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Economic Insights: **Recovery broadens**

Update for the month of September 2020

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The August drop in new COVID-19 cases in the United States allowed the recovery to broaden. The rise in new cases in Europe and a second wave in Japan is dampening their nascent rebounds. China's upturn marches on.

It was a risk-on month for financial markets, but long-term yields edged higher, handing losses to holders of safe-haven government bonds. Stock markets may have more upside as economic activity resumes. Long-term equity returns will likely be limited given current valuations.

World recovery continues apace

August can be a dull, placid month north of the equator. A time for vacations, listless markets, football, kids back to school.

How we wish for those typical dog days of summer this year.

Even so, the strong rebound from the horrendous recession sparked by the impact of this pandemic remains on track.

Traditional U.S. economic reports for July were well above expectations again. Upward revisions to earlier better-than-expected data added to the bounce. Housing activity booms. Sales of existing and new homes soars, with the latter the best since late 2006. Homebuilder confidence was the highest sine 1998. Mortgage applications are well above last year. Lumber futures, which hit a price low in March at $251 per thousand board-feet, now trade above $900, suggesting home prices will stay on the rise. Housing starts were the best since February and new building permits rose in every part of the country.

Business orders for durable goods jumped 11.2% in July, far above expectations—this after a 7.7% surge in June. Orders and shipments for non-defense capital goods ex aircraft are both essentially flat with July last year. Retail sales are back to new highs. July household income and spending kept rising. Steel production is up for the 11th straight week (but still well below last year). Regional business surveys from Federal Reserve (Fed) District Banks all show expansion. Initial claims for jobless compensation on a non-seasonally adjusted basis keep falling, now down to a still- very-high 821,600, but the fourth month below a million. We expect August job gains to exceed one million.

The July surge in daily new U.S. COVID-19 cases dampened the rise in high-frequency data. But cases appear to have peaked July 23; the latest seven-day moving average fell to 41,240, down 38.3% (here). So, daily and weekly August data resumed the uptrend. Restaurant seatings by OpenTable are rising. After a stall around 665,000 in July, daily traveler counts by the Transportation Security Administration crept higher in August and could average near 700,000. Motor gasoline demand growth flattened in July but has picked back up. Consumer spending as measured by J.P. Morgan Chase credit/debit card data leveled in July but hit a post-recession weekly high mid-August.

Absent another virus outbreak activity, the U.S. economic revival should stay on track. The third quarter rebound in real U.S. gross domestic product (GDP) could be mammoth, near 25% annual rate.

We look for fourth quarter GDP to be up 5% or more as reopenings spread and more people return to work. The rebound may slow in 2021 if many temporary furloughs and business closures turn permanent. Growth would stay a more trend-like 2.5% or so in that case. Conversely, any prospect of a safe, available vaccine in the first quarter could foster a two-quarter bounce in growth and bring the U.S. back to new highs in GDP and employment more quickly.

Japan's economy has endured a series of setbacks. The two-percentage point hike in their value-added tax last October put the economy in a tailspin. Shortly thereafter, powerful typhoon *Hagibis* brought evacuation notices to tens of millions and caused widespread flooding with dozens of fatalities. COVID-19 lockdowns began in April. After two months of respite, a second wave of infections struck. Now, Japan's Prime Minister Shinzo Abe will resign from chronic health issues.

Still, a mild recovery from the economic lockdowns is underway. Business surveys by *Market News* have turned higher. Exports are rising. While low, household and business confidence is trending up. Consumer spending has improved. July industrial production rose sharply and is well off its low. Mobility indices are holding well above the level during the late spring respite from the coronavirus. Support for the ruling party is strong and an election doesn't have to be held until October 2021, so policy will likely not change much after Abe's resignation. With the second wave of infections diminishing, we expect Japan's revival to gradually strengthen.

As in the U.S., the rash of new cases in several countries in Europe (here) in August may have dampened the recovery. *Market News* surveys of purchasing managers fell significantly, the index for service companies from a robust 54.7 to 50.1, just above break-even. The index for manufacturing edged lower to 51.7. But, at the same time, Apple mobility data continued to push a bit higher in all countries. The mild uptrend in national business confidence surveys stayed intact in August for Germany, France, Italy, and Belgium. The European Commission's measure of consumer confidence also edged up. We expect the moderate Eurozone rebound to persist.

China's remarkable industrial revival extended in August. Reports for July were robust, and industry seems mostly back to normal. Industrial production was 4.8% above a year ago; industrial profits were up 19.6% over last year versus up 11.5% in June. Fixed investment was reported as only down 1.6% year over

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year. House prices are rising; housing starts are strong. *Evercore ISI* research suggests that China's domestic air travel is booming, that August will be 85% to 90% of year-ago levels. Households still seem restrained; retail sales rose in July but remained 1.1% below the prior year. China may be one of the few countries to have recovered all its GDP loss during 2020.

Looking ahead

The world recovery from the recession is underway. China was the first to succumb and leads the way out. Giant fiscal and monetary relief packages are supporting a monster U.S. rebound. Super-low interest rates, a weakening U.S. dollar, and emerging demand from China provide an excellent backdrop for developing countries to bounce back. The rush of new COVID-19 cases in greater Europe and Japan has moderated their revitalization, but we expect only a lull in the upturn.

Rising commodity prices validate robust economic prospects. Record-low U.S. mortgage rates are creating a booming U.S. housing cycle. Surging U.S. house prices and record stock indices enhance household net worth, add to spending power and confidence and prolong the nascent expansion. With inflation quiescent for now, central banks will keep policy accommodative for a long time. A widespread second wave of COVID-19 infection would surely stop the advance and could bring a double-dip recession.

Absent that, we expect the economic mending to persist.

The Fed massages its targets

At the virtual Jackson Hole conference, Fed Chair Powell described what is an historic change in Fed policy. Two of the Fed's goals are stable prices and maximum sustainable employment. Years ago, the Fed translated the first into a flat 2% inflation target, a maximum. The new target is described as flexible inflation averaging, i.e., inflation should average 2% over time. So, if inflation stays below target for, like, a decade, the Fed would let inflation exceed 2% for a long time, so long as it didn't get out of control.

The change to the employment goal was more subtle. The Fed will now focus only on shortfalls below the goal rather than deviations above it. The Fed will strive to maximize employment and worry less about whether job growth is too strong or the jobless rate too low.

These two changes mean the Fed will shift from restraining inflation to promoting robust job growth. Here's the reasoning:

The jobless rate for Hispanics and African Americans hit record lows the last year or two and overall unemployment was the lowest in 50 years, even as fast wage growth was pulling more people into the labor force. Fed officials recognized the benefits of super-low joblessness in reducing income inequality and enticing people into the job market who had previously been on the sidelines. To this end, the Fed will let employment and the economy run hot and not worry if inflation exceeds 2% for a while.

Bottom line: The Fed funds rate will stay at its current record-low level for the foreseeable future. Second, wage growth will pick up at some point and the Fed will still not raise the Fed funds rate preemptively to stop whatever inflation may result.

Inherent in the Fed's change in policy is a belief that the long-assumed tradeoff between inflation and unemployment, called the Phillips curve, has ended. That idea: to get a low jobless rate, the Fed had to tolerate higher prices. Fed officials have observed that inflation has been low for decades, through expansions and recessions, tight labor markets and slack ones. Ergo, since inflation no longer rises as joblessness falls, the U.S. economy will benefit by the Fed promoting job growth.

The view that the tradeoff no longer exists was spawned by what is thought to be a structural change in the U.S. economy. New technologies and globalization have interacted to keep the supply of goods and services well above demand, thus keeping inflation under wraps and the Phillips curve passé.

There's a natural human tendency to believe that the future will be like the recent past. That what has happened will continue to happen. Further, the longer those trends have persisted, the more firmly we believe they'll continue—we extrapolate the past into the future. It's possible that the new Fed policy is based more on extrapolation of the last couple of decades than true structural economic change.

If the Phillips tradeoff is still alive but just resting, then the Fed may get more inflation than it bargained for. We'll find out after a few years of the Fed's new policy.

Focus on markets

Financial markets were Risk-On in August. It was a great month for equity investors with only a few emerging market indices in the red. The Dow Jones Transportation Index led the derby, up more than 12% for the month after hitting a record high on August 28. Safe haven and government bond indices performed poorly as long-term yields rose for the month. More risky indices with high-yield and emerging market bonds at least had positive returns as credit spreads mostly narrowed just a bit.

Outlook

The new Fed policy framework will keep yields on short-term U.S. treasury bonds very low, probably for years. This will also keep meaningful down pressure on 10-year U.S. treasury bond yields for a long time. Further, credit spreads (the difference between yields on U.S. government bonds and those on similar maturity corporate or emerging market bonds), have narrowed markedly from their March peaks. Super-low yields and dwindling credit spreads make it difficult for bond investors to find decent returns the next few years.

With the change in policy, the Fed clearly wants more inflation and will tolerate it at moderate levels. They will eventually achieve at least what they want. Long-term U.S. treasury yields keep trying to rise and, at some point, they'll succeed. As a result, we'd stick to shortish bond maturities, say, two to four years. That offers an opportunity to take advantage of rising long-term yields if that occurs.

We'd avoid government bonds because of basement-level yields and prefer corporate or emerging market bonds that pay a bit more. But we'd stick to the higher quality bonds in the risk bucket with which an investor is comfortable. With credit spreads already low, there's little bonus left from spread narrowing.

With tech and growth stocks wildly outperforming the rest of the market, it's clear the internal rotation to cyclical stocks we've suggested in the past isn't yet ready for prime time. The switch from growth and tech to stocks that benefit from faster growth began at

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least twice since March but failed. August ended with another surge in the Nasdaq Composite. We still think that reversal will occur, but it will take firm evidence of more inflation and a steeper yield curve to entrench it. That may take a while.

In the short-term, there may be more upside to broad stock indices as the world economy reopens and more people go back to work. But we'd be cautious. There will be fewer positive economic surprises. Stocks making new highs are priced for perfection. There will likely be volatility around the U.S. election. We may soon learn that many of those temporary furloughs were permanent.

In the longer-term, today's high valuations suggest any equity upside will be difficult and limited. We're still optimistic into 2021 but expect consolidation or potential correction before then.

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