

 ECONOMIC CURRENTS

JANUARY 11, 2021

The Hardest Mile & Push to the Finish Line

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What we hoped would be a sprint has turned into a marathon. We are in the hardest mile when fatigue sets in, causing our minds and bodies to hit a wall. Marathoners train for this inevitability, but most of us were caught unprepared.

Employment lost ground in December for the first time since April when the post-Thanksgiving surge in COVID cases triggered another round of layoffs at restaurants and bars. Traditional holiday parties and New Year's celebrations were nearly nonexistent. Schools that had reopened were forced to close and move back online, which prompted job cuts in education.

Conditions will get worse before they get better. Cases, hospitalizations and fatalities have hit new records in the wake of family gatherings during the holidays.

More contagious **variants** of the virus have emerged. The speed with which they are spreading is staggering. Ireland has seen a tenfold increase in cases in the last month; it is now exceeding the U.K., which is a much larger country. Our health care system and morgues could become overwhelmed, which would force states to adopt much more aggressive containment measures.

Vaccinations are lagging. Dr. Anthony Fauci, who is joining President-elect Joe Biden's COVID task force, is optimistic that the glitches at the outset of vaccinations can be resolved.

Fauci recently **asserted** that 100 million vaccinations in the first 100 days of the new administration is "a very realistic, important, achievable goal." This is a 24/7 proposition and requires a reset to deploy vaccines currently in warehouses.

The newly passed, \$900 billion in fiscal aid will help to blunt the pain we are enduring and help get us to herd immunity. Funds for vaccinations, testing and tracing were included in that plan and will be deployed to kick start the process. Biden has also pledged to set up federal vaccination sites.

Prospects for additional fiscal stimulus have picked up now that Democrats have gained a slim majority in the Senate. Republicans will likely join Democrats in approving additional stimulus. The goal will be to show unity. The events of January 6 rattled elected officials on both sides of the aisle. (Understatement.)

In our forecast, we have added another \$700 billion in checks, unemployment insurance (UI) benefits and transfers to the states. We assumed:

- An additional \$1400 per adult, which brings it to \$2000 per check, but limits checks for children under 17.
- An extension of the current expansion in UI benefits from March to June.
- Direct transfers to state and local governments.
- Additional rent forbearance, student loan forgiveness and funding for small businesses. (The latter may come too late to save many.)

That brings total additional aid and stimulus to \$1.6 trillion. Funds for infrastructure, including clean energy are also possible but not included in the initial ask by the new administration. To get any new legislation passed, all Democrats and independent Senator Bernie Sanders will be required to vote "aye," with the vice president casting the tie-breaking vote, unless Republicans can be persuaded.

This edition of *Economic Currents* takes a closer look at the outlook in light of recent tectonic shifts in Washington. COVID remains the largest challenge, with the third and largest wave making economic conditions worse before they start to improve. An additional \$1.6 trillion in aid will provide a much needed shot of adrenaline when we hit our hardest mile and act as a tailwind for a rebound on the other side of the crisis.

We are still hoping to reach herd immunity by early autumn, which could be a stretch given the late rollout of vaccines. Biden has pledged to rejoin the World Health Organization (WHO) to better coordinate vaccinations across developed as well as developing countries. That will facilitate a broader reopening of the global economy and allow us to better hedge against the next pandemic.

A Stronger Rebound

Chart 1 shows the effects that the Biden bump in stimulus has on the outlook through 2023. The economy will struggle at the start of 2021 and recover more rapidly thereafter. GDP is expected to cross the peak hit in the fourth quarter of 2019 during the summer of 2021, three months earlier than we last predicted.

Growth is now expected to hit 4% in 2021, the strongest pace in 20 years after contracting at a record-breaking 3.6% pace in 2020. The trajectory in 2022 is higher, as that is when the bulk of catch-up occurs.

The economy is now expected to come closer to catching up to its previous trend by the end of 2023 but shortfalls will remain. We need to do more than recoup the jobs lost to COVID; we need to replace what could have been. We were generating about 200,000 jobs a month before the crisis, or 2.4 million jobs a year. We need to recoup those jobs as well as the nearly 10 million we are still in the hole due to COVID.

Consumers Closer to Becoming Whole

Larger stimulus checks are not well-targeted; they go to those who do and do not need them but are at least quick to hit consumers' wallets. They have proven to be more effective than antiquated state UI programs in getting money into the hands of those who need it most.

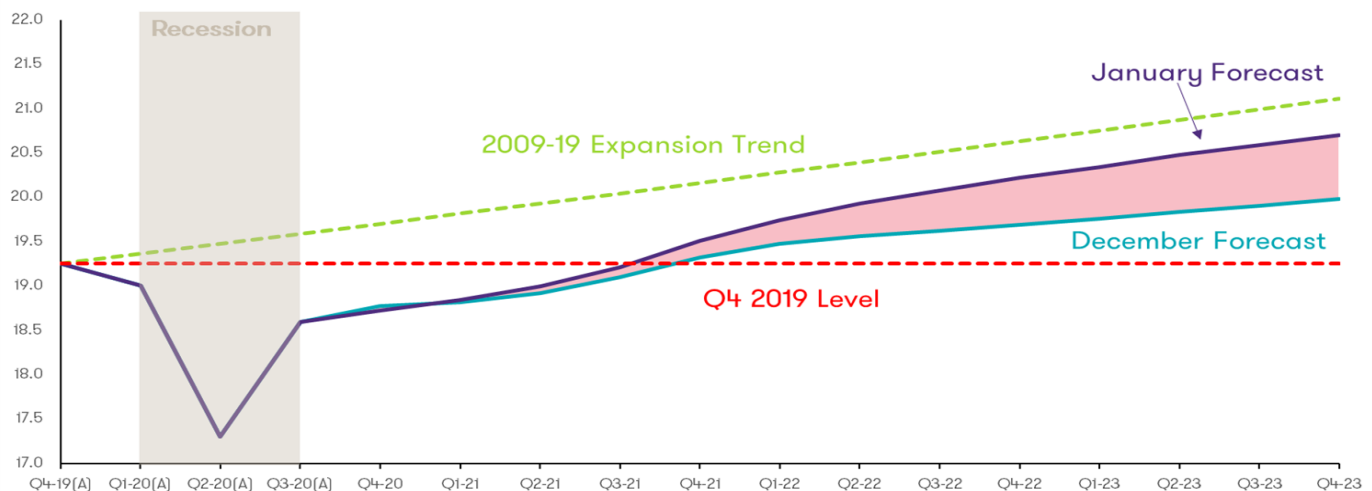
Those hardest hit by the crisis will use the lifelines to pay for the basics of food and shelter. **Moody's** has estimated that nearly 12 million renters will owe nearly \$6000 in back rent and utility bills alone by January; that was before the recent round of layoffs hit.

Others will be able to cushion their savings and use it to unleash more of the pent-up demand triggered by the crisis. The strength of the rebound in growth last spring and summer can be directly traced to the checks and generous supplements to UI benefits provided by the **CARES Act**. It didn't provide enough resources to carry the economy through the third and worst wave of infections in the fall.

Chart 1

Biden Ushers in More Stimulus

GDP, 2012 \$, Trillions



Source: Bureau of Economic Analysis, Grant Thornton LLP

The timing of the rebound will depend upon whether we embrace masks and leverage testing and tracing to reopen the economy. Other countries have proven that those tools can suppress contagion and allow more businesses to safely reopen. That would leave more room in hospitals to treat the few who do get sick with improving therapeutics instead of the rationing of care we are seeing today.

Housing Remains Robust

Home buying and building are expected to continue to rise in 2021 before leveling off in 2022. Gains will be concentrated in single-family over multifamily construction. First-time buyers are expected to supplant vacation home buyers and housing appreciation should eventually moderate.

Multifamily construction is expected to remain elevated as builders shift from luxury apartments and condos in the country's largest cities to second-tier cities and suburbs. Urban life will not die but could take time to recover. COVID accelerated the move from cities to suburbs but did not eliminate the desire to congregate or wipe out the benefits of agglomeration, or the clustering of like industries.

Investment Recovers Unevenly

Much like 9/11, COVID will siphon away funds earmarked for offensive investments. This means we will see more defensive investments in technology and protocols to hedge against the risk of another pandemic. A surge in bankruptcies and firm consolidations will accelerate the shift toward technology that cuts costs and helps businesses integrate.

The push to regionalize supply chains has not yet happened. The trade war with China simply shifted production from China to Vietnam, while China has solidified its role in the global supply chain. Some efforts to regionalize are still possible but not at the pace that many expected. Manufacturing jobs actually declined by more than 200,000 in 2019 before the crisis took hold.

An overhang of debt and the losses endured during the crisis could undermine investment and hiring in the hardest hit industries. Bailouts were largely limited to the airlines and the firms that service them.

Commercial real estate has taken it on the chin, especially in urban cores. I don't know of a single firm that isn't trying to rethink how to use its downtown office space. This has prompted many to predict a shift in services from urban areas to the suburbs.

That said, Silicon Valley discovered that much was lost in translation when employees shifted to work-from-home. Some returned to their offices to improve collaboration.

Elevated Government Spending

Government spending is expected to remain elevated over the next several years as aid and stimulus work their way through the economy. Transfers to the states take longer to reach spending than checks, bailouts, PPP loans and unemployment benefits do.

The newly passed aid package has funding for vaccines, testing, tracing, schools and hospitals. That will help to turn state and local employment around and prevent them from cutting jobs as they did in the wake of the 2008-09 crisis. There is funding to keep mass transit going, which is needed to get low-wage workers to work.

A bipartisan infrastructure bill would go further in repairing our dilapidated infrastructure and speeding a shift toward clean energy. The costs of clean energy alternatives have fallen dramatically, while jobs in clean energy have multiplied.

Record low rates have given us a rare opportunity to fill the dire needs triggered by the pandemic. The yield on long-term Treasury bonds is actually negative after adjusting for inflation; it is likely to remain that way for some time to come. That means the world is willing to actually pay us to spend more right now. The argument against spending more today was predicated upon higher interest payments crowding out private sector investment. That is not the case now.

Trade Deficit Widens

Global trade had recovered more rapidly than most expected but harsher lockdowns abroad, coupled with less robust and uneven recoveries across the emerging markets, are now expected to suppress exports relative to imports. That will keep the trade deficit widening well into 2021.

A weaker dollar could provide an additional lift to exports late in 2021 and into 2022. The U.S. remains the 800-pound gorilla in the room when it comes to the sheer volume of imports consumed; that will keep the trade deficit widening for some time to come.

Biden has no love for China or Russia and is expected to repair frayed relationships with traditional U.S. allies. He favors a return to multilateral as opposed to bilateral trade agreements, as they are better suited to pressure China and Russia with a combination of sanctions, tariffs and loss of market access.

Risks

The near-term risks remain to the downside due to the surge in COVID cases, delays in vaccines and emergence of more contagious variants. We may need to adopt more aggressive containment measures to alleviate the pressure on our health care system. This could take a larger toll on the first quarter and lengthen the timeline for herd immunity.

Threats of more violent conflicts on and around the inauguration add to those downside risks. They fuel uncertainty, which is its own tax on the economy. They could also roil financial markets. Corporate America has taken notice and suspended campaign contributions to members of Congress that voted against certifying the presidential election.

Downside risks diminish as we move into 2022. Risks could shift to the upside if worst case scenarios are avoided. Additional stimulus could reduce the scars left by COVID by providing hardest-hit households with needed support.

Inflation Warms

Bottlenecks Could Emerge

Chart 2 shows the forecast for core PCE inflation, which strips out the volatile food and energy components. This is one of the best predictors of future inflation. A rapid slowdown in inflation during the height of global lockdowns last spring set the stage for a temporary bump in inflation in early 2021. Inflation will pick up modestly and move above the Federal Reserve's 2% target in late 2023.

Fed officials want to see a modest overshoot on inflation to allow for a more complete and "inclusive" recovery. They are looking for unemployment to dip low enough to force firms to tap a larger pool of workers, including those who have suffered from systemic bias. The Fed would like to see the wages of the lowest paid workers - those hit hardest by COVID-related layoffs - accelerate.

Supply disruptions, which trigger a spike in some prices, are likely given the prospects for additional stimulus. Any jump in prices associated with those disruptions should be transitory.

Risks

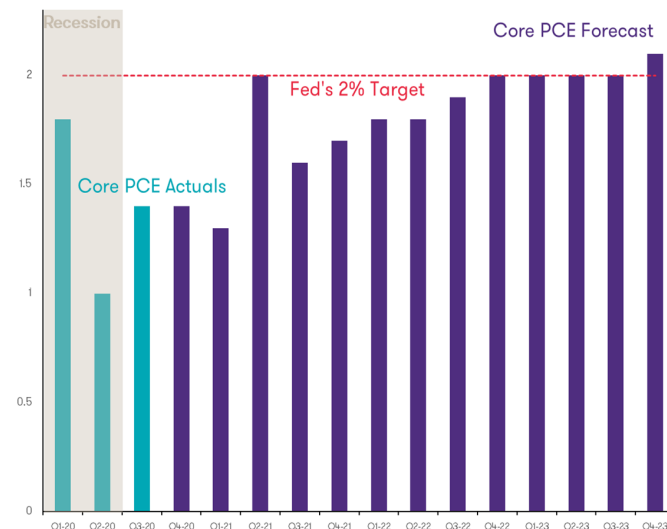
A massive stimulus package on the other side of the crisis, combined with a faster drawdown in saving, could trigger a more rapid pickup in prices. Such increases would be harder for the Fed to ignore but can be dealt with by simply raising short-term interest rates.

Fed Moves to the Sidelines

The Federal Reserve has been begging Congress for more fiscal stimulus. The recent aid package and prospects for more will alleviate pressure on the Fed to act. Fed Chairman Jay Powell has stated that the Fed will look past any temporary spikes in prices. Fed officials plan to wait for inflation to return before raising rates. They are planning to hold rates close to zero through 2023.

Chart 2

Inflation Finally Moves Above Fed's Target
Percent Change, 4Q/4Q



Source: Bureau of Economic Analysis, Grant Thornton LLP

Focus has already begun to shift from inflation to financial stability. The Fed has shunned raising rates to pop burgeoning asset price bubbles. Officials prefer to leverage the institution's regulatory authority to deal with financial bubbles.

Risks

The Fed has been forced by outgoing Treasury Secretary Steven Mnuchin to abandon many of the emergency lending facilities. That leaves the Fed with fewer tools to counter financial market volatility until his successor is sworn in.

Incoming Treasury Secretary Janet Yellen will not hesitate to reinstate emergency lending facilities. Powell served with and under Yellen when she was a Fed governor and chair. As friends and colleagues, they have a great deal of respect for one another and will work closely together.

At least one bond rating agency has threatened to downgrade U.S. government debt if we don't see a peaceful transition of power. Credit markets could seize, which would force the Fed to intervene. Treasury bond yields could spike and derail the opportunity that record-low rates have provided to stimulate the economy.

There is no precedent for such an extreme event in recent American history. This begs the question of whether the Fed would actually be able to do much if such a scenario is realized. I have to hope it's averted.

Bottom Line

Economic conditions will weaken before they get better but we now have a much needed shot of adrenaline to help us push through that hardest mile. The stimulus we are likely to get in light of the shift in the composition of the U.S. Senate will provide the tailwind needed to cross the finish line to herd immunity. Getting to herd immunity is no small task but it is attainable.

Biden's greatest challenge will be to bridge the gulf that COVID has exposed and widened and enact reforms that spur more even and, therefore, more robust growth. Only then can we address the grievances that divide us and attempt to heal. What was a marathon will become a relay race; that requires teamwork. I have no choice but to be hopeful we can do that.

Economic forecast — January 2021

	2020	2021	2022	2020:1 (A)	2020:2 (A)	2020:3 (A)	2020:4	2021:1	2021:2	2021:3	2021:4	2022:1
National Outlook												
Chain-Weight GDP ¹	-3.6	4.0	4.4	-5.0	-31.4	33.4	2.8	2.6	3.3	4.5	6.4	4.7
Personal Consumption	-3.9	4.3	4.6	-6.9	-33.2	41.0	1.8	0.3	4.7	6.1	7.3	4.8
Business Fixed Investment	-4.3	6.3	6.1	-6.7	-27.2	22.9	7.3	11.2	3.0	4.4	7.6	7.1
Residential Investment	5.7	10.2	-2.4	18.9	-35.5	63.0	30.5	8.0	3.7	-5.7	-5.2	-3.7
Inventory Investment	-77	94	113	-81	-287	-4	64	102	87	80	105	121
Net Exports (bil \$ '12)	-919	-1179	-1098	-788	-775	-1019	-1094	-1151	-1188	-1187	-1191	-1172
Exports	-13.1	9.2	9.6	-9.4	-64.4	59.6	18.4	14.4	8.4	9.4	11.0	10.4
Imports	-9.6	14.8	4.2	-15.0	-54.1	93.0	22.8	17.0	10.0	6.2	7.8	4.7
Government Expenditures	0.9	0.4	0.7	1.3	2.5	-4.8	-3.7	4.0	2.5	0.7	1.3	-0.2
Federal	4.1	1.6	-1.9	1.6	16.4	-6.2	-3.7	8.1	3.4	-2.4	-2.0	-4.2
State and Local	-1.0	-0.3	2.4	1.1	-5.3	-3.9	-3.7	1.4	1.8	2.7	3.4	2.4
Final Sales	-3.0	3.2	4.4	-3.6	-28.1	25.9	1.6	1.9	3.6	4.7	6.0	4.4
Inflation												
GDP Deflator	1.2	1.7	1.8	1.4	-1.7	3.4	2.4	1.0	1.7	2.0	1.7	1.6
CPI	1.3	2.1	2.4	1.2	-3.5	5.1	2.3	1.7	1.8	2.8	2.6	2.7
Core CPI	1.7	2.1	2.1	2.1	-1.6	4.4	1.8	2.1	2.1	1.9	1.9	2.2
Special Indicators												
Corporate Profits ²	-13.8	-3.6	11.4	-6.7	-19.3	3.5	-13.8	4.1	18.6	-18.3	-3.6	-6.2
Disposable Personal Income	6.0	6.9	-0.5	2.6	48.6	-16.3	-9.8	59.4	-11.4	-7.4	-1.1	2.6
Housing Starts (mil.)	1.38	1.53	1.45	1.48	1.08	1.43	1.54	1.60	1.56	1.49	1.45	1.44
Civilian Unemployment Rate	8.1	5.3	3.9	3.8	13.0	8.8	6.8	6.0	5.6	5.1	4.6	4.2
Total Nonfarm Payrolls (thous.) ³	-7495	6046	596	-1257	-15398	7370	1790	1180	1412	1921	1533	1151
Vehicle Sales												
Automobile Sales (mil.)	3.5	4.1	4.2	4.0	2.6	3.6	3.9	3.9	4.0	4.2	4.3	4.3
Domestic	2.5	2.8	2.7	2.9	1.8	2.6	2.8	2.8	2.8	2.8	2.8	2.8
Imports	1.0	1.3	1.5	1.1	0.8	1.0	1.1	1.1	1.2	1.4	1.5	1.5
Lt. Trucks (mil.)	10.5	12.5	13.0	11.2	6.8	11.7	12.3	12.1	12.5	12.7	12.8	12.9
Domestic	8.6	9.8	10.1	8.9	6.7	9.2	9.6	9.6	9.7	9.9	10.0	10.1
Imports	2.4	2.7	2.9	2.3	2.1	2.5	2.7	2.5	2.8	2.8	2.8	2.8
Combined Auto/Lt.Truck	14.0	16.6	17.2	15.1	9.4	15.3	16.2	16.0	16.5	16.9	17.1	17.2
Heavy Truck Sales	0.4	0.5	0.5	0.4	0.3	0.4	0.5	0.4	0.4	0.5	0.5	0.5
Total Vehicles (mil.)	14.4	17.1	17.7	15.5	9.7	15.7	16.7	16.4	16.9	17.4	17.6	17.7
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	1.1	1.3	1.4	0.7	0.7	0.9	1.0	1.1	1.1	1.2	1.2
Corporate Bond BAA	3.7	3.5	3.7	4.1	3.9	3.4	3.4	3.4	3.4	3.5	3.6	3.6
Exchange Rates												
Dollar/Euro	1.13	1.18	1.19	1.10	1.10	1.17	1.19	1.20	1.20	1.21	1.21	1.21
Yen/Dollar	106.8	106.0	105.5	108.9	107.5	106.1	104.5	104.3	104.3	104.5	104.6	105.0

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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