TRACKING THE UNCERTAIN PATH OF ECONOMIC RECOVERY

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Fiscal policy is a significant risk to the outlook. As I have discussed previously, another round of federal government outlays is badly needed to provide a bridge to 2021, when medical breakthroughs should permit a reopening of the economy. A new spending bill has been held hostage within Congress for weeks as the House and Senate are unable to agree on the vital details of the bill. In the absence of additional fiscal relief, I believe that the path of least resistance for aggregate output and spending is downward.

The US economy continues to strengthen, but at a moderate pace. Although the economy remains in recovery mode, business conditions appear tentative and fragile, while the recovery continues to lose momentum. Virtually all key measures of economic activity remain well below their peak levels from earlier this year. This Special Report provides an up-to-date assessment of current economic conditions along with an analysis of growth prospects over the next year.

- The central question faced by investors is the health and sustainability of the economic recovery that began in mid-April. Following a strong V-shaped rebound in May, the economy lost considerable momentum and is gradually approaching stall speed. An unexpected downturn could trigger a flight to safety in world financial markets and a sell-off in the high-flying US equity market.

- The direction of the economy remains hostage to public health developments. The critical issue is the extent to which a resurgence in COVID-19 infections and fatalities prompts another retrenchment on the part of businesses and consumers. A return to school and colder weather could be catalysts for a second wave of the pandemic during the remaining months of this year.

- There are numerous factors contributing to the murky short-term economic outlook. The ability to forecast the future path of economic growth is a daunting task because of heightened uncertainties associated with a wide range of economic, political, public health, and economic policy variables:

  - The path of COVID-19 deaths and a potential second wave of the pandemic
  - The speed of mass production of a vaccine approved for broad use
  - The successful inoculation of a large segment of the US population
  - The final outcome of Congressional negotiations regarding a relief package
  - The future direction of consumer confidence and household spending
  - The future path of business confidence and staffing decisions
  - Growing uncertainties associated with the November election

Chart 1: US Corporate Profits 25% Below Previous Peak
Operating Earnings US Corporations ($ Millions)
Source: Bureau of Economic Analysis

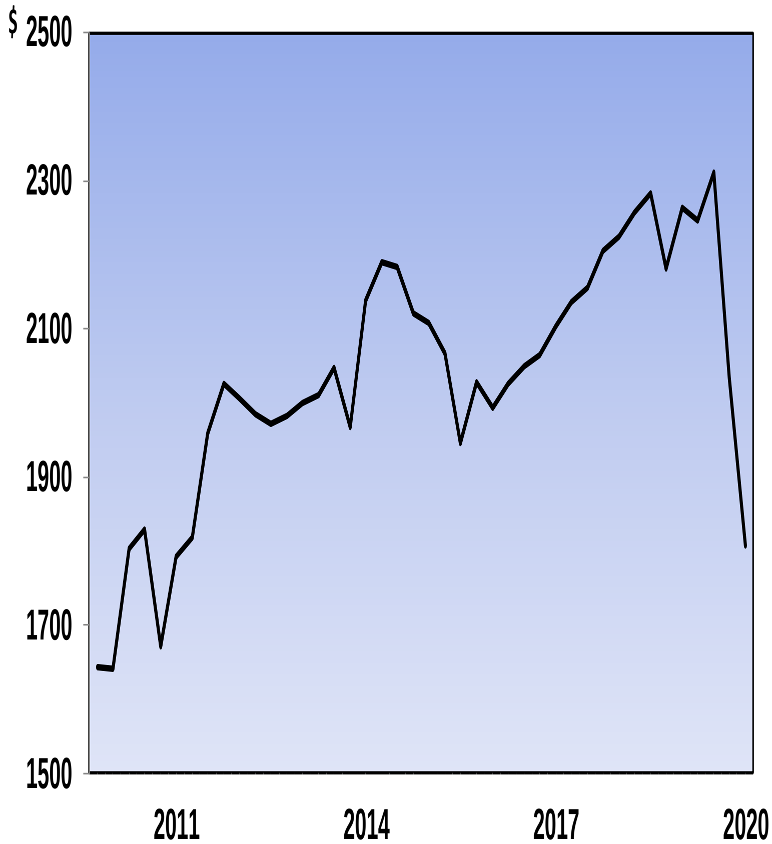
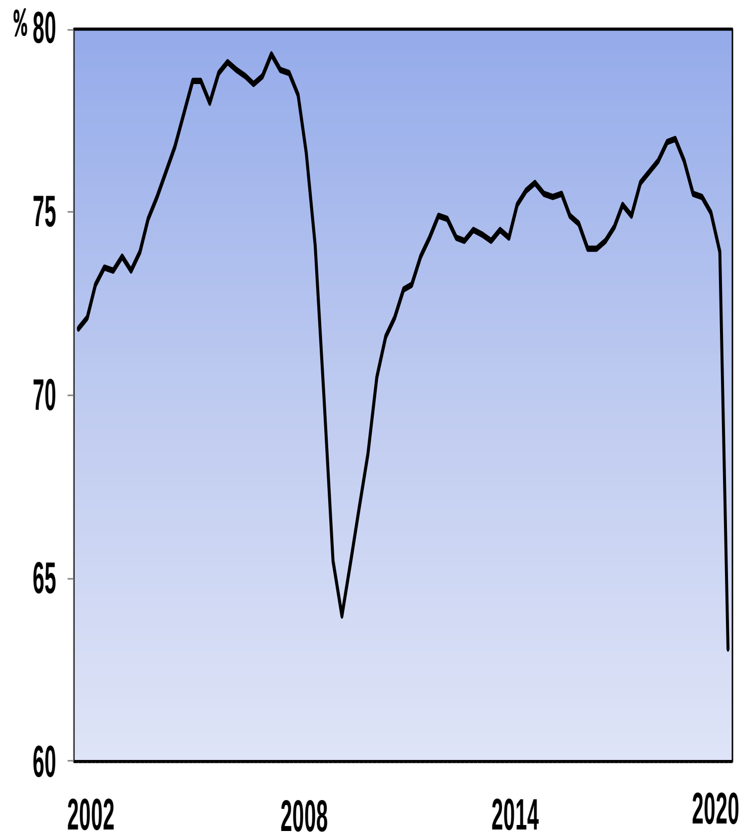


Chart 2: US Factories Operating at Less Than 70% of Capacity
Capacity Utilization (%) Rate Manufacturing Sector
Source: Federal Reserve



- There are a variety of metrics that gauge the extent to which current economic activity has fallen below normal. On the basis of second quarter GDP, the US economy is 10% below its previous peak. Based upon estimates for Q3 GDP, activity is 6.5% below its peak in the fourth quarter of last year. Capacity utilization in the manufacturing sector is at 69%, compared with a normal rate of 80% (see chart 1).

- Other key measures of economic activity portray a slightly different picture: Wages and salaries are down by 5% from their previous peak; both industrial production and private sector employment are down by nearly 10%; and operating profits for all US businesses are down by nearly 25% from their 2019 peak (see chart 2).

- In partnership with CNN Business, Moody's Analytics has created a comprehensive measure of economic activity called the ***Back-to-Normal Index***. This real-time gauge incorporates standard government data — jobless claims, factory orders, and housing starts — along with a wide range of daily and weekly data derived from private sources. This index measures the shortfall between the current level of economic activity and its peak on March 1.

Chart 3: Airline Bookings 75% Below Normal
TSA Passenger Travel, Number of Passengers Daily
Source: US Transportation Security Administration

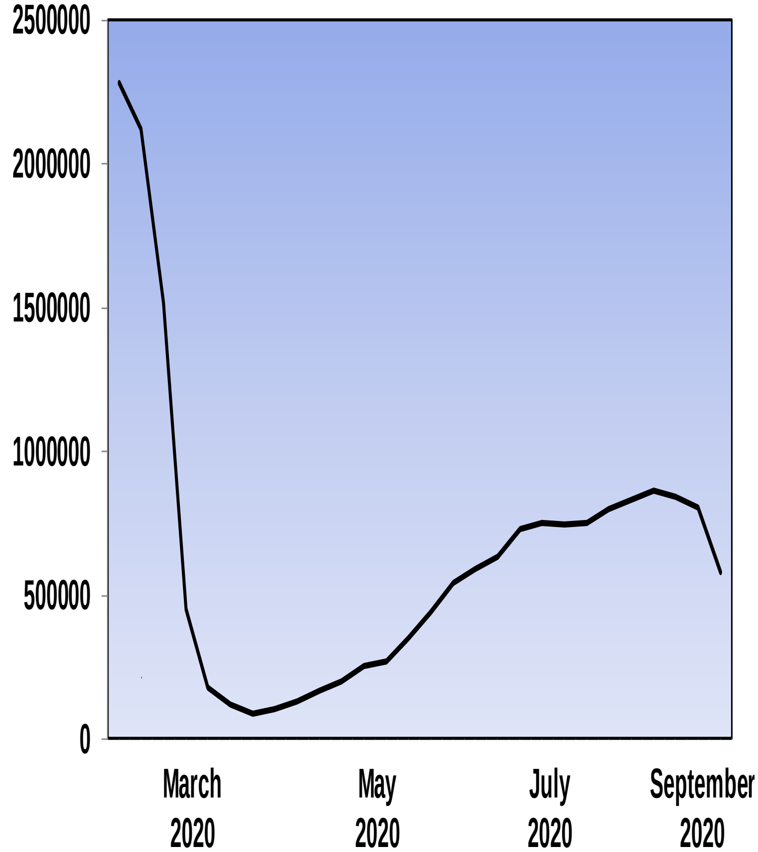
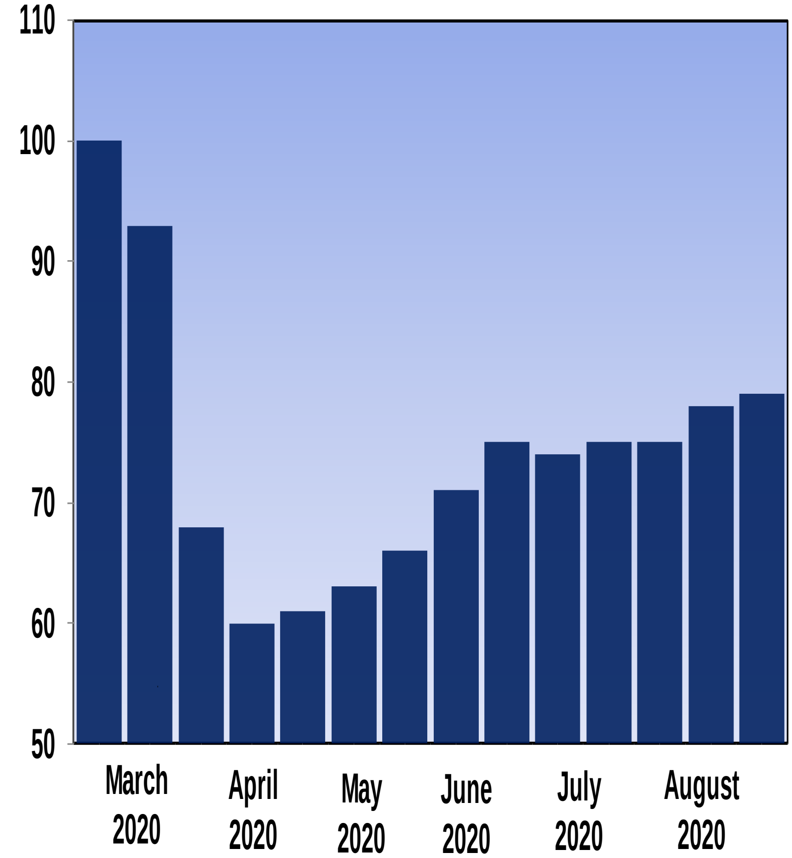


Chart 4: The US Private Sector Economic Activity Still 20% Below Normal
CNN Business/Moody's Analytics Back-to-Normal Index
Source: CNN/Moody's Analytics



- Index data from private firms include the following: Home listings (Zillow), restaurant bookings (OpenTable), rail traffic (American Association of Railroads), airline bookings (TSA), mortgage applications (Mortgage Bankers Association), weekly retail sales (Johnson Redbook), and weekly business confidence surveys conducted by Moody's Analytics (see chart 3).

- *This Back-to-Normal Index is currently at a level of slightly less than **80%** of its peak in February of this year, meaning that economic activity is more than 20% below its pre-pandemic peak*. The low point for this index was **59%** on April 17. The index rose steadily for the next two months through the middle of June, but has since flattened and moved sideways through the end of August (see chart 4).

- This sideways movement is at odds with the upcoming third quarter GDP report to be released on October 29. Economists are forecasting annualized GDP growth in excess of 25%, which would be the largest quarterly growth rate on record. *However, investors should interpret this report with considerable skepticism.*

- _The third quarter GDP report should be heavily discounted because of large statistical quirks in the quarter-to-quarter data that massively overstate the strength in the quarter_. In short, the Q2 GDP report should be viewed as a highly unrealistic gauge of underlying economic trends during July, August, and September.

- The Federal Reserve continues to view the economic outlook with trepidation and has promised to provide unlimited monetary support for as long as necessary. However, whereas monetary policy can immediately impact credit markets, it is limited in its capacity to support the real economy, at least in the short term.

- The expected return to normal for these various indicators will likely be staggered, with GDP returning to its previous peak during 2022. It will likely be 2024 before employment returns to its previous peak of 152.5 million workers. Company earnings could return to normal by early 2023, while the comprehensive CNN/Moody's economic activity index could return to normal in late-2023.

- Fiscal policy is another risk to the outlook. As I have discussed previously, another round of federal government outlays is badly needed to provide an income and cash flow bridge for businesses and households until there are medical breakthroughs that will facilitate a sustained reopening of the economy.

- A new spending bill has been held hostage within Congress for weeks because of an inability of the House and the Senate to reach a bipartisan agreement on the composition of a new spending bill. In the absence of additional fiscal relief, I believe that the path of least resistance for the US economy would be downward.

- The employment report for August was mixed. Nonfarm payrolls in the private sector rose by roughly one million, and the unemployment rate fell further than expected. However, _the monthly pace of job creation continues to slow_. _Most importantly, the net increase in August payrolls was entirely the result of a recall of workers on temporary furloughs; permanent jobs actually **declined** by 500,000_.

- Employment is likely to remain weak in the short term and lag the recovery in GDP during 2021 and possibly 2022, prompting widespread reports in the media of a jobless recovery. The ongoing weakness in ***permanent employment*** is worrisome. _Businesses appear determined to protect profit margins, implying continued tight control over labor costs_.

- Continued rapid adoption of emerging digital technologies by businesses will further undermine the demand for labor and will keep wage growth in check. Although unfavorable for the labor market and household income, these forces have positive implications for company earnings.

- Nonetheless, looking beyond the next six months, my forecast for 2021 and 2022 remains generally favorable. *The anticipated inflection point in the outlook will be defined by the mass availability of a safe and effective vaccine and/or a potent therapeutic, and could occur in the early months of 2021*. Widespread inoculation of the population by the middle of next year should allow for a progressive but methodical reopening of the economy.

- I expect financial markets to become increasingly volatile in the two months leading up to the election. Widespread uncertainty with respect to the economic, political, and public health outlook is likely to undermine investor confidence at a time when the equity market is overvalued and investor sentiment has become complacent. A consolidation phase in the S&P 500 in coming weeks appears increasingly likely.

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.