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Darkest Before the Dawn: Annual Outlook Edition

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We are still down 9.8 million jobs since the peak in February, one million more jobs than we lost during the 2008-09 recession. Employment added only 245,000 jobs in November, less than half the pace of October and the weakest pace since April.

Public health conditions will no doubt get worse before they get better. COVID hospitalizations and deaths are hitting new records. Hospitals and health care workers are overwhelmed. Beds are growing scarce, health care workers are getting sick. The care of COVID and non-COVID patients is suffering.

Those who have escaped the worst effects of COVID have relaxed social distancing measures (including masks), which has exacerbated contagion. State and local governments are being forced to reinstate containment measures to stop the health care system from collapsing.

"December, January and February are going to be rough times. I actually think they're going to be the most difficult time in the public health history of this nation," warned Dr. Robert Redfield, director of the CDC.

Employment will no doubt contract again as we weather the worst of the COVID storm between now and February. Restaurants, bars and traditional retailers were already cutting payrolls in November. Small business openings and revenues are falling. Elective surgeries are being canceled as hospitals are forced to ration beds. Many schools and universities have moved back online. Government offices are being temporarily shuttered.

The losses will pale when compared to those endured last spring. Workers who escaped the worst in the economic turmoil triggered by COVID have acclimated and shifted their spending from services to goods. The threshold from which we are cutting jobs is considerably lower than it was in March; fewer firms are affected by shutdowns. Manufacturers are allowed to stay open this time around.

A vaccine brings the hope of herd immunity and a more complete reopening of the economy in the second half of 2021. That is an eternity for those who are scheduled to lose their unemployment benefits in late December and the rising ranks who will suffer layoffs in the months to come. Rents are going unpaid as food insecurity is worsening. Donate to your local food bank.

This edition of ***Economic Currents*** weighs the costs of the resurgence in COVID cases against the benefits associated with positive news on vaccines. The vaccine can't come soon enough to prevent the economy from stumbling again but does set the stage for a more robust rebound in late 2021. The greatest threat to that outlook is the timeline on a vaccine, which is still a work in progress. States have been left to fend for themselves when it comes to coordinating the actual distribution of vaccines.

We are assuming that Congress finally reaches a compromise. We are expecting a little less than the bipartisan deal the "Gang of 8" in the Senate was able to cobble together. Senate Majority Leader Mitch McConnell and many of his Republican colleagues still want less. Congress needs those votes to get a deal done.

The 2020-21 Outlook

Economy Stumbles Before Reopening

Chart 1 lays out two scenarios for the speed with which we achieve herd immunity. The base-case scenario assumes that all goes as planned and we get there in the third quarter of 2021. Real GDP is expected to contract by 3.5% in 2020 and rebound by 3.4% in 2021, the strongest pace in 15 years. The economy is now expected to reach its previous peak in the fourth quarter of 2021.

The second scenario assumes we hit some speed bumps in the distribution of the vaccine, which delays herd immunity to year-end 2021. The economy doesn't reach its previous peak until early 2022.

Consumers Determine Contour of Growth

A spurt in spending on goods - homes, vehicles, RVs and boats - helped to buoy spending over the summer and into the fall. Those gains helped to blunt the blow to the service sector but will not be enough to keep consumer spending from faltering again in the first quarter.

The degree to which we rebound depends on how much consumers are willing to deplete saving accrued. Wealthy households saved the most and will book more lavish, but not more, vacations. Big-ticket spending on home remodeling and vehicles is expected to slow.

We need to do more to shore up the balance sheets of those hit hardest by the crisis. We want low-wage workers, with a greater propensity to spend, to be able to join the party. The surge in activity we saw last May and June was supported in large part by the CARES Act and the boost it provided for low-wage households.

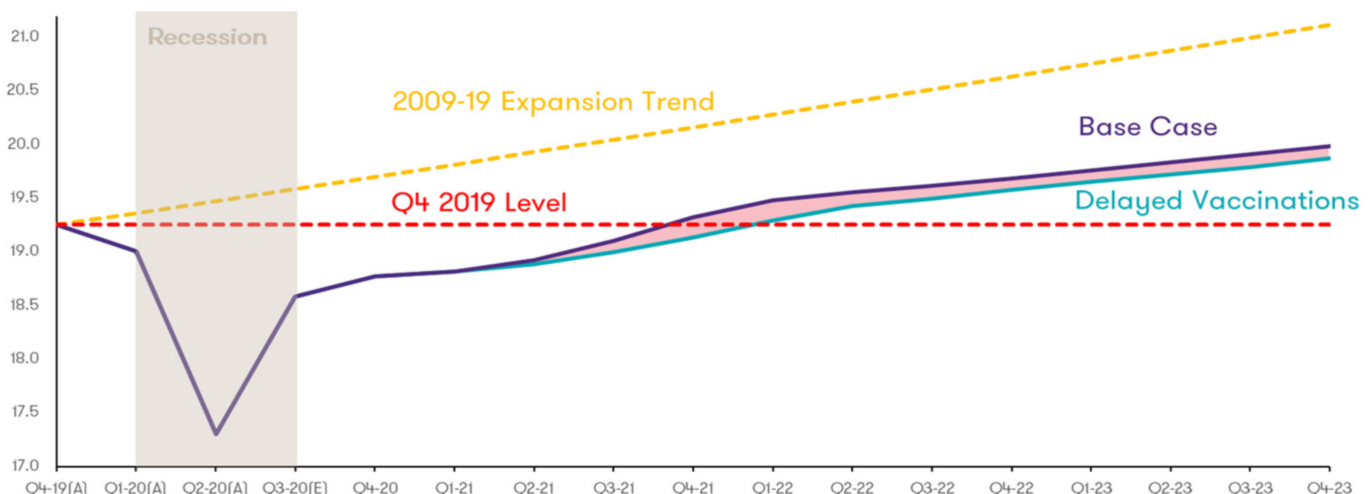
This is in addition to the need to dress the wounds inflicted by COVID. Unemployment is demoralizing. After six months, we hit a tipping point; over a third of the unemployed have crossed that threshold. (See Chart 2.)

Long-term unemployment exacts a larger toll on workers' mental and physical health, their family structures and the well-being of their children. Add the blow to educational attainment and the emerging chronic effects of COVID on workers of all ages, and it is clear we will need investments to recoup and restore the health of our labor market if we hope to mine the technological advances we have achieved.

Housing Remains Strong

Persistently low mortgage rates, a more permanent shift to work-from-home and the pent-up demand for housing among millennials suggest that home buying and building will hold at a relatively high level in the year to come. First-time buyers will supplant vacation home buyers as the primary driver of overall gains.

Chart 1



Source: Bureau of Economic Analysis, Grant Thornton LLP

COVID has exacerbated the shift from what were the hottest urban areas to second-tier cities and the suburbs. It has also accelerated the shift from California and high-tax cities in the North to the South, which is fueling new home construction. Florida and Texas are the winners.

Investment Picks Up Modestly

Business investment picked up in the wake of the crisis. Gains were focused on technology and enhancing our ability to work from home. The next round of investments is expected to focus on technology and hedging against disruptions to supply chains and climate change.

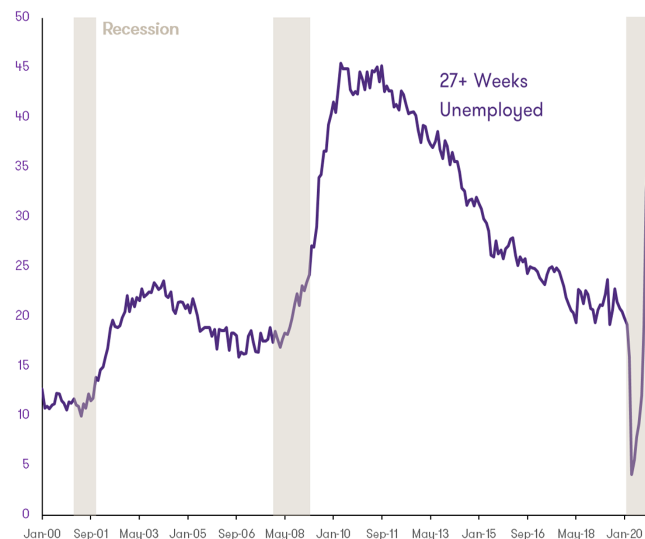
The largest hurdles will be the overhang of corporate debt and the blow to revenues due to the pandemic. Industries hit hardest include travel, tourism and entertainment. Recent research by the Federal Reserve Bank of New York suggests that those industries will hire and invest at a much slower pace after reopening.

Bankruptcies and firm consolidations are accelerating, which could further concentrate technological advances and employment growth in a few firms. This could further dampen investment and our job generating capacity. The only offset is a rise in productivity growth associated with the fact that we have finally learned how to use existing technologies. (My husband has finally figured out how to wield the universal remote.)

Chart 2

Share of Long-Term Unemployed Rising

Percent Unemployed as a Share of Total



Source: Bureau of Labor Statistics/Haver Analytics, Grant Thornton LLP

Government Spending Slows

Government spending is expected to slow dramatically after much of the next aid package expires in April. The drag from a shortfall in state and local government spending could be particularly large if Congress does not find a way to provide transfers to states.

Cuts to state and local employment were the primary reason that employment failed to recover more rapidly in the wake of the 2008-09 recession. We can't afford a repeat in the 2020s.

A bipartisan infrastructure package including transfers to the states would be a big win for the economy; we assume, however, that any detente between the two political parties will be short-lived.

Economists favor additional spending to help heal the wounds inflicted by COVID, repair our dilapidated infrastructure and stop the clock on climate change. The math of debt and deficits is easier than it once was, given the persistence of low, long-term interest rates. The multipliers on infrastructure investments are large. Members of Congress hold the power of the purse strings but they remain deeply divided over priorities. I have stopped holding my breath for politicians to do what is best for the economy.

The new administration is expected to rejoin the World Health Organization and the Paris Climate Accord. It is also expected to issue a flurry of executive orders to reverse curbs on immigration, increase regulation to reduce greenhouse gasses and to enhance conservation efforts to preserve national parklands.

The Trade Deficit Widens

Surging COVID cases have triggered a new round of restrictions in Europe and the U.S., which will suppress global growth at the end of 2020 and in early 2021. This will take a toll on both imports and exports at the start of the year. The trade deficit, which usually narrows when the U.S. economy slows, is expected to widen.

After that, the rebound in growth in the U.S. suggests that imports will outpace exports with the trade deficit further widening. Emerging markets are expected to remain particularly weak. They can't afford as many vaccines or the fiscal stimulus that we can.

Even China, which is one of the few countries to post an actual gain in 2020, is expected to slow in 2021. The result is a trade deficit that continues to widen, despite some recent weakness in the value of the dollar. The new administration is expected to keep tariffs on China; so far, tariffs have failed to bring production home and narrow the trade deficit with China.

Risks

Near-term losses are a function of the resurgence in COVID cases. More aggressive restrictions by state and local governments may be needed to ease the pressure on the health care system.

The rebound that follows is contingent on the timeline for a vaccine. Everything, from production to distribution and administration of the vaccine, is still a work in progress. States have begun to receive supplies of vaccines, which are well below initial targets. They are hoping to start vaccinating frontline workers and people living in nursing homes in the next several weeks. That is a huge task given how stressed hospitals have already become.

The resources needed to distribute a vaccine could siphon resources from other parts of the economy. That could further delay the rebound in overall economic activity. My holiday gifts are already running well behind schedule, and I ordered early.

Another stimulus package will be needed if we hope to do more than just regain ground lost, but our hopes are not high. We have yet to see how long a detente between the two parties can last. Chances that the Democrats win the two Senate runoff elections in Georgia in early January are slim. Even if they do, Democrats in the Senate are much more moderate than their counterparts in the House and not likely to enact a generous stimulus package as the president-elect has hoped.

Inflation Remains Constrained

Chart 3 shows the forecast for core PCE inflation, which strips out the volatile food and energy components. A sharp slowdown in inflation during the height of global lockdowns last spring sets the stage for a temporary bump in inflation in early 2021. Persistently weak wage growth and the shift in demand back to services from goods are expected to keep a lid on inflation for the foreseeable future.

Supply disruptions, such as we have seen in the food chain, are expected to be temporary and offset by a reduction in prices elsewhere. That provides little solace for households now running on fumes when it comes to unemployment benefits. Food insecurity has worsened rapidly in recent weeks. Additional aid from Congress could provide much needed relief but will not come soon enough to keep families fed during the holidays.

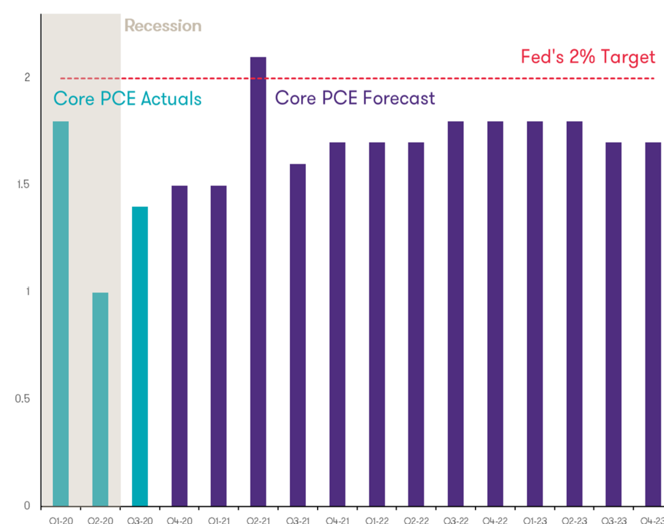
Risks

A massive stimulus package on the other side of the crisis, coupled with a faster drawdown in saving, could trigger a much more rapid pickup in prices. Those increases would be harder for the Fed to ignore. We should be so lucky. Accelerating prices are much easier for the Fed to counter than decelerating prices.

The Fed Holds the Line

Federal Reserve Chairman Jay Powell has committed to overshooting on inflation before raising short-term interest rates. This shift in policy from preemptive to post-mortem rate hikes is nuanced. The Federal Open Market Committee (FOMC) would tolerate a modest (not a major) overshoot on inflation before raising rates. The trajectory of inflation matters as much as the level.

Chart 3



Source: Bureau of Economic Analysis, Grant Thornton LLP

The Fed is basically saying that it is now willing to let unemployment plummet and wages accelerate, allowing inflation to rise but not actually flare. If Congress agrees on a much more aggressive stimulus plan, and that increase in spending spurs a more rapid drop in unemployment and jump in wages, then they would move sooner to raise rates. We don't have a rate hike in the forecast for the next several years.

In fact, the Fed is poised to do more if necessary in the near term. Following its upcoming meeting on December 16, the FOMC is widely expected to issue guidance that it could expand its asset purchases if credit markets showed signs of seizing up. New York Fed President John Williams has also reopened the door to negative rates, which Powell had closed earlier this year. Economic conditions would have to get materially worse for the Fed to go negative on short-term interest rates.

The Fed has also discussed yield curve controls, but remains reluctant to use them. Bond yields are already at extremely low levels, which undermines the case for explicit targets. Much like negative rates, they are also tough to reverse once they start.

Risks

The Fed has more tools to counter a flare in inflation than sustained weakness. More worrisome is the collateral damage a sharp jump in interest rates would mean for corporate balance sheets, which are in much worse shape than they were after the 2008-09 recession.

Bottom Line

Economic conditions are expected to worsen before they get better, but there is a light on the horizon. A highly effective vaccine could get us to herd immunity in 2021, which would allow us to fully reopen the economy. Containing the spread of COVID will allow the economy to emerge from the darkest days of the pandemic.

We will no doubt need some level of stimulus and infrastructure spending to fortify the foundation from which we rebuild. Persistently low interest rates have given us a unique opportunity. The only question is whether Congress will abandon ideology, listen to economists and act. It is rare that so many of us agree.

Economic forecast — December 2020

	2020	2021	2022	2020:1 (A)	2020:2 (A)	2020:3 (E)	2020:4	2021:1	2021:2	2021:3	2021:4	2022:1
National Outlook												
Chain-Weight GDP[1]	-3.5	3.4	2.9	-5.0	-31.4	33.1	4.2	1.0	2.2	3.9	4.6	3.3
Personal Consumption	-3.8	4.1	3.5	-6.9	-33.2	40.6	4.5	-0.2	3.4	4.8	6.0	3.6
Business Fixed Investment	-4.7	2.6	4.2	-6.7	-27.2	21.9	2.7	1.5	2.3	3.8	5.1	4.5
Residential Investment	5.7	7.4	-2.0	18.9	-35.5	62.2	30.0	-6.5	1.5	3.7	0.9	-1.3
Inventory Investment	-83	68	109	-81	-287	-4	39	65	57	68	83	103
Net Exports (bil $ '12)	-908	-1071	-1134	-788	-775	-1016	-1051	-1025	-1061	-1085	-1111	-1117
Exports	-13.1	8.7	9.8	-9.4	-64.4	60.5	17.7	11.2	9.3	10.2	11.4	10.1
Imports	-9.9	11.4	8.6	-15.0	-54.1	93.1	16.7	4.2	11.0	9.9	10.9	7.7
Government Expenditures	0.9	-0.7	-0.1	1.3	2.5	-4.9	-3.8	1.2	0.8	0.6	-0.3	-0.1
Federal	4.1	0.1	-0.4	1.6	16.4	-6.2	-3.9	1.7	1.2	0.7	-0.7	-0.4
State and Local	-1.0	-1.2	0.2	1.1	-5.3	-4.0	-3.7	0.8	0.6	0.5	0.0	0.1
Final Sales	-2.9	2.7	2.7	-3.6	-28.1	25.6	3.4	0.5	2.3	3.7	4.4	3.0
Inflation												
GDP Deflator	1.2	1.8	1.7	1.4	-1.7	3.4	2.4	1.7	1.7	1.7	1.6	1.6
CPI	1.2	2.0	2.4	1.2	-3.5	5.1	1.9	1.5	2.2	2.6	2.6	2.3
Core CPI	1.7	1.9	2.0	2.1	-1.6	4.4	1.6	1.9	1.8	1.9	1.8	2.1
Special Indicators												
Corporate Profits[2]	-7.7	-4.4	0.9	-6.7	-19.3	3.3	-7.7	-3.1	9.3	-13.4	-4.4	5.0
Disposable Personal Income	5.9	-2.2	0.4	2.6	48.6	-16.0	-11.7	5.4	-6.0	-2.9	1.3	2.4
Housing Starts (mil.)	1.37	1.46	1.38	1.48	1.08	1.44	1.49	1.34	1.51	1.47	1.51	1.45
Civilian Unemployment Rate	8.2	6.5	5.5	3.8	13.0	8.8	7.0	7.0	6.9	6.2	5.9	5.6
Total Nonfarm Payrolls (thous.)[3]	-8750	5123	779	-1257	-15398	7369	536	450	1027	2236	1410	1118
Vehicle Sales												
Automobile Sales (mil.)	3.5	4.0	4.2	4.0	2.6	3.6	3.9	3.5	4.0	4.2	4.3	4.2
Domestic	2.5	2.7	2.7	2.9	1.8	2.6	2.8	2.5	2.8	2.8	2.8	2.8
Imports	1.0	1.3	1.5	1.1	0.8	1.0	1.1	1.0	1.2	1.4	1.5	1.4
Lt. Trucks (mil.)	10.5	12.4	13.0	11.2	6.8	11.7	12.3	12.0	12.3	12.4	12.8	12.9
Domestic	8.6	9.6	10.1	8.9	6.7	9.2	9.6	9.3	9.5	9.6	10.0	10.1
Imports	2.4	2.8	2.9	2.3	2.1	2.5	2.7	2.7	2.8	2.8	2.8	2.8
Combined Auto/Lt.Truck	14.0	16.4	17.2	15.1	9.4	15.3	16.2	15.5	16.3	16.6	17.1	17.1
Heavy Truck Sales	0.4	0.5	0.5	0.4	0.3	0.4	0.4	0.4	0.4	0.5	0.5	0.5
Total Vehicles (mil.)	14.4	16.8	17.6	15.5	9.7	15.7	16.6	15.9	16.7	17.1	17.6	17.6
Interest Rate/Yields												
Federal Funds	0.4	0.1	0.1	1.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
10-Year Treasury Note	0.9	0.8	0.8	1.4	0.7	0.7	0.8	0.6	0.6	0.9	1.0	0.8
Corporate Bond BAA	3.8	3.6	3.5	4.1	3.9	3.4	3.7	3.7	3.6	3.5	3.7	3.5
Exchange Rates												
Dollar/Euro	1.13	1.18	1.19	1.10	1.10	1.17	1.18	1.18	1.18	1.18	1.19	1.19
Yen/Dollar	107.2	106.0	105.5	108.8	107.6	106.3	106.0	106.0	106.0	106.0	106.0	105.9

1. in 2019, GDP was $19.1 trillion in chain-weighted 2012 dollars.
2. Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.
3. Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

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