GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—July 13th, 2020

Virtually every state in the nation is grappling with the Hobson's choice of reopening the economy and nurturing growth, or retaining lockdown restrictions and potentially short-circuiting the nascent recovery. Until recently, the growth nurturers had the wind at their backs, as low or receding cases of the virus encouraged a broader swath of states to aggressively reopen for business. Not surprisingly, they were amply rewarded by the response, as the economy took off in and May and early June, highlighted by record-setting rebounds in jobs and consumer spending.

But the reopening of business also spurred another unsurprising development – at least according to many epidemiologists – as progress in quelling the virus reversed course and a new upsurge took hold. That trend, which began in early June has since gained traction and is now registering new highs, with cases exceeding a record 60 thousand a day, a threefold increase since mid-June. While most states are seeing upticks, the biggest spikes are occurring among those that were the earliest to lift restrictions, including Florida, Texas and Arizona. Worse, death totals continue to climb at a disturbing rate, even as total infections have soared to over 3.1 million in the U.S.

Understandably, the reopening drive is now faltering. Without clear guidance from Washington, the patchwork approach towards lifting restrictions is now being employed in the other direction. But while states may be moving at different speeds in reimposing restrictions, the overall trend has shifted decisively away from the one that stoked growth in May. Even the most resistant state has hit the pause button in the reopening process, and virtually all of them have tightened restrictions on large gatherings. Needless to say, the sectors that have benefited the most from the early reopening, most notably leisure and hospitality, travel and other businesses impacted by social-distancing measures, are feeling the brunt of the new lockdown actions being rolled out.

The economy's performance going forward will depend mightily on how serious the upsurge in cases becomes, how diligently states respond and how the public's behavior is affected by the upsurge in infections. By all accounts, all three of these influences are turning negative, and the burst of activity during the spring is wilting under the heat of the summer. Most high-frequency data indicate that growth hit an inflection point in mid-June, sapping the economy's momentum. Foot traffic at reopened malls has stalled, diners are having second thoughts about eating out in restaurants and household confidence faltered in late June and early July, according to weekly data compiled by Bloomberg.

Thus far, the negative turn of events on the health front has not stifled the job-creating engine. Companies are still rehiring furloughed workers, reflecting the reopening of businesses since the worst of the crisis in April as well as the positive impact of the Paycheck Protection Program, which has been extended through October. But even the labor market is losing some momentum. While hiring is still exceeding layoffs, the margin of difference is shrinking. New filings for unemployment benefits are declining at a much more sluggish pace than in April and May and, at 1.31 million in the latest week, is still more than double the peak seen during the Great Recession.

What's more, these numbers only reflect unemployed workers filing for regular state benefits, which exclude gig workers and others who are not eligible under the state programs but can apply for federal emergency benefits provided by the CARES Act. Claims under this program have been rising steadily, reaching 1.04 million in the July 4 week. Indeed, nearly 33 million individuals are receiving some form of unemployment insurance, either from states or from Federal emergency programs, which account for a sizeable 20 percent

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of the labor force. Hence, while the job market is healing, the wounds from Covid-19 remain deep, and it will be a long and winding road before it is restored to health.

That said, the financial markets are once again reflecting a divergence in perceptions regarding the likely path of the economy. The stock market, despite experiencing some rough patches, has generally followed a bullish path, overlooking the more ominous ramifications of the worsening health crisis. This week, the major indexes tacked on another gain, extending the vigorous rally that began on March 23. The S&P 500 has regained most of the debilitating 34 percent plunge from February 19 through March 23, when the onset of the coronavirus pandemic wreaked havoc with investor psychology. Following this week's gain, the index stood less than 6 percent from its record high reached in February while the tech-heavy NASDAQ index has soared to new peaks.

Conversely, the bond market has lately been viewing conditions through a more jaundiced lens. In early June, when the economy seemed on the verge of a V-shaped recovery and the health crisis showed signs of easing, the bellwether 10-year Treasury yield spiked up by about 30 basis points from its April low, reaching 0.90 percent. However, as infection cases started to rise and worries about new lockdowns intensified, investors once again sought out safe havens, sending prices of Treasury securities higher. This week, that search intensified; at one point on Friday, the 10-year yield slipped below 0.60 percent – the lowest since lockdown restrictions began to ease in early April – before ending the week at 0.63 percent.

To be sure, the support for Treasuries is not coming entirely from private investors, as the Federal Reserve has been a critical buyer of these securities, absorbing all of the government's new debt issues and then some in its efforts to backstop the economy and credit markets. But the Fed's actions in and of itself is a mirror image of the perceptions held by private bond investors, i.e., that the economy is anything but healthy and highly vulnerable to the negative impact of a resurgence in Covid-19 cases. Importantly, the heightened demand for bonds is drawing support from the ongoing tame inflation backdrop. The Labor Department reported this week that the producer price index fell 0.2 percent in June, a weaker reading than expected and leaving it firmly ensconced in deflation territory, down 0.8 percent over the past year.

Still, most incoming monthly data continue to support the bullish view of the economy. This week's data calendar was light, but a broad gauge of the services sector revealed a robust increase in June. The Institute of Supply Management reported that its index of non-manufacturing activity surged to 57.1 from 45.4 in May, the largest one-month increase in nearly two decades and putting it squarely in expansion territory for the first time in three months. The ISM reading echoes an equally surprising jump in the manufacturing index reported last week.

We caution, however, that these gauges give a misleading impression of the economy's strength. The indexes measure the share of industries experiencing expanding or declining levels of certain types of activities, such as employment, orders, inventories and prices. They say nothing about the magnitude of the individual movements. Hence, as companies reopened for business over the past two months, even incremental increases in, say, hiring from one to two workers counts as an expansion, even though the company may still be operating at a low overall capacity with a far smaller staff than usual. If anything, this is consistent with other recent reports that misleadingly depict a vigorous rebound in activity, such as the monthly jobs and retail sales reports. While the latest monthly increases look astonishingly large, they are bouncing off exceptionally low bases and still remain far below healthy levels.

From our lens, the easy lifting part of the recovery is now behind us, and the road ahead is fraught with hurdles. The most visible, of course, is the path of the virus, which is already slowing the economy's upward momentum and could lead to considerably more damage if the number of cases continues to accelerate. The race to find effective treatments and, more importantly, a vaccine is picking up speed, which does offer hope that the health crisis will not choke off the recovery. Also encouraging are reports that the government is poised to offer more fiscal support, albeit the extent and type is still very much open to debate. We suspect that the recovery is still on training wheels and will need every ounce of support to stay upright.

FINANCIAL INDICATORS

INTEREST RATES	July 10	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.13	0.14	0.18	2.15
6-month Treasury bill	0.15	0.16	0.20	2.08
3-month LIBOR	0.27	0.30	0.31	2.30
2-year Treasury note	0.17	0.16	0.21	1.85
5-year Treasury note	0.31	0.30	0.34	1.86
10-year Treasury note	0.65	0.67	0.71	2.11
30-year Treasury bond	1.34	1.43	1.36	2.64
30-year fixed mortgage rate	3.03	3.13	3.21	3.75
15-year fixed mortgage rate	2.51	2.59	2.62	3.22
5/1-year adjustable rate	3.02	3.08	3.10	3.46

STOCK MARKET				
Dow Jones Industrial Index	26,075.30	25,827.36	25,605.54	27,332.03
S&P 500	3,185.04	3,130.01	3,041.31	3,013.77
NASDAQ	10,617.44	10,207.63	9,588.81	8,244.14

COMMODITIES				
Gold ($ per troy ounce)	1,802.20	1,787.80	1,738.70	1,416.80
Oil ($ per barrel) - Crude Futures (WTI)	40.49	40.33	36.52	60.24

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
ISM Non-Manufacturing Index (June)	57.1	45.4	41.8	51.6
Consumer Credit (May) - $blns	-18.2	-70.2	-11.1	-7.7
Revolving Credit (May) - $blns	-24.3	-58.2	-21.5	-14.5
Producer Price Index (June)	-0.2	0.4	-1.3	-0.2