MID-QUARTER ECONOMIC REVIEW

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Summary and Major Conclusions:

The traditional business cycle is a significant positive for equity investors. Broad distribution of a vaccine will likely be the catalyst to transform a sluggish and fragile economic recovery into a self-sustaining business expansion, possibly beginning in the middle of next year. Mass distribution of a vaccine should mark the critical inflection point for the direction of the economy and corporate profitability. The 24 months ending in the middle of 2023 will likely be the most dynamic phase of the current business expansion cycle.

- The sharp rebound in business activity during May and June has faded, and key economic indicators reveal a sharp loss of momentum. The economic expansion remains intact but at a much slower rate of growth.
- Through the third quarter, output of US goods and services has recovered only two-thirds of losses incurred in March and April, and remains nearly 4% below its all-time peak at the end of 2019.
- The pandemic resulted in a permanent loss of output and income. There are also permanent losses within the small business sector: As many as one quarter of all small and mid-sized businesses will file for bankruptcy by yearend.
- It appears likely that the 2020-21 economy will be classified as a jobless recovery because growth in job creation will lag growth in output and spending. Whereas real GDP will likely return to its pre-pandemic peak later next year, employment is unlikely to return to its prior peak until 2024 or 2025.
- The outlook for the next several quarters appears challenging, with the potential for much slower growth in spending and output. A renewed economic contraction appears unlikely but cannot be ruled out. GDP growth could slow to an average trendline rate of only 2.5% through the middle of next year.
- The outlook for the world economy should improve significantly during 2021 as a vaccine becomes widely available. The US economy is technically in the very early stages of a traditional business cycle expansion that began in May. The most likely scenario is continuation of economic growth through 2023, at a minimum.
- There currently exists enormous pent-up demand for consumption and investment that could be unleased when confidence in public health conditions is restored. Real final demand could rise at a 5% annual rate during the second half of next year and throughout 2022, its fastest pace since the 1990s.
- The US economy should benefit from increased government spending during 2021. Congressional passage of a spending bill in excess of $2 trillion is virtually assured, providing income support for small businesses, unemployed workers, and state and local governments.
- Because of enormous underutilization of productive resources, strong demand is unlikely to translate into bottlenecks and rising inflation. The labor market is unlikely to return to full employment for many years, while factories are operating well below capacity with sufficient room to accommodate strong growth in output.

- Currently at an annual rate of 1.5%, core consumer inflation should remain below 2% through most of 2021. Assuming continued monetary stimulus throughout 2022, inflation could rise to 2.5% in 2022 and 3% in 2023.

- Company earnings are on track to decline by 18% for all of this year, but should rebound strongly as 2021 unfolds. Earnings growth could expand by 20% to 25% in both 2021 and 2022 — the fastest pace since 2018 — on revenue growth of 8% to 10%.

- The outlook for financial markets is dependent upon time horizon. The equity market is vulnerable to potential shocks in the short-term — pertaining to economic growth, politics, and public health issues — and could suffer another temporary setback. Valuations appear stretched as equity investors have front-run the improving economic fundamentals for 2021 and 2022.

- FDA announcement of a schedule for mass distribution of a vaccine for COVID-19 should be the catalyst for the next upleg in the equity bull market early in the new year. Forward-looking financial markets should begin to discount a reopening of the economy and steadily improving economic data as the year unfolds.

- Market expectations for a more durable economic expansion should trigger a sustained rise in both stock prices and government bond yields over the next two to three years. Investor confidence should be on the rise as the next year unfolds, suggesting that stocks could massively outperform bonds during 2021 and 2022.

- In contrast with the medium term, the long-term economic outlook is littered with formidable challenges. A confluence of adverse structural forces could reduce the dynamism of the US economy, strongly suggesting that investment returns over the next five years could significantly lag historical averages.

This week's *Economic Perspective* is the regular Mid-Quarter Economic Review, providing an update of current trends along with a summary of the outlook for economic growth and financial markets over the next one to two years.

CURRENT ECONOMIC CONDITIONS

The sharp rebound in business activity in May and June following the reopening of the economy last spring has faded, with key economic indicators revealing a sharp loss of momentum. *The economic expansion remains intact but is proceeding at a much slower rate of growth*. Through the third quarter, output of US goods and services has recovered only two-thirds of losses incurred in March and April, and remains roughly 4% below its all-time peak at the end of 2019. US GDP is currently growing at an estimated 2.5% annual rate, but will register a decline of nearly 4% for all of 2020.

Permanent Economic Losses: I expect US real GDP to return to its pre-pandemic level of $19.25 trillion by the third or fourth quarter of next year. However, it is clear that the pandemic resulted in a permanent loss of output and income. According to the nonpartisan Congressional Budget Office (CBO), *US real GDP will be 3.5% lower in 2025 than would have been the case in the absence of the health crisis and lockdowns*. Similarly, private sector employment in 2025 could be three million less than otherwise.

- **Small Businesses**: There are also permanent losses within the small business sector: It is estimated that as many as one quarter of all small and mid-sized businesses could file for bankruptcy by yearend. Finally, millions of jobs that existed prior to the pandemic are unlikely to return. It will be difficult for workers suffering permanent job losses to shift into other areas of employment.

THE NEXT THREE QUARTERS

The outlook for the next several quarters appears challenging, with the potential for a further loss of momentum in spending and output, resulting in slower growth in real GDP. An outright contraction in GDP is unlikely but should not be ruled out. The outlook in the short term is predicated upon three critical variables:

- **COVID-19**: The current surge in new infections increases the odds of new social restrictions that would impede economic activity. While another total lockdown is unlikely, regional or rolling shutdowns resulting from the spike in new cases and hospitalizations would reduce economic growth.

- **Vaccines**: The timing of one or more vaccines that would be available to large segments of the population will determine the duration of the current period of economic weakness. Availability of therapeutics such as monoclonal antibodies would also be helpful in maintaining an open economy.

- **Fiscal Policy**: The timing and size of the next round of fiscal stimulus are crucial variables in the outlook. Partisan politics has prevented Congress and the White House from agreeing on a large spending package comparable to the CARES Act earlier in the year. Passage of a new spending bill appears unlikely until early in the new year.

Public Health Conditions: Current public health data leave no doubt that the US has entered a dangerous second wave of the coronavirus pandemic. New daily cases nationwide are at record levels; hospitalizations are rising rapidly with many cities already at full capacity; and with the usual lag of three or four weeks, fatalities are also on the rise.

Vaccine Availability: With respect to a vaccine, inoculations on a very small and select basis using an Emergency Use Authorization could begin in December, although FDA approval for general use is not likely until February or March. Even then, a sufficient inventory for inoculating the broad population might not be available until April or May. Compelling signs of a strengthening economy could appear around midyear.

THE CLASSIC BUSINESS CYCLE

The traditional business cycle is a major positive for investors. The US economy is technically in the very early stages of a classic business cycle expansion. The consistent increase in spending and output since May has obscured economic disruptions and dislocations associated with the pandemic. The recession ended in April, and the domestic economy has enjoyed five months of positive growth since May. The most likely scenario is continuation of the economic expansion through 2023, at a minimum.

Inflection Point: Broad distribution of a vaccine will likely be the catalyst for transforming a sluggish and fragile recovery into a durable self-sustaining economic expansion, possibly beginning in the middle of next year. Mass distribution of a vaccine should be the critical inflection point for the direction of the economy. ***The 24 months ending in the middle of 2023 will likely be the most dynamic phase of this business expansion cycle***. Specifically, distribution of a vaccine could trigger an acceleration in GDP growth from a likely trend of 2% over the next several months to 5% beginning in the second half of next year. This positive outlook for growth is based upon several key factors:

- **Pent-Up Demand**: Current high levels of pent-up demand could be unleased when confidence in public health conditions is restored. At a rate of 15% in Q3, household savings is more than double that in the years preceding the pandemic. There is also pent-up demand for housing, autos, and business capital investment.

- **Fiscal Policy**: Congress is virtually assured of passing legislation for a fiscal spending package in excess of $2 trillion, providing badly needed income support for small businesses, unemployed workers, and state and local governments.

- **Economic Slack:** Because of an enormous supply of underutilized resources, strong demand is unlikely to translate into rising inflation or bottlenecks that would normally accompany a surge in spending and output. The labor market will be unusually slow to return to full employment, while factories will continue to operate well below normal capacity, with natural resources in abundant supply.

The bottom line is that a vaccine should allow the economy to reopen, resulting in a strong rebound in spending and output beginning in the second half of next year. As the business expansion kicks into high gear, this positive growth phase should persist into 2023, and will not be at risk until cyclical pressures and imbalances begin to build.

ECONOMIC FORECAST

The outlook for the US and world economies is dependent upon time horizon and region. China and emerging Asia will be at the forefront of economic growth, while Europe and Japan will lag. With respect to time horizon, the US economy faces daunting challenges in the short term, but medium-term prospects appear quite favorable:

- The primary independent variable regarding the timing of transition from economic weakness in the short-term to a period of accelerating growth will be the mass distribution of a vaccine for COVID-19.

- The size, timing, and composition of a fiscal spending package is the other primary catalyst for robust economic growth.

- My base forecast assumes that US GDP growth could average 2.5% over the next three quarters, followed by growth of 4% in the second half of next year and 5% for all of 2022. The pace of growth in 2022 could be the most rapid since the 1990s.

- Currently at an annual rate of 1.5%, core consumer inflation should remain below 2% through most of 2021. A rise to 2.5% in 2022 and to 3% in 2023 is possible, depending upon the thrust of monetary policy.

- Company earnings are on track to decline by 18% for all of this year, but should rebound strongly in 2021. Earnings growth could exceed 20% in both 2021 and 2022.

- Job creation is likely to lag the rebound in production, as business reorganizations allow firms to increase production at a faster pace relative to net hiring. The economy may not return to full employment until 2024 or later.

- China is at the cutting edge of the recovery in the world economy, with the potential for 6% to 7% GDP growth next year, following a 3% increase this year. China accounts for 18% of world GDP, but is expected to contribute 60% of global GDP growth in the 2021-22 timeframe, according to the IMF.

- Emerging Asian economies have also proven quite resilient and should easily outperform North America, Europe, and Japan. The eurozone economy could weaken significantly in coming quarters, as lockdown measures are put into effect to mitigate hospitalizations and deaths caused by a resurgence in new infections.

INVESTMENT OUTLOOK

Similar to the economy, the outlook for financial markets varies depending upon time horizon. The equity market is vulnerable to numerous potential shocks in the short term, implying continued exceptionally high volatility. Market risks pertain to economic growth, fiscal policy, political developments, medical progress, and the ultimate severity of the current second wave of the pandemic.

- **Short-Term Risks**: While bond market returns are likely to remain close to zero through early next year, the equity market could suffer another temporary setback as occurred in early September. Until there is a major scientific breakthrough, stock prices are likely to fluctuate within a trading range of plus or minus 5% to 10%, with a bias to the downside.

Scientific Breakthrough: Investors should be prepared for a major inflection point in the equity market in coming months in response to a medical breakthrough. could act as the catalyst for the next upleg in the equity market. An FDA approval of one or more vaccines for COVID-19 should occur very late this year for emergency use, followed by inoculations of the broad population beginning in April or May. Forward-looking financial markets should begin to discount a reopening of the economy and steadily improving economic data early in the new year.

Rising Stocks and Bond Yields: Market expectations for a more durable economic expansion should trigger a rise in both stock prices and government bond yields that could extend well into 2022. Investor confidence should be on the rise as 2021 unfolds, with balanced portfolios shifting from an emphasis on defensive to more cyclically sensitive assets. Common stocks should massively outperform bonds in both 2021 and 2022. Major factors dictating the 2021-22 investment outlook include the following:

- **Classic Business Cycle**: History clearly shows that stocks record their largest percentage gains during the first two to three years of a business cycle expansion, and the current cycle is unlikely to differ.

- **Turbocharged Cycle**: The current early cycle recovery could be especially dynamic because of the potential for an exceptionally rapid rebound in aggregate spending and output resulting from *massive pent-up demand*.

- **Policy Stimulus**: The economic recovery could also be magnified by continued record levels of government stimulus. The combination of maximum monetary stimulus and another large fiscal spending bill should provide a strong boost to growth, especially in 2021. Private market forces will propel GDP growth in 2022.

- **Low Bond Yields**: Because of the strong statistical correlation between bond yields and equity market valuations, stock prices should also benefit from a continuation of exceptionally low interest rates well into 2022.

- **Asset Allocation**: The unusually poor prospects for fixed-income returns suggests that balanced accounts could shift from a traditional 60%/40% allocation to an even greater percentage allocation to common stocks.

- **Corporate Earnings**: Prospects for a robust recovery in company earnings could be a major tailwind for the equity market. Quarterly earnings per share (EPS) for companies in the S&P 500 Index have surprised on the upside this year and could continue to exceed Wall Street estimates in future quarters. My forecast assumes EPS growth of 20% to 25% in each of the next two calendar years.

- **Equity Valuations**: Conversely, equity valuations are expensive and could act as a headwind for stock prices, in two respects: (1) The current price-to-earnings (P/E) ratio of 23x is slightly above economically justified levels, based primarily upon current yields in the bond market; and (2) A rising trend in bond yields in 2021 and 2022, as seems likely, should result in a systematic decline in P/E ratios.

- **Expected Return**: Currently at 3300, the S&P 500 Index could rise to 3800 by the end of 2021. This projection assumes 12-month forward EPS of $205 in 2022 and an average P/E ratio of 18.5x, yielding a potential total return of roughly 15%. It is reasonable to expect stock prices to lag EPS growth in an environment of rising bond yields, which have an inverse relationship with P/E ratios.

- **Negative Bond Returns**: It is virtually impossible for government bonds to generate positive returns over the next one to two years, absent a renewed recession and falling consumer prices. A US Treasury bond with a ten-year maturity could lose 5% to 10% of its market value over the next year. This estimate assumes a 1% increase in yield from its current 0.75% rate to 1.75% by the end of next year. One-year returns on high-grade corporate bonds could be a negative 3%, while high-yield corporate bonds could earn a positive 2%.

LONGER-TERM CHALLENGES

In contrast to the medium-term, the long-term economic outlook presents numerous formidable challenges. As discussed previously, my assumption is that the traditional business cycle will dominate the economic outlook over the next several years, whereas powerful underlying structural forces will be dominant in the years beyond 2023. The following is a summary of primary challenges facing the US economy in the long term:

- Near-record federal budget deficits over the next five to ten years will become serious headwinds to economic growth.
- Although not imminent, the Federal Reserve will eventually be compelled to reverse its current policy of ultra-accommodative monetary stimulus, perhaps beginning as early as 2022.
- Currently at historically depressed levels, inflation and interest rates will begin to trend gradually higher as the economy is restored to normal.
- The economic crisis brought about by the pandemic will almost certainly result in a more activist policy by the federal government. An increase in government intervention in the private sector has historically resulted in slower growth and higher inflation.

This confluence of structural forces should reduce the dynamism of the US economy, and possibly culminate in stagflation. Projections of investment returns over the next five and ten years suggest an extended period of low returns. Fixed-income markets are likely to post negative rates of return over the next five years, while annualized equity returns are unlikely to exceed 5%.

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