SMITH AFFILIATED CAPITAL

FOURTH QUARTER 2020 INVESTMENT COMMENTARY

The Economy Enters a Slower Phase of Recovery

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To say that uncertainty is rising would be an understatement. Political and policy uncertainties are surging with questions surrounding the next round of fiscal aid, questions around the outcome of the elections, questions around a peaceful transfer of power (if it occurs), and now questions surrounding the health of the president just four weeks before the November 3rd elections. And even as the health crisis has now made a direct hit on the White House, virus cases are accelerating in 34 states, prompting renewed social distancing mandates that could stifle the reopening process.

Despite this expanding list of uncertainties, all is not doom and gloom in the nation. In fact, there is much about the economy that is uplifting. Consumers are spending again, factories are revving up operations, housing activity is on a tear and, most importantly, the job market is recovering. The health crisis that has thrown the economy into the steepest contraction since the Great Depression is far from over. But the nation is slowly adjusting to its ill effects, fitfully reopening for business even as hundreds of vaccines are in the pipeline, boding well for widespread inoculation sometime next year. The numbers are not in yet, but the economy likely staged an astonishing annual growth rate of over 30 percent in the just concluded third quarter.

That said, the realist in us couldn't help but view the glass as half-empty. Seven months into this crisis, nearly one of two laid off US worker remains unemployed, the unemployment rate is still higher than in most past recessions, 60 percent of the unemployed have been so for more than 15 weeks, and the share of permanently unemployed is rising. There are still almost eleven million fewer workers collecting paychecks than there were prior to Covid-19 in February. Simply put, the job market is on the mend, but there is still a steep hill to climb before it can realistically be seen as fully healed. The best that can be said is that the harshest recession in the postwar period was also probably the shortest, as the economy appears to have turned the corner in May. And despite the growing list of impediments, it entered the fourth quarter on a positive growth trajectory. Odds are, the recovery will persist through the end of the year, but it will have to navigate more headwinds than tailwinds. Expect to see a good deal of volatility in the final quarter of a year to forget. Until a clearer picture of policies, election results, progress on a vaccine and public behavioral changes comes into focus, the next few months will not lend themselves to bold investment moves.

A Short, But Not Sweet, Recession

While the National Bureau of Economic Research (NBER) has not yet put its time stamp on the end of the recession, by all accounts the recovery probably began in May, when key economic indicators staged a vigorous rebound. Assuming no double dip and that becomes the official start of the upturn, the coronavirus pandemic-induced recession would become the shortest downturn on record, lasting only three short-months. The last six recessions had an average length of twelve months, with the shortest, starting in January 1980, ending just six months later.

Some might see optimistic signs in the shortness of the latest recession. The reason: on average it took about twice as long for the economy to fully recover from post war recessions. If that time frame were to apply this time, things would be back to normal by November, six months after the recession presumably ended. However, that would be an impossible task to achieve. With only about a month to go, the economy still has a steep hill to climb to get back to where it was prior to the pandemic. Even with a record-breaking growth rate expected for the third quarter – with most estimates tracking an annual rate of more than 30 percent – the economy would still only have recovered around two-thirds of the output lost in the second quarter.

Importantly, the outsized growth rate in the third quarter is mainly an arithmetic 'carry-over' from the strong initial phase of the recovery that began in May. As Fed chair Powell aptly noted, that initial burst of activity represented the "easy fruit" as households unleashed a torrent of pent-up demand when states began to ease lockdown restrictions. That surge in spending, moreover, was fueled by massive fiscal stimulus, which provided some unemployed workers with more income than they earned on their jobs. Indeed, personal incomes rose during the early days of the pandemic even as unemployment skyrocketed to a post-war high of 14.7 percent in April. But that fuel has mostly run out, and it is still unclear if Congress will enact a replacement package that will have as much oomph as the CARES Act.

Even if a scaled down bill is enacted, providing households with vital funds needed to finance essential goods and services, they will not be as eager to open their wallets as they did over the summer. For one, most pent-up demands have been met. For another, and more critically, the mind-set of households has shifted dramatically from the early days of the pandemic. Recall that in the weeks and even months immediately following the onset of the coronavirus, most workers who lost their jobs thought they would soon be rehired.

This, combined with the generous unemployment benefits and one-time stimulus payments, gave laid-off workers the confidence and wherewithal to continue spending, spurring the sharp rebound in consumption over the summer. Those uplifting moments are rapidly vanishing as the length of time workers are staying unemployed is extending well beyond earlier expectations, something that was vividly highlighted in the September jobs report, released on October 2nd.

Indeed, the number of workers unemployed for longer than six months – generally classified as long-term unemployed – jumped by nearly 800 thousand in September, the largest one-month increase on record. Another measure of entrenched joblessness is the number of job losers not on layoff as a percentage of the total unemployed. This gauge, which tracks the trend in permanent unemployment, jumped to 35.6 percent in September, up from 11.1 percent in April and the highest share since June 2017. Not surprisingly, only about 50 percent of laid-off workers expect to be rehired according to the latest surveys compared to 90 percent in April. The worrisome aspect of this trend is that the longer people are unemployed, the more likely their skills will atrophy and they become more detached from the labor force. When they become part of the hard-core unemployed, the task of drawing them back to the work force becomes ever-more challenging.

Entering the Perilous Stage of Recovery

The September jobs report made it abundantly clear that the economy is heading into a second, more perilous, phase of the recovery. Yes, more jobs were created than destroyed, resulting in a net 661 thousand increase in payrolls, and the unemployment rate slipped again to 7.9 percent, significantly below April's postwar high of 14.7 percent. But both measures reflect what economists refer to as a positive first derivative and a negative second derivative. Simply put, growth is still happening, but at a slower pace. The job gain in September was the weakest of the four preceding months, which averaged 2.7 million, and the 0.5 percent decline in the jobless rate compared to average monthly declines of 1.6 percent over the previous four months. What's more, the latest drop occurred mostly for the wrong reason, as fully 70 percent of the decline in unemployment reflected workers dropping out of the labor force.

At the September pace of job growth, it would take about a year and a half for nonfarm payrolls to recover the pandemic-related job losses. But that would be an optimistic timetable given the progressive slowing in hiring that is clearly underway. In fact, the October jobs report is looking ever-more precarious considering the widespread layoffs announced by an expanding list of high-profile companies in recent weeks, including those in the leisure and hospitality industry, (Disney), the airlines, energy and insurance industries. Nor are just the big blue-chip companies purging workers. Some 400,000 small businesses have closed shop, with most not planning on reopening, and millions more are vulnerable to the same fate. Small companies account for more than half of total employment in the U.S.

The downshifting in job growth is a clear sign that the economy is heading into the fourth quarter with considerably less momentum than it had over the early summer months. No doubt, a fiscal package would go a long way towards putting a floor under the slippage, as it would cushion the income plunge since the enhanced unemployment benefits under the CARES Act expired at the end of July. In August, personal income fell $543 billion and stood $1.5 trillion below the level in April. The vigorous rebound in job growth since April has only boosted wages and salaries by about $100 billion a month, so labor compensation will not make up the difference any time soon. Simply put, the surge in consumption over the summer is poised to lose its main drivers – income support and job security. We expect consumer spending to increase at a much slower pace in the fourth quarter.

Another Hurdle: Rising Debt Burdens

The $2.3 trillion stimulus proposal (the HEROES Act) by the Democrats last May stoked the predictable pushback by congressional fiscal hawks that are fearful of the enormous toll this, as well as the Dem's latest $2.2 trillion stimulus bill, would take on a Federal budget, which is already slated to reach an unprecedented $3.3 trillion deficit in the current fiscal year according to the Congressional Budget Office (CBO). True, the deficit is expected to account for the largest share of gross domestic product (GDP) since 1945 and boost the debt to GDP ratio to over 100 percent next year. But the government is benefiting from a low interest rate environment that is expected to persist for the foreseeable future and put a lid on the debt-servicing burden.

Indeed, the CBO projects that net interest payments as a share of GDP will actually decline to the lowest levels on record over the next several years. Importantly, however, the issue of burgeoning government deficits is camouflaging a potentially more ominous trend in the private sector, namely the escalating volume of debt that businesses have been taking on this year. According to the Federal Reserve's latest flow of funds data, nonfinancial business debt increased at the fastest rate on record over the first half of the year, posting annual gains of 18.4 percent and 14.0 percent in the first and second quarters, respectively. Those increases lifted total debt outstanding to $17.6 trillion, fully 90 percent of GDP. That outsized share dwarfs anything seen in the postwar era and comes at a time when the recovery is entering a perilous phase of slower growth that could well deprive companies with the revenues needed to service debt.

Not surprisingly, record increases in corporate bond issuance drove the debt increase, fueled by historically low interest rates and eager investors seeking higher returns than the meager yields on Treasury securities. But the outsized debt build-up also comes at a time of weakening corporate profits.

Indeed, corporate cash flow slipped below capital spending, resulting in the first negative financing gap since 2018 in the second quarter. Of course, the economy suffered its worse contraction during the period since the Great Depression, which vaporized business revenues.

That said, legions of companies have been able to raise copious amounts of funds at historically low rates that are locked in for years to come. But it's also noteworthy that a less credit-worthy group of borrowers accounted for an ever-larger share of these issuers, as lower-rated bonds dominated activity in the new issue market. Despite the heightened risk of default in coming quarters, credit spreads have tightened considerably since the second quarter, with the yield premium on junk-rated bonds over Treasury issues about half of what it was in late March. More recently, however, investors have demanded a larger premium, as spreads widened by about 50 basis points over the past three weeks. Still, the current six percentage point spread between high-yield bonds and Treasury securities is well below the 11.4 point spread on March 23rd, setting the stage for a possible blowout if traders are underestimating the risk of holding speculative bonds heading into a weakening economy. Commercial bankruptcy filings surged 33 percent so far this year, and are up by more than 70 percent in September from a year earlier.

Perhaps the more concerning aspect of the accelerating pace of business and government borrowing is that the economy is becoming increasingly dependent on debt to fuel growth. Following the record volume of funds raised by businesses and the Federal government over the first half of the year, total domestic nonfinancial debt in the U.S. surged to just under $60 trillion, an increase of almost 70 percent since the end of the last recession. To put that in context, GDP equaled $19.5 trillion in the second quarter. Hence, it required $3 in debt to generate $1 in goods and services in the U.S. That's up from $1.84 at the turn of the millennium and from under $1.50 from 1950 through the mid-1980s.

Low Rates to Stay Low

The increasing prospects, based on recent polls, of a Biden presidency has contributed to a modest increase in long-term rates, with the 10-year Treasury hitting a 4-month high of just under .80 percent on October 6th. Underpinning the rise is the expectation that the economy, and by extension, inflation would benefit from a much larger fiscal stimulus bill than otherwise if Biden wins. We disagree with that assessment. For one, Biden is proposing $4 trillion of additional taxes, which is more deflationary than expansionary. For another, the pandemic's economic fallout is reinforcing the medium-term influences that have exerted downward pressure on interest rates, such as disinflation and slower growth.

For another, the pandemic recession has plunged the economy into a deep hole that has opened up a wide gap in its labor and productive resources. As noted earlier, the third-quarter rebound in activity has filled barely half of that shortfall.

Even if demand continues to improve in the fourth quarter, helped by additional fiscal stimulus, the supply constraints imposed by the pandemic – such as the limited ability of entire industries, particularly leisure and hospitality – to reopen will limit the pace of growth. As long as the health crisis lingers, these constraints will remain in effect and continue to undercut the ability of an ever-broader swath of companies to survive.

Even prior to the pandemic, inflation consistently undershot the Fed's 2% inflation target. The depressed inflation readings and the great disruption in economic activity are key reasons the Fed will retain an ultra-loose monetary policy for the foreseeable future. At its mid-September meeting, the FOMC predicted that its policy rate would remain at near zero at least through 2023 and open-ended QE would continue indefinitely. At this juncture, the Fed is refraining from putting yield curve control in its toolbox although it is something that is being studied and could be put to use if needed. We suspect that if bond yields rise and threaten to derail the Fed's efforts to reach its growth and inflation goals, it will swiftly adopt, either explicitly or implicitly, that policy option.

Finally, the mounting glut of private savings should put a lid on any rise in market yields. A key short- to medium-term repercussion of the pandemic is the increased caution among firms and households. The US personal savings rate shot up to a historic 33.6 percent in April before falling to 14.7 percent in August, compared to an 8.4 percent rate in February. While the jump reflects some forced savings from the large federal benefits extended to individuals and the sharp pullback in consumer spending stemming from the lockdowns, it also consists of precautionary savings due to uncertainty surrounding the pandemic.

Businesses similarly are building up precautionary levels of cash and savings. As noted, corporations have issued record amounts of debt in the capital markets and tapped their bank credit lines. However, amid heightened uncertainty and plunging demand, business investment contracted sharply in the second quarter and is expected to only gradually rebound over the next 18 months. After the initial surge in private sector savings, we expect some reversal, especially as households increase their spending and federal benefits become less generous. However, after experiencing the second major economic shock in a little over a decade, it's likely that both household and corporate savings will remain elevated in the medium term. All else equal, this shift outward in the supply of savings will keep interest rates low.

Rates and Total Returns Quarterly And Annual Comparisons

U.S. Treasury Market (Barclays TSY Bellwethers)	Yields (%)			Total Return (%)	
	9/30/2019	6/30/2020	9/30/2020	Last Quarter	Last Year
6-Mo. Bill	1.82	0.16	0.11	0.05	1.54
2-Yr. Note	1.62	0.15	0.12	0.07	3.45
5-Yr. Note	1.55	0.29	0.27	0.18	7.20
10-Yr. Note	1.67	0.65	0.68	0.06	10.78
30-Yr. Note	2.12	1.41	1.45	-0.80	17.86

Municipal Bonds	Yields (%)			Total Return (%)	
	9/30/2019	6/30/2020	9/30/2020	Last Quarter	Last Year
Barclays GO Bond Index	1.73	1.18	1.07	0.92	4.76
Barclays State GO Bond Index	1.66	1.09	0.98	0.79	4.51
Barclays Local GO Bond Index	1.80	1.27	1.16	1.04	5.01
Barclays Revenue Bond Index	1.94	1.73	1.51	1.43	3.87

Equities	Levels			US $ Terms (%)	
	9/30/2019	6/30/2020	9/30/2020	Last Quarter	Last Year
S&P 500	2976.74	3100.29	3363	8.93	15.14
DJIA	26916.83	25812.88	27781.7	8.22	5.70
NIKKEI (Tokyo)	21755.84	22288.14	23185.12	4.59	8.54

Commodities	US $			Percent Change (%)	
	9/30/2019	6/30/2020	9/30/2020	Last Quarter	Last Year
COMEX Gold Active Monthly	1465.7	1800.5	1887.5	4.83	28.78
CRB Future Com. Pr. Index*	173.9399	137.9715	148.5066	7.64	-14.62
West Texas Intermediate Crude ($ per bbl.)	54.07	39.27	40.22	2.42	-25.61

Currencies	Levels			Percent Change (%)	
	9/30/2019	6/30/2020	9/30/2020	Last Quarter	Last Year
Yen	108.08	107.93	105.48	2.27%	2.41%
Sterling	1.2289	1.2401	1.292	4.19%	5.13%
Euro	1.0899	1.1234	1.1721	4.34%	7.54%

Global Bond Markets**	Levels			US Dollar Terms (%)	
	9/30/2019	6/30/2020	9/30/2020	Last Quarter	Last Year
German 10-Yr.Bond	-0.66	-0.53	-0.61	0.28	-0.61
Japanese 10-Yr.+ Bond	-0.32	-0.03	-0.04	0.17	-1.92
UK 10-Yr.+ Bond	0.35	0.06	0.10	1.42	6.27
Emerging Market (USD)	5.00	4.67	4.09	-0.24	2.48

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