FREQUENTLY ASKED QUESTIONS

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Summary and Major Conclusions:

A long period of underbuilding has led to a massive pent-up demand for new homes. Construction of new homes averaged less than 1 million annually during the decade ending in 2019, nearly 35% below the underlying demand of 1.5 million determined by household formation. Consequently, although the current boom in single-family homes should slow within the next one to two years, residential construction should make a meaningful contribution to GDP growth through the middle of this decade.

- A potent second wave of the coronavirus pandemic would have a significant adverse effect on the world economy. Further restrictions would impact mobility, spending, output, employment, and income. The service sector is far more vulnerable than the manufacturing sector.

- Although my forecast assumes that the economy will move sideways over the next several quarters, an outright contraction in spending and output should not be ruled out. The severity of new infections will determine the extent of restrictions to social mobility and business activity, and therefore economic growth.

- A close examination of trends beneath the headlines reveals profound weakness in employment that belies the sharp decline in the unemployment rate. Payrolls are still 11 million workers below the peak of 152.5 million just prior to the pandemic.

- The number of permanently unemployed workers has tripled from less than 1.3 million to 3.8 million. The labor participation rate has plunged from a recent peak of 63.5% to 61.5%, the lowest level since 1976. The ranks of long-term unemployed workers have more than doubled since earlier in the year.

- Although difficult to quantify, the real estate market has benefited from the coronavirus pandemic. The exodus of millions of households from highly dense metropolitan centers for homeownership in the suburbs has provided a significant boost to residential construction since the start of the pandemic.

- This additional layer of demand for single-family homes will gradually fade during 2022 and 2023 as the pandemic fades and as the economy begins to normalize. Nonetheless, traditional fundamental forces for homebuilding remain favorable and suggest continued strength in coming years.

- The federal budget deficit tripled in fiscal year 2020, jumping from $1 trillion in 2019 to more than $3 trillion, the equivalent of 16% of US GDP, the highest ratio since World War Two. Based on official forecasts, the deficit is expected to remain above $2 trillion for many years.

- These large deficits are a positive factor in the short term but a very serious negative in the long term. The pandemic has drastically increased the need for deficit spending as a bridge to when there is widespread availability of a vaccine.

- The long-term budget outlook is vastly different. A large budget deficit places a severe burden on the private sector, in the form of slower growth, rising inflation, and higher borrowing costs. Each of these forces also makes it more difficult for the US Treasury to finance the deficit.

- Record budget deficits should impede growth in the years beyond 2022, under all scenarios. Either Congress will vote to raise taxes and cut spending, resulting in fiscal drag; or Congress will ignore the deficit, in which case economic growth will slow because of the cumulative burden of large deficits on the private sector.

- The behavior of the equity market has been mystifying to many investors. The stock market crashed in February and March as spreading coronavirus infections and deaths led to a lockdown of the economy.

- The S&P 500 rallied by 60% over the subsequent six months. The sharp rally since the March 23 low can be attributed to unprecedented policy actions by the Federal Reserve and Congress in support of the sinking economy and financial sector.

- The collapse in government bond yields from nearly 2% to only 0.5% greatly reduced the attractiveness of the fixed-income market and led to the realization that there were simply no viable alternatives to common stocks.

- The primary market trend since June can be described as K-shaped, as investors have differentiated between the economic winners and losers of the pandemic. Technology and other stay-at-home stocks have performed exceedingly well while economically sensitive stocks have languished.

- A rebalancing of this massive divergence will eventually take place, based upon historical experience. Every economic recovery since the 1970s has triggered a shift in leadership from growth stocks to value stocks that persisted for the first several years of the expansion cycle. The only question is timing.

- The primary catalyst for a shift in market leadership is unambiguous evidence that the economy has embarked on a self-sustaining economic expansion. This will not occur until 2021 when there should be widespread distribution of a vaccine for COVID-19.

This week's *Economic Perspective* provides answers to frequently asked questions regarding the economic outlook, with an emphasis on the coronavirus pandemic, fiscal policy, employment, the housing market, and the behavior of the domestic equity market.

HOW MIGHT A SECOND WAVE OF THE PANDEMIC IMPACT THE ECONOMY?

The powerful second wave of the coronavirus pandemic currently under way nationwide will undoubtedly have a significant adverse effect on the world economy. Another nationwide lockdown in the US — as occurred in March and April — is unlikely, but regional and rolling shutdowns are likely. These restrictions would impact mobility, transportation, spending, output, employment, and income. The service sector is far more vulnerable than the manufacturing sector.

Currently at 8%, the unemployment rate could return to 10% by early next year. Moody's Analytics has developed a model that links the unemployment rate to changes in the number of daily infections. *According to this model, every sustained increase of 10,000 daily infections translates into a 0.5% increase in the unemployment rate*. Therefore, a sustained increase in new infections from the recent base level of 40,000 to 80,000 would result in a rise in the unemployment rate by two percentage points from the current 8% level to 10%, with a lag of one month.

HOW VULNERABLE IS THE US ECONOMY TO ANOTHER CONTRACTION IN SPENDING AND OUTPUT?

Although my forecast assumes that the economy will move sideways over the next six months, an outright contraction in spending and output should not be ruled out. The magnitude of economic weakness during the next three to six months will be predicated upon the following two factors:

- The severity of infections and hospitalizations, which will determine the extent of restrictions to social mobility and business activity.

- The fiscal response to the crisis. An estimated $2 trillion in spending is required to support unemployed workers, small businesses, and state and local governments necessary to prevent a renewed recession. A spending package that falls short of $1 trillion would result in a worse outcome. A deferral of a fiscal spending package beyond the first quarter would push the economy back into recession.

The overarching conclusion is that renewed recession is unlikely. Two factors that would increase the odds of recession are a catastrophic nationwide outbreak of COVID-19 infections and a failure of Congress to pass a spending bill by the early months of next year.

THE US UNEMPLOYMENT RATE HAS DECLINED FROM NEARLY 15% TO LESS THAN 8% IN ONLY SIX MONTHS. DOES THIS TREND ACCURATELY PORTRAY CURRENT LABOR MARKET CONDITIONS?

The headlines exaggerate the speed of recovery in the labor market, in my judgment. A close examination of trends beneath the headlines reveals profound weakness in employment. The most important of these trends include the following:

- Nonfarm payrolls are still *11 million workers* below the peak of 152.5 million just prior to the pandemic.

- Job growth has derived mainly from a *recall of furloughed workers*, while permanent unemployment continues to rise. The number of *permanently unemployed* workers has tripled from less than 1.3 million to 3.8 million.

- At 787,000, *initial jobless claims* are still above the peak of 660,000 during the financial crisis in 2009.

- *Wage growth* for the average worker has slowed from a pre-pandemic rate of 3.5% to 2% in the second quarter.

- Nearly 4.5 million workers have exited the labor force, causing a plunge in the *labor participation rate* from a recent peak of 63.5% to 61.5%, the lowest level since 1976. The ranks of *long-term unemployed* workers have more than doubled since earlier in the year.

The bottom line is that the labor market is struggling, which reinforces the urgency for Congress to provide additional fiscal support.

IS THE CURRENT BOOM IN SINGLE-FAMILY HOUSING SUSTAINABLE?

There is no question that the residential real estate market has benefited from the coronavirus pandemic, although the amount of excess demand is very difficult to quantify. The decision by millions of households to exit highly dense metropolitan centers to purchase homes in the suburbs and exurbs has provided a significant boost to homebuilding since the start of the pandemic. This phenomenon is nationwide but especially pronounced in the New York City and San Francisco areas.

It is safe to say that this additional layer of demand for single-family homes will gradually fade during the course of 2022 as the pandemic fades and as the economy begins to normalize. That said, the boom in single-family housing is unlikely to slow in a meaningful way: The traditional fundamental forces for homebuilding remain favorable and suggest continued strength in coming years:

- Mortgage rates are at all-time lows and are unlikely to rise significantly anytime soon

- Key demographic factors are positive: The prime homebuyer segment of the population — young adults in their late twenties and thirties — is growing at a rapid pace

- The supply of homes for sale is at the lowest level on record

- There is growing demand for second homes away from large cities

- A long period of underbuilding has led to massive pent-up demand for new homes

Construction of new homes averaged less than 1 million annually during the decade ending in 2019, nearly 35% below the underlying demand of 1.5 million determined by household formation. The bottom line is that although the current boom in single-family home construction should slow within the next one to two years, residential construction should make a meaningful contribution to GDP growth through the middle of this decade. `

HOW DOES THE FEDERAL BUDGET DEFICIT FIGURE INTO YOUR FORECAST?

The federal budget deficit tripled in fiscal year 2020 to more than $3 trillion, the equivalent of 16% of US GDP and the highest ratio since World War Two. Based on official forecasts, the deficit is expected to remain above $2 trillion for many years.

In terms of the US economy, these enormous deficits are a positive factor in the short term but a very serious negative in the long term. The pandemic has drastically increased the need for ***deficit spending*** as a bridge to when there is widespread availability of a vaccine. The economic recovery since May would not have occurred without the $3 trillion CARES Act; similarly, a double-dip recession in the next several quarters can be avoided only with additional large-scale federal spending.

However, the economic ramifications of deficit spending are vastly different in the long term. *Large budget deficits will add an increasingly large burden on the private sector manifested in slower growth, rising inflation, and higher borrowing costs*. Each of these forces also makes it more difficult for the Treasury to fund the deficit: Rising interest rates and inflation reduce GDP growth; slower GDP growth reduces tax revenues; and higher interest rates increase the cost of borrowing for the Treasury, thereby adding to the deficit.

The bottom line is that a slowdown in spending seems inevitable following the burst of growth expected in 2021 and 2022, under virtually all scenarios. Either Congress will vote to raise taxes and cut spending, resulting in fiscal drag; or Congress will ignore the deficit, in which case economic growth will slow because of a rising trend in interest rates and inflation.

HOW WOULD YOU DESCRIBE THE PERFORMANCE OF THE US EQUITY MARKET SINCE THE ONSET OF THE PANDEMIC?

The behavior of the equity market has been mystifying to many investors. The stock market crashed in February and March as spreading coronavirus infections and deaths led to an abrupt lockdown of the economy. The S&P 500 plunged by nearly 30% in the space of only 13 trading days, culminating in an investor panic, which triggered a stampede out of equities and into cash and government bonds. The market reversed course quickly as it became apparent that the collapse in stock prices was an overreaction. The S&P 500 rallied by 60% over the subsequent six months.

The sharp rally since the March 23 low can be attributed to several factors:

- Investors realized that the recession was policy-induced, rather than a symptom of an unhealthy economy and financial system
- Unprecedented policy stimulus from the Federal Reserve and Congress bolstered confidence regarding the potential for economic recovery
- The collapse in government bond yields from nearly 2% to only 0.5% greatly reduced the attractiveness of the fixed-income market and led to the realization that there were simply no viable alternatives to common stocks
- All else equal, the plunge in bond yields increased the theoretical present value of the equity market by 25%

The primary market trend since June can be described as K-shaped, as investors have differentiated between the economic winners and losers of the pandemic. Technology and other stay-at-home stocks have performed exceedingly well while economically sensitive stocks have languished. Since June 10, the NASDAQ 100 has risen by 15%, while an index of cyclical stocks has ***declined*** by nearly 10%.

HOW WILL THIS GLARING STOCK MARKET DIVERGENCE BE RESOLVED?

A rebalancing of this massive divergence will eventually take place, based upon historical experience. *Every economic recovery since the 1970s has triggered a shift in leadership from growth stocks to value stocks* that persisted for the first several years of the expansion cycle. The only question is timing.

Relative valuations have moved to unprecedented extremes. With a price-to-earnings (P/E) ratio of 35x, the S&P 500 Growth Index appears overvalued relative to the S&P 500 Value Index, which has a P/E ratio of 20x. The concentration of market capitalization in a select group of stocks is at record extremes. *Fully 40% of the S&P 500 is comprised of the technology and social media stocks, an all-time record for any sector*. The five largest stocks in the overall index — compromising only 1% of the number of stocks in the index — constitute 25% of the market capitalization of the overall index.

The primary catalyst for a shift in market leadership will be unambiguous evidence that the economy has embarked on a self-sustaining economic expansion. This will not occur until there is widespread distribution of a vaccine for COVID-19. Other signals of a shift in market leadership would be a sustained rise in inflation and interest rates and decline in the US dollar. Cyclical stocks generally perform best when inflation and interest rates are on the rise and when the dollar is in decline.

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