

This was not a week to search for good news on the economic, health or political fronts. Developments in all three areas couldn't be more downbeat, with the economy bordering on the catastrophic and the political becoming the theater of the absurd. Meanwhile, the health news continues to darken, with virus cases in several states climbing and putting more obstacles in the recovery path. As the Federal Reserve said in its statement from this week's policy meeting, "The path of the economy will depend significantly on the course of the virus." On that score the Fed is anything but optimistic, as Chairman Powell warned that the resurgence in virus cases is already weighing on the recovery and urged Congress to provide more aid to sustain growth.

Whether the legislative branch will heed that message remains uncertain, as the Senate closed down for the weekend on Thursday without a stimulus proposal on the table. No doubt, something will be done, as evidence that the recovery is faltering is becoming ever more compelling and an election is only three months away. The revival in restaurant dining, travel, hotel occupancy rates and credit-card usage seen in May and June has either stalled or moved into reverse; importantly, new claims for unemployment benefits rose for the second week in a row, short-circuiting the steep decline from the peak reached in late March. The loss of momentum has become particularly visible since early July, casting a shadow over the strength of the nascent recovery.

That's important because the economy has to climb a titanic hill to regain the level of performance set before the pandemic. While not surprising, the economy's report card for the second quarter contained more Fs than any rational parent would care to tolerate. The headline tells it all: real GDP contracted by a 32.9 percent annual rate during the period, a quarterly setback not seen even during the Great Depression (although quarterly data were not available at the time). Needless to say, pundits will inevitably make comparisons with that infamous time in history. But that would be unfair, as the downturn of the 1930s was not self-inflicted and it suffered double-digit declines for at least three full years, peaking at a negative 23.1 percent over the full year in 1932.

No one expects this recession to last as long or suffer the same existential collapse as was the case during the Great Depression. As noted, this downturn was self-inflicted, prompted by government –mandated business closures and social distancing measures. Once the health crisis ends and these restraints are lifted, the economy should bounce back. Indeed, the recovery is already underway, thanks to the partial reopening of the economy, and is expected to continue unless aborted by an inability to control the pandemic. That's a major caveat to be sure. But the sharp rebound in May and June puts the economy on a higher base that assures a strong third-quarter growth rate. Even if there is no further growth in July, August and September, the period would still register a strong double-digit gain.

But if the economy stalls over the rest of the summer, that statistical gain will not feel like a recovery for millions of Americans. Keep in mind that the government's massive income support that the \$1200 stimulus checks and the \$600 weekly supplement to unemployment benefits provided to a broad swath of low and middle income families enabled them to survive the downturn. Without that support, which fueled a rebound in personal consumption in May and June, the collapse in economic activity would have been even greater during the second quarter. But the government stimulus that was so vital a prop to the nascent recovery has mostly run its course and must be refueled to keep the economy's engine running.

Instead, Congress is dithering over what to put in the tank and how much fuel is needed. There are a number of disagreements between Republicans and Democrats over what to include in a fiscal relief

package and how large it should be. The Dems are striving for about \$3 trillion that would include extending the \$600 weekly jobless supplement through the rest of the year and substantial aid to state and local governments. Republicans are targeting a scaled-down package of around \$1 trillion that would include considerably less for state and local governments and smaller jobless benefits. The prevailing sentiment in the Senate is to cut the weekly supplement to \$200 a week. Both parties agree on another direct payment to households similar to the \$1200 direct payment approved in March.

From our lens, the most urgent gap to fill is the \$600 weekly supplement to jobless benefits that expired this week. Before Congress goes on its summer recess after next week, some form of enhanced benefits will likely be resurrected. The amount of the supplement, however, is no small matter. If it is cut to \$200 a week, as the Republicans want, the hit to incomes would be considerable. There are 30 million unemployed workers receiving benefits. A \$400 haircut in payments translates into \$12 billion a week – and about \$50 billion a month – of deprived income. The removal of that amount of funds from the spending stream would have a meaningful impact on GDP.

True, the direct impact would not be dollar for dollar. The income boost provided by the enhanced jobless benefits combined with the spending cutback in the second quarter enabled households to build up a formidable cushion of savings. Although the savings rate has come down from its record 33.5 percent peak in April, it still remained elevated at 19.0 percent in June. No doubt, some fraction of low to middle-income households was able to pad their savings accounts during the period, and will dip into this cushion to sustain spending if the income-supplement shrinks in coming months.

But recent studies indicate that wealthier households account for the bulk of the savings increase. Not only were their incomes not as adversely affected by the pandemic as those lower down the income scale, but lockdown restrictions that led to widespread business closures also reduced their purchasing options. These consumers could not travel, go to hair salons, restaurants or the theater, among other options that wealthier households avail themselves of. Until businesses reopen on a broader scale and make these discretionary purchases more available, the funds normally earmarked for them will remain unspent and in savings accounts. What's more, as long as the health crisis is unresolved wealthier households will refrain from certain activities that threaten their safety, many of which involve social interactions.

Simply put, the potential cutback in jobless benefits would have a disproportionate effect on consumer spending, as it deprives the very segment of the population that would spend virtually every penny of the benefit. At the same time, the flip side of this observation is just as telling. With upper income households saving a larger fraction of their income due to the unavailability of goods and services they tend to purchase, it was the unemployed workers receiving enhanced benefits that kept the economy from suffering an even greater collapse than it did during the pandemic. From a macro perspective, the stronger the safety net that Congress approves of in the coming week, the greater the prospect of a stronger recovery.

While there were hardly any bright spots in the second-quarter GDP report, the 39.7 percent annualized increase in nondefense Federal spending clearly put a floor under the record contraction during the period. Hopefully, it will serve the same growth-boosting purpose in the current quarter. The other silver lining in the report was the reduction in business inventories, which is somewhat unusual during the early stage of a recession. Typically, when consumers stop spending inventories pile up, which prompts businesses to slash new orders leading to further production cutbacks. But this recession was led by the collapse in services, reflecting lockdown restrictions that primarily affected this sector, whereas purchases of goods fell only modestly. Hence, the drag from an inventory correction should not weigh as heavily on the recovery as in past cycles.

FINANCIAL INDICATORS

INTEREST RATES	July 31	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.10	0.11	0.15	2.06
6-month Treasury bill	0.11	0.13	0.18	2.01
3-month LIBOR	0.25	0.25	0.31	2.29
2-year Treasury note	0.11	0.15	0.17	1.71
5-year Treasury note	0.21	0.27	0.30	1.66
10-year Treasury note	0.54	0.59	0.65	1.84
30-year Treasury bond	1.20	1.23	1.37	2.38
30-year fixed mortgage rate	2.99	3.01	3.13	3.75
15-year fixed mortgage rate	2.51	2.54	2.59	3.20
5/1-year adjustable rate	2.94	3.09	3.08	3.46

STOCK MARKET				
Dow Jones Industrial Index	26,428.32	26,469.89	25,015.55	26,485.01
S&P 500	3,271.12	3,215.63	3,009.05	2,932.05
NASDAQ	10,745.27	10,363.18	9,757.22	8,004.07

COMMODITIES				
Gold (\$ per troy ounce)	1,991.90	1,899.80	1,784.80	1,453.50
Oil (\$ per barrel) - Crude Futures (WTI)	40.44	41.27	38.19	55.20

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Orders for Durable Goods (June) - % change	7.3	15.1	-18.3	-1.8
GDP (Q2) -- % change, Saar	-32.9	-5.0	2.4	-4.7
Personal Income (June) - % change	-1.1	-4.4	12.1	1.1
Personal Consumption (June) - % change	5.6	8.5	-12.9	-0.8

DISCLAIMER: This communication has been prepared by Government Portfolio Advisors LLC solely for informational purposes for institutional clients. Sources for this commentary include Bloomberg and Stone McCarthy Research Associates. It is not an offer, recommendation, or solicitation to buy or sell, nor is it an official confirmation of terms. It is based on information generally available to the public from sources believed to be reliable. No representation is made that it is accurate or complete or that any returns indicated will be achieved. Changes to assumptions may have a material impact on any returns detailed. Past performance is not indicative of future returns. Price and availability are subject to change without notice. Additional information is available upon request.