GOVERNMENT PORTFOLIO ADVISORS

# Weekly Economic Update—June 15th, 2020

Just as it seemed the worst of the economic downturn and coronavirus was behind us, investors suffered another panic attack this week, sending stock prices to their biggest one-day loss since March 16 on Thursday. While the markets recovered somewhat on Friday, the reasons for the latest investor angst will likely weigh on investors for some time. Ironically, the primary catalyst that sent stock prices soaring over the past 2 ½ months remains firmly in place. At its latest policy meeting this week, the Federal Reserve reiterated its firm commitment to keep interest rates at rock-bottom levels and retain its formidable pump-priming efforts, including purchasing copious amounts of Treasury and agency securities, as far as the eye can see. It also promised to activate and expand emergency lending facilities to keep credit flowing and help jump-start the ailing economy.

But although these efforts stoked investor euphoria in March when they were announced in a series of emergency meetings, their impact this time was blunted by the grim economic prospects conveyed by Fed officials at the meeting. Recall that the Fed abstained from presenting the usual economic projections in March in deference to the uncertainty caused by the coronavirus, which was in its early stages of wreaking havoc on the economy and financial markets. With several months of observing the wrath of the virus under its belt, the Fed is no more certain of the economic impact it will have than it was in March – but is more convinced of its longer-lasting negative effects. Hence, it delivered an economic outlook that is grimmer than the markets expected. Indeed, Fed chair Powell in the post-meeting press conference opined that the Fed is not thinking about raising rates and is “not even thinking about thinking to raise rates” in the foreseeable future.

That forward guidance is about as strong a message the Fed can deliver regarding the economy’s dire prospects. If that wasn’t enough to shake up the markets, investors had another reason to worry, as more than a dozen states reported increases in coronavirus cases. It is unclear how much of the uptick is linked to the lifting of lockdown restrictions, but the threat of a second wave of infections is the most tangible obstacle to an economic recovery in the minds of policy makers as well as investors. The heightened awareness of that threat as the number of cases increased curbed the optimism over some recent encouraging economic data, particularly the surprisingly strong jobs report for May. As much as anything, the harsh correction in stock prices on Thursday suggests that the markets are more sensitive to the path of the virus than to incoming data.

To be sure, the market setback this week follows an astonishing 44 percent rally since stocks hit bottom on March 23. Hence, stock prices are still comfortably higher so far this quarter, although the S&P 500 is still about 10 percent below its pre-virus peak on February 19. Indeed, Federal Reserve data released this week highlighted just how much wealth was destroyed by the onset of the coronovirus. In the first quarter, net worth of households plunged by a record $6.5 trillion, more than double the worst quarterly setback seen during the Great Recession. If not for the increase in real estate values, which pumped up housing equity, the destruction would have been considerably worse. Importantly, the entire destruction occurred in a little over a month – from February 19 to March 23 – revealing how quickly wealth can vanish from an external shock.

Some analysts believe that this week’s setback merely took some froth out of the market, as stock prices had raced far ahead of the nascent recovery in economic activity. Time will tell if that is the case and if market volatility is poised to settle down along with sentiment regarding the path of the virus and direction the economy will take. Even as the number of cases of infection has started to rise again, so too has the race to develop a vaccine, which many health experts believe will come sooner than thought a few months

ago. The sooner a vaccine is found, the quicker will the public feel safe about resuming normal activities – and the more sustained is the recovery likely to be.

That said, all evidence indicates that the worst of the downturn is behind us and the healing process has begun. It will be a while before we know how long the recession lasts, but it didn't take long for the National Bureau of Economic Research – the official arbiter of cyclical turning points – to confirm that the nation had indeed fallen into a recession, as it officially designated March 2020 as the onset of the downturn this week. In fact, the three-month time lapse between the onset of the recession and its official designation was the shortest ever and considerably faster than the nine months to a year that the NBER normally takes to make the call. The quick response is a testament to the severity and breadth of the downturn, notwithstanding that it may turn out to be shorter than previous recessions.

Even if that turns out to be the case, the Fed has no intention of taking its foot off the gas pedal. As noted, it plans to keep rates at the lower bound at least through the end of 2022; what's more, it is prepared to use other tools if necessary to lift the economy out of recession and stave off a relapse. Unlike aggressive monetary easing cycles in the past, the Fed is not getting backlash from inflation hawks that traditionally emerge from the woodworks when they perceive the central bank is acting with reckless abandon. This time, there is little fear that the central bank's full-court press to get the economy moving will stoke an inflation outbreak. In fact, just the opposite is the case, as the recession has brought the economy closer to deflation territory than anytime in the postwar period.

That was starkly highlighted in this week's inflation reports. Both the overall consumer price index and the core index that excludes volatile food and energy prices fell for the third consecutive month. While the overall CPI has turned negative for three months or more several times in the past, it was the first time that the core index has strung together three consecutive monthly declines. To be sure, both inflation gauges are still in positive territory relative to a year ago, with the overall CPI just barely ahead at 0.2 percent. But the annual inflation rate in the core CPI is slipping dramatically, from 2.4 percent in February to 1.2 percent in May. That's still a visible cushion against deflation but the margin has shrunk to the narrowest level since 2011, when lingering deflation fears from the Great Recession were running high.

The Fed is no doubt deeply concerned about an inflation rate that is slipping further below its 2 percent target and moving ever-closer to deflation territory. But that worry is not uppermost in the minds of households. One reason: many of the goods and services getting cheaper are not being purchased, thanks to lockdown restrictions that kept consumers from traveling, eating at restaurants, buying gas for cars stuck in garages or purchasing new clothing that have little use for people forced to stay indoors. Prices on all of these items fell last month but drew little attention from consumers who were largely unaware of the discounts.

Indeed, the lockdown restrictions had just the opposite effect on household inflation expectations. With consumers forced to shelter in place they naturally ordered more food to eat at home, used more utilities, such as water and electricity, needed more medical supplies to fight infections and relied more on the Internet for working remotely and watching Netflix. Prices on all of those goods and services rose last month, with food at home prices jumping 1 percent following a 2.6 percent surge in April. Hence, an interesting dichotomy opened up in May. While actual inflation fell, inflation expectations rose. According to the University of Michigan's May survey, household inflation expectations one year ahead rose from 2.1 percent to 3.2 percent before receding back to 3.0 percent in the preliminary June survey. That's still the highest rate in more than 5 ½ years.

Importantly, the population sectors experiencing the biggest job losses from the coronavirus recession – those on the lower rungs of the income ladder – are the very ones whose budgets are squeezed more by rising food and medical costs than upper-income households. Even if, as we expect, the recovery has begun, it will be a long slog before the 40 million newly unemployed workers regain their jobs. We suspect that the Federal Reserve will keep its foot on the monetary accelerator until the job market fully revives, knowing that the most vulnerable sectors of the workforce will be the last to find employment. Whether, and

how much, of a helping hand Congress provides through additional fiscal stimulus will influence the speed with which the job market – as well as the overall economy – recovers from the recession.

## FINANCIAL INDICATORS

| INTEREST RATES | June 12 | Week Ago | Month Ago | Year Ago |
|---|---|---|---|---|
| 3-month Treasury bill | 0.18 | 0.16 | 0.12 | 2.18 |
| 6-month Treasury bill | 0.20 | 0.19 | 0.15 | 2.18 |
| 3-month LIBOR | 0.31 | 0.32 | 0.39 | 2.41 |
| 2-year Treasury note | 0.21 | 0.21 | 0.15 | 1.84 |
| 5-year Treasury note | 0.34 | 0.48 | 0.31 | 1.84 |
| 10-year Treasury note | 0.71 | 0.90 | 0.65 | 2.09 |
| 30-year Treasury bond | 1.36 | 1.67 | 1.33 | 2.59 |
| | | | | |
| 30-year fixed mortgage rate | 3.21 | 3.18 | 3.28 | 3.82 |
| 15-year fixed mortgage rate | 2.62 | 2.62 | 2.72 | 3.26 |
| 5/1-year adjustable rate | 3.10 | 3.10 | 3.18 | 3.51 |
| **STOCK MARKET** | | | | |
| Dow Jones Industrial Index | 25,605.54 | 27,110.98 | 23,685.42 | 26,089.61 |
| S&P 500 | 3,041.31 | 3,193.93 | 2,863.70 | 2,886.98 |
| NASDAQ | 9,588.81 | 9,814.08 | 9,014.56 | 7,796.66 |
| **COMMODITIES** | | | | |
| Gold ($ per troy ounce) | 1,738.70 | 1,688.40 | 1,754.10 | 1,345.30 |
| Oil ($ per barrel) - Crude Futures (WTI) | 36.52 | 38.94 | 29.76 | 52.52 |

| ECONOMIC INDICATOR | Latest Month/Quarter | Previous Month/ Quarter | Two-Months/ Qtrs Ago | Average-Past Six Months or Quarters |
|---|---|---|---|---|
| Consumer Price Index (May) - % change | -0.1 | -0.8 | -0.4 | -0.1 |
| Core CPI (May) - % change | -0.1 | -0.4 | -0.1 | 0.0 |
| Producer Price Index (May) - % change | 0.4 | -1.3 | -0.2 | -0.2 |
| Small Business Optimism Index (May) | 94.4 | 90.9 | 96.4 | 98.9 |

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