KPMG Economics

Groundhog day
Structural change watchlist

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The 1993 movie *Groundhog Day* became a cult classic. Bill Murray plays the lead character, Phil, an egocentric reporter, eager to move beyond the small-town reporting and festivities of February 2. Instead, he gets caught in a time loop, reliving the holiday over and over again.

He starts his journey frustrated and confused by the repetition. He tries to break the cycle by engaging in reckless behavior and exploiting his knowledge of future events. Those efforts left him chasing his tail, reliving February 2.

The story struck a nerve. The pandemic was like being suspended in time. We eventually escaped quarantines only to face another setback: inflation. Even the matchup for the 2024 election feels like a scene from the movie, with the same two candidates facing off as in 2020.

This publication focuses on the structural shifts underway and how they are likely to affect the course of the economy. Economists observe two forms of change:

1. Cyclical changes are shifts that play out quickly, over the course of months or quarters. The surge in home sales and the pent-up demand unleashed as the economy reopened is an example.
2. Structural changes take years to form and play out and are the primary reason that no two business cycles are alike. One example is the aging of millennials into their thirties, and the pent-up demand that triggered, while baby boomers aged in place. The two trends collided to restrict supply, and buoy home values, even as mortgage rates soared over the last two years.

Structural shifts are more powerful and longer in duration. They influence the contour and length of any given business cycle. The pandemic accelerated many shifts already in place, while triggering a whole new set of issues. Most of the structural shifts have left us with a higher level of uncertainty about the future and made the economy more susceptible to shocks and bouts of inflation.

A top 10 list

#1 Income and wealth inequalities worsen. Growing disparities in income persisted in the 2020s, despite a massive leveling up of wages. The same is true of wealth, which hit another record in the first quarter. Stock ownership hit a record high, but the bulk of those gains still accrues to high-income households.

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Why do we care? Because income and wealth inequalities place a drag on growth, limit economic and social mobility and stoke political polarization and instability. Divergent interests make consensus harder to reach and open the door to the appeal of the extremes on the right and left of the political spectrum, as discontent with the status quo mounts.

Separately, high concentrations of wealth foment speculative investments, which can lead to financial instability. The current rush to buy stocks related to generative AI is an example, as was the speculative bubble that precipitated the subprime crisis.

The largest near-term threat is the value of office space and the lending that accompanied it. Everything from pension funds to private investors reached for yield in the 2010s, which fueled alternative investments. This is the same time that most of the losses on lender balance sheets are still unrealized.

#2 A rise in political extremism. Most voters no longer feel that elected officials care about what they think. Two-thirds are dissatisfied with how democracy is functioning in the US; half do not believe either party is representative of their views.

They are not wrong. Research on the role of money in politics reveals that the purse overrides partisanship on large policy decisions.

In response, voters have opted for more extreme candidates on the left and the right. Moderates in both parties are retiring.

Odd bedfellows are forming, which one journalist dubbed "neopopulism." The extremes of the two parties have teamed up in their opposition to funding foreign wars, efforts to curb the power of large firms and their support for protectionist policies; tariffs to subsidies for "strategically important" industries, such as computer chips, have bipartisan support.

#3 Geopolitical tensions and fragmentation intensify. The wars in Ukraine and the Middle East illustrate how rapidly the geopolitical landscape can shift. Financial markets have grown complacent on a further escalating of tensions to their own peril.

This is the same time that populist leaders on the left and the right are having a moment. The surge in support for far-right candidates in parliament for the European Union (EU) is one recent example. The rise of more leftist leaders in parts of Latin America is another.

Countries are turning more inward and adopting more protectionist policies at the same time as regional conflicts are on the rise. China's move to expand its military presence in the South China Sea along with its alliances with North Korea, Russia and Iran have further strained relations.

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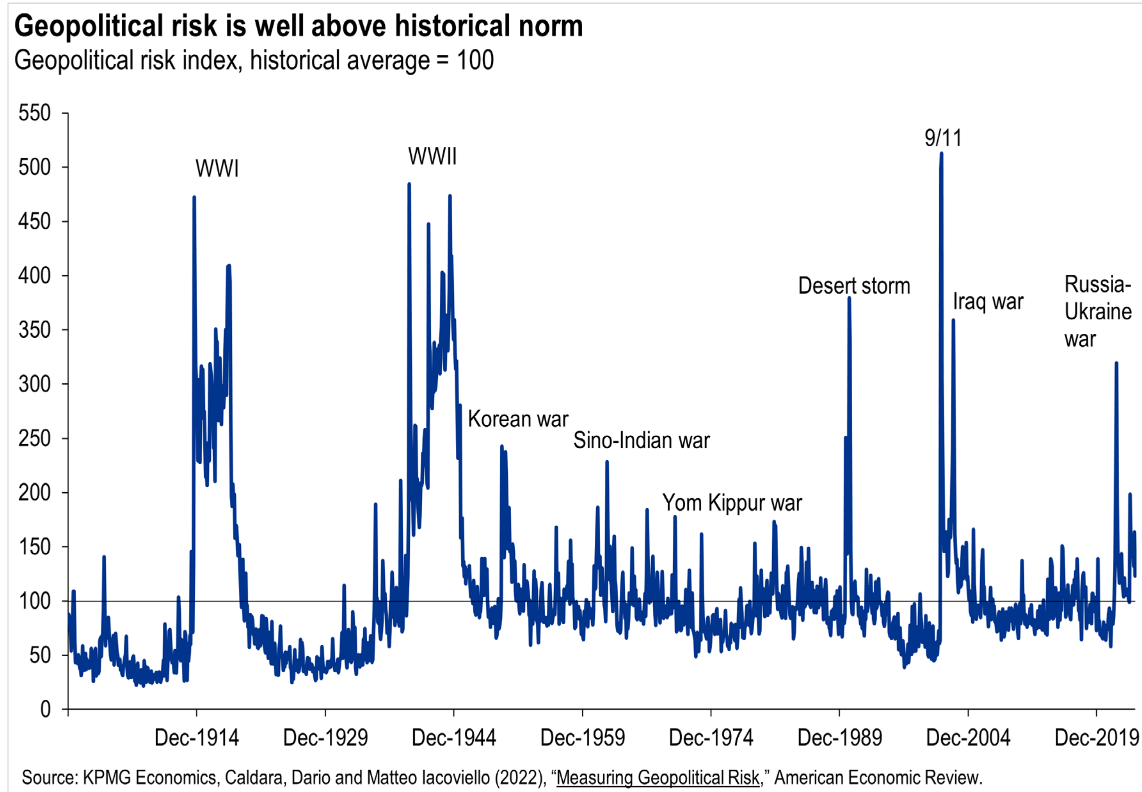
Chart 1



Source: KPMG Economics, Caldara, Dario and Matteo Iacoviello (2022), "Measuring Geopolitical Risk," American Economic Review.

#4 Backlash to trade and snags to supply chains compound. The push for global trade pacts has been usurped by a rise in regional trade pacts. That has boosted trade but made it more costly and less efficient than when producers prioritized cheap labor alone. A rise in protectionism via tariffs and the push to trade with countries who share "friendly" relations with the US are further disrupting supply chains.

The pushback on trade is bipartisan and international in scope. The EU levied tariffs on electric vehicles not long after the US, despite closer economic ties with China in its, manufacturing sector. China has already retaliated with its own dumping probe into the EU.

One thing many people mistake is who bears the costs of tariffs. Tariffs are a tax on the goods and services coming into the country that levies them; they are paid for by the consumers and producers in that country, not by the country they are levied against. There may be a strategic purpose, but they are still costly to consumers in the countries that impose them.

Even countries with trade agreements are at risk. The first review of the United States-Mexico-Canada Agreement (USMCA) is scheduled for 2026. A failure to approve it could trigger its dissolution by 2036, with more tariffs in the interim.

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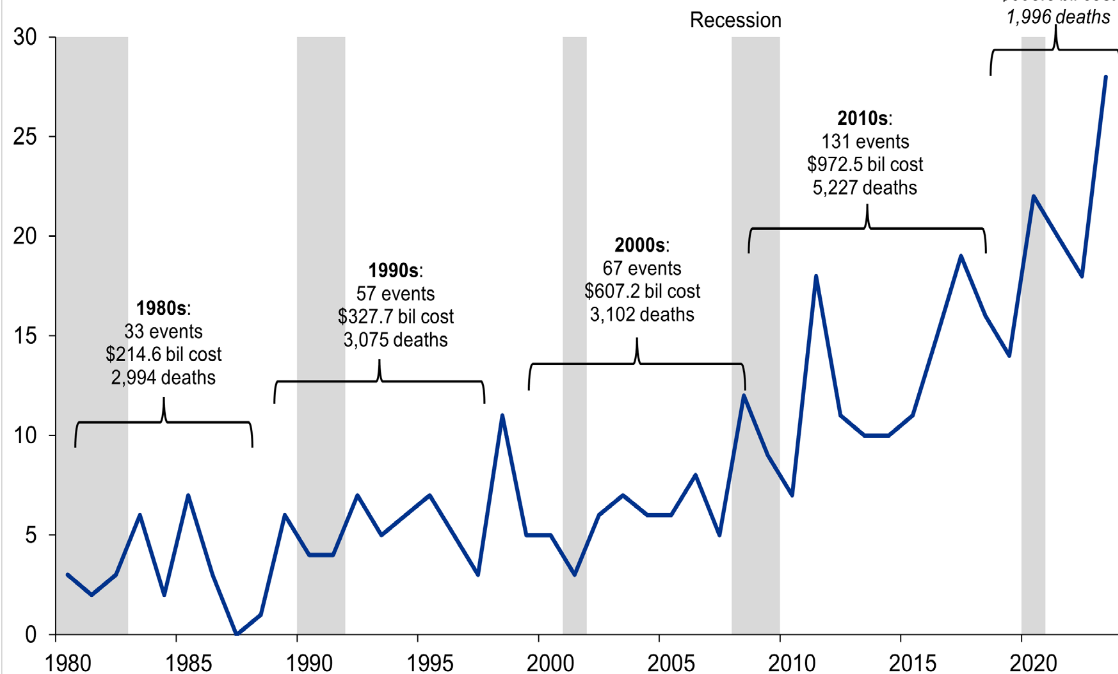
Chart 2



#5 Disruptions due to extreme weather accelerate. The National Oceanic and Atmospheric Administration (NOAA) issued its most alarming forecast for 2024. The incidence of everything from rising water levels, severe storms to heat, brownouts, droughts and fires has increased. The fallout has caused an increase in insurance-related losses and compounded disruptions to travel and supply chains.

NOAA tracks shipping when a storm warning is issued over the oceans. The ships immediately reroute to avoid the storms, which can add two days to two weeks to shipping times. Those costs show up as either a squeeze on margins or as higher inflation. Air freight has already been bid up due to a drought in the Panama Canal and attacks around the Suez Canal.

Home values have begun to reflect climate risks. Low-income households often live in the riskiest areas, with little access to or the ability to afford insurance. That leaves the government as the insurer of last resort. The rise in the number and severity of extreme weather events is not likely to abate, barring a technological breakthrough to cool temperatures.

Thus far, most of the migration due to climate change has been within country borders. People left rural areas, which no longer supported their livelihoods, for urban centers. More movement will be between countries going forward. At least a portion of the rise in immigration from Latin America and the Caribbean is due to climate disasters. Flooding in Brazil alone displaced 600,000 people directly and had spillover effects for another 2 million in May alone.

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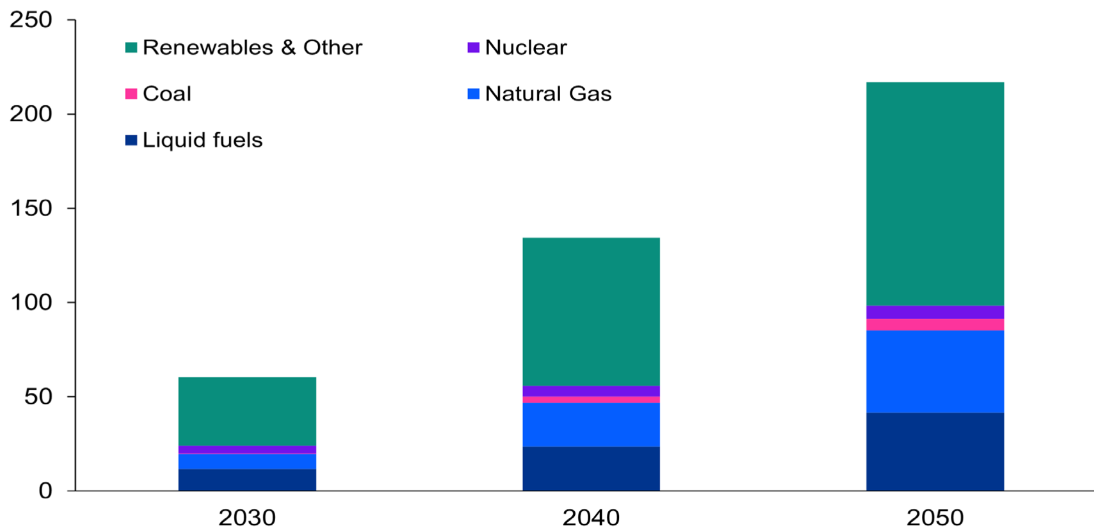
#6 Technological innovation accelerates. The pandemic functioned as a catalyst, with the pivot online forcing us to invest in new technologies and leverage existing ones. Those shifts, and the improved matching between workers and employers that occurred as quit rates in the labor market soared, boosted productivity growth last year. Training was deferred during the height of the hiring frenzy then picked up as quit rates fell.

The bulk of the shift due to the advent of generative AI (GenAI) is still ahead of us. It can take a decade or more to build out the infrastructure, learn and adopt new technologies. Many are expecting a much more rapid transformation from GenAI. It will no doubt rock our world but the jury is still out on how it will be fully adopted and the guardrails that will be imposed to limit its more nefarious uses.

Many of the pie in the sky estimates on productivity growth and job displacement did not incorporate the demand and cost of the energy needed to run GenAI models. One GenAI tool alone can easily use the same amount of electricity as 17,000 US households to support queries. Hence, the tech sector's laser focus on better storing renewable energy and tapping the potential of nuclear fusion, a nearly inexhaustible source of carbon free energy. They need that to run and expand use cases for GenAI.

#7 Energy demand soars. The ramp-up in solar and wind has been one of the most rapid shifts in technology on record. The problem is that we are chasing a moving target when it comes to energy demand. About 790 million people still lack access to electricity globally; what little access to electricity many have is inadequate. A household must have access to charge a phone and keep the lights on for only four hours a day to be classified as "electrified."

Chart 3



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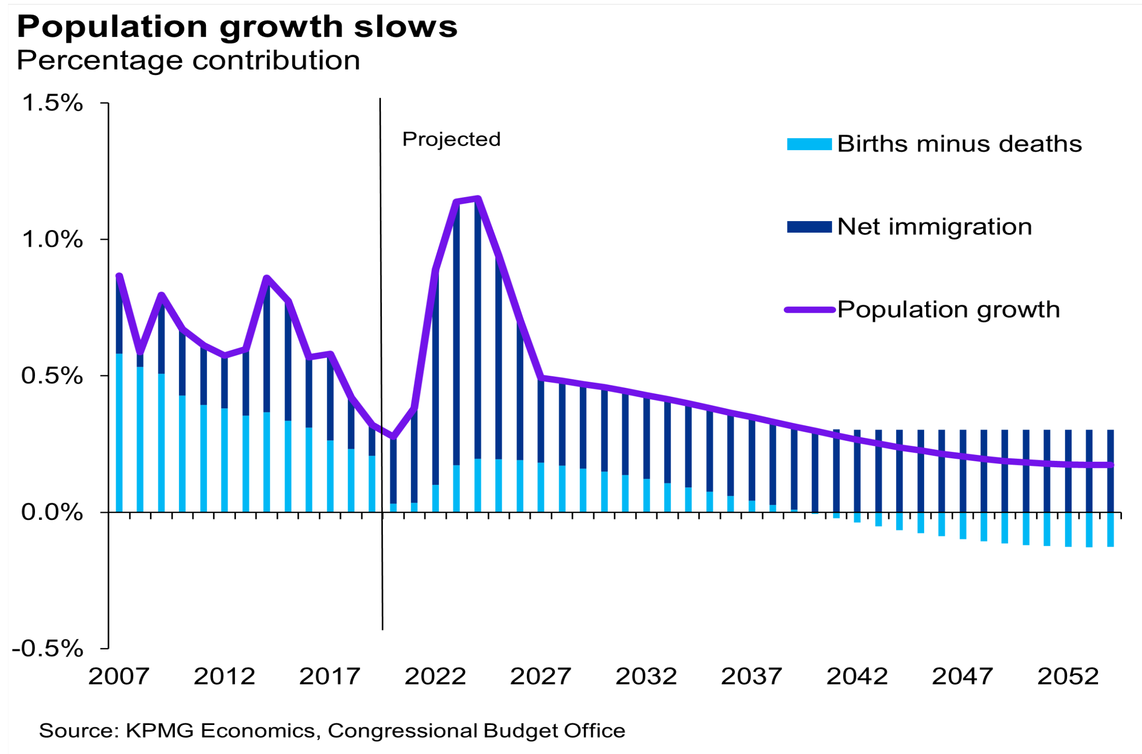
The Energy Information Administration (EIA) estimates that global electricity demand could increase sharply by 2050. Nearly all of that increase in demand is expected to be met by zero-carbon technologies, which ups the risk of stranded assets.

#8 Aging demographics and opposition to immigration. The aging of the baby boom generation is already showing up in lower labor force participation rates. Absent immigration, the prime-age labor force would not have grown since February 2020. The surge of millennials in their thirties, who now dominate the labor force, was not enough to pick up the slack left by retiring baby boomers.

Low birth rates exacerbate the problem as we move toward mid-century. Estimates by the Congressional Budget Office (CBO) show the overall population contracting by 2040, absent an influx of immigrants.

Those shifts will increase what is known as the dependency ratio – the percentage who are tapping Social Security and Medicare but are no longer paying into the system. The stress on the federal budget is substantial; they are pay-as-you go programs. Those who are working and their employers are paying for those who are drawing the benefits.

Chart 4



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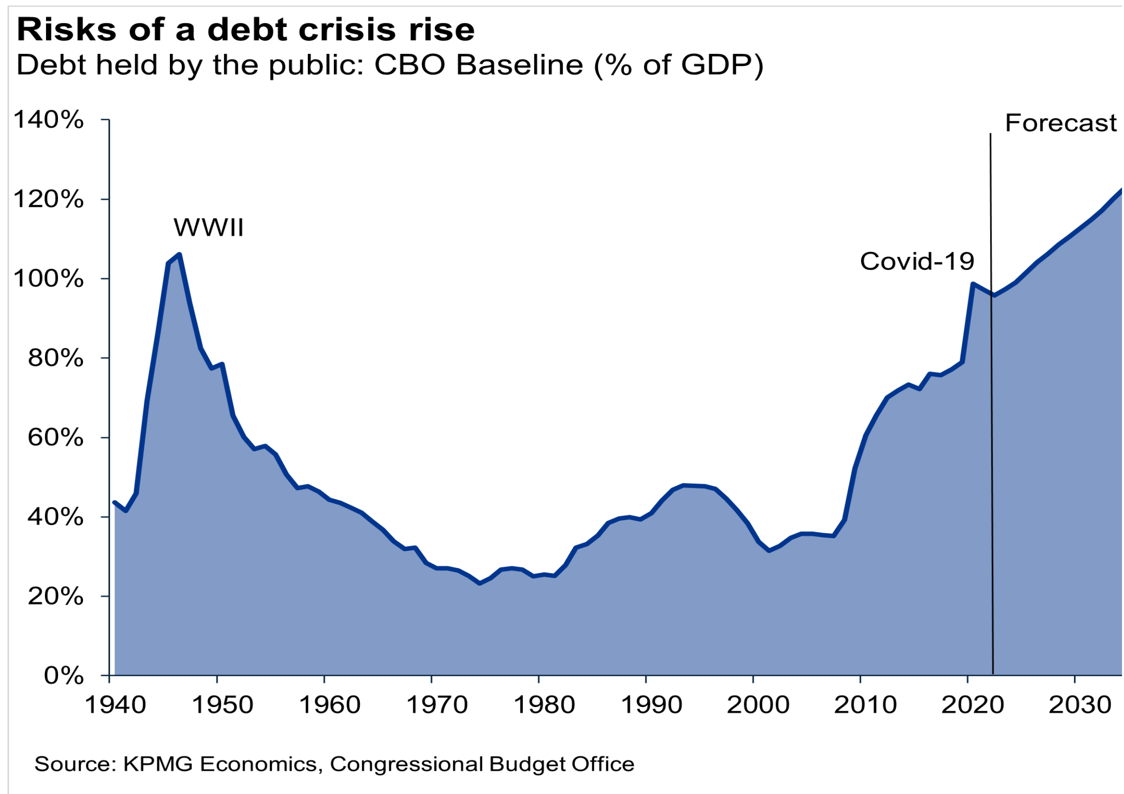
The offset is a combination of higher immigration and/or record increases in productivity growth. The labor force participation rate of foreign-born workers is higher than that of native born. Immigrants who work, even those who are undocumented, pay into the payroll taxes that support Social Security and Medicare. That does not alleviate the stress on individual cities and states due to undocumented immigration but does underscore the need for immigration reform. That and entitlement reform, which includes Social Security, have become the third rail of American politics.

#9. Risks of a debt crisis are amplified by mounting debt and political dysfunction. The nonpartisan CBO estimates that government debt will rise to 122% of GDP by 2034, the highest percentage on record. CBO assumes that expiring tax cuts from the 2017 tax reforms will lapse. Any that are extended will either have to be paid for with cuts elsewhere or will expand our debt burden.

The major credit agencies have downgraded our debt in recent years. The primary reason is the political brinkmanship surrounding the lifting of the debt ceiling, an archaic law that was never meant to be used as a weapon of mass destruction. A deliberate default on our debt would not only trigger a surge in rates and flight from the dollar as a reserve currency but could destabilize global financial markets.

That is separate from the threat of “bond vigilantes”, a term for bond buyers who punish elected officials for taking on too much debt by demanding higher interest rates. The surge in rates in the UK after a new government proposed unsustainable tax cuts in the fall of 2022 was swift and abrupt; it led to the resignations of the prime minister and the finance minister. That hasn’t happened in the US, yet.



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#10 Legacy effects of COVID prove haunting. The pandemic left scars. The ranks who are working with a disability soared along with the incidence of long COVID. Remote work became more common, which helped those who were working to remain on the job longer. The problem is that the benefits of flexible work tend to accrue more to office than front-line workers. It has also accelerated a restructuring of downtown space and where and how we do work.

Working parents, who were struggling with a childcare crisis prior to the pandemic, are getting hit hardest. They must care for kids that are now literally sick more often. What little daycare they can find won't help when their kids are home sick, or worse, hospitalized. As a parent of a child with a chronic illness, this is something I know well.

Those shifts are in addition to a surge in absenteeism among students across income strata. The absences are worse in low-income households, which stayed online longer. That and the need to miss school to care for younger siblings so a parent can work is widening the gap in education triggered by COVID, slowing economic mobility and exacerbating income inequalities.

The only silver lining is recent research on compassion, which has shown a resurgence among our youth. Compassion tends to be higher among those who report being lonely. Researchers are not quite sure why, but surmise that "being lonely acts like a 'social hunger,' driving people to seek out and empathize with others."

The shift follows a multi-decade deterioration among the compassion our youth feel, starting in the 1970s. The pivot occurred around the Great Recession and accelerated after the pandemic, suggesting that adverse events might bond us more than is apparent from our divisive politics.

Bottom Line

The pandemic amplified and accelerated many of the structural shifts underway prior to the pandemic. The tendency is to pull in and cooperate less on the global stage to solve our common challenges. Those moves have left us with a more volatile world that is more susceptible to supply shocks and bouts of inflation than the one we left.

In terms of the movie, *Groundhog Day*, we are closer to the start than the end of Bill Murray's journey toward redemption. He went through a metamorphosis that made him realize how his behavior was affecting others. That sent him on a mission to better himself and the lives of those around him. His affection for Rita, played by Andie MacDowell, was a catalyst. She was the embodiment of empathy and unconditional love.

The shift in compassion and empathy among our youth is a reason to be hopeful. It reminds me of a commencement speech I heard many moons ago. An aging Walter Cronkite, a broadcaster who was named "the most trusted man in America," made his way to the microphone; he said, "We screwed up; it's your job to fix it." We have got some work to do.

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