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QUARTERLY ECONOMIC REVIEW AND OUTLOOK

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Summary and Major Conclusions:

The pace of the economic recovery slowed markedly in recent months and further weakness seems likely over the next six months. This period of slower growth can be attributed to a combination of two forces: A fading of the aggressive fiscal policy support administered earlier in the year; and a deterioration in public health conditions as the world economy encounters a potential second wave of the coronavirus pandemic. US GDP is likely to increase at an average growth rate of only 2% to 3% over the next several quarters, while a healthy and sustained economic recovery is not probable without the benefit of a vaccine.

- As measured by gross domestic product (GDP), US economic growth surged in the third quarter at an estimated annualized growth rate of 25%, the fastest quarterly growth rate on record. This follows the weakest GDP growth rate on record in the second quarter.

- It should be noted that Q3 GDP data benefited from an unusually depressed base, which resulted in a significant exaggeration of actual economic growth in the quarter. Monthly data for July, August, and September depict an economy that has been on a sluggish growth path since the middle of June.

- The best indicator of the sideways movement in economic activity is weekly jobless claims. Following steep declines in May and June, initial claims for unemployment insurance have been on a plateau since the week of August 7, at a level slightly below the one million mark.

- The rise in employment in recent months has come mainly from increased rehiring of temporarily furloughed workers; permanent employment continues to decline. In addition, layoffs remain elevated as firms remain extremely cautious regarding the direction of the economy and business revenues.

- COVID-19 infections have been on a plateau in recent months, but remain elevated with a modest upward tilt. Scientists continue to make excellent progress in developing a vaccine. The future path of the COVID-19 pandemic remains the greatest wild card in the economic outlook.

- The outlook for the US and global economies remains highly uncertain. The most significant sources of uncertainty include the future direction of the coronavirus pandemic, the thrust of fiscal and monetary policies, and trends in inflation and employment.

- Although impossible to predict, there is considerable evidence to suggest that a second COVID-19 wave is likely to emerge in the fall and winter. If so, businesses and households will once again pull back from commercial endeavors, causing the domestic economy to weaken further.

- Availability of a vaccine for broad distribution will mark a major inflection point in the outlook. My forecast assumes FDA approval of a vaccine for COVID-19 during November or December of this year, followed by mass inoculation of the general population beginning in the second quarter of next year.

- Monetary policy is the second major variable in the outlook for the economy. In the short term, the Federal Reserve will provide whatever policy support for the economy is necessary to avoid another economic downturn, holding its main policy rate at zero for an extended period.

- The recently announced change in Federal Reserve methodology regarding inflation targeting has accentuated the crucial importance of monetary policy in the outlook. Although an economic positive in the short term, the Fed's new policy toward inflation targeting raises the risk of much higher inflation in the long term.

- Inflation could move significantly higher in the years beyond 2022. A combination of steadily rising inflation and sluggish growth could lead to stagflation, similar to the disastrous experience of the 1970s.

- Fiscal policy is another wild card in the outlook. There is unanimity among economists that the economy needs another relief package to sustain growth, but Congress has been unable to reach an agreement. Economic growth in Q4 of this year and Q1 of next year is at stake.

- My forecast for economic growth is cautious in the short term, very positive in the medium term, and negative in the long term. The economy will remain vulnerable until there is a decisive scientific solution to the coronavirus pandemic, implying sluggish GDP growth in Q4 of this year and Q1 and Q2 of next year.

- Mass distribution of a vaccine should be the catalyst for a sharp acceleration in economic growth, most likely by the middle of next year. Real GDP could potentially expand at a 4% to 5% annual rate during the eight quarters beginning in mid-2021, as pent-up demand is unleashed and the service economy restored to normal.

- The world economy is on a gradual recovery path following an unprecedented contraction in output and spending earlier in the year. The 2020 global recession will be recorded as the most synchronized downturn in modern history.

- The most notable aspect of the economic revival currently underway is the sharp divergences among countries and regions. Emerging Asia will be at the forefront of economic recovery, led by an impressive rebound in the Chinese real estate, industrial, and export sectors.

- One of the biggest surprises has been the sharp rebound in global trade in recent months, a much faster pace of recovery than during the 2008 recession. China is leading the way, with merchandise exports nearly 10% higher than one year ago.

- US company earnings bottomed in the second quarter and should advance steadily over the next several years. Following a 25% decline for all of 2020, earnings for companies in the S&P 500 could expand at a 15% to 20% annual rate through the middle of 2023.

- The longer-term outlook for economic growth is far less favorable because of formidable structural headwinds faced by the household, business, and government sectors. US GDP growth could slow abruptly during 2023, implying resumed weakness in company earnings.

- The major risk to the long-term outlook is a sustained rise in the cost of living emanating from radical policy measures recently announced by the Federal Reserve to achieve a higher rate of inflation over a full business cycle.

ECONOMIC REVIEW

The US economy rebounded in the third quarter from its worst three-month decline on record in the previous quarter. The GDP report to be released at the end of October should show that the US economy expanded at a 25% annual rate, which would be the fastest pace since data have been recorded. However, there is a considerable discrepancy between the quarterly GDP report and monthly data for July, August, and September.

US GDP Overstated: Putting aside the quarterly GDP report, a close examination of weekly and monthly data reveal that ***the economy moved sideways from the middle of June until the end of September***. This disparity can be explained by the sharp rebound during May and the first two weeks of June, which created a distorted "base effect" that enlarged the growth rate computed on a quarter-to-quarter basis.

- **A Sideways Economy**: Weekly and monthly data — as measured by consumer spending, employment, factory orders, and industrial production — clearly reveal a marked slowdown in growth from June through September. The newly created CNN/Moody's Analytics Back-to-Normal Index — a compilation of nearly 40 real-time business indicators — is moving sideways on a plateau nearly 20% below its peak earlier in the year. For an in-depth description of this index, please see the *Economic Perspective* dated September 9, 2020.

Weekly Jobless Claims: The best indicator of the sideways movement in economic activity is weekly jobless claims. Following steep declines in May and June, initial claims for unemployment insurance have been on a plateau since the week of August 7 at a level slightly below the one million mark.

- **Weak Employment**: There are additional data pointing to weakness in the labor market. Although nonfarm payrolls remain in an upward trend, the *pace* of monthly gains is slowing. Worse, *the rise in employment in recent months has come mainly from an increase in temporarily furloughed workers; permanent employment continues to decline*.

Business Profits: In addition, businesses continue to lay off workers at a rapid pace, as firms remain extremely cautious regarding the direction of the economy and business revenues. Firms are also extremely focused on restoring profit margins. The federal government's measure of corporate earnings is 22% below its all-time peak in the final quarter of 2019.

Public Health Trends: Infections of COVID-19 have been on a plateau in recent months, but remain elevated. New cases have averaged 40,000 since August, down from a peak of 75,000 in mid-July. Deaths averaged 1,000 per day in the quarter, down from a peak of 2,700 but still unacceptably high. Scientists continue to make excellent progress toward the development of a vaccine, with more than six pharmaceutical companies in final clinical trials. Nonetheless, the future path of the COVID-19 pandemic remains the greatest wild card in the economic outlook.

ECONOMIC OUTLOOK

The outlook for the US and global economies remains highly uncertain. The most significant source of uncertainty is the future direction of the coronavirus pandemic, including the timing of mass distribution of vaccines for the US and world populations. The other primary sources of uncertainty include the thrust of fiscal and monetary policies and the trends in inflation and employment.

[1] The COVID-19 Pandemic: A healthy and sustained economic recovery is not possible without a solution to the coronavirus pandemic. Although impossible to predict, there is considerable evidence to suggest that a second wave is likely to emerge in the fall and winter. If so, businesses and households will once again pull back from commercial endeavors, further weakening the domestic economy.

[2] Vaccine Timeline: The outlook for public health conditions is heavily dependent upon the development and distribution of a safe and effective vaccine. *At every phase of this health crisis, both the politicians and the public have underestimated the tenacity of the virus and overestimated our ability to contain it*. Based upon current available evidence, the most likely path of a scientific solution to the public health crisis is as follows:

- FDA approval of one or more vaccines during November or December of this year
- Very selective allocation of a vaccine to various high-risk segments of the population under an Emergency Use Authorization (EUA)
- A large build-up of inventory during the first quarter of next year
- ***Initial mass*** inoculation of the general population beginning in the second quarter and continuing through the rest of 2021

Under this potential scenario, business and consumer confidence should begin to trend higher in the early months of next year and lead to a sustained acceleration of growth in spending, output, and employment during the second half of the year.

[3] Federal Reserve: Next to the pandemic, monetary policy is another major variable in the outlook for the economy over the next several years. In the short term, the Federal Reserve will provide whatever policy support necessary to avoid another economic downturn. I expect the Fed's main policy rate to remain at zero through 2023, and to increase very slowly thereafter.

- **Inflation Targeting**: The recently announced change in Federal Reserve methodology regarding inflation targeting has accentuated the crucial importance of monetary policy in the longer-term outlook. Although a positive in the short term, the Fed's new policy toward inflation targeting raises the risk of much higher inflation in the long term.

- **Potential for Stagflation**: The Fed is playing with fire with respect to future inflation but is sufficiently frustrated by its total inability to achieve its 2% inflation target that it is willing to accept the risk. The upshot is that inflation could move significantly higher in the years beyond 2022. A combination of higher inflation and slowing growth could lead to stagflation, an insidious combination of very slow growth and steadily rising inflation, similar to the disastrous experience of the 1970s.

[4] Fiscal Policy: Fiscal policy is another wild card in the outlook. There is unanimity among economists regarding the need for another relief package, but Congress cannot reach an agreement. Sustainability of the economic recovery in the fourth quarter of this year and first quarter of next year is unequivocally dependent upon a sizeable spending and relief package from Congress.

ECONOMIC FORECAST

My economic forecast can be divided into three phases, incorporating three distinct timeframes through 2023:

- **Short-Term Outlook**: The pace of the economic recovery has been in a slowing trend and further weakness seems likely over the next three to six months. This period of slower growth can be attributed to two primary driving forces: (1) Fading of fiscal support associated with the original $3 trillion relief package that expired on August 31; and (2) An expected deterioration in public health trends in the fall and winter. US GDP is likely to increase by only 1% to 2% over the next two to three quarters.

- **Medium-Term Outlook**: The much-improved outlook I expect one year from today can be attributed to two factors: (1) A sustained reopening of the economy made possible by distribution of a safe and effective vaccine; and (2) The early years of a classic business cycle expansion, which typically witnesses the most dynamic pace of economic growth. GDP could expand at an average annual growth rate of 4% to 5% from the middle of next year to mid-2023.

- **Long-Term Outlook**: Economic conditions are likely to steadily deteriorate as 2023 unfolds because of numerous long-term structural forces that could undermine the smooth functioning of the economy. (Please see the *Economic Perspective* dated September 21, 2020, for more on this topic). Beyond 2023, the US economy could be characterized by very slow growth, rising inflation, an erosion of business profit margins, and higher long-term interest rates.

THE WORLD ECONOMY

The world economy is on a gradual recovery path following an unprecedented contraction in output and spending earlier in the year. ***The 2020 global recession will be recorded as the most synchronized downturn in modern history***, as virtually all nations simultaneously instituted harsh lockdowns to protect their populations from the deadly coronavirus.

- **Supply and Demand Shocks**: Phase one of the downturn was a massive supply shock as production and investment came to a grinding halt. Phase two was a massive demand shock as consumers adopted strict social distancing practices to avoid infection and build savings.

Wide Divergences: The most striking aspect of the economic revival currently underway are the sharp divergences among countries and regions. Compared with most geographic regions, emerging Asia will be at the forefront of economic recovery, led by an impressive rebound in China. Conversely, recoveries in Europe, Japan, Latin America, and the US will lag those of China and South Korea. There are three explanatory factors at work:

- Effectiveness and skill of policymakers in managing the pandemic
- The magnitude of government stimulus in supporting aggregate spending
- The relative importance of the manufacturing versus service sector

China has been the most successful country in managing the pandemic while the US has been the worst. China, Germany, and South Korea have benefitted from strong manufacturing sectors, while Spain, Italy, the UK, and the US are more heavily dependent upon services. Finally, the fiscal and monetary policy response by the US was by far the most aggressive among the major economies.

World Trade: One of the biggest surprises has been the sharp rebound in global trade in recent months, a much faster pace of recovery than during the 2008 recession. China is leading the way, with merchandise exports nearly 10% higher than one year ago. Strength in world exports reflects the greater relative strength in the consumption of goods worldwide relative to that of services.

China Leading: Following its worst quarterly decline in nearly three decades, the Chinese economy has rebounded strongly, with positive growth of 3% in Q2 and estimated growth of greater than 10% in Q3. China has benefited from five powerful forces:

- Stringent lockdown measures that allowed the Chinese economy to open far sooner than other countries
- Aggressive monetary stimulus manifested in strong growth in credit
- Aggressive fiscal stimulus focused on infrastructure spending and revival of China's state-owned industrial sector
- Solid growth in China's core real estate market
- A robust recovery in manufacturing, primarily for inventory building and for export trade

Country GDP Assumptions: My forecast assumes that Chinese GDP will increase by 3.5% this year, followed by growth of 9% and 6% in 2021 and 2022, respectively. Europe, Japan, and the US will recover at much slower rates next year, within a range of 3% to 4%. Sparked by growth in China, emerging Asia will lead the world recovery next year with average GDP growth of 7.5%.

CONCLUSION

Economic weakness will likely persist until there is substantive progress in resolving the public health crisis during the first half of next year. China may be an exception and could act as an engine of world growth and perhaps a catalyst for a surprisingly strong rebound in global manufacturing and world trade. A vaccine will mark an inflection point in the world economic recovery, permitting a more widespread reopening of the economy. Approximately one year from now, traditional business cycle forces will be in control, creating an environment for accelerating growth in both GDP and company earnings.

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