GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—October 19th, 2020

As if we haven't had our fill of "October Surprises", this week's batch of data provided another round of mixed messages that make the art of forecasting an economist's nightmare. On the one side you have a pandemic that shows no sign of letting up, with Covid-19 cases accelerating to the highest level in more than two months. With cold weather and the flu season about to descend on the nation, the health crisis continues to cast a dark cloud over the economic landscape, imparting downside risks into every economic forecasting model, including that of the Federal Reserve.

To be sure, the march towards a vaccine remains very much in train, and health experts expect one to be widely available within the first half of next year. While that would be a record time for development, surveys show that more than half the population fears the vaccine is being rushed to the market and, for safety sake, would not get vaccinated right away. That distrust, which is considerably greater than shown in earlier surveys, dilutes the positive impact that the promising medical achievement would otherwise have on economic activity. It also bolsters the notion that households would retain the mind-set that has influenced behavior throughout the pandemic, adhering to social-distancing customs and other behavioral adjustments that suppress activity involving in-person interactions.

On the other hand, household spending continues to exceed expectations, something that was starkly apparent in this week's retail sales report for September. Indeed, retail sales ended the third quarter with a bang, surging by 1.9 percent, more than double the consensus forecast and the strongest in three months, Compared to a year ago, sales are up 5.4 percent, the strongest annual increase so far in 2020. Nor did one or two outliers skew the total higher. Except for a mild 1.6 percent decline in sales at electronic and appliance stores, all major categories of sales rose last month. Even the drop in electronic sales may raise some eyebrows, as the spread of remote working has clearly stoked demand for PCs and other gear designed for that purpose. But such sales surged by an eye-opening 55 percent in the third quarter, so the September pullback is likely an aberration more than anything else.

Importantly, the control group of sales (total sales excluding food, autos, gasoline and building materials) which feed directly into the GDP calculation of personal consumption, increased by a formidable 1.4 percent, boosting the total 9.1 percent above its year-earlier level. That's the strongest annual gain since at least 1992. The retail sales report does not adjust for price changes, so the nominal gain overstates the actual spending strength last month. For example, the 4.0 percent increase in sales at auto dealers, which account for about twenty percent of total retail sales, may reflect mostly higher prices, as used car and truck prices staged their biggest increase in September since 1969. Covid-19 has discouraged people from taking public transportation and spurred a mass movement out of cities to rural areas where cars are needed and are commanding higher prices.

Nonetheless, the latest burst of retail sales confirms that consumers spearheaded a vigorous rebound in GDP during the third quarter. We estimate that real personal consumption jumped by an annual rate of 40 percent during the period, driving a 34 percent increase in real GDP. As eye-popping as the surge is, it would still only recover about two-thirds of the output lost during the second quarter, leaving a huge hole to fill before the economy can return to pre-pandemic levels. Importantly, the path ahead will not be as smooth as the one just traveled. Even as consumers kept their wallets and purses open over the summer, they are facing a far less hospitable future that will tamp down their eagerness to spend.

One major headwind is the income haircut that is coming from the withdrawal of fiscal stimulus. Keep in mind that lower and middle income consumers led the rebound in consumption during the third quarter,

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fueled by the stimulus checks and extra $600 weekly unemployment benefits provided under the Cares Act. These consumers devote a larger share of their spending budgets to goods rather than services, which contributed to the outsized gains in retail sales over the past few months. However, those purchasing-power boosters are running dry, as the enhanced benefits expired in August and leftover funds from the stimulus payments are rapidly shrinking. So far, the squeeze on budgets has been cushioned by the bloated savings that households have managed to put aside out of the stimulus checks. But that source of spending is not sustainable, as the savings cushion is deflating and layoffs are rising.

Indeed, just as consumer spending has held up better than expected, the expiration of enhanced employment benefits has not generated the spike in job seekers that many thought would occur once the generous payments were slashed. But neither has it discouraged people from filing applications for unemployment benefits, which remained stubbornly high in September despite the reduced benefit payments. More worrisome, however, is that latest figures from the Labor Department suggest that layoffs are picking up. First-time claims for unemployment benefits spiked by 53 thousand to just under 900 thousand in the week ending October 10, the highest number since late August.

One-week does not make a trend, and the latest spike may be more noise than substance. Still, the prospect that the unemployment lines are getting longer is supported by high-frequency data as well as the Labor Department's recent monthly jobs report. Hiring is slowing, job listings are lower and household surveys indicate that jobs are becoming less plentiful. Given this softening labor market backdrop, which is impacting lower-wage earners more than those higher up the income ladder, a critical source of strength behind consumer spending is poised to weaken. To be sure, some of the slack is being taken up by increased spending on services, as the easing of lockdown restrictions over the summer unlocked spending by higher net worth households on restaurants, travel and other services.

But with cases of Covid-19 now accelerating in the majority of states, renewed restrictions on social gatherings are already taking place, which threaten to short-circuit the rebound in spending on services. It's doubtful that lockdowns as severe as those that occurred earlier in the pandemic will return. That prospect is politically unpalatable given the show of lockdown fatigue that is proliferating among broad swaths of the population. The hope is that targeted restrictions would lessen the drag that threw the economy into recession in the second quarter and enable the recovery to proceed. The risk, of course, is that by taking this route, the odds are higher that a second wave of the virus will gain traction and force a harsher response later this winter.

Simply put, the confluence of forces point to a slowing economy in the fourth quarter that could reach stall speed by the end of the year if more fiscal aid is not forthcoming. At this juncture, lawmakers are still at loggerheads over a pandemic relief bill, although the House Speaker and Treasury Secretary are reportedly heavily engaged in negotiations. But the chances of something coming out of Washington before the election look grim. Even the White House chief economic spokesman admits that a bill before the November 3 elections is highly unlikely. While Speaker Pelosi and Secretary Mnuchin are reportedly not far apart in terms of the size of a package, the Senate majority leader, Mitch McConnell, is adamant that his chamber would only support a much smaller bill than the one being bandied about, something in the neighborhood of $2 trillion.

Ironically, the strong retail sales report may only stiffen McConnell's reluctance to approve a large budget-busting bill, particularly as it came on the same day the Treasury announced that the Federal deficit tripled in fiscal 2020 to $3.1 trillion. Aside from raising the ire of fiscal hawks in the Senate, the majority leader might believe that the economy is in little need of additional support. After all, if consumers are still spending freely, where is the urgency for more stimulus? From our lens, this would be a misguided look in the rear view mirror of a growth engine that is rapidly losing fuel and that, without additional fiscal aid, will be running on near empty in coming months.

Hence, whatever the election outcome turns out to be, the economic data after November 3 should more decisively reflect a slowing economy. That, together with a less politically-charged environment on Capitol

Hill, should put Congress in a more receptive mood to compromise, setting the stage for a pandemic relief bill. It may not be as large as what the economy needs, but even a “stimulus light” would help offset the powerful drags from the ongoing spread of the virus until a vaccine become widely available and is widely accepted by the public.

FINANCIAL INDICATORS

INTEREST RATES	October 16	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.11	0.11	0.10	1.67
6-month Treasury bill	0.12	0.13	0.11	1.63
3-month LIBOR	0.22	0.22	0.23	1.97
2-year Treasury note	0.15	0.17	0.14	1.58
5-year Treasury note	0.32	0.34	0.28	1.56
10-year Treasury note	0.75	0.78	0.70	1.75
30-year Treasury bond	1.53	1.58	1.46	2.25
30-year fixed mortgage rate	2.81	2.87	2.87	3.69
15-year fixed mortgage rate	2.35	2.37	2.35	3.15
5/1-year adjustable rate	2.90	2.89	2.96	3.35
STOCK MARKET				
Dow Jones Industrial Index	28,606.31	28,586.90	27,657.42	26,770.20
S&P 500	3,483.81	3,477.14	3,319.47	2,986.20
NASDAQ	11,671.56	11,579.94	10,793.28	8,089.54
COMMODITIES				
Gold ($ per troy ounce)	1,902.90	1,934.70	1,957.10	1,493.90
Oil ($ per barrel) - Crude Futures (WTI)	40.78	40.54	40.95	53.71

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Consumer Price Index (Sept) - % change	0.2	0.4	0.6	0.1
Core CPI (Sept.) - % change	0.2	0.4	0.2	0.2
Producer Price Index (Sept.) - % change	0.4	0.3	0.6	0.1
Retail Sales (Sept.) - % change	1.9	0.6	1.1	2.6
Industrial Production (Sept.) - % change	-0.6	0.4	4.2	-0.3