[Possible Hysteresis – Longer Term After Effects of the Pandemic]

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The stock market, like a wise wizard, has the capability of looking to the future and seeing reality. A number of my clients in the past have asked me why the stock market rises while "main street" struggles, and the market declines as main street flourishes? The reason is simple – stock prices aren't just reflective of "what is" but also of "what will be," or at least what most serious investors believe it will be.

This cycle, the stock market started rising even as virus infection rates were extremely high, and GDP growth was still contracting. There isn't anything unusual about this apparent de-link of market prices to current "known" reality. As noted, stock prices usually front-run known reality. Stock prices, and most market pundits focus on events and expected variables over the next 12-18 months. But the downturn we experienced earlier this year (and the return of the current, lesser lockdown) was so severe, so far-reaching, that effects of the downturn may not be fully recognized for years.

Now that we know who the next president is going to be, and now that the world has a vaccine to fight the pandemic, the outlook has become less variable. That being said, and because the blow to the economy was so severe, the remedy, the official government actions, were extreme compared to previous periods of economic weakness. What possible unintended consequences may the economy face over the long term, due to the after-effects of the pandemic?

Below please find an excerpt from my economic piece created a couple of months ago in which I start to address possible longer-term ramifications of the pandemic and the remedy applied to the economy to fight the pandemic.

Longer-Term Thoughts – Costs of the Pandemic and Government Remedy

Some thoughts as to the long term. First, the degree of volatility in economic activity change has been unprecedented. Think of economic activity as water running through a hose. The contraction in the second quarter acted as a kink in the hose, rapidly slowing the flow, with a build-up occurring behind the kink. The third quarter represented a partial release of the kink, but the kink will remain in place until a vaccine to fight the virus is in place. Is there permanent damage that has been done to the "hose" in the above example? Even when the "kink" is released, will we see permanent economic damage? Will there be what economists call "hysteresis," or an economic event which continues (economic weakness) even though the cause of the event (COVID-19) is removed?

Now that the election and the vaccine development is behind us, we can focus more clearly on, not just the pace and tenor of the economic recovery, but on possible, long-term costs of the pandemic – costs that may occur even though the cause of the problem – the virus – has been eliminated.

Potential Hysteresis Event – Systemic Slowing in Growth
First, government spending has risen dramatically, accompanied by the amount of government debt. According to data from Ned Davis Research, since 1950, government spending as a percent of GDP ranged between 18% and 22%. The spike in government largesse has increased spending to 34% as of the end of the third quarter 2020.

Is there an economic cost to this government spending? Do we risk hysteresis because of the increase in government spending? Part of the answer to this question depends on how sustainable the increase in government spending proves to be. As the economy recovers, and the pandemic becomes a thing of the past, will government spending contract?

If we examine the oddity above in a historical light, note the period of 1981 – 2003, when government spending as a percent of economic activity declined from 24% to 19%. During that period of time, GDP growth averaged 3.4%. Since then, as government spending has risen compared to the size of the economy, GDP growth has averaged 1.6%, less than half the 22-year growth rate when government spending as a percent of GDP was contracting, according to data from the World Bank.

Some say that government spending has little or nothing to do with slow GDP growth. True Keynesian economists may suggest that government spending is a good thing, as it tends to spur growth in final demand. History tells us that isn't always the case.

A few years ago, I conducted a 50-country study that attempted to answer the question of government spending (as a percent of GDP) and attendant GDP growth. Consistently, on a global scale, irrespective of "developed" or "emerging" status, there has been a negative correlation between rising government spending and GDP growth. In other words, around the world, when government spending as a percent of GDP rises, GDP growth has tended to slow.

This of course raises the legitimate question – does rising government spending cause a contraction in economic growth, or does a contraction in economic growth cause a rise in government spending? In my opinion, at the end of the day, the two data streams go together – globally, consistently, irrespective of which came first. Rising government spending over long periods of time go hand in hand with slowing economic growth.

The lesson from this oddity – if the recent upside blowout in government spending isn't reversed, we should expect to see a significant slowing in secular GDP growth, corporate profits and job creation levels in the long-term.

The Nation's Balance Sheet – Another Long-Term Risk Factor
Along with government spending has come the need to finance that spending. The government has to gin up the money from somewhere. Taxes, borrowing from investors and the outright practice of printing money are all three levers which the government can pull to "create" spending power.

But an increase in taxes tends to go hand in hand with economic growth slowing. Going directly to the bond market, asking private global investors to lend trillions of dollars of spending tends to raise interest rates. Neither of these alternatives are preferable during an economic growth collapse like we saw earlier this year.

So, the third alternative is brought forward – the government simply "prints" the money that they have been spending. According to data from Ned Davis Research, the "real" (after inflation) activity of the Federal Reserve will rapidly raise the growth rate of M1 (defined as all cash or currency plus checking account deposits) and M2 (defined as M1 plus savings accounts, CDs and money market fund balances). The 12-month "real" growth rate of M2 creation has been +23.7% as of the end of November 2020.

Since 1960, the average M2 growth rate has been 3.7%, according to the Conference Board. The highest level of M2 growth since 1960 was around 10% in 2009. The recent blowout growth rate in money supply has been unprecedented over the last 70 years. Remember, in economics (as is the case for most things in life) there are no free lunches.

Some are saying, "Hey, don't worry, the Federal Reserve will simply print money to purchase all of the bonds on the market, providing a never-ending stream of 0% money to the government to spend as they see fit. As long as the dollar is the world's reserve currency, there will always be a demand for a never-ending rising stream of U.S. dollars."

The actual cost of government largesse may be delayed. That is, until interest rates rise, the government has to pay more to attract more capital, not only on new bonds, but also on maturing existing bonds. It is a factor that could blowup if either interest rates rise markedly, or the value of our currency contracts significantly or the United States is no longer the core global reserve currency. Then the chickens come home to roost, and the true cost of the government's rescue plans come into focus.

The Long-Term Risk – Stagflation to Occur?
The two points that may lead to hysteresis I have highlighted above are both related to a more active government in a macro-economic sense.

We noted global evidence that a significant increase in government spending as a percent of GDP has tended to accompany slower, long-term economic growth. At the same time, we have seen money growth adds to inflationary pressures over the long term if accompanied by a rise in money velocity. These two oddities are pointing to the potential that history may indeed start to repeat itself.

The U.S. economy last experienced a period when growth was waning and inflation was rising. During the 1970s, many called the economic malaise of that decade a period of "stagflation," or a period when inflation was rising and GDP growth was shrinking.

2021 Outlook Still Intact
I am still of the opinion that "real" GDP growth should be strong and inflation well-behaved in 2021. It should be a good economic year, as the pandemic winds down, and people accept new behaviors as standard fare.

For 2021, my outlook is calling for:
1. Pandemic to end, with the distribution and application of the vaccine to reach 40%+ of the population.
2. Real GDP growth of 4%.
3. Inflation to rise slightly to 2%.
4. Unemployment to fall by the end of the year, but stay above the levels we saw in early 2020.
5. Corporate profits (S&P 500) to rise by 20%+.

6. Longer-term capital demands to rise as a number of service-related businesses attempt to reopen.
7. Yield curve to steepen.
8. Value of U.S. dollar to gradually decline to many foreign currencies.

In concert with the points made in today's piece, I suggest the following thoughts may be well worth considering over the longer term:

1. **Inflation may eventually rise** to the longer-term average of 3%+, as money velocity rises during the next economic expansion.
2. **The FX value of the U.S. dollar** will, on balance, contract on a 3-5-year time frame.
3. **Long-term U.S. Treasury bond yields will rise** back to the "real" level of 1.7%, meaning that nominal bond yields are expected to rise to 4%+, occurring over a long period of time.
4. **Longer-term bonds may be less attractive than they were historically,** as they will not provide balanced investors with the same risk-management benefits as has been the case in the past due to extremely low current coupon rates.
5. **As inflation picks up**, pressure for a meaningful increase in household incomes will occur. Wage costs will increase along the lines of inflation pressure. It starts with a mandated $15 per hour minimum wage and ripples from there. Watch for labor unions to become more active in demanding higher wages.
6. **As wage gains accelerate**, government tax receipts will rise as well (why do you think some politicians want to mandate the $15 per-hour minimum wage?).
7. **Corporate profit margins** (in labor-intensive businesses) may be under pressure.
8. **Stock market P/E ratios should contract** over a period of time, as inflation and interest rates grind higher.
9. **GDP growth may struggle** to grow by more than 2% per year on a sustainable basis.