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Economic Perspective
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EMPLOYMENT, CONSUMER SPENDING, BUSINESS FAILURES, AND FISCAL POLICY

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There are four economic variables that are of crucial importance for the unfolding of business trends for the remainder of this year and during 2021: Employment; consumer spending; credit losses, delinquencies and defaults, and business failures; and fiscal policy. The interaction of these four variables will be instrumental in determining the path of economic recovery. The health of the household and business sectors is tightly interwoven, as are the strength of the labor market, business solvency issues, and the future path of fiscal policy.

Summary and Major Conclusions:

- The US economy and financial markets continue to be buffeted by powerful crosscurrents, as reopenings in many states have been partially offset by a return to more stringent social distancing practices in many other states.

- The surge in new infections since early June has had a devastating impact on certain regions and sectors of the economy. States accounting for nearly three-quarters of US GDP have either halted their reopenings or reinstituted new social distancing measures.

- It seems plausible to assume that the coronavirus pandemic will be a depressant on the global economy until there are one or more vaccines available for mass inoculation. My assumption is that vaccines will be approved later this year and available for mass distribution during 2021.

- The next six months could present enormous economic challenges. Although the current surge in infections in the south and west could run its course before summer end, the odds of a second wave of coronavirus infections in the fall and winter are in excess of 50%.

- Following a sharp V-shaped recovery in May and June, the US economy has exhibited a clear loss of momentum in July, as the resurgence in COVID-19 cases in sunbelt and southwestern states has resulted in a reinstatement of safety measures, prompting reduced mobility across the country.

- I have lowered my projected growth rates for GDP. The untimely resurgence in new COVID-19 cases will slow the pace at which the economy reopens, which means that the trajectory of the recovery will be slower than previously anticipated.

- There are four economic variables that are of crucial importance for the unfolding of business trends for the remainder of this year and during 2021: Employment; consumer spending; business failures; and fiscal policy. The interaction of these four variables will be instrumental in determining the path of economic recovery.

- A central theme in my forecast is that consumers, rather than businesses, are the key to economic recovery. However, the health of the household and business sectors is tightly interwoven, as are the strength of the labor market and the future path of fiscal policy.

- A declining trend in wages and salaries along with tighter lending standards by banks means that growth in personal consumption will be reliant upon job creation and fiscal stimulus to an unusual extent.

- Following a sharp rebound in May and June, US labor market conditions appear to be deteriorating. The strong pace of job creation in the spring months is rapidly losing momentum — as measured by weekly unemployment insurance data — and is arguably the best high-frequency measure of domestic economic activity.

- The labor market continues to be buffeted by two opposing forces: Re-hiring of furloughed workers and layoffs of workers classified as permanently employed, as businesses manage staffing levels in an uncertain environment. Since May, re-hiring of furloughed workers has outpaced new layoffs, but this trend could easily reverse.

- Additional fiscal stimulus is crucial for sustaining the economic recovery. Failure to provide supplemental funds for key sectors of the economy would culminate in an immediate decline in spending by both households and businesses. Unemployment benefits for the average worker are scheduled to decline by 60% on August 1.

- The failure of the House and Senate to agree to a compromise spending bill of a minimum $2 trillion could be disastrous for employment, consumer spending, state and local governments, and the survival of many small businesses.

- Assuming passage of a new fiscal package, the probability of a double-dip recession is low, although the odds have clearly increased since the outbreak in new coronavirus cases. High levels of cumulative pent-up demand and ongoing monetary policy stimulus should support at least a moderate recovery in spending through the first half of next year.

The US economy and financial markets continue to be buffeted by powerful crosscurrents, as reopenings in many states have been effectively offset by a return to more stringent social distancing practices in many other states. *Twenty-two states have either reversed or paused reopenings*. Just three states — California, Texas, and Florida — account for **44%** of new coronavirus cases reported daily, but only slightly more than one-quarter of the total US population. Conversely, four northeastern states — New York, New Jersey, Connecticut, and Massachusetts — account for less than **3%** of total new cases, but 12% of the population.

On the policy front, while the Federal Reserve continues to provide maximum support for the economy and financial markets, fiscal policy support is fading, as the vast majority of the original $2.8 trillion fiscal package passed in March has already been spent. Another spending package from Congress is desperately needed, but passage prior to the election is far from a sure thing, as partisan politics becomes a formidable obstacle.

This week's *Economic Perspective* examines the likely path of the economy during the remainder of this year, with a focus on the crucial interaction among labor markets, consumer spending, business solvency, and fiscal policy.

COULD YOU PROVIDE AN UPDATE ON CURRENT ECONOMIC TRENDS?

Following a sharp V-shaped recovery in May and June, the US economy has slowed in July, as the resurgence in COVID-19 cases in sunbelt and southwestern states has prompted a reinstatement of safety measures, resulting in reduced mobility across the country. The predictable result is a sideways movement in many measures of economic activity.

The surge in new infections since early June has had a devastating impact on certain regions and sectors of the economy. According to Moody's Analytics, *states accounting for nearly three-quarters of US GDP have either stopped their reopenings or reinstituted new social distancing measures*.

These restrictive measures will be reflected in softening July data on consumer spending, employment, and travel. Following 14 consecutive weekly declines since early April, *initial jobless claims* for the week ending July 11 were essentially flat with the previous week at 1.3 million and above economist predictions. *Google mobility data* indicated that travel to retail, recreational, and work destinations has slowed markedly.

As I have been saying since the onset of the pandemic, *the path of both the economic recovery and financial markets will be driven by trends and developments in the public health arena*.

WHAT ARE YOUR ASSUMPTIONS REGARDING THE CORONAVIRUS PANDEMIC?

It seems plausible to assume that the coronavirus pandemic will be a depressant on the global economy until there are one or more safe and effective vaccines available for broad distribution. My assumption is that vaccines will be approved later this year and available for mass inoculation during 2021. Consequently, there is a reasonable likelihood that most of the public health constraints on the US economy will be minimal one year from now.

However, the next six months could be challenging. It is possible that the current surge in infections in the south and west will run its course before summer end, assuming consistent use of face masks, increased testing capacity, and adherence to other social distancing practices. However, this possible plateau in cases could be followed by a second wave of coronavirus infections in the fall and winter.

HOW ARE THESE ASSUMPTIONS INTEGRATED INTO YOUR ECONOMIC FORECAST?

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 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 more gradual than previously anticipated.

The exponential rise in cases could even result in renewed lockdowns in some states and regions, 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.

COULD YOU DISCUSS THE CRITICAL INDEPENDENT VARIABLES ASSOCIATED WITH YOUR ECONOMIC FORECAST?

There are four economic variables that are of crucial importance regarding the unfolding of business trends for the remainder of this year and during 2021: Employment; consumer spending; credit losses, delinquencies and defaults, and business failures; and fiscal policy. *The interaction of these four variables will be instrumental in determining the path of economic recovery*. A central theme in my forecast is that consumers, rather than businesses, are the key to economic recovery. However, *the health of the household and business sectors is tightly interwoven, as is the strength of the labor market and the future path of fiscal policy*.

COULD YOU ELABORATE ON THE LINKAGES AMONG THESE FOUR VARIABLES?

I would start with the basic conclusion that a sustained economic recovery is heavily dependent upon consumer spending. However, a declining trend in wages and salaries along with tighter lending standards by banks means that ***growth in personal consumption will be heavily reliant on job creation and fiscal stimulus***.

Because the funds from the original $2.8 trillion relief package are nearly exhausted, a second fiscal spending package is badly needed. The risk is that intense divisiveness between the House and the Senate will block passage of another relief package. *Failure of Congress to reach an agreement would almost certainly end in a double-dip recession*.

The other critical driver of consumer spending is employment. *Future labor market trends are predicated upon two conflicting forces: Re-hiring of furloughed workers partially offset by a new wave of layoffs among workers classified as permanently employed, as firms adjust to changing demand trends*. Layoffs are also resulting from business failures, especially among small and mid-sized firms. A breakdown of monthly labor market data tells the story: Since their peak of 152.5 million in February, nonfarm payrolls are currently lower by 14.5 million, or nearly 10%.

WHAT IS THE OUTLOOK FOR EMPLOYMENT?

Despite a sharp rebound in May and June, US labor market conditions appear to be deteriorating. The strong pace of job creation in the spring months is rapidly losing momentum, as measured by weekly unemployment insurance (UI) data — arguably the single best high-frequency measure of domestic economic activity. For the week ending July 11, initial jobless claims remained stuck at over 1.3 million filings, a manifestation of a continued heightened level of layoffs.

As discussed above, the labor market continues to be buffeted by two opposing forces: Re-hiring of furloughed workers and layoffs of permanently employed workers, as businesses manage staffing levels in an environment of reduced final demand. Since May, re-hiring of furloughed workers has outpaced new layoffs, *as evidenced by the decline in continuing claims for unemployment insurance benefits*, which have fallen from a peak of 25 million on May 8 to 17.5 million currently.

However, this favorable trend could reverse direction — depending upon the trend in new COVID-19 infections — as more stringent social distancing guidelines are put into effect. This regrettable scenario would force businesses to retrench further, as would a worsening trend in business failures and bankruptcies.

TO WHAT EXTENT IS GROWTH RELIANT UPON ADDITIONAL FISCAL STIMULUS?

Additional fiscal stimulus is crucial for sustaining the economic recovery. Failure to provide supplemental funds for key sectors of the economy would culminate in an immediate decline in spending for both households and businesses.

- Unemployment benefits for the average worker are set to decline by 60% in August.

- Government funds for small businesses under the Paycheck Protection Program (PPP) are nearly exhausted and need additional funding.

- Many state and local governments are hemorrhaging red ink because of a collapse in tax revenues and rising spending. The failure of Congress to agree to a compromise spending bill of a minimum $2 trillion could be disastrous for employment, consumer spending, and the survival of many small and medium-sized businesses.

HOW WOULD YOU SUMMARIZE YOUR THOUGHTS ON THE US ECONOMY?

The US economy is at an important juncture. The resurgence of COVID-19 infections in many southern and western states is resulting in widespread increases in social distancing guidelines and restrictions, along with a declining trend in social and commercial mobility. Even partial regional shutdowns will weigh heavily on economic activity, most notably consumer spending, employment, services, transportation, and manufacturing.

Following broadly based strength in May and June, economic data in July and beyond could weaken sequentially. The probability of a double-dip recession is low, but cannot be ruled out and has increased since the outbreak in new coronavirus cases. The worst-case scenario would be severe and widespread lockdowns across many regions, thereby impacting a large swath of the American economy.

In the end, high levels of cumulative pent-up demand and ongoing monetary policy stimulus should support at least a moderate expansion in aggregate output and spending through yearend. The economy will not be truly out of the woods until there are one or more vaccines available in mass quantities, expected in 2021.

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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.