The Kiplinger Letter

FORECASTS FOR EXECUTIVES AND INVESTORS

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Dear Client: Washington, Sept. 1, 2022

After mushrooming amid scant regulation… Cryptocurrencies are in for many new rules in the next few years, as regulators in both the U.S. and other Western countries seek to bring some order to this free-wheeling new sector of the financial world.

FINANCE

The most basic challenge regulators face: Deciding what exactly cryptocurrencies *are*. Are they securities, and should they be regulated as such? Or are digital currencies commodities, and thus subject to different rules and rulemakers? For instance, the Securities and Exchange Comm. thinks that some crypto should be seen as securities regulated by the SEC. But a federal judge ruled that virtual currency like bitcoin is a commodity, subject to the Commodity Futures Trading Comm. (The crypto industry would prefer to be regulated by the CFTC, a smaller and arguably laxer agency.)

Then there is the question of stablecoins… digital tokens linked to conventional pegs of value like the U.S. dollar, but not necessarily backed up by an equivalent amount of the conventional asset.

Should their issuers be treated like banks that are regulated as depository institutions? So far, stablecoins have largely operated in a vacuum, but regulators are worried that they could fail if not sufficiently backed by the tangible asset they peg to, causing substantial losses for unwitting users.

Nonfungible tokens, or NFTs, are another regulatory question mark. NFTs confer ownership of unique digital properties…images, works of art, collectibles, etc. A few sell for inexplicable sums, making them possible vehicles for money laundering.

Regulatory answers to these issues won't come overnight. But they're coming. Australia and the European Union have begun issuing crypto rules. The U.K. plans to do so soon. China largely banned crypto usage…too threatening to communist rule.

In the U.S., the current regulatory landscape is an incomplete patchwork.

The first step will be setting priorities. In an executive order, President Biden has tasked the SEC, CFTC, IRS and other agencies with developing rules for crypto that focus on protecting the stability of the financial system, protecting consumers, and promoting beneficial new financial services that may be made possible by crypto. Meanwhile, lawmakers are mulling legislation to clarify what different digital assets are and which agencies should regulate them. It'll be a while before any such bill can pass.

If all this sounds a bit academic, keep in mind just how big crypto has gotten.

One in five Americans reports having traded cryptocurrencies. Younger people are especially likely to be active in the market, yet many don't understand the risks.

The value of all cryptocurrencies soared to $3 trillion last year, then crashed to $1 trillion more recently amid extreme volatility. Since early 2021, over 46,000 folks have jointly lost $1 billion in crypto-related scams…casualties of a financial Wild West.

Economic Forecasts

GDP growth
1.6% in '22,
0.5% to 1.1% in '23

Interest rates
10-year T-note rising with better news; expect decline as news softens

Inflation
Peaks at 9.0%; 8.0% at end '22; 3.0% at end '23

Unemployment
3.6% at end '22,
4.0% at end '23

Crude oil
Trading below $90 per barrel this autumn

Corporate earnings
Large firms, quarterly change:
Q3 –3%, Q4 4%, 23Q1 –1%, Q2 4%

Complete economic outlook at **kiplinger.com/outlooks**

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THE FED The Federal Reserve will stay on its current path of interest rate hikes well into next year, unless a recession intervenes. Jerome Powell, the Fed chairman, has reiterated his commitment to bringing down inflation, saying it's less risky to raise rates for too long than to start easing too early.

The Fed wants the economy to slow, so supply can catch up with demand, allowing price pressures to ease. While housing is already slowing sharply, Powell is particularly concerned with the labor market and ongoing worker shortages, which are pushing up wages. Even when adjusting for an aging population, there are still roughly 2 million Americans who should be in the labor force but aren't.

HOUSING The slowdown in housing markets should restrain home price increases, at the very least, and may even force home prices to come down a bit. Higher mortgage rates are taking a toll on new-home sales, which have fallen to their lowest level in six years, while inventories have risen to a 13-year high. Sales of existing homes have also fallen steadily, though inventories remain low (1.3 million units), meaning supplies will remain strained both this year and next.

Millennials are in their peak household formation and home-buying years, which is contributing to the severe shortage of affordable entry-level housing.

But household formation will show a significant decline within five years, as the smaller Generation Z follows. Household formation will continue to fall till 2040, when it will be only half of what it is currently. Eventually, supply will catch up with lower demand, easing long-term pressure on housing prices.

SUPPLY CHAINS Shipping delays from China should dissipate by the end of the year. But ripple effects will continue, for now. Unloading delays have nearly ended on the West Coast, and negotiations with the longshoremen's union look promising. But East Coast ports are still congested from ships trying to bypass West Coast ports. The cost of shipping a container from China to the West Coast is now $5,200, down 40% from its peak in March, but still nearly triple its prepandemic level.

Piles of empty containers continue to sit at U.S. ports and shipping terminals, taking up space and chassis needed for efficient operations. Ocean freight carriers aren't incentivized to move containers back to Asia, since they already have enough of them there. Federal regulators have taken notice and pledged to get involved.

AG Some bad news on the food price inflation front: Drought is taking a toll on key growing regions throughout the world. The U.S., for example, looks set to have its smallest corn crop since 2019, with observers in the Midwest reporting extensive crop damage from brutal heat and a lack of water. Meanwhile, China...a top grain importer...is experiencing its worst drought since the 1960s, which could increase its grain purchases from abroad and exacerbate supply woes.

While prices of corn, wheat and soybeans have cooled from record highs...

They remain highly elevated amid strained global supplies, resulting in part from Russia's ongoing invasion of Ukraine. A deal to allow the resumption of grain shipments from Ukrainian ports has offered some reason for optimism. But even if it holds, more is needed to replenish depleted global grain stocks.

Keep an eye out for bad weather surprises that could send prices soaring.

METALS Drought has also affected the output of metals in places like China, where hydropower helps enable the energy-intensive production of aluminum, zinc and other industrial metals. The good news: Smelters in China's Sichuan province are once again receiving a reliable power supply.

Despite supply concerns stemming from smelter shutdowns in Europe...

China will remain the most important bellwether for metals prices. The big question: Can Chinese demand hold up amid a global factory slowdown?

EDUCATION

COVID-19 is fueling yet another shortage, this time in the classroom. Nationwide, schools are short around 300,000 teachers and support staff, according to the National Education Assn., the nation's largest teachers' union.

The problem is twofold: Teachers are leaving the profession in droves. A Jan. survey found that 55% of educators are thinking of leaving the profession earlier than they had initially planned, up from 37% in Aug. of last year.

And schools are having a difficult time recruiting their replacements.

One reason: Colleges are producing fewer new teachers. Case in point: Around 85,000 students earned bachelor's degrees in education programs in the 2019-20 academic year, a 16% fall from a decade ago and less than half of what it was in the 1970s, according to Dept. of Education statistics.

Recruiting is especially difficult in certain high-need specialty areas, including special education, science and mathematics, and foreign languages...

And in poor school districts that lack the resources to attract new teachers.

Schools will cope with the shortage however they can until the supply of teachers is replenished. Ideas include larger class sizes, shorter school weeks, relaxed requirements for certain credentials, hefty signing bonuses and more.

HEALTH CARE

One industry that's better prepared than most to weather a recession: Health insurance. According to a report by Moody's Investors Service, health insurers aren't totally immune from the effects of ongoing inflation and slowing economic growth, but they are less exposed than the economy as a whole. One reason is the short-term nature of health insurance policies, which are renewed annually and allow for the incorporation of pricing pressures.

An economic downturn could still hit insurers in a number of ways. Job losses would negatively impact enrollment in employer-sponsored health plans, while simultaneously driving up utilization among those who remain employed, who want to use their coverage before possibly losing it by being laid off.

But history suggests that the sector will fare better than others. In 2008, insurer earnings declined by 27%, compared to a 77% decrease for the S&P 500. Moreover, insurers are arguably better prepared for an economic downturn now than they were in 2008, in part because of diversification. For example, UnitedHealth, Cigna, Humana and Elevance Health all now own many noninsurance assets, such as pharmacy and health info services, insulating them from enrollment declines.

DEFENSE

While the commercial jetliner market continues its post-COVID ascent... Military aircraft demand is also bolstering the aerospace industry's recovery. Military aircraft are a much smaller share of the aerospace market than jetliners. In 2018, the last "normal" year for the industry, there were $64 billion in new orders for defense aircraft and parts, versus $168 billion for nondefense aircraft and parts. But while demand for commercial jetliners plunged during the pandemic, orders for military aircraft held up much better, thanks to continued Pentagon spending on military hardware. U.S. defense spending is expected to remain elevated for the foreseeable future, thanks to the currently hostile geopolitical environment.

Pentagon tactical-aircraft procurement spending will return to record levels in the 2023 fiscal year (over $16 billion), after falling below $15 billion in FY22.

The F-35 will dominate Pentagon aircraft spending for the next decade, but other programs will also expand in that time, like the B-21 bomber...good news for prime contractors Lockheed Martin and Northrop Grumman, in particular.

For now, the industry's greatest challenge is keeping up with demand. Like other businesses, aerospace suppliers have experienced supply chain issues. This will likely accelerate a recent trend of greater flexibility in government contracts, giving suppliers more leeway when confronted with shortages of critical inputs.

TELECOM T-Mobile's new partnership with SpaceX faces plenty of technical hurdles. But the satellite-to-cellular plan reveals an exciting future where cell service is more ubiquitous, without special equipment, even in the hardest-to-reach spots. T-Mobile is creating a new network using SpaceX's Starlink constellation of satellites, which will broadcast signals via a section of T-Mobile airwaves for texting service. T-Mobile says it will work on smartphones anywhere, as long as you can see the sky.

The service doesn't start until the end of next year and delays are possible, from weather or other issues. T-Mobile is waiting for SpaceX to launch new satellites.

T-Mobile isn't the only company looking at satellite-to-smartphone tech. Apple is reportedly working on it, as are AST SpaceMobile, Lynk and Omnispace.

The direct satellite-to-device market could be big by the end of the decade. Northern Sky Research, a space market research company, predicts that revenues for the nascent market will hit nearly $20 billion by 2030, from nothing this year.

TECH Just how important are automakers to chipmakers, and vice versa? Ford CEO Jim Farley is making a pit stop to speak before chip executives in Nov. as the keynote presenter at the Semiconductor Industry Assn. Awards dinner.

Autos are a booming market for semiconductors, from cheap analog sensors to pricey advanced artificial intelligence processors, and everything in between. It's the global industry's fastest-growing segment and a huge focus of chip sellers.

Semiconductor sales to the automotive sector could surge to $250 billion by 2040, up from $40 billion in 2019, according to professional services firm KPMG.

Electric vehicles require twice as many semiconductors, on average, versus autos with an internal combustion engine...a driving force behind the growth. All cars are getting more chips for wireless connections and autonomous features.

TRAFFIC U.S. roads keep getting more dangerous as traffic fatalities continue to spike. In 2022's first quarter, almost 10,000 people died in motor vehicle crashes, says the National Highway Traffic Safety Admin...the most fatalities for a first quarter since 2002 and the seventh straight quarterly increase. Last year, nearly 43,000 people died in car crashes, up about 11% versus 2020, and the most since 2005, says NHTSA.

The root causes aren't clear, but more drivers on the road are likely a factor.

Federal officials say they expect, or at least hope, deaths will soon decrease in response to increased funding for highway safety research and outreach programs in the bipartisan infrastructure law. NHTSA also has a new antispeeding campaign. Note that not all states had more traffic deaths: 19 saw a decline in the first quarter.

TRAVEL Over half of American adults are expected to travel over Labor Day weekend. An estimated 137 million of them plan to do so, matching 2021's figures, according to a survey commissioned by the travel website The Vacationer. Two-thirds of travelers will take a car and one-quarter will fly, with the rest using other means.

Domestic round-trip airfare will cost an average of $278 during the weekend, a 23% increase versus last year, and up 20% over 2019, says travel website Hopper. Despite costly tickets, more will fly than during the Fourth of July or Memorial Day.

About half of Americans say that high gas prices will affect their travel plans. Of those traveling for the holiday, half say they plan to stay within 100 miles of home.

Yours very truly,

Knight Kiplinger

Sept. 1, 2022 THE KIPLINGER WASHINGTON EDITORS

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