HOW WILL THE CURRENT ECONOMIC RECOVERY DIFFER FROM NORMAL?

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The thrust of monetary policy over the next two years is likely to differ from that of all previous economic recovery cycles, with the possible exception of the 2010 expansion cycle. Typically, fearful of generating inflation and excessive credit creation, the Federal Reserve is quick to reverse course from excessive monetary stimulus to a neutral policy, once there is confirmed evidence that a sustained economic recovery is firmly in place. This is unlikely to be the case in the current cycle.

Summary and Major Conclusions:

- Although the 12 recessions since 1945 were each unique in certain ways, they all shared many common characteristics. For example, the catalysts for recession have generally been the same, the most common being a severe tightening in monetary policy to combat unacceptably high inflation.

- The current economic recovery that began in May will be unlike any previous expansion cycle during the past seven decades. The numerous idiosyncratic factors associated with the recession strongly suggest that the expansion cycle will also be unique.

- Although the domestic economy appears to have turned the corner, it faces numerous challenges that will attenuate the pace of recovery. The most important is the lingering impact of the coronavirus pandemic and its potential to undermine economic activity as new restrictions are put into place.

- Until the virus is conquered, the US economy will proceed on a start-stop-restart basis and continue to operate at levels well below normal capacity. This is especially true of various travel-related and leisure and hospitality industries.

- There is enormous churning in the labor market: Although large numbers of furloughed workers have been recalled to work, workers that were previously employed are losing their jobs as businesses eliminate positions among existing staff.

- It seems plausible to assume that the rapid growth in the use of digital applications and other forms of automation during the lockdown will escalate in coming years, resulting in a more rapid displacement of workers in certain industries.

- All world business cycle recoveries since 1970 benefitted from a locomotive of economic growth. However, there are no obvious candidates to serve as an engine of growth in the current cycle. Only China and the US have the capability to act as locomotives of growth, but both countries face powerful headwinds.

- Another strong economic headwind is the rapid pace of business failures and closures, particularly among small and mid-sized firms, most notably restaurants, consumer service companies, and retail establishments.

- Never has the small business sector been at greater risk of survival than in the current cycle. Unlike large corporations, small businesses do not have anywhere near the same access to capital.

- In contrast, the nation's largest firms have tapped the corporate bond market to an unprecedented extent. The amount of debt capital raised by large US companies this year has shattered all records, helping many larger companies offset liquidity and cash flow strains.

- The primary economic repercussion will be a marked consolidation phase in many domestic industries over the next three years. Increased concentration in many key industries will result in higher profit margins for industry leaders, along with increased pricing power.

- The thrust of monetary policy over the next two years is likely to differ from those of all previous economic recovery cycles, with the possible exception of the 2010 expansion cycle. Investors should expect an extended period of extreme monetary ease.

- The Fed has stated that because monetary policy has persistently undershot its 2% target for many years, a period of above-target inflation would likely be tolerated. If so, this insurance policy against deflation could result in a higher inflation rate beyond the next two years.

- Long-term interest rates are likely to remain depressed for an unusually extended period. There is unlikely to be the usual snapback in yields that typically occurs in the early recovery phase.

Although the 12 recessions since 1945 were each unique in certain ways, they all shared many common characteristics. For example, the ***catalysts*** for recession have generally been the same, the most common being a severe tightening in monetary policy to combat unacceptably high inflation.

The other catalysts for recession in the past have involved sharp cutbacks in spending, investment, and lending to correct previous excesses. These include excess spending on housing, commercial real estate, capital goods, or inventories; and excessive debt levels that led to a credit crisis and a decline in credit availability. The duration of the typical recession has been nine to 12 months; and with the exception of the 2008 recession, the subsequent economic recovery has typically been V-shaped.

Unique Circumstances: The current economic recovery that began in May will be unlike any previous expansion cycle during the past seven decades. *The numerous idiosyncratic factors associated with the recession strongly suggest that the expansion cycle will also be unique*. These can be summarized as follows:

1. An *unprecedented catalyst* for the recession — a worldwide pandemic
2. The *abrupt nature* of the downturn, occurring almost instantly and without notice
3. The *deepest but also shortest recession* on record
4. The highly concentrated *magnitude of the contraction* in output, spending, and employment, within the space of only two or three months
5. The unprecedented amount of *fiscal and monetary policy* stimulus
6. The exceptionally high *uncertainty* created by the pandemic with respect to forecasting, and the severe impact on private sector confidence

The following is an analysis of the specific manner in which these factors could affect the shape, scope, and contour of the unfolding economic expansion.

The focus of US equity investors continues to alternate between steadily improving economic data and the worsening trend in the COVID-19 pandemic, resulting in exceptionally high day-to-day volatility. This week's *Economic Perspective* tries to reconcile the divergences in these opposing trends, and provides a summary of economic and financial market assumptions.

SLUGGISH PACE OF ECONOMIC RECOVERY

Although the domestic economy appears to have turned the corner, there currently exist numerous daunting headwinds that will almost certainly moderate the pace of recovery. The most important is the lingering impact of the coronavirus pandemic and its potential to undermine economic activity as new restrictions are placed on businesses and communities.

A Start-Stop Economy: *Until the virus is conquered, the US economy will proceed on a start-stop-restart basis and continue to operate at levels well below normal capacity*. This is especially true of various travel-related and leisure and hospitality industries, along with the broad transportation sector. Profound weakness in many manufacturing industries will also undermine the recovery.

While federal government spending should boost growth, spending by state and local governments — which greatly exceeds the volume of spending by the federal government — will remain weak for many quarters. And with expansion plans on hold, business capital investment will also remain weak, as will exports, with a recovery of world trade well into the future.

Cautious Consumers: Household spending appears to be on a sustained growth path, but the pace of recovery is likely to be moderate. Consumers face a variety of headwinds, including very high unemployment, falling wage and salary income, improving but still very depressed consumer confidence, and a low level of job security. Moreover, banks have begun to tighten lending standards, for credit cards, consumer instalment loans, auto loans, and residential mortgages. *Consequently, unlike any previous recession, the household sector is dependent upon employment, rather than credit creation, to restore spending to normal*.

PERSISTENTLY HIGH UNEMPLOYMENT

The number of workers on nonfarm payrolls is rebounding but fewer than 40% (8 million) of total cumulative job losses (22 million) have been restored. There is enormous churning in the labor market: Although large numbers of furloughed workers have been recalled to work, previously employed workers have lost their jobs, as businesses cut jobs among existing staff.

As a result, nonfarm payrolls are still down 10% from the pre-COVID peak, resulting in a current unemployment rate of 11%. More concerning is the 18% *underemployment rate* — a broader definition of job market slack that includes involuntary part-time workers and (discouraged) workers who want to work but have stopped looking. Most striking is the 25% of the workforce that have lost their jobs or have experienced cuts in wages and in hours worked.

- **Digitalization and Jobs**: Although difficult to prove, it seems plausible to assume that the rapid growth in the use of digital applications during the lockdown will escalate in coming years, resulting in a more rapid displacement of workers in certain industries. Greater utilization of communications services, IT applications, software, and automation is likely to slow the recovery in job creation, even as the economy recovers.

- **Vicious Cycle**: *The greatest systemic economic risk is a potential vicious cycle involving employment, consumer spending, and business failures*. Any weakening in consumer spending would have an adverse impact on small firms, triggering a surge in business failures, and therefore increased job losses. This negative feedback loop would involve further downward pressure on consumer spending, additional business failures, rising unemployment, and so on.

NO GLOBAL ENGINE OF GROWTH

All world business cycle recoveries since 1970 benefitted from one of the major economies serving as locomotive of economic growth: Germany in the 1970s, Japan in the 1980s, the US in the 1990s, and China in the two recovery cycles in the 21st century, 2003 and 2009. *However, there are no obvious candidates to serve as engines of growth in the current cycle*.

Only China and the US have the capability to act as locomotives of growth, but both countries face strong headwinds. The US economy is unlikely to gather sufficient momentum to lead the world out of recession until later next year and in 2022, until the economy has fully reopened. The US labor market will likely remain depressed until final demand begins to accelerate, which is unlikely absent a strong recovery in confidence, which in turn is unlikely until there is mass availability of a vaccine.

China's economy was hard hit by the initial coronavirus outbreak and lockdown that followed. Moreover, unlike in 2009 — when government stimulus amounted to nearly 13% of GDP — policymakers are deeply concerned about high levels of debt, and have acted less forcefully. Consequently, fiscal stimulus this year will amount to only 5% of GDP. China's economy is expected to grow by only 1% in 2020 — which compares with growth of 9.7% in 2008 and 9.4% in 2009.

BUSINESS FAILURES

Another strong economic headwind is the rapid pace of business failures and closures, particularly among small and mid-sized businesses, most notably restaurants, consumer service companies, retail establishments, and small energy firms. *Never has the small business sector been at greater risk of survival than in the current cycle*. Unlike large corporations, small businesses do not have anywhere near the same access to capital.

In contrast, the nation's largest firms have tapped the corporate bond market to an unprecedented extent. The amount of debt capital raised by large US companies in the first half of this year was ***double*** the previous six-month total recorded in 2017, helping many larger companies withstand liquidity and cash flow strains resulting from the collapse in revenues. Some small and mid-sized companies benefited from the US Treasury's lending program, but many have not, and will be forced to shut their doors.

The primary economic repercussion will be a marked ***consolidation*** phase in many domestic industries over the next three years, as large companies become bigger and stronger, at the expense of small- and medium-sized businesses. Increased ***concentration*** in many key industries will result in higher profit margins for industry leaders, along with increased pricing power.

FEDERAL RESERVE POLICY

The thrust of monetary policy over the next two years is likely to differ from those of all previous economic recovery cycles, with the possible exception of the 2010 expansion cycle. Typically, fearful of generating inflation and excessive credit creation, the Federal Reserve is quick to shift from excessive monetary stimulus to a neutral policy, once there is confirmed evidence that a sustained economic recovery is firmly in place. This is unlikely to be the case in the current cycle.

Because of the unique nature of the coronavirus recession — and the severity of the shock to the demand side of the economy— the Fed will likely maintain an accommodative policy for an extended period, and for much longer than has been the case in the typical cycle. The Fed is also likely to be spooked by the likely protracted period of very high unemployment and chronic fears of deflation.

Policymakers are also fearful of a potential wave of business failures, delinquencies, and defaults on consumer loans, and a sharp increase in the corporate bond default rate, all of which is highly deflationary. Because of its heightened fears over deflation, the Federal Reserve is determined to create inflation as ever before.

DEFLATIONARY PRESSURES

Core consumer inflation has declined from 1.8% to 1.0% in less than four months, and further weakness in likely, reinforcing the Fed's resolve to keep its foot on the accelerator. It is also likely that the Fed will not be content with an inflation rate of 2%, its long-term policy target.

The Fed has stated that because monetary policy has persistently undershot its 2% target for many years — core inflation has averaged only 1.6% over the past decade — a period of above-target inflation would be appropriate, and would likely be tolerated. If so, this insurance policy against deflation could result in ***unintended consequences***, in the form of a higher inflation rate beyond the next two years.

My forecast assumes that the Federal Reserve will keep its policy rate at zero throughout 2022, at a minimum. I also assume that the Fed will continue to provide large amounts of liquidity to the financial system through outright purchases of government and corporate bonds and through direct loans to businesses. *The bottom line is that the Fed is virtually assured of overstaying its welcome with monetary support, with the potential of creating a worrisome inflation cycle in the years after 2022*.

LONG-TERM INTEREST RATES

Long-term interest rates tend to lead the economy at economic turning points, typically reaching their cyclical bottom six months prior to the end of recessions. The behavior of government bond yields is likely to follow a different path in the current cycle, in two respects:

1. The cyclical low in government bond yields was ***coincident*** with the end of the recession. The yield on the ten-year US Treasury bond bottomed at 0.55% in late March and early April just as the recession was hitting bottom, and has risen to only 0.65%.

2. Long-term interest rates are likely to remain depressed for an unusually extended period. There is unlikely to be the usual snapback in yields that typically occurs in the early recovery phase. The yield on the ten-year Treasury bond is virtually unchanged from its record low from four months ago.

During the previous recession, the market yield on the ten-year Treasury bond hit bottom at a market yield of **2%** at the end of 2009, and quickly **doubled to 4%** within a period of only six months. The average yield on the Treasury bond was 3.75% during the first three months of 2010. It seems highly unlikely that government bond yields will rebound as quickly and forcefully over the next year.

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Bloomberg Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index: Measures the performance of rules based, market value-weighted inflation protected securities issued by the U.S. Treasury. It is a subset of the Global Inflation-Linked Index (Series-L).

CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

MSCI World Ex US Index: Measures the performance of the large and mid-cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

S&P 500® Index: The S&P 500 or Standard & Poor's 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies.

S&P 500 Equal Weight Index (EWI) Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

Value Line Index is the equal-weight version of the widely-used S&P 500. The index includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight - or 0.2% of the index total at each quarterly rebalance.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.