Economic Insights: **Severe recession, unprecedented rebound**

Update for the month of October 2020

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The world recovery from the COVID-19 lockdown and recession has turned uneven. China's rebound continues apace. The United States' revival remains robust with solid momentum going into the fourth quarter. A resurgence of virus activity across Europe and Japan has nearly flattened economic growth since July, delaying their recoveries. Equity markets have suffered their familiar September volatility and setbacks, which will likely continue through year end.

A mild uptrend should reemerge in the New Year if expectations of strong profit growth are realized.

Patchy world recovery

The lockdown response to the surge in COVID-19 infections and fatalities brought unparalleled economic devastation and record job losses in March and April. The rebound in the following few months was just as incredible, but in reverse, in job gains and economic revival. That spectacular resurgence of growth has turned into an ongoing expansion in some places, one with a more sustainable pace. However, the recent surge in COVID-19 infections in parts of Europe and Japan is impeding their return to normalcy.

Recent U.S. data support an optimistic economic view for current robust growth and its continuation into next year. Business surveys of purchasing managers by Market News for the composite and manufacturing indices are the highest since early 2019. Most regional Federal Reserve (Fed) business surveys are the highest since late 2018. Capital spending is returning with a vengeance; new orders of capital goods excluding aircraft in August surpassed year-ago levels and shipments of those goods were nearly flat with last year. Business confidence is still below pre-COVID levels; but it's rising and far above what prevailed during the financial crisis.

Households are participating enthusiastically in the rebound. Housing activity is spectacular with robust home sales, record homebuilder confidence, super-low mortgage rates, rising affordability, and home purchase mortgage applications way above last year. JP Morgan Chase credit/debit card data on non-recurring consumer spending was 5.8% below last year for the week ending September 18; outside of a spending surge around Labor Day, that's the best since March. Data from tracktherecovery.org (here) shows average spending for the first two weeks of September down 2.7% from January versus an August average of 5.0% and progressively worse for July and June. Consumer spending also showed little decline from the July 31 end of the $600 supplemental jobless benefit. Confidence is still below pre-pandemic levels, but is resilient and rising; the Bloomberg measure of the Consumer Comfort Index is the highest since April 5.

The drop in daily new U.S. COVID-19 cases from the surge in July flattened out in September after falling by a third in August (here). Fortunately, the number of fatalities is still falling gradually, with the latest seven-day moving average on September 29 of 728. So, high-frequency data is slowly advancing. OpenTable data on restaurant seatings and Transportation Security Administration traveler counts are improving.

Third quarter U.S. real gross domestic product (GDP) should show a mammoth rise of 25% to 30%. Unless there's another surge in virus activity, the U.S. economic revival has several reasons to stay on track in the fourth quarter and through 2021:

- Consumer spending has been growing faster than output; inventories are very lean, which bodes well for further gains in hiring and output.
- Vigorous housing activity means healthy job growth in related areas: construction, lending, appraisal, sales, furniture and materials.
- Initial claims for jobless benefits stay high, but, continuing claims are falling, suggesting new hiring is much greater than new layoffs.
- The $300 weekly jobless benefit retroactive to August 1 is helping sustain consumer spending.
- The household saving rate is a high 14%, giving consumers the wherewithal to spend.
- Auto production is still rising.
- Monetary stimulus works with a lag, so the economic boost will persist through 2021.

With these lifts, fourth quarter U.S. GDP should be in the 6% to 8% range. Without a safe, effective and available vaccine, growth in 2021 could slow to trend of 2.5%, as many of the temporary business closures and furloughs become permanent.

China is the other driver of world growth as their astonishing rebound from the COVID-19 recession marches on. Industry reports for August were healthy. The manufacturing business survey by Market News, at 53.1, is almost a decade high. Industrial output is now 5.6% over last August and has recovered back to the prior uptrend line. Fixed investment is just a touch below a year ago. Credit growth is surging. Exports accelerated to a gain of 11.6% with solid demand from the rest of the world. House prices are up 4.9% from last year and property sales volume is surging. Retail sales were above year ago levels for the first time this year as the recovery broadens out. We expect steady growth well into 2021.

A second wave of virus infections in greater Europe and Japan has already dampened their recoveries. Markit News indices of Eurozone business surveys weakened fairly dramatically in

September. The composite index lost nearly two points and at 50.1 just barely shows expansion. The details point to a huge dichotomy between services and manufacturing. The rise in new cases is hardest on the service sector as many Eurozone countries rely heavily on tourism for growth. Manufacturing is in a solid expansion with the index at 53.7%, well above breakeven. Still, even the rise in German business confidence has slowed. United Kingdom business surveys and other data show a very strong rebound through the summer that has been slowed recently by another wave of virus activity.

A fading revival is a similar story for Japan. Market News indices of Japanese purchasing manager surveys are stuck in contraction territory. While there have been sizeable rebounds in consumer spending, industrial output, and business and consumer confidence, they all remain well below pre-COVID levels. The surge in daily new cases in greater Europe and Japan may be due in part to much greater testing as it hasn't been accompanied by a rash of hospitalizations and fatalities. We expect their recoveries to resume in the fourth quarter.

Looking ahead

The world recovery from the devastating recession continues apace, but has turned uneven, given the eruption of virus cases in greater Europe and Japan. Revivals in the U.S. and China are driving world growth. Commodity price rises have stalled a bit in September but are holding most of the gains since March. This validates the global economic renewal as well as prospects for its continuation. Monetary accommodation by central banks will keep short-term yields low for years.

Did the COVID-19 recession reset the world economy to begin another long expansion? Or is this rebound just a nice lull after which the ills that built up during the prior long upturn will reassert themselves? The jury is still out on that question just yet. But whatever broad profit snags that existed in early 2020 are being fixed as businesses use this opportunity to cut costs, raise productivity, and extend debt maturities with interest rates at multi-century lows.

A safe, effective, and widely available vaccine would surely upgrade the prospects for a new, long-lasting uptrend. Absent a serious second virus wave this fall and winter, the world rebirth will march ahead.

Will interest rates, inflation stay low?

The change in Fed policy and the comments after the September Fed meeting practically guarantee that the fed funds rate will stay in its 0% to 0.25% range until 2023. With negative official rates in the Eurozone and Japan, the Bank of England is thinking about joining the NIRP (negative interest rate policy) posse of central bankers.

Promises of substantial bond purchases by most developed country central banks, coupled with short rates anchored near zero for years, keeps significant down pressure on yields of long-term government bonds. It will be hard for yields on 10-year U.S. Treasury bonds to rise even to 1% much before early 2021.

What about after that? The dramatic change in Fed policy to "average inflation targeting" was designed to convince investors it was serious about more inflation. The Fed has wanted to generate a little inflation ever since the financial crisis but has been unsuccessful. The change to a target of average inflation mostly had the effect of pointing out that monetary policy may be, or is already, losing its effectiveness.

Because of that failure, the most important policy change isn't the new monetary accommodation. It's the combination of determined monetary ease, mammoth fiscal stimulus, and the lack of much budgetary restraint, especially in the U.S.

In addition to this significant change in policy, the COVID-19 crisis has accelerated the reshoring of some supply chains back to their home countries. For over two decades, globalization has lowered inflation by companies employing low-wage workers in China and other emerging countries to keep production costs low.

As globalization fades, the low inflation it fostered may dwindle with it. Merging the impact of fiscal and monetary policy shifts with the quickened trend to reshoring, it's difficult to imagine that the decade of the 2020s will not see a little more inflation than the consensus believes possible.

Financial market outlook

In late August, the stock market seemed primed for a correction. September and October have historically been volatile and subject to sharp downdrafts. Markets had a huge run since March and the leaders were priced for perfection. Investors were very bullish; downside protection was extremely cheap since few thought it was needed. It happened as September was not a pretty month for most financial markets. Japan was one of the few countries where broad market indices ended ahead. With government bond yields staying flat for the month and credit spreads widening a bit, few bond indices had good returns.

Even so, underlying equity fundamentals seem mostly okay. The world recovery is continuing. Profit growth will be picking up. Absent a serious second wave, it's hard to see the catalyst for a severe downside move. Nevertheless, the volatility and moderate weakness of September could easily persist through the end of the year. The U.S. election season will stay uncertain and the outcome may not be known for a while. Equity weakness could be triggered no matter who wins. At some point, economic reports will come in below expectations.

While caution is warranted in the near-term, the odds favor moderate equity upside over the next year. The Fed and other central banks will stay aggressively easy. More fiscal spending will surely be coming. It appears a vaccine will be on the horizon early next year helping households and businesses return to some normalcy. Profit growth will resume as companies are firmly cutting costs. Further stock market weakness in the fourth quarter could create investment opportunities for next year.

The momentum of the favorite tech stocks faded in September. And with reflation likely coming, we'd move to sectors that do well when growth picks up, like materials and industrials. Financial stocks should do well in that environment, too, as the yield curve should steepen, but aggressive monetary policy has prevented that. Overall, we'd prefer U.S. stocks but believe that reflation will help push emerging market equities higher in the next year too.

On a one-year horizon, we'd prefer stocks to bonds as bond investors will have a hard time finding good returns. Yields on safe haven government bonds are so low, we'd avoid them. Within the bond universe, corporate or emerging market bonds with their slightly higher yields should be favored. That's with a couple of caveats. To prevent losses from higher long-term interest rates, one could stick to shorter maturities, like two to four years. And while credit spreads could narrow a little further next year, we'd prefer staying with higher quality bonds in whatever risk bucket fits one's risk tolerance.

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