MID-QUARTER ECONOMIC REVIEW

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An assessment of the US equity market must differentiate between pre-vaccine and post-vaccine environments. The absence of sustained sequential growth in GDP and company earnings through yearend implies a sideways trend in the equity market for much of the remainder of this year. While a major market sell-off is unlikely, equity investors should be prepared for a potential decline of 10% or more. The outlook for common stocks should improve later this year and during 2021. Availability of a vaccine early next year should allow for a more aggressive restarting of the economy, which should reinforce investor confidence regarding the prospects for growth in company earnings and dividends.

Summary and Major Conclusions:

- Although I have not changed my economic outlook for a U-shaped recovery, I have lowered the probability of this outcome and increased the odds of alternative scenarios less favorable to financial markets.

- Following a sharp V-shaped rebound in May and June, the US economy lost momentum in July. Lack of visibility with respect to public health trends means that the economic outlook is extremely unpredictable at this time, with negative implications for financial markets.

- The systematic relationship among new COVID-19 cases, the level of social distancing, and the direction of the economy is indisputable. The outbreak in new infections since mid-June is reflected in an abrupt slowdown in economic growth.

- Business activity collapsed in March and April in direct response to the abrupt nationwide shutdown during those months. US GDP contracted by 9.5% between Q1 and Q2, or 33% at an annual rate, the worst quarterly decline on record.

- The steep decline in new infections in April and May allowed companies to resume business, workers to return to their jobs, and consumers to spend. As a result, nearly one-half of GDP lost in March and April was recovered in May and June. Third quarter US GDP could expand at a 15% to 20% annual rate.

- The domestic economy is currently on a plateau, caused by a rapid increase in new coronavirus infections nationwide since early June. Aggregate spending and output are likely to move in a general sideways pattern until medical breakthroughs clear the way for an aggressive restarting of the economy.

- In a broad multiyear context, the contour of the economy will likely shift from a sideways plateau to a U-shaped recovery, with the rate of economic growth beginning to accelerate as 2021 unfolds.

- The Federal Reserve is unlikely to begin to raise its policy rate until 2023 at the earliest, and will continue to provide additional liquidity to the financial system through quantitative easing until economic growth is on a sustained upward path.

- As of this writing, Congress has been unable to agree on a badly needed stimulus package to support the economy through yearend. The failure of Congress to pass another federal relief package for households, businesses, and state and local governments would greatly increase the odds of a double-dip recession.

- Contrary to its classic role as a lagging indicator, employment is the most important independent variable with respect to achieving a durable and sustained business expansion. A sustained recovery in consumer spending and business investment is unlikely, absent healthy growth in employment.

- Inflationary pressures are likely to remain dormant for the foreseeable future. My forecast assumes that consumer inflation will average 1.5% over the next 12 months, but not reach 2% until late 2022 or early 2023.

- Unsurprisingly, the collapse in output has triggered a steep decline in US corporate earnings, which appear to be on track to decline by more than 35% for all of this year. Assuming improving public health conditions in 2021 and 2022 and a rebounding economy, earnings per share (EPS) could increase by 25% and 20%, respectively.

- Following an estimated 8% contraction this year, real GDP growth in the eurozone could increase at a 4% rate in 2021 and a 3% pace in 2022. The level of real GDP might not return to pre-COVID output until 2023 or 2024.

- The Chinese economy is leading the rest of the world in recovery from recession. While further strengthening in China's economy appears likely over the next year, its rate of growth could be constrained by its record high ratio of debt to GDP.

- The fixed-income market offers minimal appeal to long-term investors on a risk/reward basis. With current yields at rock-bottom levels, bond investors should expect negative rates of return over the next several years, as market interest rates gradually drift higher.

- An assessment of the US equity market must differentiate between a pre-vaccine and post-vaccine environment. In the absence of a vaccine, sluggish growth in GDP and company earnings through yearend implies a sideways-to-lower trend in the equity market.

- While a major market sell-off is unlikely, equity investors should be prepared for a potential decline of 10% or more. The outlook for common stocks should improve later this year and during 2021, assuming good news on the medical front.

- Availability of a vaccine early next year should allow for a more aggressive restarting of the economy, which should reinforce investor confidence regarding the outlook for company earnings. The combination of an upward path in earnings, very low interest rates and inflation, and continued expansionary monetary conditions should also support a durable rally in stock prices.

- Growth stocks should continue to be market leaders until public health conditions improve sufficiently for a robust revival of economic growth. A decisive shift in favor of value stocks will occur only when investors are confident that the world economy has exited the danger zone posed by the global pandemic.

- Similarly, non-US stocks will begin to outpace the domestic equity market, following more than a decade of underperformance. The catalyst for a shift in leadership will be concrete evidence that the world economy has entered a solid recovery path and that the US dollar is in retreat.

Following a sharp V-shaped rebound in May and June, the US economy lost momentum in July. It appears likely that the surge in spending, output, and employment in May and June is not sustainable, and that a flattening or even mild contraction in spending is likely in coming months, consistent with widespread restrictions on social and economic mobility. Lack of visibility with respect to public health trends means that the economic outlook is extremely unpredictable at this time, with negative implications for financial markets.

THE CORONAVIRUS AND THE ECONOMY

- The *systematic relationship* between new COVID-19 cases, the level of social distancing, and economic data is indisputable. Future economic growth is heavily dependent upon the well-established *negative feedback loop* between public health trends and the rate of utilization of economic resources.

- Business activity collapsed in March and April in direct response to the abrupt nationwide shutdown during those months. US GDP contracted by 9.5% between Q1 and Q2 — or 33% at an annual rate — the worst quarterly decline on record. The unemployment rate spiked to nearly 15% in April, the highest level since the 1930s.

- The steep decline in new infections in April and May allowed companies to resume business, workers to return to their jobs, and consumers to spend. *As a result, nearly one-half of the GDP lost in March and April was recovered in May and June*. However, this sharp rebound proved to be short-lived: The domestic economy is currently on a plateau, caused by a rapid increase in new infections nationwide since early June.

- The deterioration in public health conditions has led to a reversal in reopenings and a stricter framework of social distancing mandates. *As of the middle of July, states accounting for approximately 75% of total US GDP have either paused or sharply reversed the reopening of their economies*.

- The most likely path for the US coronavirus epidemic is for rolling outbreaks across the country until a vaccine is available. Initial signs of a second wave are beginning to appear in the Midwest, most notably in Illinois, Wisconsin, Michigan, and Missouri, as renewed reopenings have increased the level of transmission. The implication of this scenario of rotating infections across states is a flattish trend in economic output.

MACROECONOMIC TRENDS

- High-frequency economic data for the second half of June and all of July reflect a renewed weakening in spending and output, along with net job losses. The expected 12% to 15% annualized growth in third quarter GDP can be explained by purely *statistical factors and so-called base effects*: On a sequential month-to-month basis, real GDP between June and September will be seen as a plateau. A generally flat trajectory of GDP is likely to persist in coming months.

- The housing market is the strongest sector of the domestic economy, and is experiencing a V-shaped recovery, propelled by record-low mortgage rates, massive pent-up demand, and favorable demographics. The index of pending home sales is at the highest level in 15 years, while single-family construction is on a steep incline. The homeownership rate (68%) has surged to the highest level since 2006.

- The economic outlook for the next year and beyond is dependent upon FDA approval of one or more vaccines in quantities of hundreds of millions of doses. Production and distribution to the public is expected to begin in the first half of next year, but the actual timing could be a wild card in the outlook. Whenever it might take place, availability of a vaccine should lead to a change in behavior and a significant restarting of the US economy, presumably in the first half of next year.

- In the interim, the trajectory of the economy in coming months will likely be sideways and resemble a plateau, assuming a continued high level of confirmed new cases and hospitalizations. A more severe second wave of COVID-19 in the fall and winter could trigger aggressive regional lockdowns, resulting in a mild contraction in quarterly GDP and rise in unemployment — although any setbacks to growth would likely be far less severe than during March and April.

- Decisions regarding school openings in September could have a significant impact on economic activity. The extent to which students are required to receive online instruction at home will affect the labor market, as parents struggle to balance work and childcare. Most susceptible to job instability are parents with children between the ages of 5 and 12, representing 15 million households nationwide.

- In a broad multiyear context, the contour of the economy will likely shift from a sideways plateau to a U-shaped recovery, with the rate of economic growth beginning to accelerate as 2021 unfolds. Real GDP could grow at a 6% annual rate during the second half of next year and first half of 2022, before settling into a sustainable 2.5% long-term growth path thereafter.

- There are numerous supports for sustained economic growth beyond this year, including the following: (1) A continued boom in residential construction; (2) Massive pent-up demand for consumer and capital goods and services; (3) Continued unprecedented monetary stimulus; (4) Restocking of depleted inventories; and (5) A continued secular boom in digitalization and communications.

- *An important long-term economic theme is industry consolidation*, as market leaders capitalize on the current unprecedented economic and financial stress, and gain market share at the expense of smaller competitors. The relentless trend in digitalization of the economy will benefit large companies that possess scale because of their capacity to more easily implement productivity-enhancing applications.

GOVERNMENT POLICY

- The Federal Reserve has been extremely successful in supporting credit markets and the financial system, promising to do “whatever is necessary” to provide a solid foundation for the economy. The Fed is unlikely to begin to raise its policy rate until 2023 at the earliest, and will continue to provide additional liquidity to the financial system through quantitative easing (QE) until the economy is on a healthy and sustained growth path.

- As of this writing, Congress has been unable to agree on a badly needed stimulus package to support the economy through yearend. My assumption is that the House and the Senate will agree on a $1.5 trillion spending bill, which will provide funds for an extension of emergency unemployment insurance, another round of stimulus checks, and funds for state and local governments. The failure of Congress to pass another federal relief package for households, businesses, and state and local governments would greatly increase the odds of a double-dip recession.

EMPLOYMENT, INFLATION, AND EARNINGS

- Contrary to its classic role as a lagging indicator, employment is the most important independent variable with respect to achieving a durable and sustained business expansion. High-frequency data — most notably weekly jobless claims — signal a weakening in hiring and increase in layoffs. Last week’s increase in ***continuing claims*** implies that hiring is lagging layoffs. A sustained recovery in consumer spending and business investment is unlikely absent healthy growth in employment.

- Inflation data since March are the lowest in more than seven decades. Inflationary pressures are likely to remain dormant for the foreseeable future, although sustained deflation is unlikely. Core consumer inflation ***declined*** at a 1% annual rate in the second quarter, but has moved into positive territory in June and July. On a year-over-year basis, the core Consumer Price Index is rising at a 1.2% annual rate, the slowest pace since 2011.

- With unemployment in excess of 10% and capacity utilization below 67%, inflation is unlikely to reach the Federal Reserve's strategic target of 2% for an extended period. The Employment Cost Index — the best measure of worker compensation — rose at an anemic 2% annual rate in Q2, the slowest pace since 2017. My forecast assumes that consumer inflation will average 1.5% over the next 12 months, but not reach 2% until late 2022 or early 2023.

- Unsurprisingly, the collapse in output has triggered a steep decline in US corporate earnings. Following a year-over-year decline of 25% in Q1, earnings per share (EPS) for companies in the S&P 500 are on track to decline by more than 40% in Q2. For the full year, EPS could decline by more than 35%. Assuming much improved public health conditions during 2021 and 2022 — along with a rebounding economy — EPS could increase by 25% and 20%, respectively.

THE WORLD ECONOMY

- Following an estimated 8% contraction this year, real GDP growth in the eurozone could increase by 4% in 2021 and 3% in 2022. The level of real GDP might not return to pre-coronavirus output until 2023. The combination of a weak economy, record-low inflation, and a strong euro will encourage the European Central Bank (ECB) to maintain an ultra-accommodative policy for many years.

- Consistent with its early COVID-19 outbreak — along with draconian government-mandated lockdowns — the Chinese economy is leading the rest of the world in recovery from recession. Following its historic first quarter decline of 6.8%, China's GDP in Q2 registered an annual growth rate of 3.2%. While further strengthening in China's economy appears likely over the next two years, its rate of growth could be constrained by the country's record high ratio of debt to GDP.

- <u>A major theme in the outlook is a multiyear shift in leadership in foreign exchange markets</u>. The US dollar (USD) appears to be at a significant inflection point, following five years of extraordinary strength. From its February peak, the USD has declined by nearly 10% versus a basket of world currencies. The dominance of the USD over the past decade may be at an end, to the benefit of the eurozone, Japan, and emerging Asia.

- There are many factors contributing to a less favorable outlook for the dollar, which I will discuss in future weekly reports. A bulging federal budget deficit and a surge in the national debt are important factors, as is the rising uncertainty surrounding domestic politics. Last week, Fitch Ratings revised its outlook for US sovereign debt from stable to negative, citing the country's worsening public finances.

- A sustained decline in the US dollar would have significant economic and investment ramifications. *Most importantly, a weakening USD is a distinct positive force for world liquidity conditions, and therefore global economic growth*. With respect to the US, a lower dollar is supportive of exports and manufacturing in general. Domestic profits also benefit from a weak USD. As a countercyclical currency, the USD will weaken decisively when a global economic recovery is solidly in place.

FINANCIAL MARKET OUTLOOK

- The fixed-income market offers minimal appeal to long-term investors on a risk/reward basis, with current market yields on US Treasury bonds at 0.55% and investment-grade corporate bonds at 1.75%. The current market yield of only 5.35% on speculative-grade debt does not adequately compensate investors for the expected rise in defaults over the next year. Bonds should lag common stocks by a significant margin over the next several years.

- An assessment of the US equity market must differentiate between pre-vaccine and post-vaccine environments. The absence of sustained sequential growth in GDP and company earnings through yearend — as the economy remains compromised by the high level of infections — implies a sideways trend in the equity market for much of the remainder of this year. While a ***major*** market sell-off is unlikely, equity investors should be prepared for a potential decline of 10% or more.

- The outlook for common stocks should improve later this year and during 2021. Availability of a vaccine early next year should allow for a more aggressive restarting of the economy, which should reinforce investor confidence regarding the outlook for company earnings. The combination of an upward path in earnings, very low interest rates and inflation, and continued expansionary monetary conditions should support a durable rally in stock prices beyond this year.

- The US equity market is slightly overvalued. On the basis of the 12-month forward price-to-earnings (P/E) ratio of 22.5x for the S&P 500, large-cap stocks are above their five-year (17.0x) and ten-year (15.5x) averages, according to FactSet. *It should be noted that higher valuations for common stocks are warranted in an environment of record-low bond yields*. A close examination of economic sectors reveals *glaring divergences* within the overall market between overvalued and undervalued stock groups.

- Growth stocks should continue to be market leaders until public health conditions improve sufficiently for a robust revival of economic growth. *A decisive shift in favor of value stocks will occur only when investors are confident that the world economy has exited the danger zone posed by the global pandemic*. In the same way, non-US stocks will begin to outpace the domestic equity market when the world economy is on a solid recovery path and with the US dollar in retreat.

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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.

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