appealing as sub 1% sustained real growth will become the new reality in the decade to come.

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CITATIONS:

1. The Wall Street Journal, May 27, 2022
2. The Wall Street Journal, May 27, 2022
3. The Wall Street Journal, May 27, 2022
4. CNBC, May 27, 2022
5. The Wall Street Journal, May 25, 2022
6. The Wall Street Journal, May 25, 2022
7. seekingalpha.com/article/4494904-why-government-spending-makes-the-economy-weaker