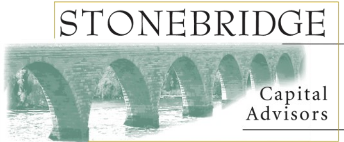

Stonebridge Economic Outlook

Forecast Update

December 9th, 2020

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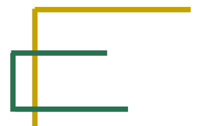
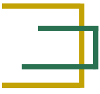




Summary: Based on the most recent data, U.S. real output is on track to grow rapidly in the fourth quarter rather than struggle as shown in the previous forecast. This strength in the fourth quarter appears to be surprisingly widespread across all major categories but still led by robust consumer spending. As such, it should be no surprise that the key to the economic outlook for 2021 will be consumer spending again as well. Apparently extrapolating the recent momentum, the consensus expects consumer spending to continue to recover at a solid pace throughout next year. Although I too expect consumer spending to expand in 2021, I am concerned for various reasons that consumers may at times lack the means, if not the methods, to consistently grow spending. During the economic crisis caused by the pandemic, information technology and enhanced delivery systems provided most consumers with an alternative method to shopping in the store, which allowed consumer spending to recover far more than it would have otherwise. Moreover, information technology also provided many workers the ability to work from home, which combined with the generous government assistance programs implemented during the pandemic provided consumers with the means to spend as well. Going forward, there are a few potential stumbling blocks on this score. First is whether the jobs lost during the pandemic return as quickly as now expected once the pandemic ends. Second is whether additional stimulus packages will follow and how generous they might be. Third is whether the vaccine will be distributed as widely and as quickly as now expected; any delay in vaccinations would most likely delay the end of the pandemic. Since financial markets are once again reflecting very optimistic expectations about the economic outlook, any disappointment could prove troubling. At the moment, such disappointments are most likely to be temporary. Not until the Federal Reserve successfully revives inflation in the U.S., assuming that it can, will there be any economic retribution for the U.S. government's growing tendencies to finance benefits with debt monetized by the Fed. Needless to say, that is not something we need to worry about for now but may be worth storing in our memory bank for later.

Mea culpa

Since the coronavirus-induced lockdowns in April, the economic forecast for 2020 was that the U.S. economy would contract in the first quarter, continue to decline dramatically in the second quarter, rebound sharply in the third quarter and struggle to grow in the fourth quarter. Through the first three quarters of 2020, the economy has essentially followed that scenario even though the second-quarter plunge and third-quarter rebound were far more dramatic than anticipated. This is where the mea culpa applies because based on the data through early November, the U.S. economy is on track to deliver solid growth in the fourth quarter rather than no change as expected earlier.

In this regard, according to the current-quarter models of real gross domestic product (GDP), notably the GDPNow estimate from the Federal Reserve Bank of Atlanta, the economy is on track to grow at a double digit pace at an annual rate in the fourth quarter. As shown in Table 1, I doubt that real GDP growth in the current quarter will end up being that robust but it still is expected to be far better than previously expected. As a result, the unemployment rate for the fourth quarter most likely will fall further than anticipated earlier as well.

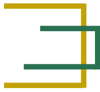


Table 1
U.S. Economic Forecast

	2019	2020				2020f	2021f
		Q1	Q2	Q3	Q4f		
Real Gross Domestic Product	2.3	-5.0	-31.7	**33.1**	**3.7**	**-1.9**	**2.0**
Consumer Price Index, All	2.0	1.2	-3.5	3.8	1.2	0.6	1.7
Consumer Price Index, Core	2.3	2.0	-1.6	3.1	1.1	1.2	1.7
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	8.5	**6.7**	**6.7**	**5.0**
Price of WTI crude oil ($/bbl)	57.0	45.8	27.8	40.1	41.5	41.5	52.0
Trade-Weighted Dollar	116.4	117.9	123.0	117.0	114.0	114.0	**112.0**
S&P 500 Operating Earnings	157.1	19.5	26.8	**38.0**	**36.6**	**120.9**	**158.6**
Percent vs. Year Ago	3.6	-48.7	-33.0	**-5.1**	**-10.0**	**-23.0**	**31.2**
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	0.8	0.8	1.2
30-Year Mortgage Rate	3.7	3.5	3.2	3.0	2.8	2.8	3.3
Bank Prime Rate	4.8	4.1	3.2	3.2	3.2	3.2	3.2

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.

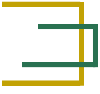
Annual changes in real gross domestic product (GDP) and all measures of inflation are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. The annual estimates of the unemployment rate, the price of crude oil, the trade-weighted dollar and all interest 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. Trade-weighted dollar is the new broad index from the Federal Reserve Board.

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

Indeed, the average unemployment rate for the fourth quarter is now expected to be slightly less than where I thought it would be next year at this time. The bottom line is that the economy appears to be on its way to a full recovery from the adverse economic effects of the pandemic much sooner than expected earlier.

Nevertheless, real GDP growth for all of 2021 is still expected by historical standards to be relatively slow for the first year of a recovery. This may be a precursor for the average pace of real GDP growth over the next business cycle; that is, slow-motion by historical standards.



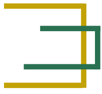
A few analysts, myself included, were concerned about the U.S. economy being able to sustain the recovery beyond the third quarter. This concern was reinforced by the failure to enact another stimulus package before the election as well as the recent restrictions reintroduced in many states in the wake of another wave of virus cases and deaths. Pandemic fatigue, new temporary virus-induced restrictions and the lack of another stimulus package notwithstanding, I doubt that overall economic activity will struggle in the fourth quarter largely because consumers have successfully adjusted their spending during the pandemic. In particular, many of the very generous government assistance programs implemented earlier are still in place (providing the means) and the mostly positive experience consumers have had transitioning to online shopping (providing the method) have allowed consumer spending not only to rebound far more dramatically during the pandemic than I had anticipated earlier but to remain elevated longer as well. The question is whether the means and the methods will be enough to sustain spending growth without a quick end to the pandemic.

Markets are Betting on Better Days Ahead

Nevertheless, what happens in the fourth quarter of this year seems inconsequential to financial market participants. They seem to be more interested in the more optimistic outlook for 2021. A key element of this optimism is the potentially strong economic gains, led by consumer spending, beyond the end of the pandemic, which is more likely to occur next year given recent reports that vaccinations against the virus could be widely dispensed by next summer. There is no doubt that consumers will have the method to spend once the pandemic ends given the likely return of person-to-person services. The question will be whether consumers will still have the means to sustain spending at the solid pace the consensus seems to expect.

The consensus forecast for real GDP growth for all of 2021 is about 4.0 percent on a year-over-year basis according to the Philadelphia Fed Survey, moderately higher than the 3.1 percent year-over-year growth rate assumed in my forecast and twice the 2.0 percent gain on a fourth quarter to fourth-quarter basis shown in my forecast. I could not find a fourth quarter to fourth quarter estimate of real GDP growth in the online summary of the Philadelphia Survey but if there is one, I would guess that it would be more optimistic than 2.0 percent. One feature of my forecast not obvious in the average forecast of the Philadelphia Fed Survey is a far more uneven annual growth rate from quarter to quarter. In particular, I expect real GDP to be flat in the first quarter, rebound somewhat in the second quarter, surge in the third quarter and then slow markedly to a pace closer to the U.S. economy's potential in the fourth quarter. The consensus forecast for real growth is far steadier over the four quarters of next year.

In the first quarter of 2021, no change in consumer spending, a slowdown in residential investment, a pause in business investment and some weakness in state and local government spending is expected to result in a modest gain in real final sales. However, a slowdown in inventory accumulation following huge gains in the second half of last year is expected to offset final sales growth, causing the level of real GDP in the first quarter to be flat compared to its level expected in the fourth quarter of this year. Of course, another generous fiscal assistance package enacted very early next year could alter this outcome by providing consumers with the means to sustain spending at a more elevated pace. On the other hand, there is also the prospect that consumers may postpone some spending, even if they have the means, until the vaccinations are more widely administered, which may not happen until the second quarter.

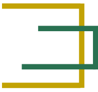


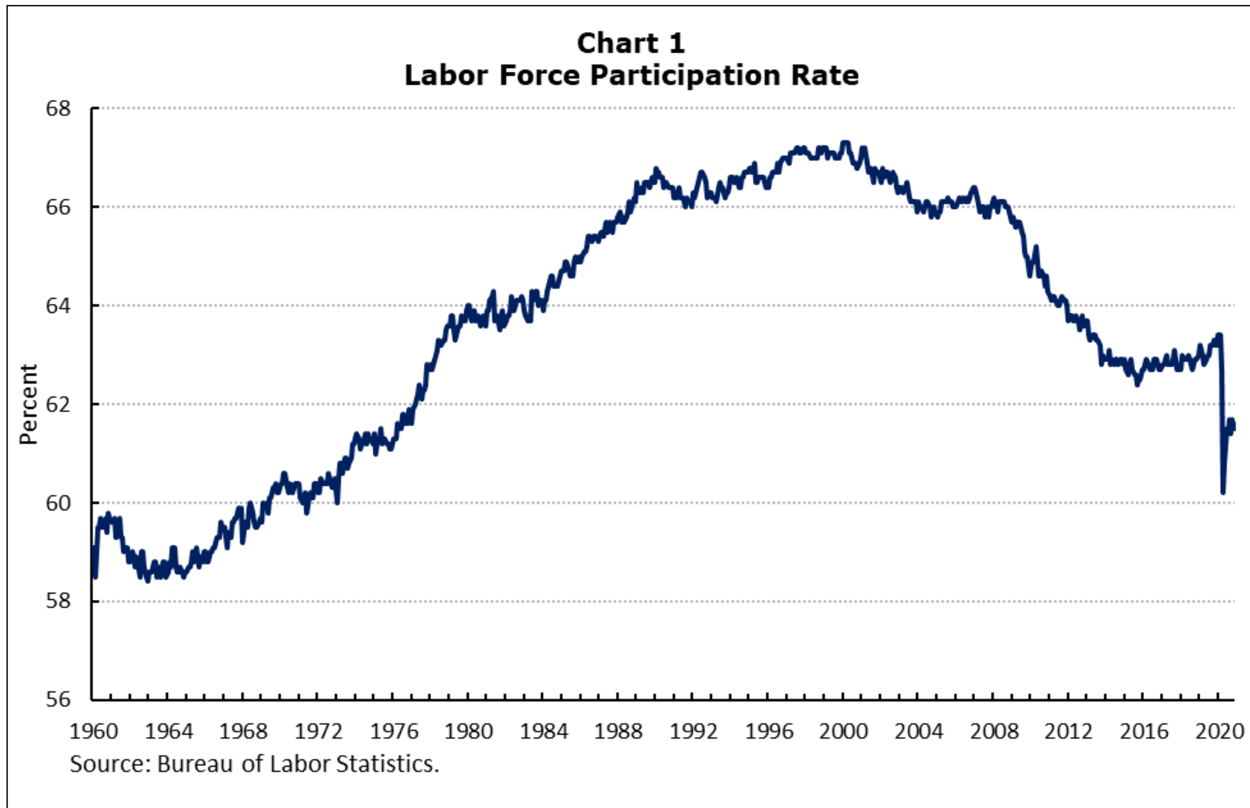
In the second quarter, real GDP is expected to edge higher. Another assistance package most likely will be enacted by then, especially if the data for the first quarter looks mildly disappointing early or if consumers get a bit impatient about the delivery of the COVID vaccine. The improvement in spending in the second quarter will be decent but far from spectacular. Not until the end of the second quarter and into the third quarter is the economy expected to accelerate markedly but only a temporary spurt without another follow-up stimulus package next spring/summer. Not surprisingly, it will be consumer spending that will lead the charge in GDP growth, reflecting the euphoria of having both the means and the methods to spend. Once this euphoria subsides, the economy will settle back to normal. Of course, normal in this case is defined as a return to potential real growth, which I estimate as even lower now than it was before the pandemic began.

In addition, there are other features of the forecast that have been revised as well in light of more recent developments. First, the unemployment rate is now expected to drift lower to an average of about 5.0 percent for the fourth quarter of 2021 from 6.7 percent for the fourth quarter of this year. Clearly the economy's quicker than expected recovery has aided a quicker than expected decline in the unemployment rate. Interestingly, one factor that apparently mitigated the spike in the unemployment rate earlier this year was the sharp decline in labor force participation (the percent of the population either working or looking for work). The labor force participation rate plunged in April to 60.2 percent, its lowest level since January 1973 (see Chart 1). Moreover, the fact that the participation rate, despite a mild rebound, has remained low has helped reinforce the more recent drop in the unemployment rate. My expectation is that as the labor market returns to normal and jobs are more widely available, then the participation rate will gradually edge higher again but whether it returns to its pre-pandemic level of over 63 percent is unclear. This could help lower the civilian unemployment rate, which is now expected to fall to 5.0 percent by the end of next year, without creating as many new jobs as needed in the past to push the unemployment rate down to this level.

Second, S&P 500 operating profits per share for all of next year have been revised dramatically higher in the current forecast. Earlier, I was expecting operating profits to total $140 a share over the four quarters of 2021. That estimate has been revised to about $156 a share. Given that the economy grew much faster in the third quarter and is on track to grow markedly better than expected in the fourth quarter, the level of economic activity underlying corporate profits is considerably better than anticipated earlier. Such an expectation is very reasonable but just how much better profits will be may depend on when the pandemic ends. It now looks as if this could happen sometime in the middle of next year. The question is whether this will be soon enough to provide the boost to S&P 500 profits for all of next year expected by the consensus. Although I am now more optimistic about profitability next year than I was in September, I am not as optimistic as the consensus seems to be at the moment.

That said, several features of the updated forecast for 2021 are very similar to what they were last time; including consumer price inflation remaining benign for most of next year but maybe not as low as it is likely to be for all of this year, the trade-weighted dollar falling further, short-term interest rates remaining near zero and longer-term interest rates continuing to edge a tad higher by the end of next year on concerns that the Federal Reserve's massive accumulation of Treasury debt will add monopsony risk to the market as the recovery takes hold. Needless to say, the outlook is inundated with uncertainties.

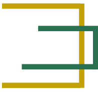




The Future of Jobs

Clearly one of the pillars of the economic recovery is that consumers continue to acquire the means to spend. The consensus view at the moment is that jobs will quickly return once the vaccinations are widely distributed, providing consumers with the necessary means to spend. I hope that is true but I hesitate to think it will be that easy. In particular, the U.S. economy may be at the brink of a major shift in attitudes toward employment, as well as a major shift in job opportunities due to the surge in online business activity. I contend that the driving force behind these shifts has been the pandemic and the unprecedented generosity of relief benefits from the federal government. For many of the unemployed receiving benefits, the amount provided through government programs during the pandemic exceeded the level of income they earned when employed. Indeed, the stimulus checks were an added bonus for many, raising expectations of what the government will do during a crisis. The key will be what is considered a crisis in the future. Arguably in today's world, everything is considered a crisis until proven otherwise.

A potential risk is that individuals become addicted to government assistance, forcing relief benefit programs to survive beyond the recession. Will this mark the beginning of a new entitlement program of "guaranteed minimum income" or the even broader "universal basic income"? That seems to be the direction the government income and tax programs have been moving for some time as evident by the direct stimulus payment programs during the 2001 and 2008 recessions. The apparent success and popularity of direct payments to households most likely were instrumental in garnering support for the direct payments program this time, as well as the $600 bonus added to weekly unemployment benefits of eligible recipients.

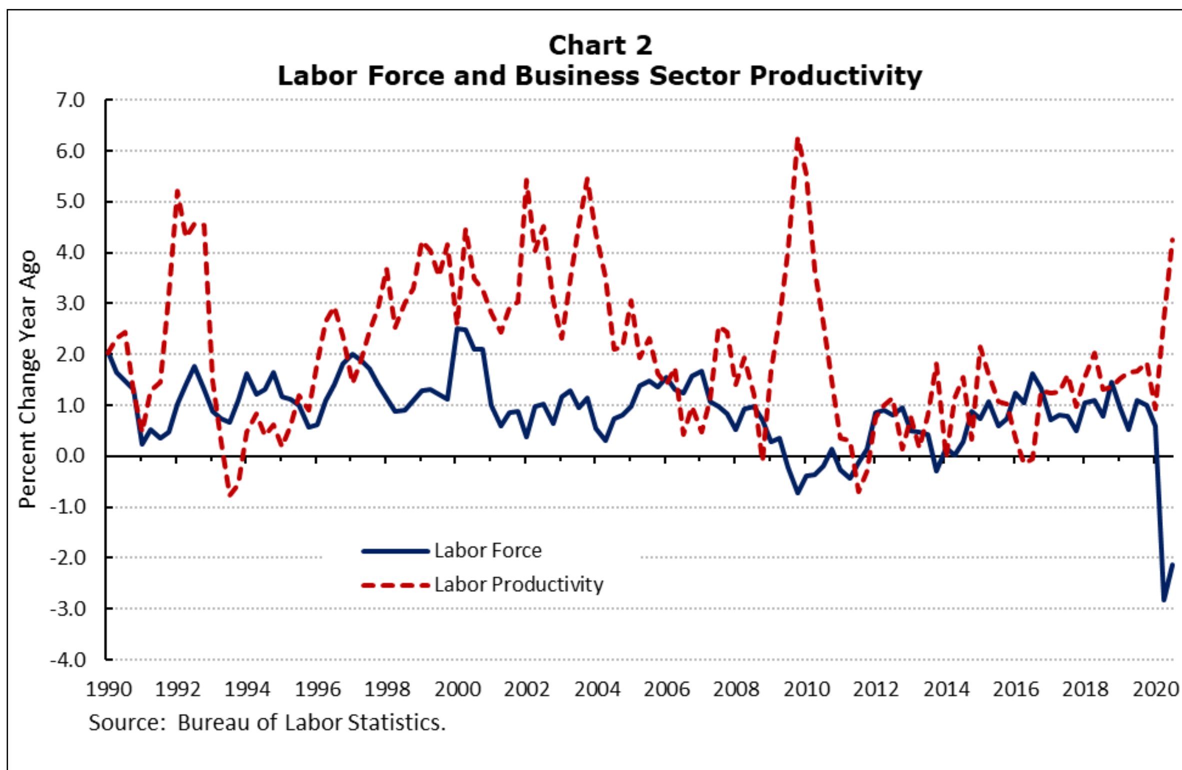


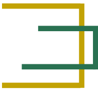
Interestingly, the public's growing addiction to government sponsored benefits now seems a lot easier to accommodate given the preference of many policymakers and analysts to finance government spending with debt monetized by the Federal Reserve—essentially how the pandemic assistance programs have been financed—as an inexpensive and riskless way for the government to support the economy. Who would not want "helicopter money" as long as the helicopter was hovering above them? According to the proponents of providing such benefits by monetizing debt, the only limit is an uptick in consumer inflation, which they essentially have declared impossible anytime soon.

The contradiction in this argument is that the success of permanent direct government payments to sustain economic growth financed with monetized debt may be self-defeating to the extent that it has an adverse effect on goods and services produced without the corresponding drop in consumer demand. After all, there are only two ways to increase output, more workers (hours worked) or increased productivity.

Most would agree that the pandemic has introduced productivity gains through the increased use of enhanced technology to conduct business remotely, both in the goods and service sectors. These gains are reflected in the productivity data in each of the last two quarters as shown in Chart 2. The question is whether such productivity gains can be sustained. I am skeptical that they can since much of the recent gains in productivity were most likely annexed from the future.

Of course, the other data series in Chart 2 is the percent change from a year ago in the labor force (potential hours worked). Clearly when the economy struggled in the past, labor force growth has slowed but nothing like the recent plunge during the pandemic, as Boomers and women left the labor force. The question is how quickly the labor force will rebound. I suspect that it will depend greatly on just how long and how generous future government direct payments to households will be, as well as Boomers retiring in the future.





My concern is that although financing government spending with debt monetized by the central bank may seem palatable for a while, it will eventually have serious consequences for the economy and the potential growth of the economy for future generations. If you think young people feel disenfranchised now, just wait until they are middle aged and expected to pick up the tab for government spending financed with monetized debt.

The bottom line is that the U.S. has rebounded dramatically since May and is likely to continue to improve albeit at a slower and a more uneven pace over the forecast horizon.

Implication for Financial Markets

The Federal Reserve continues to aggressively expand an already elevated balance sheet in an effort to stimulate an economy still dealing with the pandemic. Recall early in the previous expansion following when market participants were fretting about the Fed ending quantitative easing and reducing the balance sheet it accumulated during the recession? At the time, I noted any reduction in assets by the Fed would be minimal because we had become addicted to quantitative easing. It had become part of our market DNA.

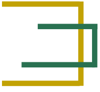
Once again, some market participants are fretting about the Fed reducing its massive balance sheet once the recovery is well underway. I suspect that this concern is premature because the addiction this time has the potential to become more widespread. In particular, it is not only the markets' addiction to quantitative easing (Fed purchases of debt) but the households' addiction to government largess (crisis relief benefits) that will limit the Fed's willingness or ability to reduce their debt holdings. After all, the last thing the Fed would want to do is cause interest rates to rise dramatically, imposing substantially higher debt servicing costs on the government's budget.

That said, as the Fed continues its massive operations of monetizing the debt, it may increase the risk of future inflation, which in turn will result in longer-term interest rates edging higher in line with the degree of such risk. At the moment, that risk seems very low but probably not as low as it was now that the economy seems to be recovering from the recession earlier this year, as well as before the Fed added another $3 trillion to its already elevated debt portfolio and the likelihood of adding more next year.

The stock market continues to amaze. Despite the plunge in March, the S&P 500 stock price index is up 14.5 percent so far this year, clearly exceeding my expectations.

I contend that the stock market is currently priced to reflect very optimistic expectations about the economic outlook, suggesting that any disappointment could prove troubling. The only disappointment I see in the near term is if the economy fails to live up to expectations, which would test the question of whether the stock market actually reflects the overall economy. In that regard, the factors that could help ease the impact of a less robust economy on corporate profitability are a weaker dollar, higher crude oil prices, higher home prices and interest rates remaining historically low. At the moment, such disappointments are most likely to be temporary. Not until the Federal Reserve successfully revives consumer price inflation in the U.S., assuming that it can, will there be any economic retribution for the U.S. government's growing tendencies to finance relief benefits with debt monetized by the Fed. Needless to say, such retribution is not something we need to worry about for now but may be worth storing in our memory banks for later.

Based on this assessment, it looks as if stocks are in a new bull market (assuming that the old one ended in February), which suggests that we buy the dips once again. Although I doubt that this new bull market will last as long as the previous one, it seems certain to survive at least through the end of next year given the strong likelihood of the pandemic ending soon.



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