QUARTERLY ECONOMIC REVIEW AND OUTLOOK

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Based upon economic data for May and June, the recession ended in April and a new business expansion cycle is underway. Employment, retail sales, and construction are in a cyclical uptrend that could gain momentum in coming months. However, the strength and sustainability of the economic recovery will remain in doubt until the coronavirus pandemic is brought under control or until an effective vaccine is available for mass inoculation. The resurgence in new cases and hospitalizations in the south and west in recent weeks is worrisome and could result in renewed partial lockdowns in certain regional hot spots.

Summary and Major Conclusions:

- The plunge in second quarter US GDP was the largest contraction for any quarter since the 1930s, with an estimated annualized decline in real GDP of 33%. This compares with a decline of 8.5% in the fourth quarter of 2008, and the post-World War II record of 10% in the first quarter of 1958.

- The contraction in aggregate spending, output, and employment can be attributed to the COVID-19 pandemic, which prompted a lockdown of virtually all economies worldwide. The pandemic ended the longest economic expansion in US history.

- The sudden halt to economic growth has been highly deflationary, with selling prices in decline in each of the past several months. The core consumer price index plunged at a 1.5% annual rate over the past three months, the worst decline on record.

- The recession ended in April, and data for May and June suggest that a moderate economic recovery is underway. The COVID-19 recession was the deepest but also the shortest recession since the Civil War, encompassing only two months.

- There is a wide range of data signaling a rebound in economic activity in May and June. Most encouraging is broad evidence of a cyclical rebound in the housing market. Every economic recovery since 1950 has been led by the housing sector, with the obvious exception of the 2009 recovery.

- Other signs of improvement can be found in May data on automobile sales, chain store sales, and household income. Nonfarm payrolls increased by a surprisingly large 2.5 million workers and the unemployment rate fell to 13.3%.

- That said, there are growing risks to the outlook as this report goes to print. The recent resurgence in new COVID-19 infections and hospitalizations — mainly in the west, southwest, and deep south — could threaten the currently in-process economic recovery if strict social distancing practices need to be reinstated.

- The assumptions for my economic forecast have not changed, although these could be at risk, depending upon the severity of the coronavirus outbreak in coming weeks. Any backsliding in terms of keeping an open economy will be reflected in disappointing economic and profit data.

- My forecast assumes a decline in real GDP of 5% this year, followed by growth rates of 4.5% in both 2021 and 2022. The absolute level of real GDP is not likely to return to its pre-coronavirus peak until the second half of 2022.

- Corporate earnings tend to closely track GDP and should therefore rise and fall along with the economy. Operating earnings could decline by 30% for all of 2020, but rebound by 25% next year and another 20% in 2022.

- Consumer inflation will likely remain suppressed until late 2022 or 2023. Following an estimated 1% increase this year, core consumer prices could rise by 1.5% in 2021 and 2% in 2022. Faster inflation is possible in 2023, depending upon the thrust of monetary policy in 2021.

- My conviction in a sustained business expansion cycle rests upon several key factors, including unprecedented monetary and fiscal stimulus, improving credit conditions, and massive pent-up consumer demand, following three months of lockdown.

- There can be little doubt regarding the resolve of the Federal Reserve. Additional fiscal support from Congress and the White House is also likely but far from certain. With funds from previous spending programs winding down, the sustainability of the recovery is critically dependent upon further government spending.

- Governments outside the US have responded to the crisis with breathtaking speed. The amounts of fiscal stimulus authorized by policymakers in Germany and Japan are triple those provided in response to the 2008 financial crisis. Monetary stimulus in Europe, China, and Japan has also been aggressive.

- The unanticipated revival in coronavirus cases in the final weeks of June both regionally and nationwide is worrisome. The blatant disregard for wearing protective masks and practicing social distancing evident in many states as they reopen is a clear and present danger to the economic recovery.

- The primary risk to my economic forecast is the potential for a worse than expected second wave of the pandemic in the fall and winter months. My assumption is that the outbreak of new infections will be regional, rather than nationwide, and is unlikely to reach dangerous levels.

- I also assume that policymakers will be extremely reluctant to order another nationwide lockdown. As a result, although a second wave would almost certainly have a negative economic effect, another economic downturn appears unlikely.

- In the positive column, the pace of medical research and development has been unprecedented. There are numerous vaccines in advanced clinical trials, and one or more could be approved by yearend and be available for inoculations on a mass scale during the first half of next year.

- Widespread availability of an effective vaccine would be a game changer, and could trigger a V-shaped economic recovery in 2022. Availability of a therapeutic would also facilitate a faster pace of economic recovery. Absent powerful new medications, the economic recovery is likely to be sluggish and uneven, and constantly at risk.

Note to Readers: *As this report goes to print, the coronavirus epidemic is at a crucial juncture. The US appears to be in the early stages of an untimely resurgence of COVID-19 cases and hospitalizations in more than two dozen southern and western states, raising the risk of renewed lockdowns and quarantines. Consequently, the future path of the coronavirus epidemic in the US is becoming increasingly uncertain, with obvious associated risks to the fragile and tentative economic recovery currently underway. The upshot is that the actual path of the economy during the remainder of this year could vary substantially from current forecasts, depending upon the unfolding of public health trends over the next several weeks.*

ECONOMIC REVIEW

The plunge in second quarter US GDP was the largest since the 1930s, with an annualized decline of 33%. This compares with a decline of 8.5% in the fourth quarter of 2008 and a post-World War II record of 10% in the first quarter of 1958. The level of real GDP in Q2 is nearly 10% below that of 2019, and the lowest level since 2015.

The unemployment rate spiked from a 50-year low of 3.5% in February to a post-war peak of 14.7%, improving slightly to 13.3% in May and an estimated 12% in June. US corporate earnings fell at an annual rate of 30% in the quarter, the worst quarterly decline since 2008.

Global Pandemic: The collapse in aggregate spending, output, and employment can be attributed to the COVID-19 pandemic, which prompted a lockdown of virtually all economies worldwide. In the US, businesses shut down in response to a collapse in consumer demand, as shelter-in-place orders issued by most states across the country resulted in economic paralysis. The pandemic ended the longest economic expansion in American history.

Public Health Conditions: The second quarter witnessed rapidly unfolding developments in the public health arena during the second quarter. Although the numbers of new cases, hospitalizations, and fatalities have been steadily declining since April, the most recent data are discouraging in two respects:

- The steady decline in new infections since April has been extremely disappointing when compared with Europe and Japan, where new cases have declined precipitously, a result of vigilant sheltering in place along with aggressive testing and contact tracing.

- At the regional level, new cases and hospitalizations have spiked in more than 20 southern and western states, most notably Arizona, California, Florida, Arkansas, North and South Carolina, Tennessee, Texas, Nevada, Alabama, and Oklahoma (see chart 1).

Chart 1: Exponential Rise in COVID-19 Cases in Arizona
Confirmed Coronavirus Cases, State of Arizona
Source: Johns Hopkins University

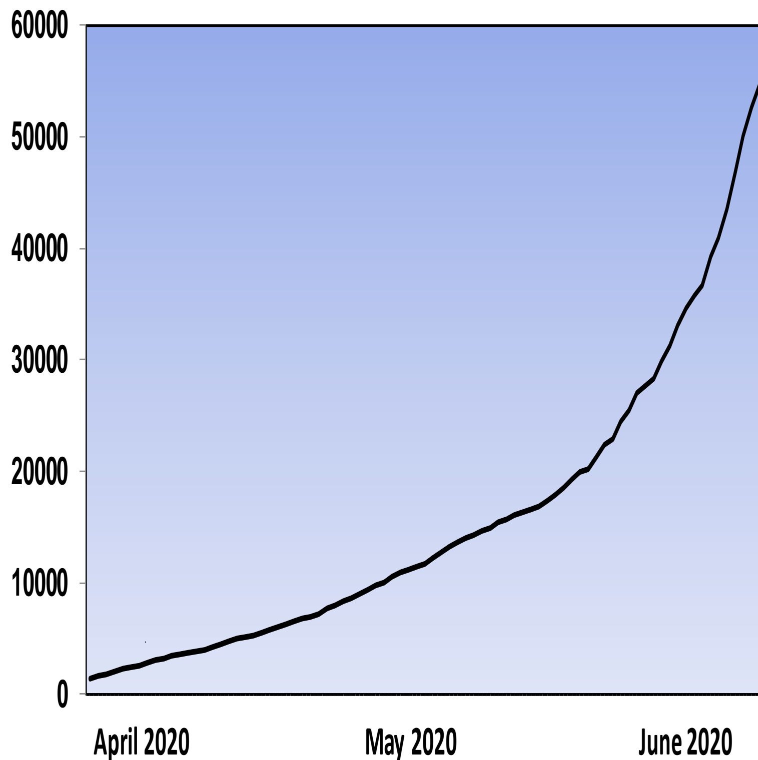
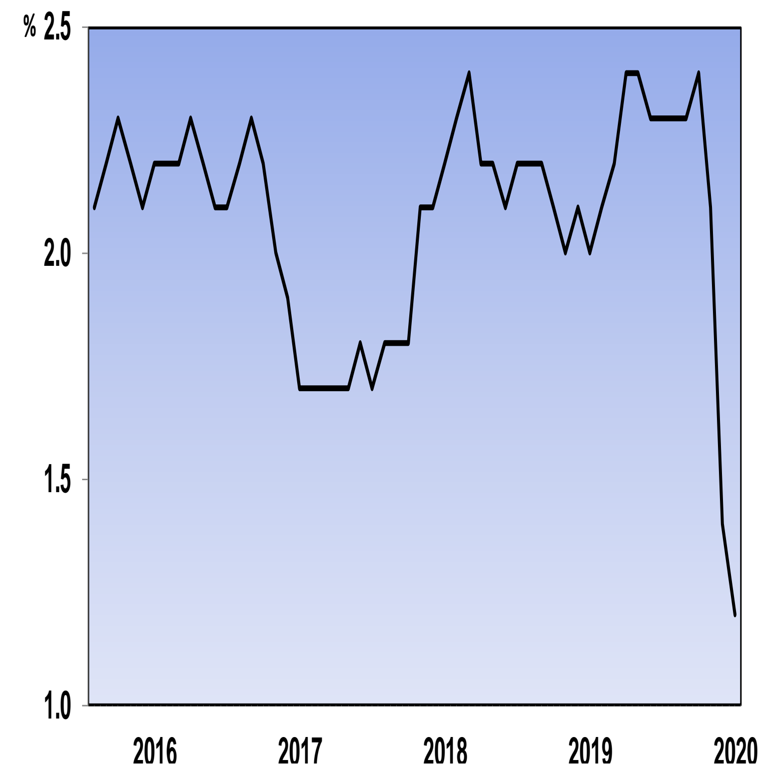


Chart 2: US Consumer Inflation Falling at a Record Pace
Core Consumer Price Index, Annual % Change
Source: Bureau of Labor Statistics

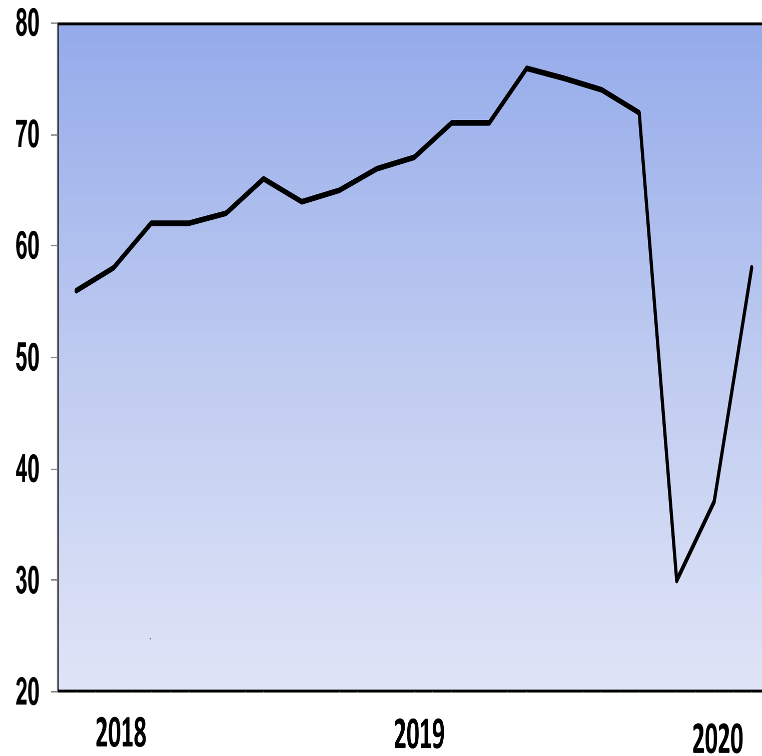


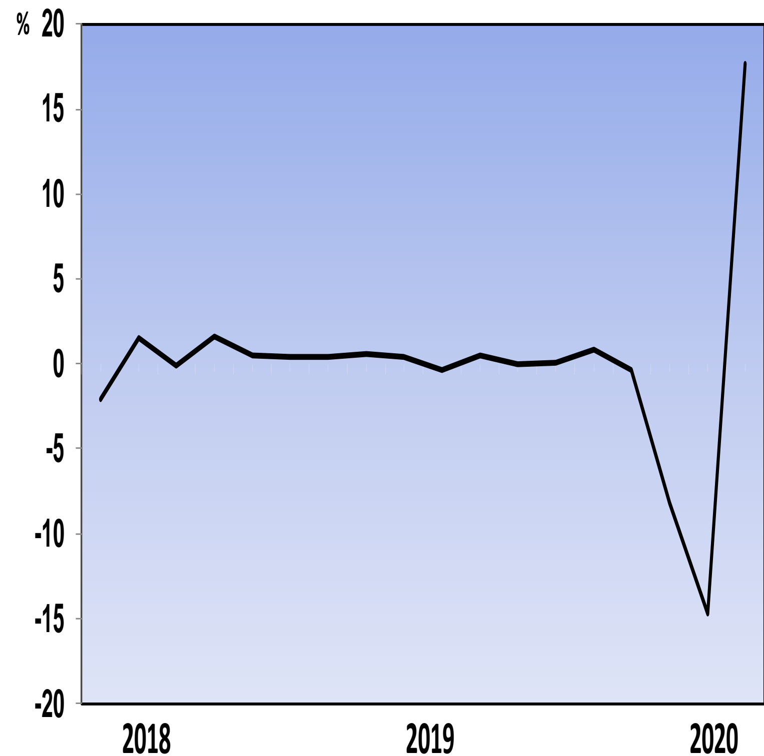
The offsetting good news has been concrete progress in the development of an effective vaccine at an unprecedented pace. _However, the recent unfavorable trends pertaining to new cases and accelerating transmission are worrisome, and in the worst case could undermine the economic recovery, at least until there is a vaccine for mass distribution_.

Deflationary Pressures: As would be expected, the collapse in economic activity was highly deflationary, with selling prices actually in decline over the past several months. The core consumer price index (CPI) ***plunged*** at a 1.5% annual rate over the three months ending in April, the worst decline on record. The core CPI ended the quarter at a level only 1% above that of a year ago, the lowest annual pace in nearly a decade (see chart 2).

ECONOMIC OUTLOOK

The recession ended in April, and data for May and June suggest that a moderate and uneven economic recovery is underway. The COVID-19 recession was the deepest but also the shortest recession since the Civil War. Just as the catalyst for the recession was a voluntary shutdown of the economy by state government mandates, the catalyst for the recovery is the staggered reopening of the economy on a state-by-state basis and in several phases.





Signs of Recovery: There is a wide range of data signaling the rebound in economic activity in May and June.

- Most encouraging is evidence of a solid rebound in the housing market. Applications for mortgage loans are in a steady rise, while sales of newly built homes in May were actually higher than those of May 2019. *Every economic recovery since 1950 has been led by the housing sector, with the obvious exception of 2009* (see chart 3).

- Automobile sales rose by more than 40% in May versus the previous month.

- Nonfarm payrolls increased by a surprising 2.5 million in May.

- Despite an 8% month-to-month decline in wages and salaries in May, household income rose by 10%, supported by a $3 trillion increase in government transfer payments.

- Monthly retail sales in May increased at a record 17% rate versus the previous month, the fastest monthly rate on record (see chart 4).

Chart 5: Restaurants Are in a Slow Recovery Mode
The Year-Over-Year % Decline in Seated Diners
Source: Open Table

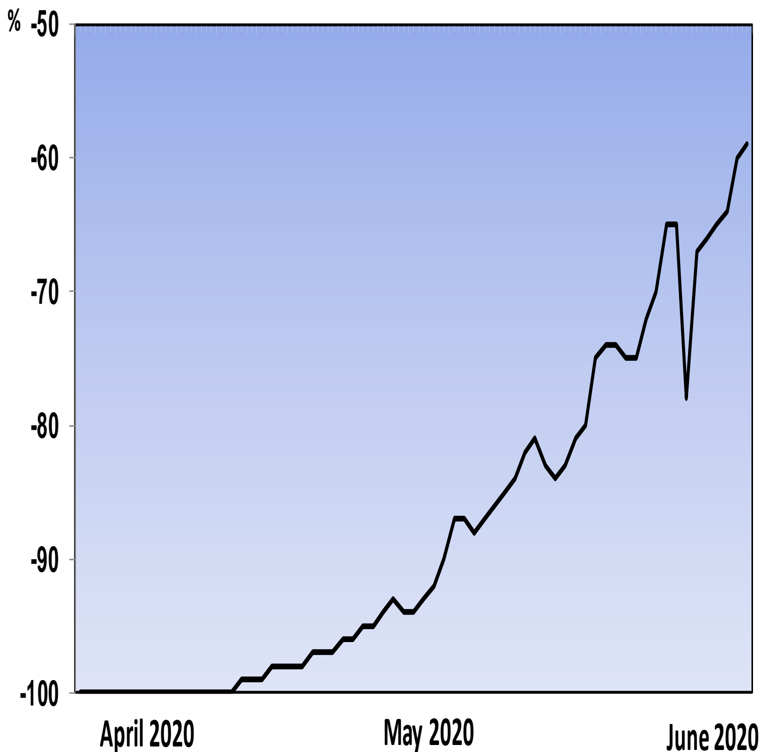
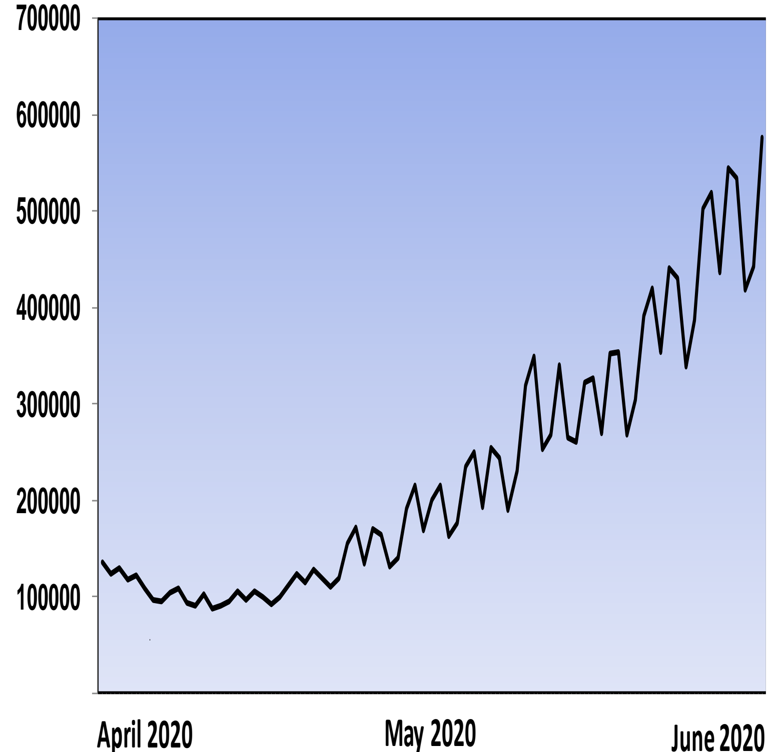


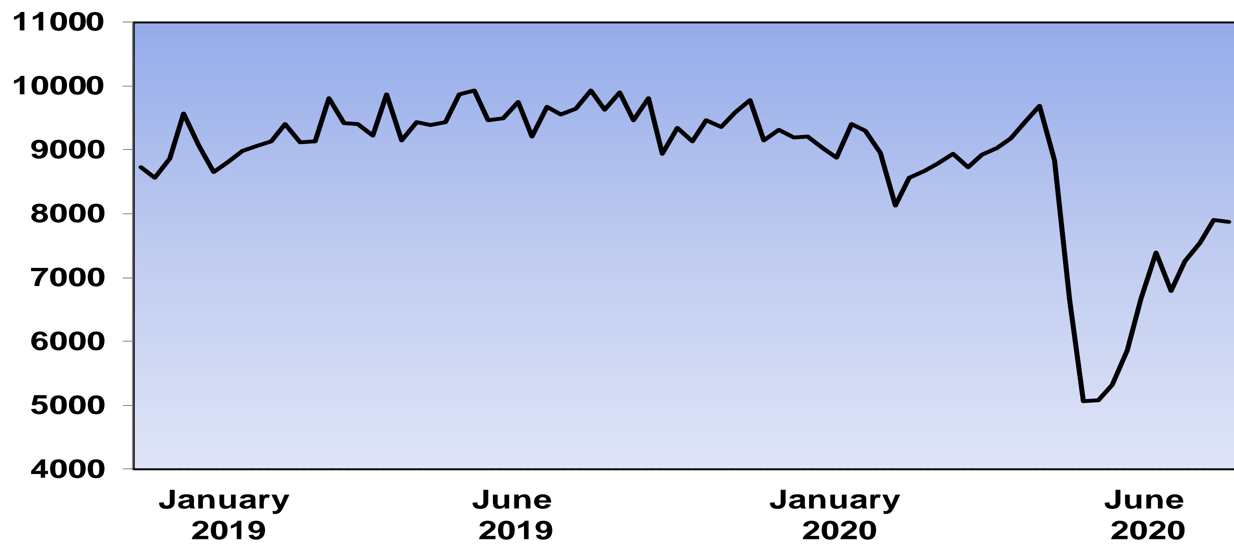
Chart 6: Airline Bookings in a Very Gradual Uptrend
US TSA Checkpoint Number of Travelers
Source: Transportation Security Administration



- Restaurant sales have increased from deeply depressed levels (see chart 5).
- Similarly, airline bookings are increasing from deeply depressed levels (see chart 6).
- Domestic gasoline consumption has rebounded by 40% from its April low (see chart 7).
- Rail container and trailer loadings have also bounced off their April bottoms.
- Average hotel occupancy rates have risen from a low of 10% to 51%.

ECONOMIC FORECAST

The underlying assumptions for my economic forecast have not changed. I believe that the demand side of the economy bottomed in April, while production bottomed in May. Virtually all key indicators should show sequential growth in June, continuing throughout the second half of this year. The details of my forecast can be summarized as follows:



- Real GDP could decline by 5% for all of 2020, followed by rebounds of 4% to 5% in both 2021 and 2022. The absolute level of real GDP is not likely to return to its 2019 all-time peak of $19.22 until the second half of 2022.

- A sustained recovery in the US economy should be evident in quarterly GDP data. Following its record decline in Q2, real GDP should rebound strongly in Q3 and somewhat less so in Q4. My forecast assumes annualized GDP growth of 18% to 20% in Q3 and 5% to 10% in Q4.

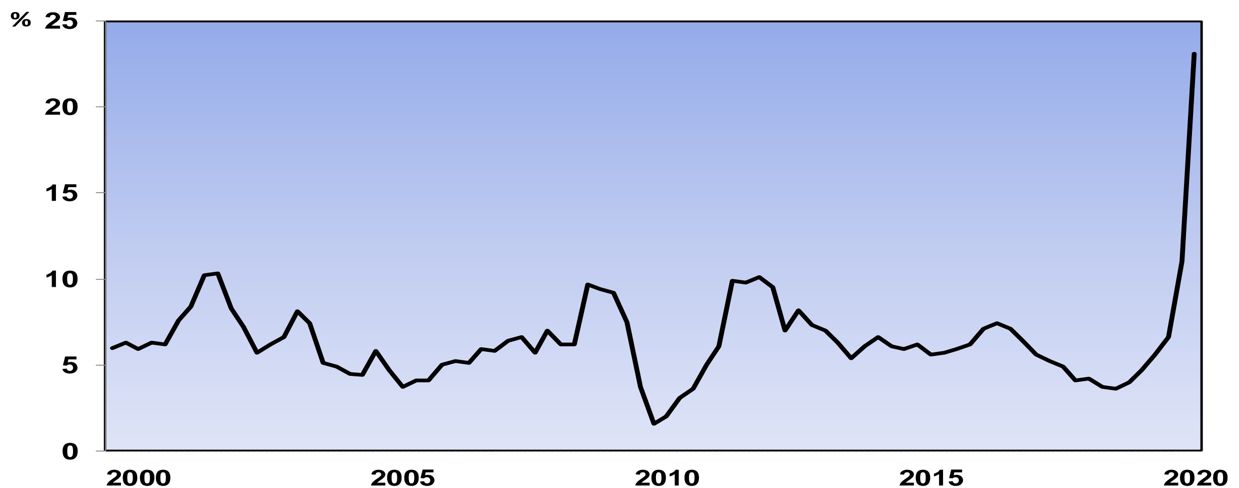
- Residential construction should be the leading edge of recovery in 2021 and 2022. New housing starts could rise to 1.5 million units next year and climb to 1.85 million in 2022, the highest level in nearly 15 years, led by the single-family segment.

- Automobile sales should also be at the forefront of the recovery. Following an estimated decline of 20% this year, vehicle sales could rise by 25% in 2021 and another 15% in 2022.

- Nonfarm payrolls could rise by an average monthly rate of 200,000 in 2021 and 350,000 in 2022. Currently at 13.3%, the unemployment rate could fall to 9.5% at the end of this year and to 7.5% by yearend 2021. A return to full employment, estimated at 5%, is unlikely until 2024.

- Consumer inflation will likely remain suppressed until late 2022 or 2023. Following an estimated 1% pace this year, core consumer inflation could rise to 1.5% in 2021 and 2% in 2022. Faster inflation is possible in 2023, depending upon the thrust of monetary policy in 2021.

Chart 8: US Money Supply Expanding at a Record Pace
The M2 Money Supply, Annual % Growth
Source: Federal Reserve



- Corporate earnings closely track GDP and industrial production, and should therefore rise and fall along with the economy. Operating earnings could decline by close to 30% for all of 2020, but rebound by 25% next year. A further gain of 20% appears likely in 2022.

- For the companies in the S&P 500, *my forecast assumes earnings per share (EPS) of $115 this year, down from $163 in 2019. I expect EPS to rise to $145 and $175 in 2021 and 2022, respectively*.

It must be emphasized that any forecast for the economy over the next six to nine months must be viewed by necessity as very fragile and fluid. The resurgence in confirmed coronavirus cases in recent weeks is a major threat to economic growth because of the increased potential for partial shutdowns in regional hot spots. *At a minimum, investors should not expect the economy to recover in a straight line over the next year, but rather in fits and starts*. Investors should also be prepared for downgrades to company earnings expectations, depending upon the news on COVID-19.

CRITICAL ECONOMIC VARIABLES

The direction of financial markets over the next year ultimately depends upon the outlook for growth in US GDP and corporate earnings. There is no change in my base case scenario that the recession ended in April and that a U-shaped recovery is underway. My conviction in a sustained economic expansion rests upon the following key factors:

- Monetary Policy: Fed Chairman Jerome Powell has made it clear that policy will continue to support the economy and financial system with whatever tools necessary. The M2 money supply is currently growing at an annualized rate of nearly 25%, the fastest pace on record (see chart 8).

Chart 9: Home Mortgage Commitment Rates at an All-Time Low
Interest Rate on Residential Real Estate Loans
Conventional 30-Year Fixed-Rate Loan
Source: Freddie Mac

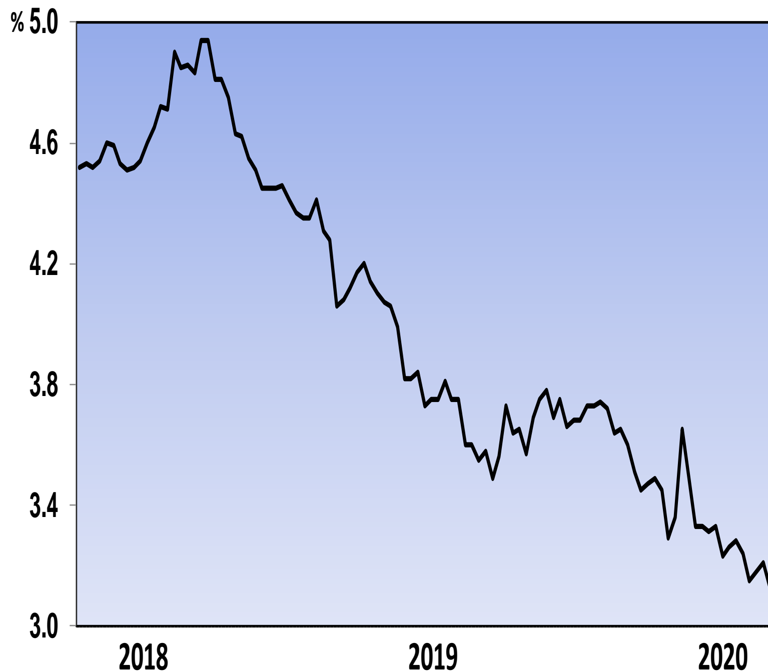
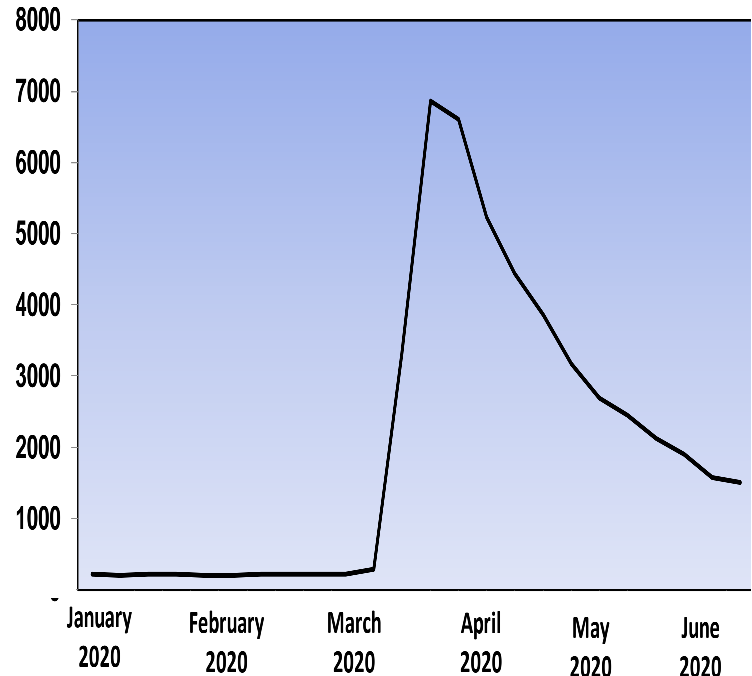


Chart 10: US Labor Market Depressed But Slowly Healing
Weekly Initial Claims for Unemployment Insurance
Thousands of Workers
Source: US Labor Department



- Fiscal Policy: Congress and the Treasury have responded aggressively to the crisis with massive spending programs exceeding $3 trillion in the form of greatly expanded unemployment benefits, generous payments to households, and grants to small and medium-sized businesses. But additional spending is needed: *With funds from previous spending programs winding down, the sustainability of the recovery is critically dependent upon further government spending*.

- Credit Markets: The availability of credit for businesses and households remains plentiful, thanks to the extraordinary policy support of the Federal Reserve. The amount of corporate bond issuance has shattered all records. Mortgage rates have declined to an all-time low of 3.1% (see chart 9).

- Non-US Governments: Major governments worldwide have responded to the crisis with breathtaking speed. The amounts of fiscal stimulus authorized by policymakers in Germany and Japan are ***triple*** those provided in response to the 2008 financial crisis. Monetary stimulus in Europe, China, and Japan has also been aggressive.

- Employment: The surge in job losses peaked in April, as did the unemployment rate. Nonfarm payrolls rose by 2.5 million in May and should continue to trend higher in coming months, as temporarily furloughed workers return to their jobs. Initial jobless claims remain elevated but are in a slowly improving trend (see chart 10).

- Household Income: Although wage and salary income has declined, total household income rose sharply in April and May as a result of massive federal government transfer payments to households.

- Pent-Up Demand: The sharp pullback in household spending has resulted in considerable deferred demand accumulated during the lockdown, which could be unleashed in coming months as employment, incomes, and confidence improve. The personal savings rate is at an all-time high of 33%, more than ***double*** the previous high in 1975.

COVID-19 Risks: While recent economic data have been encouraging, the future direction of the US economy remains heavily dependent upon developments relating to the coronavirus pandemic. In that regard, the rapid pace of business reopenings in recent weeks has ignited a sharp upturn in infections. There are four crucial considerations with respect to the pandemic:

- Regional Resurgence: The revival in confirmed cases in the second half of June both regionally and nationwide cannot be easily dismissed. Most worrisome is the blatant disregard for wearing protective masks and practicing social distancing that has characterized the reopening of the economy, most notably in the south and southwest.

- Second Wave: Another risk to my economic forecast is the potential for a large second wave of the pandemic in the fall and winter months. My forecast assumes that the outbreak of new infections later this year will be regional, rather than nationwide, and not of catastrophic magnitude.

- Nationwide Lockdown Unlikely: I am also assuming that policymakers will be extremely reluctant to order another nationwide lockdown, which means that outbreaks will be dealt with by the private sector — comparable to Apple’s decision to close stores in Arizona and Florida — and through targeted interventions by state and local authorities. Although a second wave would clearly have a negative impact on business conditions, a severe downturn in the economy appears unlikely.

- Scientific Innovation: In the positive column, the pace of medical research and development is unprecedented. There are numerous vaccines in advanced clinical trials, and one or more could be approved by yearend, with inoculations on a mass scale beginning early next year. Availability of one or more coronavirus therapeutics would also increase private sector confidence and result in a faster pace of economic recovery.

Until the arrival of inventive medications, the US economy will continue to operate well below full employment, with only moderate growth in spending and output.

Robert F. DeLucia, CFA, was formerly Senior Economist and Portfolio Manager for Prudential Retirement. Prior to that role, he spent 25 years at CIGNA Investment Management, most recently serving as Chief Economist and Senior Portfolio Manager. He currently serves as the Consulting Economist for Prudential Retirement. Bob has 45 years of investment experience.

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