Weekly Market Commentary

September 21, 2020

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The Federal Reserve placed a megaphone over the bully pulpit this week, shouting as loud as it can that monetary policy will do whatever it takes to keep the economy on the recovery track. There was no ambiguity in the statement following the policy-setting meeting that concluded on Wednesday, nor in the comments by Fed chair Powell in his post-meeting press conference. Simply put, the Fed's forward guidance was clear: interest rates will remain at rock-bottom levels at least until the end of 2023 or when the job market is fully healed and inflation rises to above two percent for a period of time. If that doesn't do the job, the central bank has other tools at its disposal to maximize its effort, including ramping up asset purchases, utilizing lending facilities and putting even more oomph into its forward guidance.

Some might argue that the Fed is overdoing its message, noting the economy is already firmly ensconced on the recovery trail and its heavy-handed cheerleading could generate more results than it is wishing for. But that argument – implying that the Fed could be blindsided by an inflation resurgence next year – would be more persuasive if the economy was closer to recovering the massive loss in jobs and output that occurred during the height of the pandemic-induced recession earlier this year. True, Fed officials admit in their latest summary of economic projections that the virus did not take as big a toll on the economy and labor market as expected, as the both GDP and employment are projected to be considerably stronger this year than envisioned back in June, when the last quarterly SEP was compiled.

But the new projections are hardly barnburners. While acknowledging the initial rebound has been stronger than expected, the Fed is also aware that the "easy fruit" has been picked and the road ahead is fraught with risk. Indeed, even as it raised its forecast for this year, it lowered its growth projections for 2021, expecting a GDP growth rate of 4.0 percent instead of its previous estimate of 5.0 percent. In fact, it does not expect the economy to return to its pre-pandemic level of output until the end of 2021. That would be quite a lengthy recovery period. On average, full recoveries take about twice as long as the recessions that preceded them. If, as seems likely, the pandemic recession ended in April, spanning three months, the economy would be operating below its capacity for a much longer period of time than usual. And with the unemployment rate not expected to return to 4.0 percent until 2023, it is hard to see where inflationary pressures would come from.

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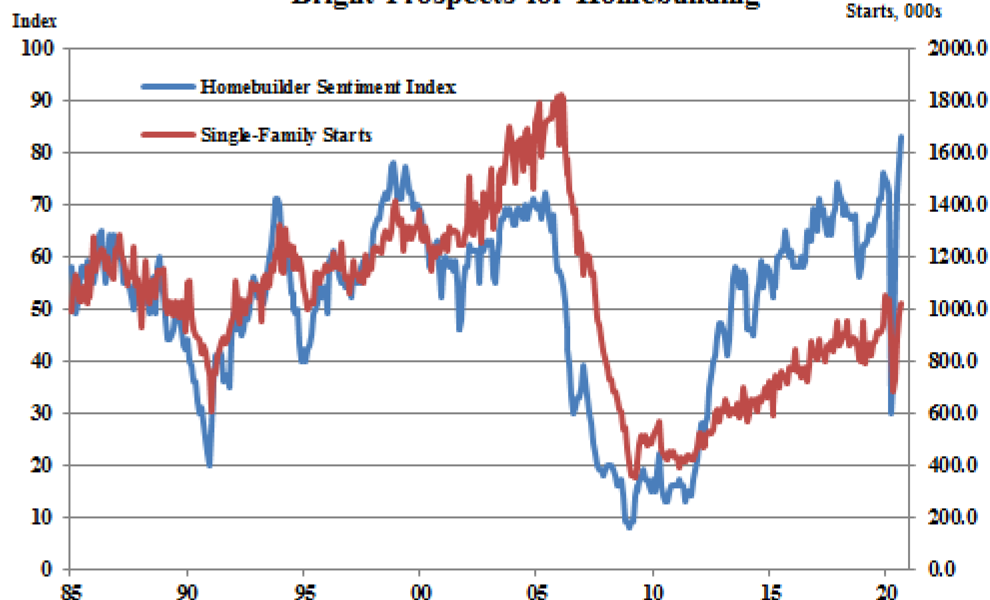
Summary of Economic Projections
From September 15-16 FOMC Meeting

Variable	Median[1]				
	2020	2021	2022	2023	Longer run
Change in real GDP	-3.7	4.0	3.0	2.5	1.9
June projection	-6.5	5.0	3.5		1.8
Unemployment rate	7.6	5.5	4.6	4.0	4.1
June projection	9.3	6.5	5.5		4.1
PCE inflation	1.2	1.7	1.8	2.0	2.0
June projection	.8	1.6	1.7		2.0
Core PCE inflation[4]	1.5	1.7	1.8	2.0	
June projection	1.0	1.5	1.7		

To be sure, Fed projections, like those made in the private sector are just that – projections made with the best available evidence. With a nod to John Maynard Keynes, when the facts change, so too does the mind-set of those making projections. In the current instance, the facts on the ground are particularly vulnerable to change. Among the most notable is the question of whether the economy will receive another dose of fiscal stimulus, which Fed chair Powell strongly indicated will be needed to sustain the recovery. With Congress scheduled to go on recess in early October, the time is running short to get something done before the election. Recent reports are providing a mixed message. On paper, the two parties are far apart on the bills proposed, with the House approving $2.2 trillion and the Senate $650 billion. But the pressure for compromise is building and even President Trump is urging Republican colleagues to put more muscle into their proposal.

We are cautiously optimistic that more stimulus will be forthcoming, although its size and scope is open to question. That said, the need for fiscal aid is becoming ever more palpable, although the economy continues to recover from its breath-taking plunge in the second quarter. Indeed, some sectors are thriving, fueled in part by the very pandemic that wreaked havoc in the second quarter. People are frantically searching for larger homes to shelter in place and to flee crowded urban areas, where the virus is spreading more rapidly. Home sales are skyrocketing and spurring residential construction. Homebuilder sentiment has never been higher than currently recorded, and building permits for single-family homes are almost back to their pre-pandemic level.



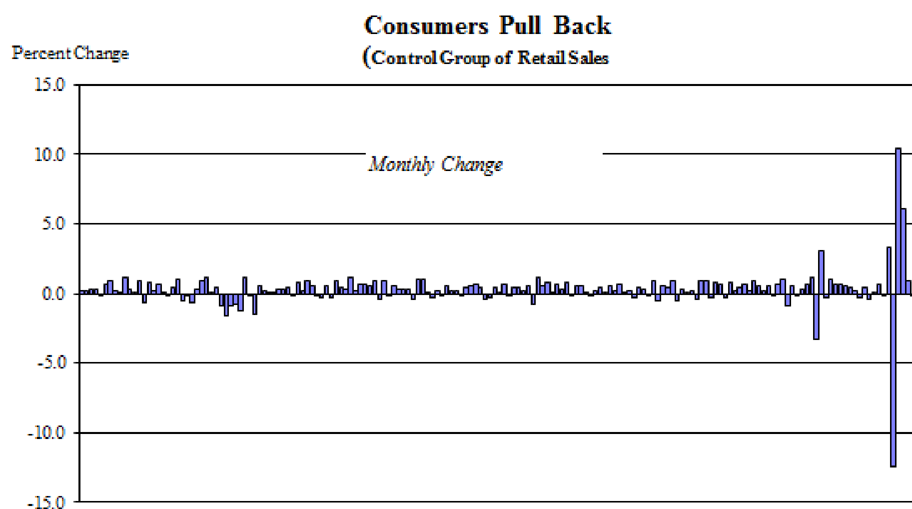
With mortgage rates expected to remain at historic lows for the foreseeable future, prospective buyers should continue to have a strong financial incentive to purchase a home. And with inventories is short supply, this demand should sustain the uptrend in residential construction. This is one area of activity that could provide the Fed with an upside surprise; what's more, since it is the most credit-sensitive sector of the economy, it's strength can be directly linked to the Fed's policies. Still, residential construction has a modest influence on overall activity, accounting for less than four percent of GDP, so it's unlikely that even a booming housing market would be enough to power the economy through the headwinds from the ongoing health crisis.

The key to the strength and sustainability of the recovery ultimately lies with consumers, who generate 70 percent of the fuel that drives growth. No doubt, they have provided the heavy lifting needed to jump-start the economy out of recession. Consumer spending is rebounding strongly in the third quarter, powering GDP to a robust growth rate that is on track to exceed 30 percent for the period. But even that strong rebound will only recover about two-thirds of the complete pandemic-induced collapse in consumption during the second quarter. Most of the snapback in spending has been for consumer goods, which account for less than one-third of total household purchases. Most consumption is for services, where supply continues to be limited by lockdown restraints and social-distancing mandates.

Hence, retail sales, which are mostly for goods, are spearheading the spending rebound. The good news is that retail revenues increased in August for the fourth consecutive month, lifting the total above pre-pandemic levels. The bad news is that the sales growth is losing momentum, with the 0.6 percent increase in August the weakest in four months. The slowing pace has been dramatic, from +18.3 % in May to 8.6% and 0.9 % in June and July, with the July gain revised down from a previous estimate of a 1.2 percent increase. Worse, the control group of sales, which excludes volatile auto, gasoline, building materials and foods that enter directly into the GDP calculation, slipped 0.1 percent last month, the first decline since April.

The setback in the control group of sales, which also follows a downwardly revised increase in July, highlights the loss of consumer momentum from the early reopening days of the economy, when the rollback of lockdown restrictions got underway. The initial burst of sales represents the low-hanging fruit that Powell alluded to, as households eagerly jumped to satisfy pent-up demand. Importantly, the surge in sales was nurtured by the fiscal stimulus, most notably the CARES Act passed in March, which provided direct payments of up to $1,200 to households, enhanced unemployment benefits that included a top-up of $600 a week to unemployed workers and forgivable loans to small businesses under the Paycheck Protection Program (PPP).

Not coincidentally, the setback in retail sales comes during the first month after those programs expired. Keep in mind that not all of the government payouts were exhausted; households entered August with an exceptionally high 17.8 percent saving rate, which no doubt included some leftover funds not spent in July. Likewise, many small businesses still retain cash from the PPP to cover payroll and sustain operations. Hence, the consumer pullback last month would likely have been considerably worse without that cushion of government funds. But those funds are quickly running dry and the absence of a replacement pandemic stimulus bill so far portends a continuation of the weakening trend in September.



To be sure, the private sector is taking up some of the slack, as the 10.6 million increase in payrolls over the past four months has boosted labor compensation. But wages and salaries are still almost half a trillion dollars below their pre-pandemic level, even as government support payments has shrunk. What's more, prospects for worker earnings are anything but robust. Like retail sales, the monthly gains in jobs are slowing, with the 1.4 million August increase in nonfarm payrolls less than half the average 3.1 million increase over the previous three months. Layoffs remain stubbornly high, as new filings for unemployment benefits continue to total nearly twice the peak levels of the last recession.

With Congress still at loggerheads, the prospect of seeing a replacement pandemic relief bill is rapidly fading. That together with the relatively downbeat economic forecast delivered by the Federal Reserve this week may be taking a toll on the financial markets, as stock prices staggered to a loss for the second consecutive week, the first back-to-back setback since the last two weeks of April. That may, of course, set itself up for a vigorous rally if something comes out of Washington before the scheduled recess. From our lens, more is at stake, as the survival of the recovery is very much at risk is Congress fails to act.