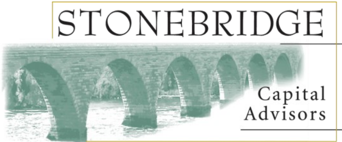

Stonebridge Economic Outlook

Forecast Update

June 11th, 2020

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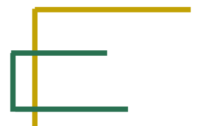
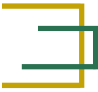




Summary: *For most of this year, the U.S. economic outlook will be dominated by COVID-19, including the unusual steps taken to contain the spread of the virus as well as the unprecedented macroeconomic policies taken to ease the economic pain caused by the containment efforts. With many states shutting down non-essential businesses and issuing stay-in-place orders in mid-March, real gross domestic product (GDP) in the first quarter declined 5.0 percent at an annual rate. Most of the shutdown orders remained in place for all of April but were eased a bit in many cases in May. Despite further progress in reopening the economy in June, the damage to the economy in the second quarter from the earlier shutdowns will be severe; real GDP is expected to plunge at least 25 percent at an annual rate. On the other hand, the reopening of the economy over the next few months (assuming that the impact of COVID-19 on the economy subsides) should boost economic activity in the third-quarter; real GDP is expected to rebound about 15 percent at an annual rate. However, whether this bounce in third-quarter activity will be sustained in the fourth quarter is still unclear. The sudden, sharp and in some cases prolonged business closures to contain COVID-19 suggest that the economic destruction that normally occurs during a recession most likely is underway but is disguised somewhat by the economy attempting to reopen. As normally happens in a recession, many businesses will fail and as normally happens in a recovery, new businesses will open. Unfortunately, it generally takes time for new businesses to gain traction. As a result, a sustained recovery may take longer than most now expect. Reopening the economy may be just as misleading with regard to the strength of the recovery as locking down the economy was with regard to the severity of the recession.*

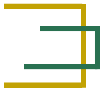
Virus Distorted Outlook

It is official. The National Bureau of Economic Research (NBER) has determined that the U.S. economy entered a recession in February. In my roughly 50 years as an economist, I do not remember a recession that had such a well-defined start as this one, which may explain the unusually quick determination by the NBER. Typically, it takes almost a year after the fact for the NBER to determine the start of a recession.

The question is whether the end of the recession will be equally as well defined. The consensus at the moment seems to be that it will, as reflected by the results of the May survey of 42 economists conducted by the Federal Reserve Bank of Philadelphia. According to this survey, real gross domestic product (GDP) is expected to decline over 30 percent at an annual rate in the second quarter, following a decline of 5 percent in the first quarter. This seems to be the two consecutive quarters of declining real GDP that makes up the recession. The survey then suggests that real GDP starts a sustained recovery in the third quarter, with real GDP climbing over 10 percent at an annual rate in the third quarter, followed by nearly 7 percent annualized gains in each of the next two quarters.

Although I would roughly agree with the consensus on the second and third quarter outlook for real GDP, I question whether the economic recovery will be so straightforward. After all, reopening the economy is a necessary condition for recovery but not a sufficient condition.

Clearly the lockdowns in response to the pandemic have been very destructive to the U.S. economy, even with the massive aid/assistance packages from the government. In the March forecast, real GDP growth for the four quarters of 2020 were expected to be up 0.3 percent, as increases in the first and fourth quarters were expected to offset declines in both the second and third quarters. Recall that this forecast was developed before California issued the first stay-at-home order on March 19th, which was quickly followed by other states imposing similar restrictions. As a result, the economy deteriorated fast, dragging down real GDP in the first quarter by 5 percent at an annual rate. Indeed, most everyone agrees with the trajectory of real GDP in the second and third quarter. As shown in Table 1, second quarter real GDP is now projected to plunge 25 percent at an annual rate (versus 32 percent according to the



Philadelphia Fed survey), followed by a bounce in the third quarter of 15 percent at an annual rate (versus 10.6 percent according to the Philadelphia Fed survey).

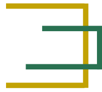
As it turns out, the key difference between my outlook and the consensus is what might happen in the fourth quarter of 2020, after the impact of the virus on the economy subsides. My assessment is that the economy suffers a bit of fatigue from the reopening push, as consumers begin to realize that their finances are not as solid as they were before the pandemic hit and the CARES Act stimulus ends. It does no good for consumers to have pent-up demand if they do not have the wherewithal to satisfy it. Recall that there were still 18 million fewer payroll jobs in May than in March, despite jobs jumping a surprisingly strong 2.5 million in May from a month earlier. Although payroll jobs most likely will continue to improve over the next few months, I doubt they will get back to their March level anytime soon. In fact, a second wave of layoffs are more likely to occur at some point in the third or fourth quarter as more businesses fail in their attempt to reopen.

As a result, the forecast is far more volatile and on balance more pessimistic than it was in March. In particular, corporate earnings are now expected to be even more disappointing than before, inflation to be more uneven, and unemployment to be higher. That said, with the sharp increase in the supply of debt, both public and private, associated with the assistance programs (even with the Fed buying much of it), most likely will prevent longer-term Treasury yields from falling much further and may actually edge higher temporarily. The same can be said for credit yield spreads, which may narrow briefly as the consensus becomes enthusiastic about the recovery only to widen again when that enthusiasm wanes.

Operating Earnings Likely to Disappoint

The equity market and the economy seem to be out of step at the moment and although not unusual, it generally proves to be unsustainable. After all, the state of the overall economy is eventually reflected in corporate earnings, which in a stable interest rate environment should drive equity prices (zero or near zero for the foreseeable future seems pretty stable to me). The first-quarter data tends to support this view. That is, the overall economy contracted 5 percent at an annual rate, operating earnings plunged 48 percent from a year earlier (based on the earnings reports from roughly 98 percent of the companies in the S&P 500) and the S&P 500 price index fell 20 percent. Interestingly, this substantial hit to operating earnings occurred in a quarter that started with two months of solid economic activity. More interestingly, although the economy is expected to register a record decline in the second quarter, the consensus has S&P 500 operating earnings improving somewhat from the first quarter. It is unclear to me how that is possible given the economic devastation in April and the uneven reopening of the economy in May.

In fact, the consensus has the economy and operating earnings improving quickly and completely by next year. I suspect that the recovery will take longer for both. The U.S. economy is very resilient and many companies will figure out how to survive in the post-pandemic normal but there also will be numerous companies that will fail because of the high costs of making the transition. It will require new businesses that have some pricing power or more productivity business models to fill the void. The survivors will need time to recover and the new businesses will need time to establish a sustainable business. This suggests to me that once the economy bottoms, it will take months for the economy to recover the losses from the pandemic, as it normally does after a recession.



According to the bottom-up estimate from Standard and Poor's, operating earnings per share for the companies in the S&P 500 index are now expected to be down 30 percent for all of 2020 ($110 a share this year versus $157 last year). The current consensus for operating earnings for all of 2021 is $162 a share, a record high. In the 2007-09 recession, operating earnings per share peaked in the second quarter of 2007 before declining to a low in the fourth quarter of 2008. It wasn't until the first quarter of 2012 (almost three years) that operating earnings per share hit a new high. While this recession is different, it still will take longer than a year for companies to restore profits to a new high.

Table 1
U.S. Economic Forecast

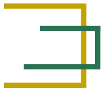
	2019	2020				2020f	2021f
		Q1	Q2f	Q3f	Q4f		
Real Gross Domestic Product	2.3	**-5.0**	**-25.0**	**15.0**	**-1.2**	**-4.0**	**2.5**
Consumer Price Index, All	2.0	1.2	**-2.2**	**2.3**	**1.4**	**0.7**	**1.7**
Consumer Price Index, Core	2.3	2.0	**-1.0**	**1.5**	**1.2**	**0.9**	**1.4**
GDP Chain-Type Price Index	1.6	**1.4**	**-0.5**	**1.0**	**1.5**	**0.8**	**1.2**
Civilian Unemployment Rate	3.8	3.8	**13.3**	**10.8**	**10.0**	**10.0**	**8.0**
Price of WTI crude oil ($/bbl)	57.0	45.8	26.7	36.0	42.0	42.0	60.0
Trade-Weighted Dollar	116.4	117.9	**123.0**	**117.0**	115.0	115.0	116.0
S&P 500 Operating Earnings	157.1	**19.7**	**18.0**	**23.1**	**25.0**	**85.8**	**139.0**
Percent vs. Year Ago	3.6	**-48.1**	**-52.0**	**-42.0**	**-36.2**	**-45.4**	**62.0**
91-Day Treasury Bill Rate	1.6	1.1	0.1	0.1	0.1	0.1	0.1
10-Year Treasury Note Yield	1.8	1.3	0.6	0.7	0.7	0.7	1.8
30-Year Mortgage Rate	3.7	3.5	3.5	3.6	3.7	3.7	4.5
Bank Prime Rate	4.8	4.1	3.1	3.1	3.1	3.1	3.1

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Standard and Poor's, Federal Reserve Board, Department of Energy, and Federal Home Loan Mortgage Corporation.

Annual changes in real gross domestic product (GDP) and all measures of inflation are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. The annual estimates of the unemployment rate, the price of crude oil, the trade-weighted dollar and all interest rates are averages for the last quarter of the year indicated. S&P 500 operating earnings per share are for the period indicated.

Quarterly changes in real GDP and all measures of inflation are percent changes from the previous quarter at annual rates. For the unemployment rate, the price of crude oil, the trade-weighted dollar and all interest rates, quarterly estimates are averages for the quarter indicated. S&P earnings are per share for the period indicated.

f-forecast; bold type reflects a major change from the previous forecast



Here is my assessment of S&P 500 operating earnings per share through the end of 2021:

- First-quarter operating earnings per share as reported by Standard and Poor's are estimated at $19.70 versus $37.99 for the same quarter a year ago, a decline of roughly 48 percent. This represents a very substantial deterioration in earnings in a very short period of time.

- According to my top-down assessment, second-quarter S&P 500 operating earnings per share likely will be about $18 versus the bottom-up expectation of $23 reported by Standard and Poor's. My top-down estimate represents a drop of 52 percent from a year ago, a slight deterioration from the 48 percent decline in the first quarter. Market participants may be disappointed if earnings fall (even a little) rather than improve in the second quarter.

- S&P 500 operating earnings in the third quarter according to my top-down estimate should improve a bit to $23.1 a share, reflecting the bounce in economic activity likely to occur due to the economy reopening. The implication is that profit margins will be squeezed by the added cost of doing business in the pandemic economy, as well as sluggish revenue growth from weak demand.

- The key will be just how quickly income improves as the recession eases. In that regard, personal income grew a whopping 12.9 percent in April due entirely to the stimulus checks from the government. Wages and salaries fell $740 billion, offset in part by the $360 billion increase in unemployment insurance benefits. However, it was the $2,593.8 billion increase (at an annual rate) in other government transfer pay benefits to persons that really pumped up personal income in April. Personal income will take a serious dive in May without another stimulus check.

- Since income rose and spending tanked, the personal saving rate surged in April to 33 percent. In May, income will fall without another stimulus check and spending will rise as the economy reopens, causing the saving rate to retreat dramatically but still remain elevated by historical standards.

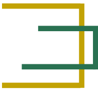
For all of 2020, I expect S&P 500 operating earnings to be roughly $86 a share versus the $109 a share bottom-up estimate reported by Standard and Poor's. For all of 2021, I expect operating earnings per share to rebound to $139 a share versus the $162 a share reported by equity analysts to Standard and Poor's. The key factors contributing to the differences between my earnings estimates and the consensus are that I expect the start of the economic recovery to be delayed longer and for it to be sluggish and uneven once it gets underway.

Inflation In a Pandemic

Consumer prices most likely fell in the second quarter as suggested by the declines of 0.4 percent and 0.8 percent in March and April, respectively. A sharp decline in gasoline prices was a major cause of the decline in the all items price index the last two months, with decreases in apparel, motor vehicle insurance, airline fares, and lodging away from home also contributing. Excluding food and energy, the consumer price index fell 0.1 percent in March, its first decline since 2010, and 0.4 percent in April, the largest monthly decline in the history of the series.

Clearly the mandated shut downs of non-essential businesses and the stay at home orders contributed to the sharp drop in consumer spending in March and again in April, forcing businesses that were allowed to remain open to adjust to shifts in demand. Grocery

Sources: Bureau of Labor Statistics and Bureau of Economic Analysis.



stores, internet companies, online purchases of goods and online entertainment services most likely experienced sharp increases in sales, while many retail businesses that had to rely on drive-through, curb-side or delivery most likely experienced a sharp drop in sales. For those businesses that saw a jump in demand, prices probably rose, but for those businesses that saw demand plummet, prices probably fell. To assess the outlook for prices, it may be worthwhile to determine the extent of pricing power going forward. My guess is that most businesses as they reopen will have very little pricing power initially but could eventually pass-through a separate fee to customers to cover the added cost of safety measures taken by the business. For example, my dentist has reopened and is now charging an extra $10 a visit to cover the cost of the protective materials used by her and her staff. Others could follow.

For all of 2019, the consumer price index (CPI) increased 2.0 percent, matching the long-standing target of the Federal Reserve's Open Market Committee. However, in the first quarter, thanks to the arrival of COVID-19, CPI inflation slipped to 1.2 percent, owing in large part to the 0.4 percent decline in March. For the second quarter, the overall CPI is expected to decline 2.2 percent at an annual rate, largely due to the sharp decline in April. With the reopening of the economy, the CPI for May and June is expected to show a small gain on balance, as gasoline prices rise somewhat along with food, rent, medical care and household operations.

Indeed, many of the service businesses that were closed in response to the pandemic, are likely to reopen with somewhat higher prices to help cover the cost of safety measures taken to contain COVID-19. I expect those increases to be a key factor behind the expected increase in the CPI in the third quarter, along with an attempt by businesses to turn a profit in a weak demand environment.

By the fourth quarter, most of the economy should be open and prices adjusted to reflect the new reality. As a result, the CPI is expected to increase very little in the fourth quarter, as weak demand continues to drag on the pricing power of businesses. This will be most evident on the pricing of consumer discretionary items.

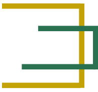
For all of 2021, the overall CPI is expected to rise at a slightly faster pace than expected for all of this year but still very subdued by historical standards. If massive federal budget deficits and an extremely accommodative monetary authority are the roots of a spike in inflation, it is not expected to surface through the end of next year.

Labor Market—Is the Recession Over?

According to the Bureau of Labor Statistics, nonfarm payroll jobs increased markedly in May following a whopping 20.7 million in April. The consensus of economists was that payroll jobs would not start to improve until June, which is when the economy was expected to reopen in a more significant way. Apparently, more businesses reopened and brought back furloughed workers sooner than anticipated.

The May job gains were led by leisure and hospitality, education and health services, and retail. More than all of the 1.24 million returning workers in leisure and hospitality were in the food services and drinking places category (up 1.37 million). Dentist offices reopening for business accounted for the bulk of the 424 thousand increase in education and health services jobs in May. The 368 thousand returning workers in retail were widespread but uneven, with automobile dealerships and general merchandise stores leading the gains and electronic and appliance stores leading the losses.

The median forecast of 42 economists surveyed by the Philadelphia Federal Reserve Bank in mid-May expected payroll jobs to decline an average of 7.7



million in the second quarter before rebounding an average of 2.3 million a month in the third quarter. With the 2.5 million increase in payroll jobs in May, the average monthly decline for the second quarter is now expected to be about 5.5 million. Going forward, the Philadelphia Fed consensus outlook for payroll jobs for the fourth quarter is an average monthly gain of 900 thousand.

Most economists were encouraged by the gain in payrolls in May as they argued that it provided support for their more optimistic outlook for the recovery. In contrast, I was disappointed that the gain was not larger following the loss of over 20 million jobs in April. After all, even with the surprising May improvement, there are still 18.2 million fewer jobs now than in March. I suspect that it will take time to absorb the excess labor now in the market. That said, payroll jobs will continue to increase at an unusually rapid pace over the next few months as the economy continues to reopen. As mentioned before, however, the key will be how the economy does in the fourth quarter of this year and into next year. At the moment, I doubt the recovery will be as straightforward as the consensus now expects.

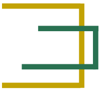
The same analysis can be applied to the household survey and the unemployment rate. Here too the May headline statistic surprised the consensus, falling to 13.3 percent from 14.7 percent in the prior month rather than increasing to roughly 17 percent. The only thing I knew and still know for that matter is that the unemployment rate skyrocketed in April due to the lockdowns to contain COVID-19 and that once the lockdowns were eased the unemployment rate would improve. Exactly how fast was debatable. Of course, with the sizable improvement in May, the temptation is to extrapolate the same gain every month for the rest of the year, which if it happened would get the unemployment rate back to 3.5 percent by the end of this year.

As mentioned above, I doubt that the recovery will be that straightforward or that even. In fact, as long as the economy attempts to reopen, payroll jobs should increase and the unemployment rate decline. My concern is that workers will be recalled, in part to satisfy the requirements of getting Paycheck Protection Program (PPP) loans forgiven, especially for those businesses that chose to keep the original eight-week period (June 30) to spend the money rather than extend the period to 24-weeks as allowed under the newly signed Paycheck Protection Flexibility Act (PPF). Also under the PPF legislation, new borrowers under the PPP have five years to repay the loan instead of two. Existing PPP loans can be extended up to five years if the lender and borrower agree. The interest rate remains at 1 percent. However, I am sure forgiveness would be the preferred outcome.

The question is whether businesses that meet the criteria for forgiveness by hiring everyone back can retain a full staff in the post-lockdown economy. I worry that many businesses will find it difficult to maintain the same payroll as before without any pricing power or a fraction of the trade they had pre-lockdown. As a result, the improvement in the labor market will be pronounced but will it be sustainable? I think not.

The Yield Curve and Credit Spreads

Given the consensus that the economy is on the road to a rapid recovery from the COVID-19 lockdown, it should be no surprise that the yield curve has steepened once again, albeit at a very low level of overall rates. For example, the Federal Reserve has pegged the overnight federal funds rate at slightly above zero and has implemented a massive program of lending facilities to various constituents, the most recent being municipalities. With the Fed buying nearly all debt securities, it is no wonder that the overall level of rates is so low, including yields on longer-term Treasury obligations. However, long-term Treasury yields are not as low as they were. In recent weeks, as the stock market has rallied, the yield on the



10-year Treasury note has risen to about 0.9 percent from 0.65 percent.

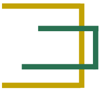
With the short-term Treasury yields at roughly 0.2 percent thanks to the Federal Reserve cutting its federal funds rate target to near zero in mid-March, the Treasury yield curve has turned positive (see Chart 1). The implication is that, with the recession underway, a recovery is ahead. The problem is that a positively sloped yield curve provides very little information about the timing of such a recovery, just as an inverted yield curve offers little information about when a recession will begin (only that one is likely ahead).

I suspect that the yield curve will remain positively sloped for the duration of the recession, although maybe not at the current levels. There was talk about yield curve control by the Fed, which is clearly part of their strategy given the lending facilities they have established to help assure that debt markets function properly. If the economy is recovering as the consensus now assumes, then it will be increasingly difficult for the Fed to justify continuing to support debt markets as aggressively and extensively as they originally planned, in part because the cost of borrowing will go up despite the Fed's efforts to prevent such a development. The short-term rally mantra of market participants is "don't fight the Fed." Nevertheless, there will be times when the market pushes the Fed in a certain direction regardless of whether the Fed wants to go there. The steeper yield curve in recent weeks may be just such an example.

Chart 1
Treasury yield Curves

Percent
3.0
2.5
2.0
1.5
1.0
0.5
0.0
8-Jun-20
7-Jun-19
3M
6M
12M
2Y
5Y
10Y
30Y
Maturity

Source: Bloomberg.



On the other hand, if the unavoidable uptick in economic activity in the third quarter is not the start of a sustained recovery but rather a bounce off an artificially imposed extreme low for the economy, then the Fed may postpone certain policy initiatives but not completely abandon them when the economy looks vulnerable again later this year or into 2021.

The bottom line is that I expect the Treasury yield curve to remain roughly where it is for now or steepen a bit further, so long as the consensus of a recovery is in place. However, once it starts to look like the economy cannot sustain a recovery, as I expect it will, the yield curve will become less steep once again but still at very low levels. Once the economy does start to work its way out of recession, the yield curve will steepen further but at higher rates across the maturity spectrum.

Credit spreads may be fickle as well. Again, if the recovery is underway then credit spreads should narrow, but if the recession lasts longer then credit spreads should remain wide or widen further. At the moment, the consensus seems to be that the recovery is underway, which helps explain why credit spreads have narrowed recently. According to the ICE BofA data, the spread between the BBB rated U.S Corporate Index Option-Adjusted and a spot Treasury curve jumped in March, peaking at 488 basis points on March 23 before retreating to 203 basis points by June 8. However, given my economic outlook, I expect credit spreads to widen out again once the consensus becomes suspicious of the third-quarter bounce as the start of the recovery. At the moment, that may not happen until the fourth quarter of this year.

The views expressed here reflect those of Daniel E. Laufenberg, Ph.D. as of the date noted and not necessarily those of Stonebridge Capital Advisors. They may change as economic fundamentals and market conditions change. This commentary is provided as a general source of information only and is not intended to provide investment advice for individual investor circumstances. Past performance does not guarantee future results.