SMITH AFFILIATED CAPITAL

THIRD QUARTER 2020
INVESTMENT COMMENTARY

Despite Rebound, the Economy Still Deeply Depressed and Covid-19 Resurgence Heightens Risk of Another

In this Issue:

The vigorous rebound in some key economic indicators in May, particularly for jobs and retail sales, has given some the misguided impression that the economy is off to the races, leaving unpleasant memories of the Covid-19 recession in the dust. As tempting as that prospect seems at the moment, we are highly skeptical that it will play out as hoped. Just as economists and investors were initially too cautious in estimating the magnitude of the recession brought on by the virus, so too are they getting carried away by the strength of recent data. Indeed, economic and financial conditions are evolving at such a rapid rate that incoming data are not only stale but also practically irrelevant.

Although the final estimate of first-quarter GDP revealed the steepest contraction in activity since the Great Recession, that 5.0 percent decline will be a few orders of magnitude worse in the second quarter. We are currently tracking a near-35% annualized GDP plunge for the period driven by a collapse in consumer outlays, severely constrained business activity and stalled trade flows. In all, the peak to trough decline in GDP should easily surpass 10 percent, representing a shock three times as bad as the Great Recession in only a couple of months.

Odds are, April marked the trough of the recession, unless the resurgence of the virus sends the nation back into lockdown and short-circuits the recovery. One thing is sure: While the NBER made the recession call in record time – just three months after its onset on June 9 – it will not be quick to declare the end of the recession. Our recovery tracker shows that the striking rebound in activity in May has already lost some momentum in June. Household and business sentiment wavered late in the month, trade is sapping more growth than thought and the reopening of businesses is not bringing back enough customers to cover costs. Bankruptcies are poised to skyrocket as will loan defaults that will reverberate back to the banking system. The major sources of strength that drove consumer spending in May have already expired (the $1200 stimulus checks) and so will the expanded unemployment benefits at the end of July. The next shoe to fall may well be the stock market, which is pricing far more strength in growth and profits than is likely to materialize in coming years. And while much of the media is highlighting the struggles of households and small business, a bigger catastrophe may be brewing among state & local governments where massive layoffs loom amidst plunging tax revenues.

A Surprising, but Temporary Burst of Activity

The record-setting spike in consumer spending in May together with the unprecedented jump in nonfarm payrolls during that month quickly ignited expectations that the economy is poised for a V-shaped recovery. The rebound in activity together with another Federal Reserve “put” in the form of promised and actual massive injections of liquidity and new credit facilities stoked a stock market rally that recovered almost all the debilitating market plunge from February 19 to March 23 when the onset of Covid-19 in the U.S. created havoc with investor psychology. But the resurgence of jobs and consumer spending has tenuous underpinnings. Forget for the moment that one-month does not make a trend.

The more important caveat is that these outsized gains are coming off extremely low bases, thanks to the breathtaking plunge in economic activity that took place in March and April. A better way to gauge the rebound in jobs and retail sales is to see where they stand relative to where they were prior to the pandemic. In both cases, there is still a huge mountain to climb. For example, if the 2.5 million-payroll increase in May were to be repeated month after month, it would still take close to a year to regain all of the losses seen in March and April. Likewise, for consumer spending, as the record 8.2 percent surge in personal consumption expenditures in May merely erased a third of the decline that took place over the previous two months. Real outlays are still almost 10 percent below year-ago levels.

Put another way, the initial stage of a recovery is always the easy lifting part. It also generates the most optimism because the rebound in economic activity is usually the strongest, leading many to expect the gains to continue at the same rate. That’s rarely the case. In the current instance, two forces - one that typically occurs early in an upturn and another that is unique to this cycle - powered the initial spurt in activity. Even the typical catalyst was unusual in certain respects.

Typically, the economy gets a healthy early boost from the unleashing of pent-up demand. Depending on the depth and length of the recession, households postpone nonessential spending during downturns, due either to a lost job or the fear of losing one. They will continue to prioritize essential expenses - food, rent, mortgage payments and medical services, for example - but postpone discretionary purchases on such things as a motor vehicle, TV or other appliances as well as recreational services, creating a pent-up demand for these items. Instead, the monies not spent goes into savings accounts, ready to be unleashed when the recession ends.

Not only did that dynamic play out in May, it did so in spades. That's because the sudden stop in all forms of activity brought on by Covid-19 lockdown restrictions resulted in a record contraction in consumer spending, generating an even greater volume of pent-up demand than is customary in downturns. Unlike previous recessions, however, households in the aggregate suffered no loss of incomes when the job market turned south, thanks to the unprecedented support from the government. Indeed, the $3 trillion in government transfer payments to households in the form of $1200 stimulus checks and expanded unemployment benefits were more than three times greater than the decline in wages and salaries in April. Most of these excess funds were initially channeled into savings accounts, driving the savings rate up to a record 32.2 percent in April. Hence, households had more than enough firepower to finance their pent-up demands in May, underscoring the surge in sales that month as businesses in the majority of states reopened their doors in varying stages.

Consumers Have Less Fuel in the Tank

The catalyst behind that burst in spending, however, has either vanished or at best is fading fast. Yes, wages and salaries did provide some support in May, increasing 2.7 percent thanks to the surge in payrolls during the month. But given that worker paychecks are still 8.6 percent below pre-pandemic levels, it's doubtful that they provided much oomph to the spending surge. In essence, households had to draw on their huge savings balances to finance purchases, driving the savings rate down from a record 32.2 percent in April to a still-astronomical 23.2 percent in May.

The reason households had to raid their savings accounts is because they lacked the massive support provided by the government's $1200 stimulus checks received in the previous month. Instead, a major source of income came from unemployment insurance, which jumped by a record $825 million during the month and amounted to almost 15 percent of wages and salaries. Normally, these benefits account for a miniscule share of household budgets, averaging less than 3 percent of wages and salaries. But even the help from jobless benefits was not enough to compensate for the loss of stimulus checks, and personal income actually fell by 4.2 percent during the month.

Importantly, the bulk of the jobless benefits consisted of expanded payments under the government's Pandemic Unemployment Compensation program, which reflects the $600 weekly checks that unemployed workers receive in addition to their regular state jobless benefits. This program is set to expire at the end of July and at this juncture there is only Senatorial support in Congress to extend it. Indeed, the window for Congress to do anything to prop up household finances is rapidly closing. After lawmakers return from their July 4 hiatus, they will have two short weeks to enact legislation before taking off again in August. After that, nothing of consequence is likely to happen as the election campaign heats up.

Huge Drag from State and Local Governments

With the virus surging in many parts of the nation, prompting state governors to pause or backtrack on their reopening plans, the threat to the recovery is becoming ever-more palpable. From our lens, another round of stimulus will be urgently needed to sustain the nascent recovery. Importantly, Washington will not only have to provide support to the private sector, but critically to state and local governments, which are struggling mightily. Indeed, state and local government finances are being pummeled as a result of the Global Coronavirus Recession.

Revenues are plummeting as the economy contracts, with individual income taxes and sales taxes in particular expected to fall sharply. We estimate that state and local governments will experience a revenue shortfall of about $605 billion through the end of 2021 and that pressures on the spending side related to the recession will add another $65 billion to the two-year budget gap. Importantly, this is an estimate of the shortfall brought about by the recession and doesn't capture new spending burdens on state and local budgets arising from the spread of Covid-19. Among them are increased costs for health care and for implementing measures, such as statewide shutdowns, to limit the disease's spread.

As the flow of red ink deepens, spending on goods and services will be slashed as most state and local governments are required by law to maintain balanced budgets. This alone will directly put a drag on GDP. But the ripple effects will extend beyond the direct pullback in outlays as governments will need to operate with smaller payrolls. State and local jobs have already been reduced by 1.6 million since February, with employment in education accounting for two-thirds of the decline. Unlike in the private sector, there was no bounce-back in state and local jobs in May. In addition, cuts in state and local budgets will depress employment by contractors or firms that receive government grants.

The drag from struggling state and local governments will persist well beyond the health crisis. As was the case following the Great Recession – when state and local job losses totaled 655,000 – the recovery in lost jobs will lag significantly behind the private sector, reflecting the delayed response of tax revenues. After the Great Recession ended in 2009, state and local employment did not return to its pre-recession peak until 2019, a full five years after the private sector recovered all of its recession losses. Given our sense that this recovery will stumble due to probable flare-ups of the health crises, resulting in a growth path resembling the Nike swoosh rather than a V, it will take considerably longer this time for government payrolls to regain pre-recession levels.

Health Concerns: A Major Threat to Recovery

The biggest risk to the outlook over the next six months is the prospect that a second wave of the virus will emerge. If it does, the economic impact will depend on a variety of factors. One risk is that policymakers would be reluctant to re-impose restrictions due to lockdown fatigue among the public. Doing so might also be perceived as a tacit admission that the government had previously made mistakes. But failure to respond to a sustained rise in case numbers could trigger more severe lockdown restrictions to contain the virus down the road. Nor would a weak or delayed government response provide much of a growth boost if it leads to a sharp rise in voluntary social distancing.

In this regard, concerns are growing that cases in more than half the states are accelerating, pushing the daily national rate to new record highs. At this stage, the true medical significance of the increases is hard to know - and in any case is perhaps better left to epidemiologists to assess. Most health officials believe that the rise in cases is not the start of a second wave, but rather a failure to ever contain the original spread of Covid-19. Complicating matters even more is that the sharpest upticks in cases are occurring among the states that were the earliest and most aggressive to lift restrictions, which has ominous implications if governors in those states do not respond forcefully to this trend for political reasons.

In any event, a resurgence of the virus clearly has the capacity to undermine the recovery, prompting businesses to shut down anew and spurring households into another quarantine, either voluntarily or by government mandate. Even if a second wave is not forthcoming, the scars from Covid-19 will change the behavior of consumers. The imperative to stay safe will supersede the desire to satisfy material needs, restraining spending below where it otherwise would be. Until a vaccine or effective treatment becomes widely available, people will not likely resume normal activities. That includes businesses many of which are accelerating a push to do more with less workers. Walmart, for example, is testing a new payment system that allows it to eliminate all cashiers. Put simply, as the doors of the economy continue to reopen the road back to normalcy will be long and winding.

Deflationary Pressures Increasing

Against this backdrop, an unprecedented amount of monetary and fiscal stimulus has been thrust into the economy to fight the Covid-19 recession, which has raised some concerns about an inflation outbreak down the road as the economy recovers.

From our lens, the bigger threat facing policy makers is deflation not inflation. Indeed, there is a high probability that core inflation will turn negative later this year. Core inflation rates have fallen an average 2 percentage points from peak to trough in past recessions. Given that the starting point for the core inflation is already under 1.5 percent, this implies a move into negative territory. The St. Louis Fed's deflation probability indicator (based on a range of data) gives a 75 percent chance of falling prices over the next year.

Recently, some have argued that strong money supply growth since February must lead to high inflation in the next few years. But we think there are good reasons why the recent surge in money supply growth may be less worrying than it seems. First, the current circumstances in which the surge in money growth is occurring are unique. The surge reflects a sharp rise in government and private borrowing, but this has been undertaken to fill the massive cash flow gap that firms and households are facing due to the enforced shutdown of large parts of the economy. Firms have also drawn heavily on existing credit lines in the (probably correct) expectation that new credit may be much harder to get in the near future. In part, then, the rise in money growth represents a sharp rise in demand for liquid assets by the private sector, reflecting financial distress more than monetary excess. A monetary surge like this should not be inflationary as the liquidity being provided is being hoarded, rather than diverted into higher consumer spending or investment. Simply put, the 'velocity' of money has dropped steeply, which offsets any impact on prices of a rising supply.

Even as the economy reopens, we doubt inflation will rise and instead think price dampening effects are likely to dominate. Unemployment and precautionary saving by firms and households will hold down spending (part of the raised demand for liquid assets may linger); commodity prices may remain low; firms may engage in long-term efforts to repair balance sheets damaged by taking on emergency loans; banks may try to tighten up credit supply, reflecting damage to their balance sheets due to rising loan defaults. We believe that the Fed will do everything in its power to ward off deflation, which is consistent with its current aggressive approach to cushion the economy against Covid-19. Even if it succeeds, there is little question that low inflation will persist as far as the eye can see, validating Fed chair Powell's recent comment that he is "not even thinking about thinking of raising rates." Low inflation and low interest rates will be embedded in the economic landscape well beyond the end of the health crisis.

Rates and Total Returns Quarterly and Annual Comparisons

U.S. Treasury Market (Barclays TSY Bellwethers)	Yields (%)			Total Return (%)	
	6/30/2019	3/31/2020	6/30/2020	Last Quarter	Last Year
6-Mo. Bill	2.05	0.10	0.16	0.01	2.09
2-Yr. Note	1.74	0.23	0.15	0.14	3.92
5-Yr. Note	1.76	0.38	0.29	0.50	8.44
10-Yr. Note	2.00	0.70	0.65	0.68	14.24
30-Yr. Note	2.53	1.35	1.41	-0.71	29.76

Municipal Bonds	Yields (%)			Total Return (%)	
	6/30/2019	3/31/2020	6/30/2020	Last Quarter	Last Year
Barclays GO Bond Index	1.87	1.73	1.18	2.86	5.34
Barclays State GO Bond Index	1.79	1.68	1.09	2.83	4.93
Barclays Local GO Bond Index	1.97	1.78	1.27	2.87	5.76
Barclays Revenue Bond Index	2.13	2.20	1.73	2.73	4.15

Equities	Levels			US $ Terms (%)	
	6/30/2019	3/31/2020	6/30/2020	Last Quarter	Last Year
S&P 500	2941.76	2584.59	3100.29	20.54	7.49
DJIA	26599.96	21917.16	25812.88	18.51	-0.54
NIKKEI (Tokyo)	21275.92	18917.01	22288.14	17.97	6.98

Commodities	US $			Percent Change (%)	
	6/30/2019	3/31/2020	6/30/2020	Last Quarter	Last Year
COMEX Gold Active Monthly	1413	1583	1800.5	13.74	27.42
CRB Future Com. Pr. Index*	181.0378	121.7868	137.9715	13.29	-23.79
West Texas Intermediate Crude ($ per bbl.)	58.47	20.48	39.27	91.75	-32.84

Currencies	Levels			Percent Change (%)	
	6/30/2019	9/30/2019	6/30/2020	Last Quarter	Last Year
Yen	107.85	107.54	107.93	-0.36%	-0.07%
Sterling	1.2696	1.242	1.2401	-0.15%	-2.32%
Euro	1.1373	1.1031	1.1234	1.84%	-1.22%

Global Bond Markets**	Levels			US Dollar Terms (%)	
	6/30/2019	3/31/2020	6/30/2020	Last Quarter	Last Year
German 10-Yr.Bond	-0.44	-0.55	-0.53	0.17	0.84
Japanese 10-Yr.+ Bond	-0.22	-0.07	-0.03	-0.18	-1.29
UK 10-Yr.+ Bond	0.76	0.24	0.06	1.42	6.27
Emerging Market (USD)	4.88	7.19	4.67	10	2.96

Source: Bloomberg Financial Data
*Thomson Reuters/Jefferies CRB Commodity Excess Return Index
** Global Bonds Represented by Bloomberg Barclays Indices