Stonebridge Economic Outlook

Forecast Update

September 14th, 2020

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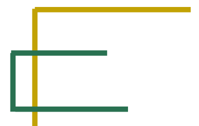
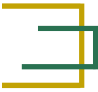




Summary: *As mentioned before, the steps taken to contain the pandemic of COVID-19 exaggerated the severity of the recession in the second quarter, just as the efforts to reopen the economy most likely will overstate the strength and sustainability of the recovery. Not until at least the fourth quarter of this year is the U.S. economy expected to return to something that more closely resembles normal. What does a return to normal mean? If it means that the economy returns to the same phase of the business cycle it was in before the pandemic, then I suspect that it will be far less optimistic than the consensus now expects. The concern here is that much of the economic activity at the margin so far this year has been driven by government debt-financed payouts, artificially supporting businesses and consumers, while adding dramatically to government debt. On the other hand, if the economic adjustments made during the pandemic removed the excesses and inefficiencies that were starting to weigh on the economy before the pandemic, then the economy may be positioned to sustain a recovery. A third possibility is that the transition of the Federal Reserve System from an independent policy group to a "de facto" funding agency of the Treasury Department becomes a permanent arrangement under the auspices of Modern Monetary Theory {MMT). More importantly, MMT seems to be gaining support among policymakers. Such support could result in the Federal Reserve continuing to monetize federal debt used to fund existing and new government spending programs even after the pandemic ends. Although the Fed's actions are advertised as providing "free" money, nothing is ever free. According to the principles of economics, there is always an "opportunity cost."*

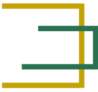
A Return to Normal

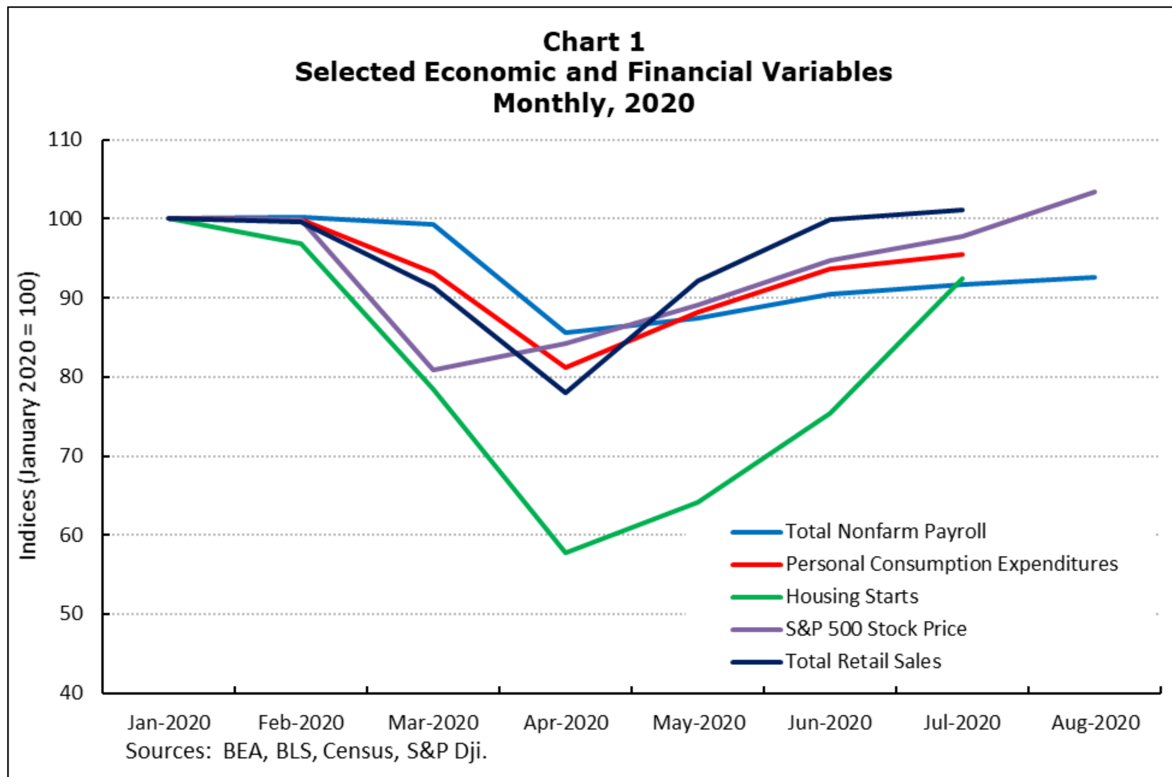
Based on recent economic data, the U.S. economy has rebounded sharply in the third quarter from the dramatic plunge in activity registered in the second quarter. Indeed, it looks as if the rebound in real gross domestic product (GDP) in the third quarter will be more pronounced than anticipated in the June forecast; that is, a surge of 26 percent at an annual rate versus a 15 percent pace expected earlier.

According to the latest estimates from the Bureau of Economic Analysis, real GDP plunged at a 31.7 percent annual rate in the second quarter, following a 5.0 percent drop in the first quarter. These two consecutive quarterly declines in real GDP had a great deal to do with the National Bureau of Economic Research declaring in June that the U.S. economy fell into recession starting in February. Although the economy contracted a bit more dramatically in the second quarter than the 25 percent drop anticipated in my June forecast, it just made the highly anticipated rebound in economic activity in the third quarter more likely as the economy attempted to reopen. The advance estimate of third-quarter real GDP will not be available until the end of October, just before the election.

There are a host of economic data series pointing to a substantial bounce in economic activity in the third quarter, a few of which are plotted in Chart 1. First is nonfarm payroll jobs, which registered another solid gain of 1.4 million in August and has recovered over the last four months about half of the 22 million jobs lost in March and April. The much heralded V-shaped recovery in payroll jobs seems to be unfolding but it still is far from complete. I suspect that any near-term gains in payroll jobs will slow considerably. At some point in the near term, payroll employment may even retreat again that many of the furloughed workers who are still considered on the payroll in the establishment survey will not return to work, either because they retire or they are let go[1]. The airlines are a good example of companies that are offering either early retirement or severance packages to employees to reduce payroll costs. If the number of takers fall short of the job cuts targeted, payroll

[1]Furloughed workers are treated differently in the household survey (unemployment rate) than in the establishment survey (payroll jobs). In particular, furloughed workers are considered unemployed in the household survey but are still considered on the payroll if they receive pay for any portion during the pay period including benefits.



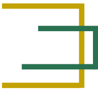


jobs still are expected to be lost in these industries. However, many of these cuts will not take place until later this year.

Personal consumption expenditures over the three months ending in July (the most recent data available) have provided another example of a solid rebound from the virus-induced plunge earlier in the year. Apparently consumers had the wherewithal to support the rebound in spend, despite the loss of jobs. Nevertheless, the bounce in spending so far has still fallen short of its pre-pandemic level. It will be interesting to see if consumers will continue to acquire the wherewithal to support further gains in spending if jobs do not recover as quickly as most market participants now expect.

Housing statistics are another area that market participants have offered as evidence that the V-shaped recovery is underway. As shown in Chart 1, housing starts have rebounded sharply from the plunge earlier in the year. However, even here the level of starts in July were still below where they were in January. Several factors may explain the renewed strength in housing, including the increased use of our houses during the pandemic and the likelihood that this is the new normal for some. After all, our houses are now our offices, our schools, our entertainment centers, our restaurants and our fitness centers. More importantly, for many jobs, we can do all of this anywhere and no longer need to worry about commuting.

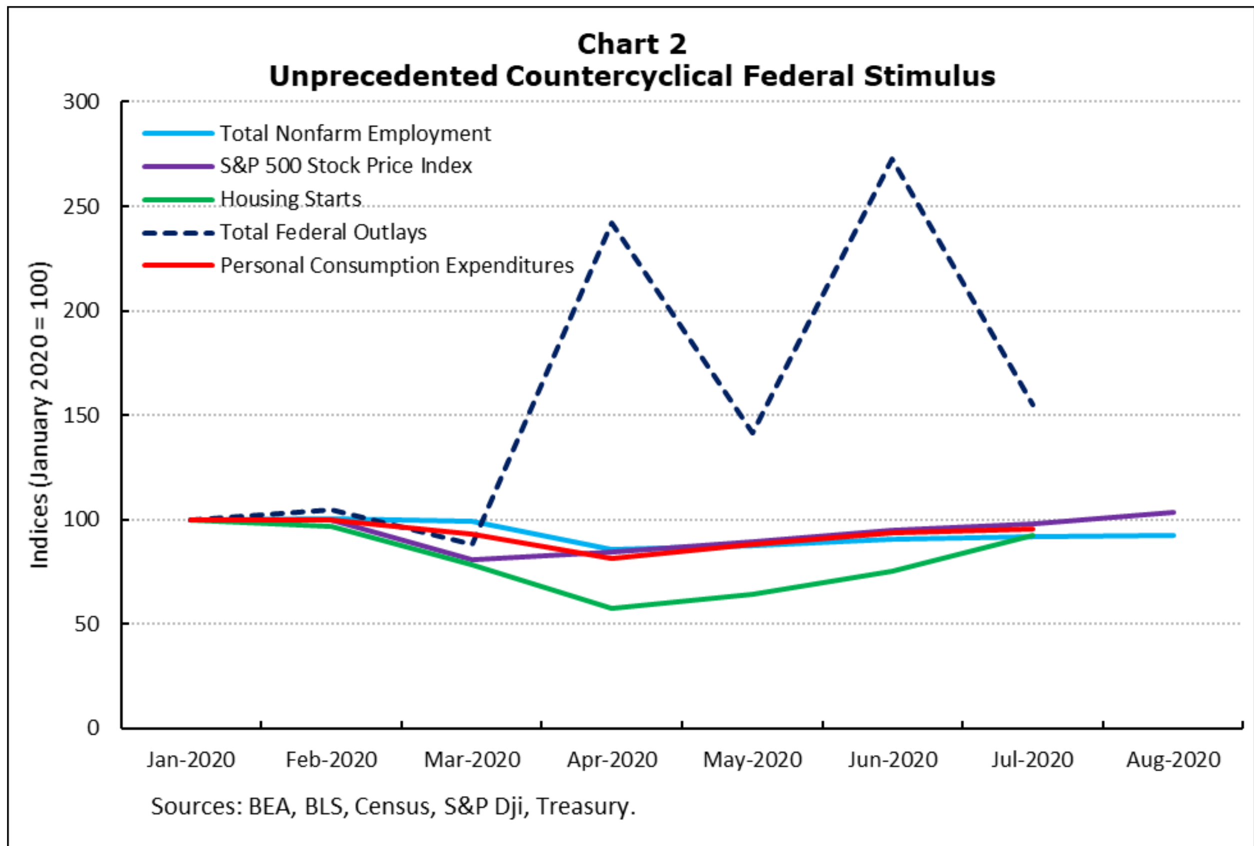
The two final data series in Chart 1, the S&P 500 stock price index (monthly average) and retail sales, are included because both have been offered as evidence that the economy has already recovered from the virus-induced plunge. The stock market has rebounded to new highs in anticipation of a sustained recovery in both the economy and corporate earnings. Retail sales have rebounded in large part because of the switch in spending from services to goods—grocery store sales versus eating

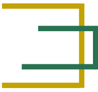


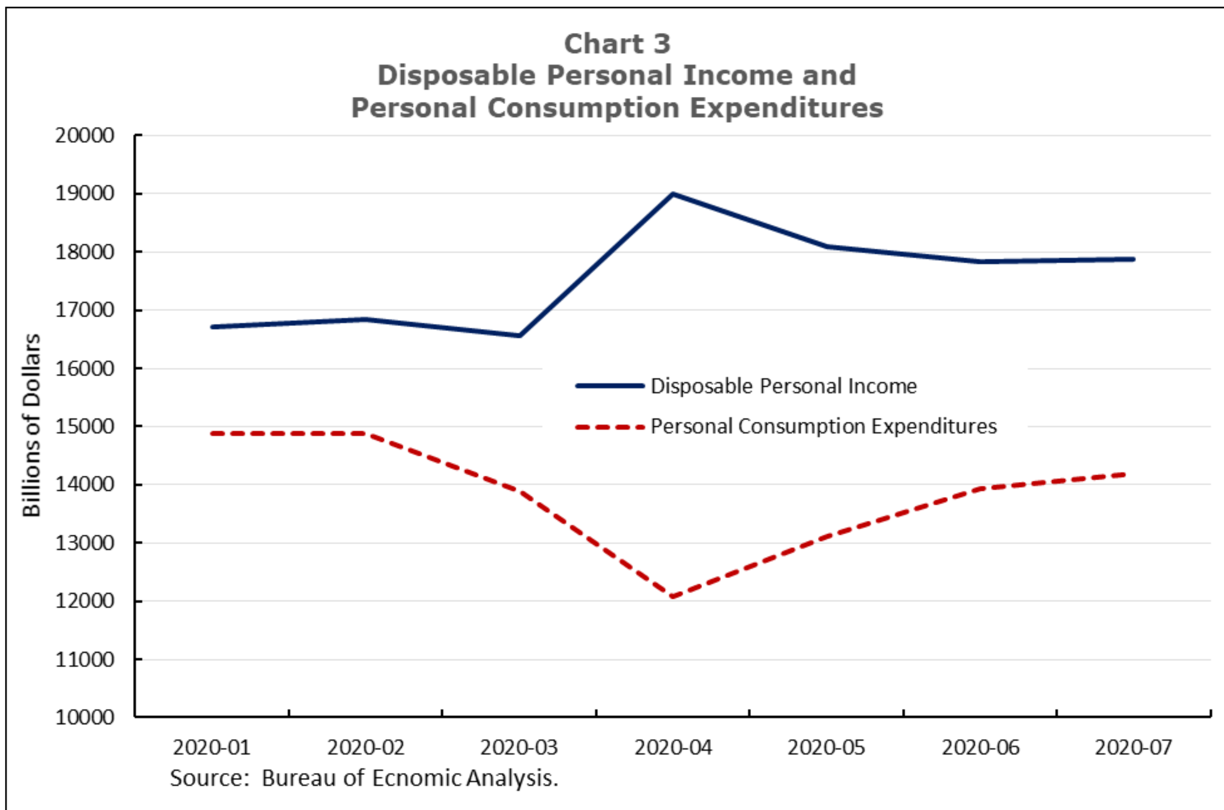
establishments, motor vehicles instead of airline tickets and do-it-yourself home improvements rather than vacations just to mention a few. That said, retail sales are only a portion of consumer expenditures, so it really does not fully capture how the consumer sector is doing. A more comprehensive measure is personal consumption expenditures mentioned earlier.

In any event, the question is whether the recent rebound in these data series will continue through the end of this year and into 2021. To help answer this question, I have plotted federal government outlays against most of these data series to get a feel for how important the stimulus package has been to the rebound in economic activity (see Chart 2). On a relative basis, federal outlays overwhelm the private sector statistics, which simply reinforces what we already knew—the countercyclical stimulus packages offered in the CARES Act have provided the economy with the means to offset some of the financial hardship inflicted by the pandemic. The implication is that without it, the economy would not have rebounded as quickly or as much as it did in the third quarter. As a result, it raises the question of whether the economy can sustain this rebound without further stimulus. Many seem concerned that it cannot, which may explain why there is strong support for another round of government payouts to consumers, small businesses and maybe even state and local governments.

However, even if the government provides more relief, it may simply postpone the economic fatigue likely to occur when the relief payments end. Typically, government spending would not only stimulate current economic activity but also serve as the catalyst for future economic growth. So why not this time? In large part, it may have something to do with how the money is spent. Transfer







payments, which is essentially what is being offered currently, does not have the same long-term economic benefit as government investment on infrastructure and research. Not only does infrastructure spending add jobs presently but it also adds to the capital stock needed to improve production in the future.

Spending on research adds jobs but also most likely will eventually add to productivity, which will enhance output in the future as well. Indeed, as shown in Chart 3, the stimulus programs did boost personal income as expected but consumers could not spend it causing the personal saving rate to jump. At the moment, household finances on average look very good. How long will it last without government assistance?

Several commentators have compared the fiscal efforts of the federal government in its war against COVID-19 with its fiscal efforts to fight World War II, especially with regard to federal spending. In that regard, there may be some lessons from World War II that could apply today. In particular, the large increase in debt service costs from the short-term surge in spending on the war eventually led to increased taxes on the highest-income individuals and a new broad-based tax on the general public. During World War II, the top individual marginal tax rate rose to a staggering 94 percent and remained at 91 percent for nearly two decades—until 1964. Also, Congress converted the income tax from a "class" tax that applied mostly to those with high incomes to a "mass tax" that most Americans paid. At the moment, there is no effort to raise taxes on the financial winners of the pandemic to help pay for the relief to the financial losers.

It is unlikely that the marginal tax rate will be raised as high as it was during World War II but it most likely will be hiked at some point. Other possible tax changes likely to be considered once the pandemic ends include higher taxes on long-term capital gains

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

and dividends, new taxes on unrealized capital gains or wealth and increased taxes on corporate profits. In addition, there may be an effort to add another "mass tax" to the list, such as a value-added tax or a federal sales tax. Of course, this assumes that policymakers will attempt to restore the government's fiscal position in the post-epidemic world. Policymakers may be content with large federal budget deficits that are monetized by the Federal Reserve as long as there are no unpleasant consequences.

Table 1
U.S. Economic Forecast

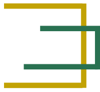
	2019	2020				2020f	2021f
		Q1	Q2f	Q3f	Q4f		
Real Gross Domestic Product	2.3	-5.0	**-31.7**	**26.0**	0.0	-4.4	1.1
Consumer Price Index, All	2.0	1.2	-3.5	3.8	1.0	0.6	1.7
Consumer Price Index, Core	2.3	2.0	-1.6	3.1	1.0	1.1	1.4
GDP Chain-Type Price Index	1.6	1.4	-1.8	2.5	0.9	0.8	1.2
Civilian Unemployment Rate	3.8	3.8	13.0	**8.9**	**8.5**	**8.5**	**6.8**
Price of WTI crude oil ($/bbl)	57.0	45.8	27.8	40.0	39.0	39.0	50.0
Trade-Weighted Dollar	116.4	117.9	123.0	117.0	115.0	115.0	116.0
S&P 500 Operating Earnings	157.1	19.5	**26.9**	30.0	28.5	**104.9**	140.0
Percent vs. Year Ago	3.6	-48.7	**-33.0**	-24.6	-27.2	**-33.2**	33.5
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	0.7	0.6	0.6	0.6	1.0
30-Year Mortgage Rate	3.7	3.5	3.2	3.0	2.9	2.9	4.0
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



In that regard, a return to normal may not look like normal before the pandemic. I suspect that normal for one may not be normal to another. Instead I would prefer to see the return to a self-sustained economic expansion rather than a vague return to normal. Although such an expansion eventually will occur, I doubt that it will be as soon as the consensus now seems to expect. Essentially the economy still needs to experience a period of adjustment to reset for the next business cycle, which explains why I still expect the economy to face some serious headwinds later this year and into 2021.

Pent-up demand will drive consumer spending growth but only if the wherewithal to spend is sustained. I am concerned that government relief benefits are neither a reliable nor a sufficient condition for such a sustained recovery. Generally the boom in consumer spending that jump starts the economy is triggered by a sharp rise in real income owing to lower prices and job gains. With inflation already near zero and job gains beyond furloughed workers difficult to come by, the situation looks more challenging than in the past. For that reason, the current forecast is little changed from the June forecast as shown in

Table 1.

For the most part, I have no quarrel with the consensus view that the U.S. economy grew somewhere between 25 to 30 percent at an annual rate in third quarter. However, I do quarrel with the consensus view that the U.S. economy will continue to rebound in the fourth quarter. As noted above, my biggest concern is that in the absence of another round of fiscal stimulus, the financial conditions of consumers start to erode in the fourth quarter, making it very difficult to sustain economic growth.

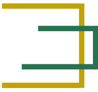
As a result, my forecast for the fourth quarter of this year and the first half of next year is more pessimistic than the consensus. Real GDP is expected to be flat in the fourth quarter, as a small gain in consumer spending is offset by weak net exports, a pause in housing and a mild pullback in business fixed investment. Over the first half of 2021, real GDP growth is expected to be near zero as well, declining some in the first quarter before rebounding a bit in the second quarter. This reflects the adjustment period that is needed to get the economy back on track. The surprising aspect of this is that the recovery, once it does get started again is likely to be slow-motion by historical standards.

Interestingly, the unemployment rate in the fourth quarter and during the first half of next year will likely be lower than shown in the June forecast in large part because of the unusual abundance of furloughed workers as well as a far more sluggish rebound in the labor force participation rate than most expect. In both cases, it takes fewer new jobs to push the unemployment rate down.

The New Federal Reserve Requires A New Theory

Since the last forecast, the Federal Reserve reported that its inflation target has changed from a high of 2 percent to an average of 2 percent, suggesting that more inflation will be tolerated before the Fed will feel the need to shift to a less accommodative monetary policy. This appears to be a new Fed in search of a new theory to justify its recent as well as its future actions. Modern Monetary Theory (MMT) seems to fill that void. I contend that the transition to a new Federal Reserve has been in place for at least a decade, starting with the Federal Reserve's response to the financial crisis of 2008 (some might argue that the transition started with the Greenspan-led Fed's response to the stock market crash of 1987).

Proponents of MMT contend that a government can create new money by issuing debt denominated in its own fiat currency, which in turn is purchased by its central bank (monetization of government debt). According to advocates, the primary risk once the



economy reaches full employment is inflation, which can be addressed by gathering taxes to reduce the spending capacity of the private sector. They also claim that default is never an issue because the federal government can always print more money to pay its debts. Finally, since the central bank buys the debt rather than private investors, the federal government does not compete with the private sector for scarce savings.

There are three aspects of MMT that bother me. First, the idea that money is free. I suspect that the risk of inflation is not something that should be taken lightly. Clearly there is no inflation at the moment but that does not guarantee that it will never be a problem. The argument is that once inflation starts to surface, policymakers can raise taxes to suppress excess demand. Good luck with that.

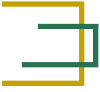
Second, the federal government can never default on its debt. Wait a minute! What is money? It is simply a non-interest bearing government obligation. Although the government may not default on its bonds, it could effectively default on its currency by issuing so much that it no longer has value as a medium of exchange. I refer to the hyperinflation of the 1920s in Germany, when it was cheaper to burn the currency in the stove than use it to buy wood. I argue that such an outcome or something less dramatic would be equivalent to a default on government obligations; in this case, it would be currency. By the way, if money has no value, then financial assets denominated in dollars would have no value either.

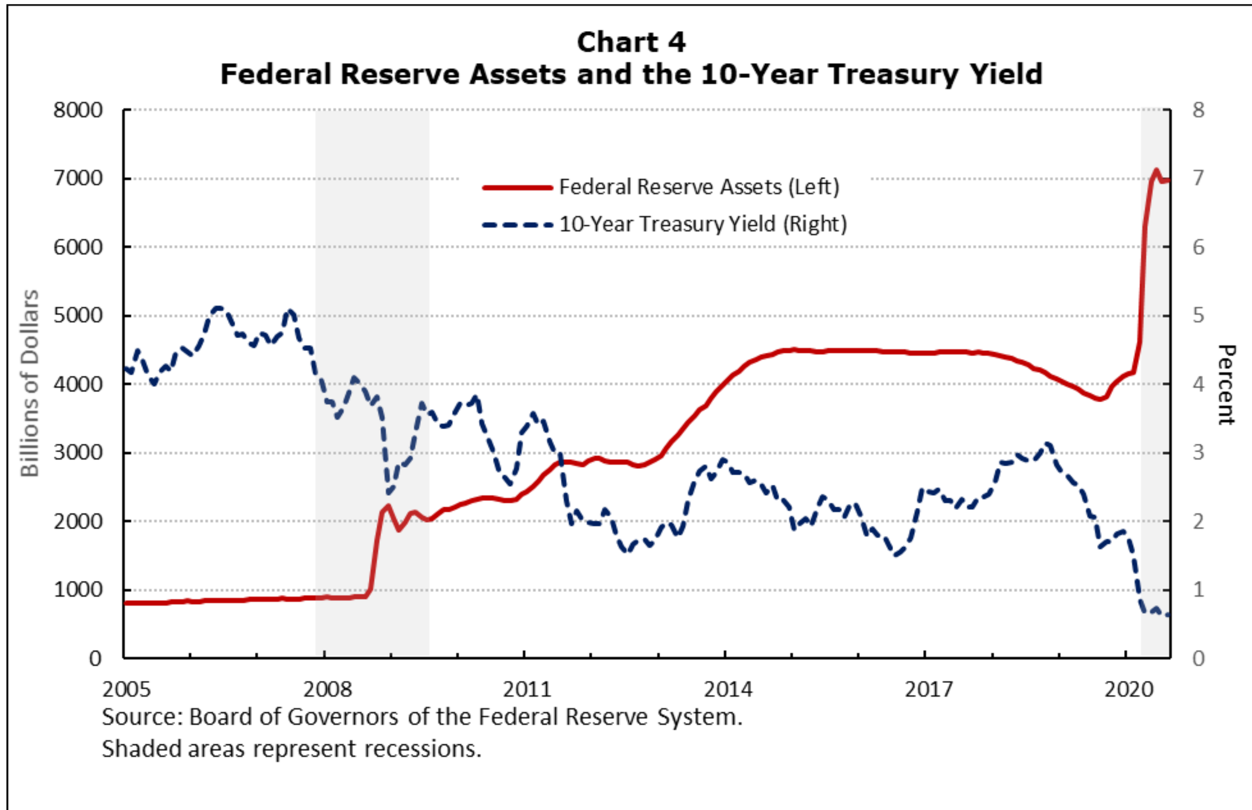
Third, the Federal Reserve would no longer be independent of Congressional appropriations and in turn no longer independent of the U.S. Treasury Department because its primary function would be to fund government spending. As such, it would effectively become a de facto agency of the U.S. Treasury. Under such circumstances, macroeconomic goals of the Federal Reserve would no longer be relevant. Instead, the Fed's operations would be to regulate financial institutions and fund federal government spending. It would be fiscal policy—spending and taxes—that would be used exclusively to manage the economy.

The bottom line is that this would be a far different Federal Reserve than the one I remember from my 14 years on the Fed's research staff. The proponents of MMT contend that it is a good thing because it would unleash the full potential of a central bank to fund government programs. I look at it as an excuse for the federal government to spend money it does not have. Eventually we will discover that there was an opportunity cost to so-called "free money" after all. Timing this comeuppance, however, will be difficult.

Implication for Financial Markets

Based on the economic outlook, financial markets are expected to be mixed. Interest rates most likely will remain low until a sustained recovery is well underway. I doubt that the yield curve will invert again without negative yields, which the Federal Reserve seems reluctant to pursue but it could flatten a bit further. As shown in Chart 4, the Federal Reserve has aggressively expanded an already elevated balance sheet during the pandemic. Remember when market participants were fretting about the Fed ending quantitative easing and reducing its balance sheet. At the time, I noted that we would become addicted to quantitative easing and that any reduction in assets by the Fed would be minimal. Nothing the Fed has done recently has changed my mind. In fact, proponents of MMT would argue that the Fed can continue to add to its balance sheet as long as inflation remains benign. Essentially inflation is the only constraint on government debt issuance, but at the moment inflation is dismissed as unlikely anytime soon and easy to manage if it does happen. I cannot argue with the former but am a bit suspicious of the later.



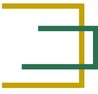


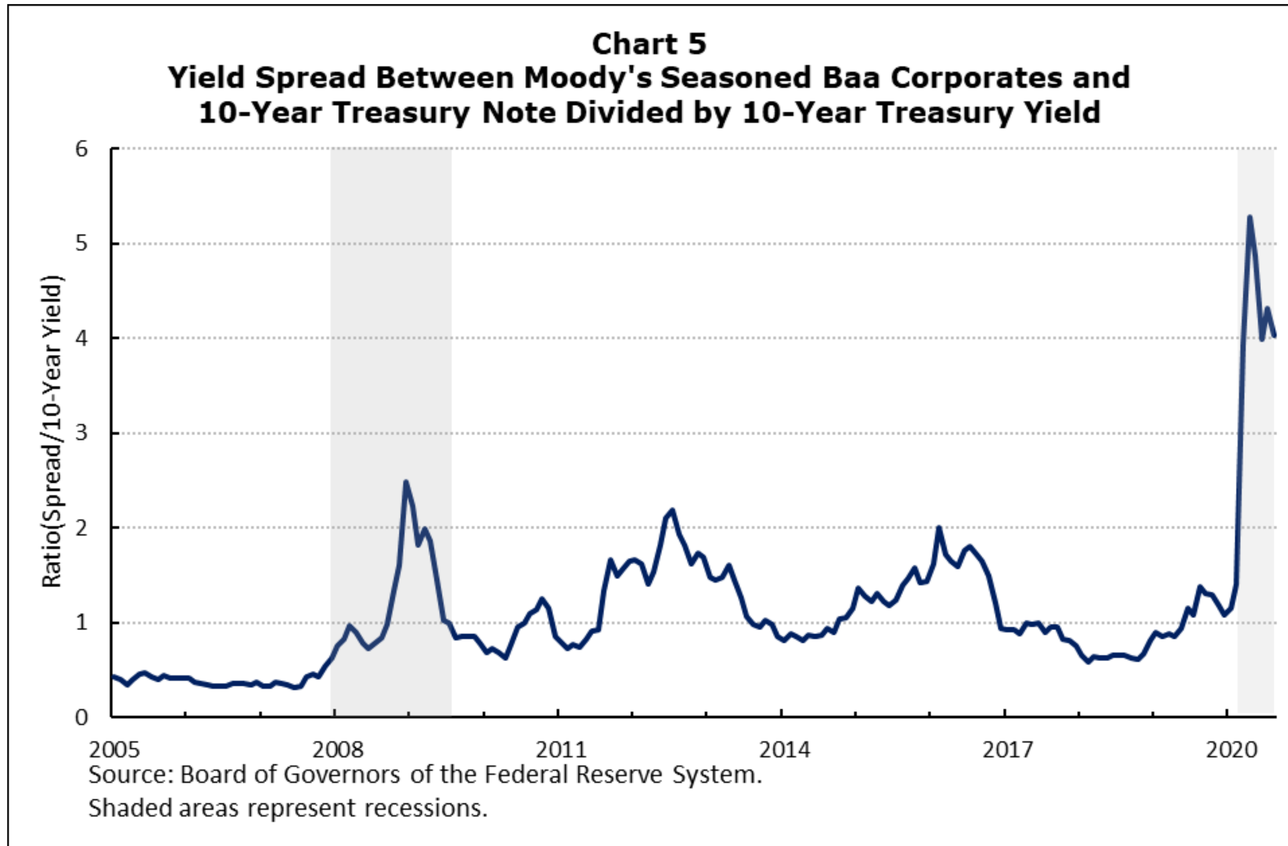
Source: Board of Governors of the Federal Reserve System.
Shaded areas represent recessions.

Credit spreads widened out during the economic shutdowns earlier this year but have narrowed somewhat since. Shown in Chart 5 is the credit spread between Moody's seasoned Baa corporate bond yields and the 10-year Treasury note yield relative to the level of the 10-year Treasury yield. An interesting aspect of this series is that the relative spread this year climbed even more than it did during the Great Recession of 2008, primarily because the yield on the 10-year Treasury note has fallen to such a low level. Despite the likelihood of a substantial bounce in third-quarter real GDP growth, I remain concerned that the recession is still in place, which means that credit spreads relative to Treasury yields are unlikely to narrow dramatically anytime soon.

Finally, S&P 500 operating profits are now expected to be about $105 a share this year, up from the roughly $86 a share forecasted in June. However, the stock market seems to be treating this year's drop in profits as temporary, expecting the level of operating profits per share to return very quickly to their level before the pandemic hit. I am less optimistic that profits will rebound so quickly. As such, my estimate of 2021 profits remains at about $140 a share, below the consensus estimate of about $165. Not only do I expect lower profits, I expect most of the miss in profits to occur in the first half as the economy completes its reset for a sustained recovery.

In particular, I doubt that consumers will have sufficient wherewithal next year to satisfy all of the pent-up demand they may have acquired during the pandemic. Of course, if we establish new government programs that guarantee a minimum level of income and provide universal health care both financed with federal debt rather than tax revenue, then the economy may get a brief boost but at the expense of future growth. Indeed, the pace of the expansion under such circumstance most likely will be even





slower than the slow-motion pace I now expect. Precedents for guaranteed individual income (stimulus checks and enhanced unemployment benefits) and universal health care (government support for COVID-19 treatment and prevention) were established by the CARES Act. More always seems better, especially if it is advertised to be free! Stay tuned.

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.