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Mission Unaccomplished:

Gridlock Undermines Outlook

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Everything from a buoyant stock market to continued job gains and a sharp drop in the unemployment rate in August has left Congress gridlocked. Why should Members of Congress act when the economy is healing so fast on its own? Because the stock market is not the economy. It is even less representative of the overall economy today than it was in the past. The gains in employment are not nearly enough to fill the hole left by COVID-19. Employment is still down by 11.6 million jobs since the onset of the crisis, 25% more than we lost to the Great Recession.

Job losses were in every major sector, but greater for low-wage workers. Leisure and hospitality is still down 4.4 million jobs from its peak in February.

The ability to work from home, combined with buoyancy in the major stock indices, has created a bubble that has sheltered higher wage households from experiencing those losses so far. Job losses in finance have been especially small, which is exacerbating the deafening dissonance between Wall Street and Main Street.

The pace of jobs recovery has slowed, while the ranks of the permanently unemployed have risen. Our ability to call back workers laid off due to the pandemic is diminishing. Restaurants, bars and hotels cannot fully reopen as long as the pace of infections remains elevated. Professional sports can be played, but fans can't be present in any real numbers without risking contagion. Cheering for your favorite team can accelerate the spread of the airborne disease, especially in venues with air that is recirculated.

Inequality has worsened. The unemployment rate has fallen much more rapidly for white than Black and Hispanic workers, while women were hit harder by layoffs and school closings than men. The labor force has actually lost 3.7 million workers since the precrisis peak in February; women account for two million of those losses. Child care will be critical to bringing women back. Without it, the pipeline of women at all income strata is compromised.

A surge in infections tied to school and university reopenings, and the decisions to send those students home, could further exacerbate the spread of the virus as we move into September. Add in the Labor Day celebrations and a refusal to embrace masks by a large swath of the population. Dr. Anthony Fauci has warned of an even higher pace of infections.

That could boost hospitalizations and once again overwhelm hospitals and frontline workers before a second wave hits with the onset of flu season. Celebrations will have to be dramatically scaled back or cancelled entirely during the peak of the holiday season.

This edition of ***Economic Currents*** shows what will happen if gridlock in Congress persists. Funds that expired but were allocated by the CARES Act could be modified, while they debate additional supplements to unemployment insurance (UI). The supplements included in executive orders are expected to run out in three to four weeks' time. That is better than nothing but woefully insufficient to keep spending afloat if infections surge again after Labor Day.

Our forecast assumes that we do not achieve herd immunity with a vaccine until mid-2021. That is consistent with projections by the Centers for Disease Control and Prevention (CDC) that several vaccines could be approved and in production by year-end 2020. Efforts to speed the approval of a vaccine could compromise the uptake if they undermine our confidence in the safety and efficacy of a vaccine.

A Square Root
Base Case Deteriorates

Chart 1 shows the path of the forecast with little to no additional aid provided by Congress to offset the blow to individuals and businesses triggered by the pandemic before the election. After rebounding at close to a 30% pace in the third quarter, we could essentially flatline in the fourth and first quarters before a vaccine becomes available in 2021.

The result is what many are now terming the square root recovery for its rapid rebound followed by a plateau in growth. The economy does not reach its precrisis peak in our baseline forecast until late 2022, six months later than if Congress approved more aid today. The damage created by bankruptcies, permanent business closures, firm consolidations and long-term unemployment will compound.

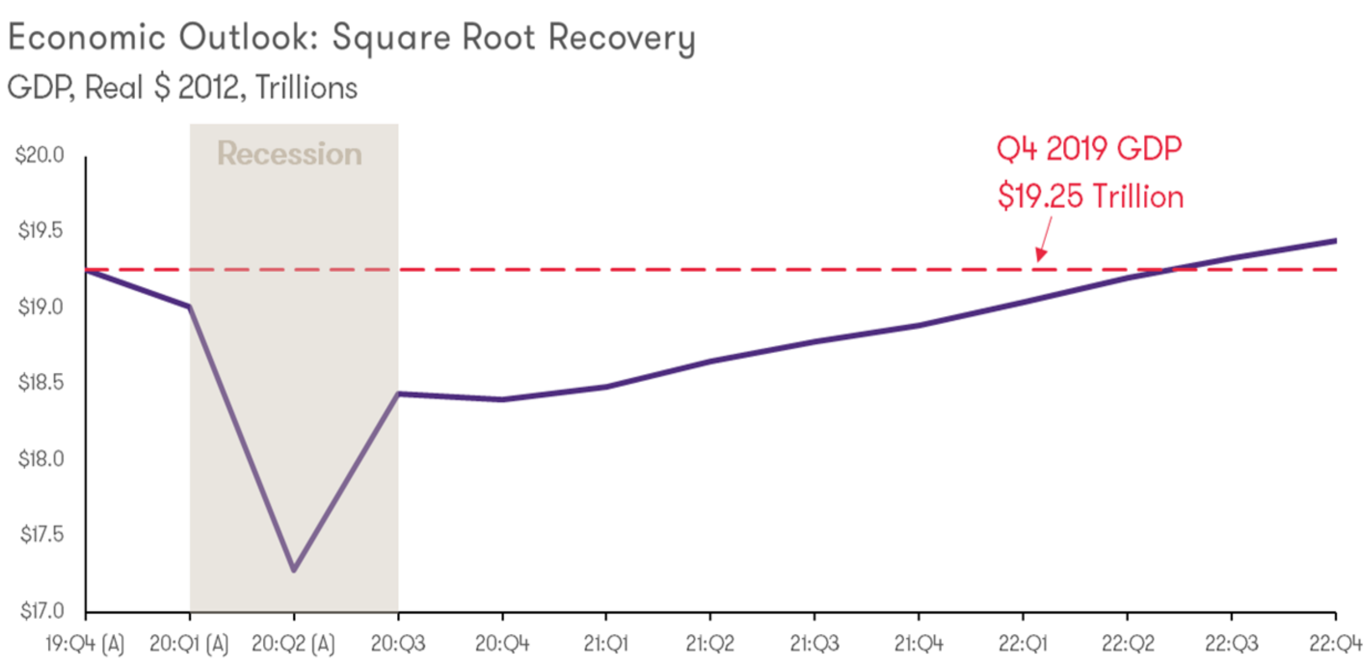
Fear Triggers Consumer Caution

We already know that the fear of contagion affects our collective behaviors. Baby boomers, who account for about a third of consumer spending, are among the first to pull back when cases and hospitalizations surge. Such shifts in spending occur regardless of lockdowns. It first occurred prior to lockdowns in late February and March, then again in late June and July.

Adding insult to injury for the more than 29 million people still collecting UI is a lapse in the $600 per week federal supplement in late July. An executive order to replenish a portion ($300 per week) of that supplement for most UI recipients will partially blunt that loss. Only five of the 40 states that applied for the funds were able to tap them by the end of August. The benefits are slated to run out in three to four weeks. UI recipients who receive less than $100 per week in regular benefits will get nothing extra.

Measures of consumer confidence have cratered in response to that blow and concerns that the effects of COVID-19 will be longer lasting than initially hoped. An unusually high saving rate during lockdowns and the shift in spending toward luxury vehicles, exercise equipment, second homes, boats and home repairs only partially offsets weakness tied to the lapse in supplements and persistently high rates of infection.

Chart 1



Source: Bureau of Economic Analysis, Grant Thornton LLP

The majority of the more than $669 billion in Payroll Protection Plan (PPP) loans ran out in August. Another $140 billion is still sitting in government coffers but needs to be modified to allow cash-strapped firms to reapply. That will not stop a tidal wave of bankruptcies already in the pipeline but could provide a lifeline for some firms still struggling to make ends meet.

A staggering **35%** of firms surveyed by the Conference Board have no idea when they will return to offices. This takes away from spending on services in urban centers where jobs that allow employees to work from home are more prevalent. Job postings - a sign of job creation - have slowed over the summer and remain suppressed.

Without transfers from the federal government, cuts to state and local government employment will also mount. This will add to the headwinds of colder temperatures and any pullback tied to new infections that could occur.

Housing Loses its Luster

The outlier has been home buying and building, which was rebounding rapidly in the wake of initial lockdowns. High-income millennials used the crisis as a reason to pull the trigger and move out of the largest cities into more affordable, second-tier cities.

Wealthy buyers are snapping up second homes in resort towns while existing homeowners have put their time at home to good use and are finally making much-needed upgrades and repairs. Those gains will slow once we catch up on the delayed sales and construction.

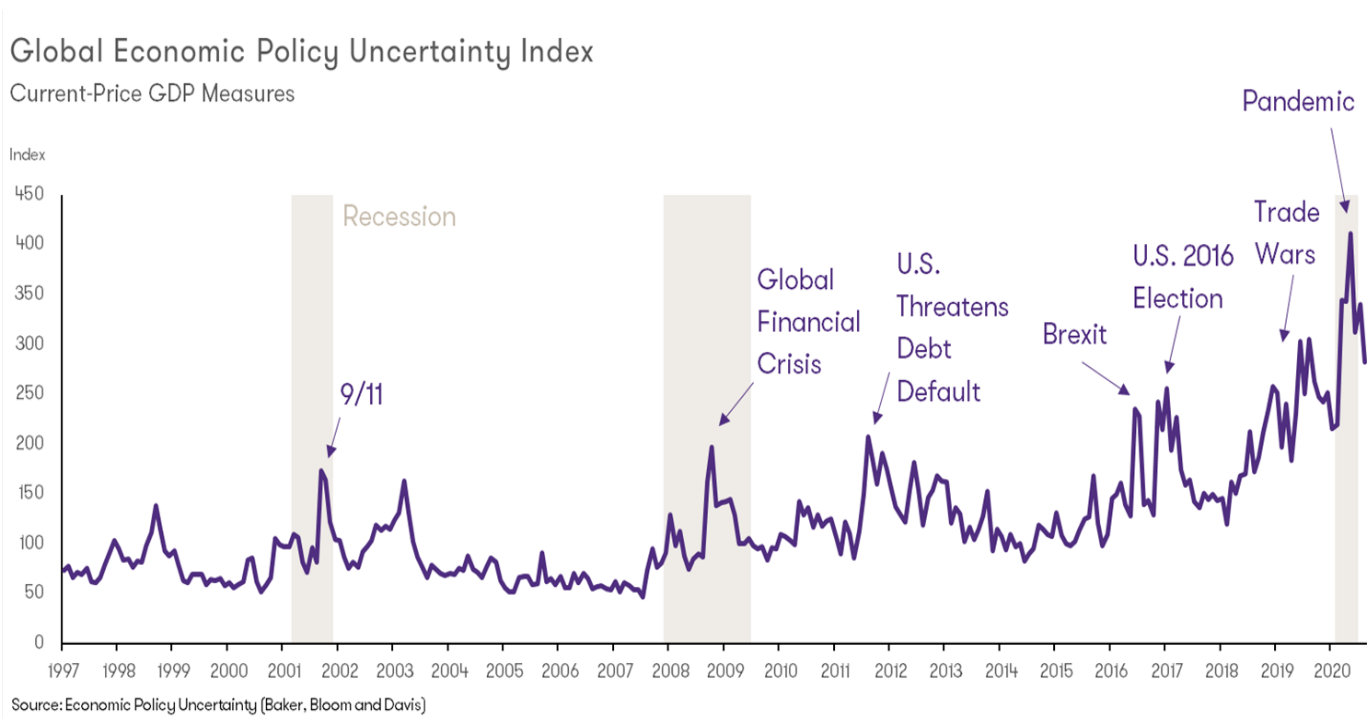
Universities are struggling to stay open as the virus surges. Closing down again takes a toll on everything from local businesses to the apartment market. Evictions due to the loss in UI supplements are still rising, despite efforts by the CDC to stop landlords from evicting renters laid off due to COVID. Congress has failed to authorize funds to help renters and landlords.

Even luxury apartments in what were once some of the hottest urban markets are showing signs of distress. Many are waiving the first two months of rent and expanding amenities, including free COVID testing in some high rises in New York, to lure back renters.

Businesses Hesitate

Chart 2 tracks a measure of **policy uncertainty** via media mentions of uncertainty in prominent newspapers. In August, policy uncertainty was still close to the highs of the trade war. Failure to come up with an aid bill prior to the election could further exacerbate those concerns.

Chart 2



Why do we care? Because businesses tend to hesitate when they are uncertain about the future. The Conference Board's August CEO survey underscores what's at stake. More than a third of CEOs of global companies expect to cut capital spending by 10% or more over the next twelve months. Almost as many plan to cut jobs. Nearly half expect to limit or eliminate wage increases.

Commercial real estate is expected to be hit hard. Bankruptcies and store closures in retail have surged, while many firms are planning to scale back their office footprint in the wake of COVID-19. The pandemic has acted as an accelerant to trends already in place, including the move from in-store to online shopping and working from home. (I have come to think of it as living at work as the work rarely stops.)

Equipment and machinery upgrades will be hit. Farm bankruptcies have surged, which will curb spending on farm equipment. Construction equipment orders will be affected by a shortfall in large construction and infrastructure projects. An infrastructure bill could alleviate that pain but, much like an additional aid package, I am not holding my breath.

The bright spots? Investments in online retail and support, the regionalizing (not reshoring) of supply chains and cybersecurity. Hackers at home and abroad have launched an avalanche of attacks since lockdowns began.

Government Spending Falters

Congress has agreed to separate a continuing resolution for the federal budget from the gridlock over additional aid. That will keep the government open but not add anything to overall federal spending. The bigger problems will happen at the state and local levels, which represent the lion's share of government spending.

Without transfers to the states, much of the drop in employment at the state and local levels will become permanent. Those losses topped 1.1 million in August from their peak in February. The majority of those losses are in education, which cannot be brought back until schools are up and fully running again. Even the budget shortfalls we are enduring will limit the number of workers who can be recalled. First responders will be next in line for state and local budget cuts.

Trade Improves

Many U.S. trading partners have proven to be much more effective at managing COVID-19 outbreaks, by using more aggressive tracing and isolation efforts. Compliance with quarantines is particularly important as it helps to contain the spread and keep more of the economy running through outbreaks. As a result, exports are expected to bounce back faster than imports, which will act as a shock absorber to the weakness at home. Manufacturers are expected to hold up better than service providers.

We are assuming most countries will avoid additional lockdowns. A resumption of such measures would result in dire economic consequences, at home and abroad. The forecast does not take into account another escalation in trade tensions with China prior to the election, a considerable downside risk.

Fed Commits to Boosting Inflation

The Federal Reserve is betting that the initial supply shocks triggered by the pandemic - closures of meat and poultry processors, shortages of cleaning supplies and personal protective equipment (PPE) - will be transitory. We have already seen prices at grocery stores decelerate after surging in spring. The larger concern is a vicious cycle of lower employment, wages and decelerating or falling prices.

The Federal Reserve is expected to adopt an average inflation target as soon as September. That means it will allow for a modest overshoot of the 2% inflation target - in the 2-¼% to 2-½% range - for a year or so to allow for a catch-up in employment. Fed officials learned from the last expansion that the economy is much less prone to inflation than previously thought. A slight overshoot on inflation, with wages instead of profits rising as a share of the economy, is needed to rectify that.

There are guardrails. The Fed is looking for a little, not a lot, of inflation. It would not hesitate to raise rates if inflation were to flare.

The Fed is also concerned about stoking asset price bubbles. For that, the Fed must rely on regulatory powers, which are more limited in reach than changes in interest rates.

Why wouldn't the Fed just raise rates to pop bubbles during a recession? Because low rates are only one aspect of financial bubbles while raising rates would make the recession much worse.

The Federal Reserve is clearly reaching its limits; officials know it. Pleas for more fiscal policy are growing louder. Chairman Jay Powell refused to step into the middle of the debate during a recent NPR interview, except to say "I think it really does behoove us as a country, as a very wealthy country, to use our great powers to support people who did nothing wrong." Amen.

Bottom Line

Congress needs to take its eyes off the stock market and focus more on the people who elected them. They are still hurting and need support for the basics of food and shelter. We need more funding for testing and tracing to curb the spread of the virus, which would allow more businesses to reopen. States need funds to keep teachers in schools and first responders on the front lines. The goal is to boost our immune systems so that more survive the pandemic and emerge to fuel a healthier recovery.

Economic forecast — September 2020

	2019 (A)	2020	2021	2019:4 (A)	2020:1 (A)	2020:2 (E)	2020:3	2020:4	2021:1	2021:2	2021:3	2021:4
National Outlook												
Chain-Weight GDP[1]	2.4	-4.2	2.3	2.4	-5.0	-31.7	29.6	-0.8	1.8	3.7	3.0	2.2
Personal Consumption	2.3	-4.5	2.8	1.6	-6.9	-34.1	38.2	-0.5	0.7	4.7	2.6	1.7
Business Fixed Investment	3.1	-5.9	-1.3	-0.3	-6.7	-26.0	11.7	-4.3	-1.4	1.1	1.4	0.9
Residential Investment	-0.2	2.2	1.2	5.8	18.9	-37.8	52.8	-1.7	-2.7	-2.1	1.7	2.3
Inventory Investment (bil $ '12)	45	-139	16	-1	-81	-286	-112	-76	-37	-3	38	64
Net Exports (bil $ '12)	-918	-832	-840	-862	-788	-761	-907	-873	-827	-849	-850	-835
Exports	0.5	-11.4	9.0	3.4	-9.4	-63.2	79.8	17.1	12.0	2.7	8.8	10.2
Imports	0.3	-10.8	6.9	-7.5	-15.0	-54.0	85.9	7.2	2.7	4.8	6.6	5.7
Government Expenditures	2.5	1.2	-1.0	2.4	1.3	2.8	-2.1	-6.2	0.1	0.7	0.7	0.2
Federal	3.7	5.0	-0.9	3.9	1.6	17.6	3.0	-11.6	-0.1	0.6	0.5	-0.8
State and Local	1.8	-1.1	-1.2	1.4	1.1	-5.5	-5.4	-2.5	0.2	0.7	0.9	0.8
Final Sales	2.4	-3.3	1.6	3.2	-3.6	-28.5	25.0	-1.5	1.0	3.0	2.2	1.7
Inflation												
GDP Deflator	1.7	1.0	1.3	1.4	1.4	-2.0	3.1	1.0	1.3	1.3	1.3	1.7
CPI	1.8	1.2	2.4	2.4	1.2	-3.5	5.1	1.7	2.8	2.6	2.4	2.3
Core CPI	2.2	1.7	1.9	2.0	2.1	-1.6	4.1	2.0	1.8	1.9	1.8	1.6
Special Indicators												
Corporate Profits[2]	10.8	-14.2	-7.8	10.8	-6.7	-20.1	30.1	-14.2	-7.0	2.5	-36.0	-7.8
Disposable Personal Income	2.2	5.9	-5.5	1.9	2.6	47.0	-22.5	7.4	-24.0	2.6	1.5	0.7
Housing Starts (mil.)	1.30	1.32	1.32	1.43	1.48	1.06	1.45	1.30	1.29	1.33	1.33	1.35
Civilian Unemployment Rate	3.7	8.6	7.3	3.5	3.8	13.0	9.1	8.6	8.1	7.0	7.0	6.9
Total Nonfarm Payrolls (thous.)[3]	1388	-10409	5663	221	-1257	-15406	4524	1730	1101	2326	1032	1204
Vehicle Sales												
Automobile Sales (mil.)	4.9	3.5	3.7	4.5	4.0	2.6	3.6	3.7	3.7	3.7	3.7	3.7
Domestic	3.5	2.5	2.6	3.3	2.9	1.8	2.6	2.7	2.7	2.6	2.6	2.6
Imports	1.4	1.0	1.1	1.2	1.1	0.8	1.0	1.0	1.0	1.1	1.1	1.1
Lt. Trucks (mil.)	12.1	10.2	12.1	12.3	11.2	6.8	11.3	11.6	11.7	11.8	12.2	12.5
Domestic	9.7	8.4	9.5	9.7	8.9	6.7	8.9	9.2	9.2	9.3	9.6	9.8
Imports	2.4	2.3	2.6	2.6	2.3	2.1	2.4	2.4	2.5	2.5	2.6	2.7
Combined Auto/Lt.Truck	17.0	13.7	15.8	16.8	15.1	9.4	14.9	15.3	15.4	15.5	15.9	16.2
Heavy Truck Sales	0.5	0.4	0.4	0.5	0.4	0.3	0.3	0.4	0.4	0.4	0.4	0.4
Total Vehicles (mil.)	17.5	14.0	16.2	17.3	15.5	9.7	15.2	15.7	15.8	15.9	16.3	16.6
Interest Rate/Yields												
Federal Funds	2.2	0.4	0.1	1.6	1.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
10-Year Treasury Note	2.1	0.8	0.8	1.8	1.4	0.7	0.7	0.7	0.7	0.8	0.9	0.9
Corporate Bond BAA	4.4	3.7	3.4	3.9	3.9	3.9	3.4	3.7	3.4	3.2	3.5	3.5
Exchange Rates												
Dollar/Euro	1.12	1.13	1.18	1.11	1.10	1.10	1.15	1.18	1.18	1.18	1.18	1.19
Yen/Dollar	109.0	107.2	106.0	108.7	108.8	107.6	106.3	106.0	106.0	106.0	106.0	106.0

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.