



IS THE ECONOMIC GLASS HALF FULL OR HALF EMPTY?

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I have not changed my forecast of a U-shaped economic recovery in 2020 and 2021, but have reduced the expected growth rates for GDP. The untimely resurgence in new COVID-19 cases and hospitalizations will slow the pace at which the economy reopens, which means that the trajectory of the recovery will be slower than previously anticipated. The exponential rise in cases could even result in renewed lockdowns, as preventative measures are reinstated. The expansion is unlikely to falter: A double-dip recession becomes likely only in the event of another nationwide lockdown, which appears to be a low probability at this time.

Summary and Major Conclusions:

- The focus of US equity investors continues to alternate between steadily improving economic data and the worsening trend in the COVID-19 pandemic. Investors have cheered the reopening of the economy in May and June and the positive trend in economic data.
- At the same time, some investors have become more risk averse in response to the sudden surge in COVID-19 infections and hospitalizations. The result has been a stampede into a select group of mega-cap technology stocks and an aversion to economically sensitive stock groups.
- The US economy has been in a sharp recovery from its point of maximum weakness in April. However, strong growth rates in key indicators are misleading because they are a measure of recovery from an extremely depressed base.
- A more useful framework for investors is the absolute level of activity, rather than the percentage growth rate. The manufacturing sector is operating at roughly 65% of capacity, well below its normal operating rate of 80%. Most depressed are the recreation, leisure, and hospitality industries.
- The US labor force is operating well below normal, with the official unemployment rate at 11%, compared with an estimated full employment rate of 5%. A broader definition of underemployment is 18%, while more than 25% of workers are underemployed and have suffered a reduction in wages and hours worked.
- Assuming a moderate pace of recovery in economic activity over the next 12 months, I expect the level of real GDP to return to its 2019 peak during the second half of next year. It may take corporate earnings a bit longer to return to their 2019 peak, perhaps by early 2022.
- The number of US workers on nonfarm payrolls is currently 10% below the peak level earlier this year, and is unlikely to return to that level until 2022. Worse, the unemployment rate is a notable lagging indicator, and is unlikely to return to full employment until 2023 or 2024.
- An abundance of underutilized resources suggests that inflationary pressures will be very slow to build, thereby keeping costs under control. Moreover, companies will have limited pricing power and workers even more limited bargaining power.

- The implication is that consumer inflation will remain below the Federal Reserve's official long-term target of 2% for an extended period. A combination of unusually low inflation and highly accommodative monetary policy should exert persistent downward pressure on long-term interest rates.
- Risk assets such as common stocks will remain vulnerable until there is greater clarity with respect to the future path of company earnings. A resumed upward trend in corporate profitability is predicated upon a healthy economy, which in turn is dependent upon a stabilization in COVID-19 infections.
- Financial market conditions are likely to shift in response to announcements of medical breakthroughs, expected later this year. Prospects for a more complete reopening of the US economy should lift economic confidence, thereby triggering a rising trend in both stock prices and bond yields.
- Continued low interest rates and inflation should support higher price-to-earnings (P/E) ratios. In the current environment, a P/E of 20x is justified, assuming that US Treasury bond yields remain below 2%. P/E ratios averaged 16x over the past 25 years, when the yield on ten-year Treasury bonds averaged 3.85%.
- Favorable equity and fixed-income market trends could persist throughout 2022, at a minimum. The improvement in economic confidence should be the catalyst for a shift in equity market leadership from growth stocks to value stocks.

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.

COULD YOU SUMMARIZE THE CURRENT STATE OF THE US ECONOMY?

The US economy has been in a recovery from its point of maximum weakness in April. The rate of change in key variables — most notably employment, retail sales, factory orders, and housing construction — appears to be robust, but these strong growth rates are misleading because they measure the recovery from its extremely depressed base in April.

A more useful framework within which to monitor economic conditions is the **absolute level** of activity, rather than the percentage growth rate. In addition, to the extent that public health conditions begin to deteriorate markedly in the near future, it should be understood that May and June economic data will become **obsolete lagging indicators**, and therefore less relevant in forecasting future trends.

HOW DEPRESSED IS THE LEVEL OF ECONOMIC ACTIVITY RELATIVE TO NORMAL?

The answer varies from industry to industry. The manufacturing sector is operating at roughly 65% of capacity, well below its normal operating rate of 80%. The financial services sector is operating at a much higher rate because of a greater potential for remote work and greater ease of virtual communications with clients.

Most depressed are the recreation, leisure, and hospitality industries. Airlines are operating at only one-third of capacity, while restaurants are operating at close to 40%. Hotel occupancy rates are less than 50% nationwide. Gasoline consumption — which is a proxy for aggregate miles driven — has rebounded from only 60% of capacity at its low to 90% currently.

Finally, the US labor force is operating well below normal, with the official unemployment rate at 11%, compared with an estimate of 5% for full employment. A broader definition of ***underemployment*** is 18%, while the broadest measure of labor market weakness is at 25%. This latter metric includes all workers who are underemployed, plus those who have suffered a reduction in wages and hours worked.

HOW LONG WILL IT TAKE FOR THE US ECONOMY TO RETURN TO NORMAL?

Assuming a moderate U-shaped recovery over the next 12 months — followed by accelerating growth later next year — I expect the level of real GDP to return to its 2019 peak during the second half of 2021. *However, GDP is only one measure of normal.* It will take *corporate earnings* a bit longer to return to their 2019 peak, perhaps during early 2022. The labor market will be the last segment of the economy to be restored to normal.

The number of US workers on nonfarm payrolls is currently more than 14 million, or 10% below the peak level earlier this year — and is unlikely to return to that peak until 2022. Worse, the unemployment rate is a notable lagging indicator, and is unlikely to return to full employment — estimated at approximately 5% — until 2023 or 2024. In short, the US economy is likely to remain below normal operating equilibrium for an extended period.

WHAT ARE THE IMPLICATIONS OF THIS SO-CALLED 90% ECONOMY?

The socioeconomic repercussions are most worrisome. Income inequality is likely to worsen until the economy is firing on all cylinders. ***The primary economic impact will be on employment, interest rates, and inflation.*** The labor market will likely remain below full employment for many years. An abundance of underutilized resources suggests that inflationary pressures will be very slow to build, thereby keeping costs under control. Moreover, companies will have limited pricing power and workers even more limited bargaining power.

The implication is that consumer prices will remain below the Federal Reserve's long-term target of 2% for an extended period. Without appreciable pricing power, firms will attempt to restore profit margins through tight control on labor costs and staffing, a highly deflationary force. A combination of unusually low inflation and highly accommodative monetary policy should exert downward pressure on long-term interest rates.

HOW HAS YOUR ECONOMIC FORECAST CHANGED?

I have not changed my forecast for a U-shaped economic recovery, but I have changed the expected growth rates for GDP. Simply put, the untimely resurgence in new COVID-19 cases and hospitalizations will slow the pace at which the economy reopens, strongly suggesting that the trajectory of the recovery in business activity will be slower than previously anticipated.

The exponential rise in cases could possibly result in renewed lockdowns, as preventative measures are reinstated. Nonetheless, the fragile in-process economic recovery appears sustainable, implying a low probability of another outright recession. A double-dip recession becomes likely only in the event of another nationwide lockdown, which appears to be a low probability at this time.

COULD YOU DISCUSS HOW THE OUTLOOK FOR THE CORONAVIRUS PANDEMIC MIGHT AFFECT YOUR FORECAST?

It is striking how quickly public health conditions within the US have deteriorated. It is especially shocking considering the excellent progress made by most countries in Europe and Asia. While daily new infections in the US reached a record of 71,000 on Saturday, new cases in Canada, Europe, and Asia have **declined by more than 90%** from peak levels in the spring. Daily new infections in Italy have plunged from a peak of 6,550 in late March to only 188 on Saturday, a decline of **97%**.

Statements from the White House that the surge in confirmed cases is simply a result of increased testing are both deceptive and inaccurate. The surge in hospitalizations along with a near doubling of the **positivity rate** from 5% to close to 10% are indicators of the increased severity of the pandemic within the US. The reproduction rate is currently above the 1.0 threshold in 42 states. The number of tests daily has risen to more than 650,000, but testing has actually slowed in recent weeks because of disruptions to supply.

In short, public health conditions are deteriorating at an alarming clip and future trends are impossible to predict with any degree of accuracy. It is not advisable for investors to either extrapolate current trends or predict a spontaneous peak any time soon. COVID-19 is obviously the major wild card in the outlook.

COULD YOU DISCUSS THE POSSIBLE INVESTMENT IMPLICATIONS?

Risk assets such as common stocks will remain vulnerable until there is greater clarity with respect to the future path of the coronavirus pandemic. Beyond the near term, the investment implications could be quite positive during a period when the economy is simultaneously on a sustained recovery path and productive resources are underutilized. Common stocks should be notable beneficiaries of this somewhat counterintuitive scenario, for at least three reasons:

- Low interest rates and inflation are consistent with higher price-to-earnings (P/E) ratios. In the current environment, a P/E of 20x is justified, assuming that US Treasury bond yields remain below 2%. This compares with an average P/E of 16x over the past 25 years, when the market yield on ten-year US Treasury bonds averaged 3.85%.
- Historically, business cycle recoveries that began at a time when resource utilization was depressed proven to be more sustainable and of longer-than-average duration. The equity market typically performs best during moderate-growth expansions that become stretched over many years — as was the case in the 2009-to-2019 business expansion cycle.
- An extended period of extremely accommodative monetary policy, as expected under these conditions, would also provide a powerful support to the equity market as excess liquidity exerts upward pressure on asset prices.

HOW WOULD YOU CHARACTERIZE CURRENT EQUITY MARKET CONDITIONS?

Global equity markets are currently in a mode of rapidly recurring gyrations, as investors struggle to distinguish between challenging short-term forces and a generally favorable long-term outlook. Consequently, widespread uncertainty regarding public health trends should place a cap on stocks prices until there are concrete signs that the crisis is being resolved.

The equity market **consolidation phase** that began in early June could persist for a number of months, with stocks fluctuating within a trading range. In this trading environment, investors are likely to remain risk averse, and continue to concentrate their portfolio holdings in the market leaders of the past six months. These include large-cap growth stocks in general, but in particular mega-cap technology, communications, and media stocks.

Since the beginning of this year, the Russell 3000 Growth Index has *risen* by 14%, while the Russell 3000 Value Index has *declined* by 18%, ***a staggering absolute performance gap of 32%*** occurring within a space of less than seven months. *Value stocks will become sustained market leaders only when there is concrete evidence that the pandemic is under control.* A combination of attractive valuations and prospects for faster relative earnings growth could favor value stocks for the next several years.

INVESTMENT CONCLUSIONS

Financial markets are likely to take their cue from public health rather than economic data. The direction of both stock prices and long-term bond yields could be sideways through the summer and early fall. However, at some point within the next six months, financial market conditions are likely to shift dramatically in response to announcements of public health breakthroughs.

The combination of one or more vaccines and therapeutic treatments should pave the way for a dismantling of shelter-in-place practices and greater economic mobility. Prospects for a more complete reopening of the US economy should lift economic confidence, thereby triggering a rising trend in both stock prices and bond yields. These equity and fixed-income market trends could persist through 2022, at a minimum.



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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 quantitatively 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.

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