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Economic and Market Outlook

September 30, 2020

Hello Earth!

Anybody who claims to have a firm
handle on the economy's path
is either delusional or lying.
--Joshua Shapiro (Economist)

Section I. No Pre-existing Models Leaves Confusion for Expectations

Part-A. Ignore GDP for Now

As we wrote in our June Report, The Covid-19 Recession:

> Perhaps, in the final analysis, we should simply say that the uncertainty level is so high because of the sudden shutdown of the economy from the pandemic, and that forecasting faces conditions in both the economy and financial markets that will not be fully appreciated until after the recovery.
>
> The economy and investors have no pre-existing models of what to expect; thus, there are no clear defenses against the shocking disruptions. There are no playbook or best practices to help.
>
> How and when Consumption and Industrial Production reach prior levels remain in debate.
>
> It is clear the stock market rally from the late-March lows is based on a sharp, or V-shaped, recovery conclusion.

As far as the shape of recovery, we took issue with the common forecast of a sudden V-shaped return to pre-Recession levels.

We continue to expect a slow, lackluster, "U"-shaped recovery.

The U.S. economy shrank by an annualized -32.9% decline in the second quarter. Annualized means how much Gross Domestic Product (GDP) would decline if it were to continue at the same second quarter rate across four quarters (i.e., -8.225 Q2 x 4 Quarters = -32.9%).

Chart-1 (U.S. Real GDP Change: Actual vs. Expectations for Q3:2020) clearly shows an outsized third quarter recovery for GDP of 20.7% (Median Q3 Nowcast).

The second quarter number has importance mainly in showing how deep a hole the economy must climb out of.

The third quarter's expectation of a gain of 20.7% is a healthy rebound, but is still far from a sufficient recovery to offset the decline of the second quarter (i.e., a decline of 32.9% requires a gain of 49% in recovery just to be even).

In our view, the fourth quarter is likely to gain 3-to-4%.

The average forecast from the Fed Governors calls for GDP to shrink -6.5% for the full year 2020.

The -6.5% decline for the year may not sound bad, but the drop will in fact be the worst for any year since WWII.

We say to ignore GDP headline reports for a while, simply because in order to determine a forecast for 2021, economists need to see what happens to the fall/winter Covid-19 case levels and what happens when government assistance runs out.

Said differently, the level of economic uncertainty is way too high to create reasonable forecasts for GDP, Corporate Earnings, or Employment levels.

Part-B. Fed Says: Need More Fiscal Spending

The Fed has clearly and effectively responded to the Covid-19 crisis by drawing down interest rates close to zero, buying trillions of dollars of assets, and creating an array of emergency lending programs.

Their efforts have been particularly beneficial to financial markets, but without greater fiscal (i.e., government spending) rather than monetary (i.e., Fed) policy, the rebound in the economy is likely to be anemic, according to Fed Chair Jerome Powell. He has repeatedly said that he expects Congress to do more to help unemployed workers, businesses, and City and State governments hurt by the Covid-19 pandemic.

According to *The Wall Street Journal*, in an article entitled, "Why Fed Officials Are Begging for More Stimulus from Lawmakers" (Sept. 13, 2020):

> Some colleagues [in the Fed] have been more outspoken.
>
> "Trouble is brewing with the expiration of those relief policies," Chicago Fed President Charles Evans told reporters.

For this *Wall Street Journal* article, Evans went further:

> A lack of action or an inadequate one presents a very significant downside risk to the economy today.

The article continues:

> The economy has rebounded this summer, but some easy gains were expected. The ranks of temporarily laid-off workers have fallen by two-thirds, or around 12 million, since the spring. Officials are uneasy because more than two

> million Americans have permanently lost their jobs, and these numbers seem likely to increase as vulnerable businesses shut down.
>
> “We do think it will get harder from here,” said Mr. Powell in an interview with National Public Radio earlier this month.
>
> Fed officials are eager for a fiscal booster shot for two reasons. The first reflects the limits of their tools that became apparent well before the pandemic-induced downturn. The second stems from the unique nature of the current shock.
>
> With the Fed unwilling to cut rates below zero, officials are focusing on how to provide more stimulus through “forward guidance” specifying how long they plan to keep rates very low and continue buying Treasury securities and mortgage bonds. They could do this by spelling out inflation and labor-market conditions that would warrant tighter monetary policy
>
> Forward guidance and asset purchases helped lower long-term rates, which can boost investment and spending, after the 2008 crisis. But they may provide less zip today, because long-term yields are much lower—a reflection of how investors already expect a longer period of low rates.

Chart-2 (Rate Records) shows the difference between 10-Year-Treasury-yield (Inflation-adjusted) levels subsequent to the 2008-09 (June) Great Recession and the current Recession that began February 2020.

At the time of this writing (Sept. 24, 2020), Congress was still debating the size of an aid package, from $3.5 trillion on the maximum side, down to $0.5 trillion at the low end.

Whether an agreement is reached or not before the election, what is unlikely to be included is any significant amount for State and Local governments. It is as if the millions of people working for State and Local governments do not need help while the millions working for corporations do. It should be clear that all sectors need help from the pandemic that has essentially crippled everyone.

The implications for a lack of State and Local aid are dire. For example, most workers whose jobs cannot be done from home, but who have kids, cannot return to their jobs if the children are not cared for in schools. It has become glaringly evident that, beyond education, schools provide essential benefits for the economy in providing day care, and even nutrition, for workers’ children, as well as jobs for teachers, administrators, and support staff.

With State and Local revenues lower by 30-to-40% since February of this year, budgets must be cut back, and with cuts, comes rising unemployment in the public sector. Simply put, the public sector needs help as well as the private sector.

Covid-19 has struck the entire economy—period!

To understand more fully why the uncertainty level is so high and, in turn, why economic recovery is more likely to be slow rather than sharp, please note the cross-currents and directional reversals in much of the critical data that follow.

Part-C. The Confusion Confronting Economic Forecasting

Point-1—Employment Data

Chart-3a (Unemployment Rate) shows the devastation to Employment created by the shutdown of the economy.

While the early part of the recovery shows the Unemployment rate improving from 14.7% in April to 8.4% in August, the August rate remains the highest since the early years of the post-2007-09 recovery from the Great Recession. Note that on a percent change from a year ago, the August level has no equal since 1955.

What is more than sad, and yet perhaps more consistent with our best guess of a very slow economic recovery, appears in Chart-3b (Conversion Rate into Permanent Layoffs).

Note that in Chart-3a, as the Unemployment Rate has been falling from highs of more than three times year-ago levels, to just over 120% greater than the year-ago level, Chart-3b shows the percent of nonpermanent nonemployed workers who have become permanent layoff has skyrocketed. These Charts show good news (the Unemployment Rate) followed by bad news (permanent layoffs).

The longer that it takes for the economy to normalize, the more likely the temporary job losses will become permanent.

Point-2. Retail Sales Data

Please again note confusion. Chart-4 (Advance Real Retail and Food Services Sales) shows a dramatic recovery from a negative annualized rate of change from 12 months ago of -22% in April 2020 to a +2% in August 2020 over August of 2019.

However, if we look at the rate of change on a month-over-month basis, note in Chart-5 (Advance Retail Sales: Retail and Food Services, Total) that there has been a major pull back in the monthly rate of change since May.

Chart-6 (Conference Board Consumer Confidence Index) gives no confidence. In August, the Index not only fell back into the negative, but reached a new Recession low for 2020.

Point-3. Industrial Production

Chart-7 (Industrial Production Index) shows recovery underway, but still about 8% below a level of expansion.

Point-4. Employment to Labor-Force Size

Chart-8 (All Employees, Total Nonfarm/Civilian Labor Force Level) not only shows the historic fall, but the recent level (August) remains equal to or below all prior Recessions going back to 1958.

Point-5. Hours of Production

Chart-9 (Average Weekly Hours of Production and Nonsupervisory Employees, Manufacturing) is also showing progress, but remains in contraction.

Point-6. Recession Probabilities

Chart-10 (Smoothed U.S. Recession Probabilities) does us a favor by having a two-way forecast: first, Recession is called when the trend line goes above 30% and, second, a Recovery is called when it falls back below 30%. Note the Index was moving from 100% Recession towards an expansion/Recovery call until a reversal recently to continue the Recession.

In fact, the same Index, looked at on a very short-term basis—see Chart-11 (Smoothed U.S. Recession Probabilities)—shows the Index rising again. Care is warranted.

Point-7. Stocks

The President and Wall Street pundits have seemingly made the stock market the key barometer of economic health, despite the fact that most stocks are owned by the top 10% of investors as measured by percent of assets held in the form of stocks.

All we can say is that stocks are currently overvalued by any historic standard. Overvaluation tells us nothing about when to sell but, instead, tells us a lot about the risk of being fully invested in stocks.

In today's market, overvaluation is most pronounced in the Technology sector of investments.

Chart-12 (Nasdaq 100 / S&P Ratio) tells us that the favored investment of today (i.e., Technology stocks in the Nasdaq) has reached a level not seen since the Technology-stock Crash of 2000-02.

Chart-13 (Paying Up) points out that the S&P 500 Index has been trading at the most expensive levels since 2000.

So the S&P 500 is overvalued, and the most popular Technology sector itself, the most overvalued.

Chart-14 (Chicago Fed National Activity Index) tells us that, at a time when the market is at its most overvalued in twenty years, the economy remains in a Recession. Moreover, the directional change of economic indicators is approaching contraction levels again.

Section II. <u>Concluding Remarks</u>

Investor Business Daily (*ILD*) observed the following in their September 11, 2020, publication:

> There's nothing wrong with being largely or entirely in cash for now. Not only do you preserve your capital, you preserve a positive mindset for when the stock market rally is clearly back on track. The worst possible outcome is to take a series of losses now, then be too weary or fearful to take part in a better trading environment.

We share a similar view. But depending on the separate risk profiles of our clients, we have also used hedging strategies, together with or in addition to cash, to achieve our <u>primary goal of protection of principal</u>.

When we have sufficient data to conclude that both corporate valuation levels and economic recovery potentials present again an opportunity for portfolio constructions and asset selections to be made on a sound basis, we will lift hedges and reduce cash in favor of the long-term goals for each client.

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