GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—October 26th, 2020

The ongoing battle on Capitol Hill over a coronavirus relief bill continues to dominate trading on Wall Street, with positive signs of a deal sending stock prices and bond yields higher and vice versa when talks appear to be falling apart. The administration and House Democrats are close in terms of dollar amounts, hovering around $2 trillion, but the Senate Majority leader, Mitch McConnell stands in front of the goal posts, backed by a formidable cadre of fiscal hawks who refuse to accept another budget-busting deal of that magnitude. Adding to this complicated mix, President Trump insists that if a deal is struck with the Democrats, he will twist the arms of Republicans to get it approved. As the choppy trading week drew to a close, it looks like reaching an agreement before the elections will be a nail-biter.

Nonetheless, most lawmakers agree that some stimulus will be needed to breathe life into the recovery, as the fading impact of the fiscal jolt provided under the Cares Act last spring is depriving the recovery of much-needed fuel. The Federal Reserve is fully on board with that sentiment, with most officials urging Congress to err on the aggressive side. To buttress their case, they, as well as former Fed officials, refer to the early withdrawal of fiscal stimulus that contributed to the slow recovery following the 2008 financial crises and recession. Aside from the debate over the size of a stimulus package, there is also the controversy over whether or not the recovery is on a self-sustaining path with or without more fiscal support. Some see the glass as more than half-full, encouraged by the fact that the economy has already recovered about half of the lost output and jobs in a few short months, and the momentum should remain firmly on track for the foreseeable future. Critics, however, view the glass as half-empty, discouraged by the fact that the economy is “only” half way back and still has a steep hill to climb return to pre-pandemic levels even as it faces mounting headwinds from the pandemic.

We concur that the next phase of the recovery will be a more strenuous path to travel. The “easy fruit” as Fed chair Powell noted has already been picked when the economy fitfully reopened in the spring. But the burst of job growth and the unleashing of pent-up demand in that first phase are ebbing even as the headwinds from the pandemic are gaining traction. New cases of the virus are accelerating and hitting a broader swath of states, prompting local leaders to impose tougher restrictions on social gatherings and other measures that are slowing, if not reversing, the reopening process. Meanwhile, the expiration of programs that have bolstered household purchasing power in the spring and summer portends weaker consumer demand in coming months. Even if a stimulus bill does become a reality sooner rather than later, it will take months before the legislation is formalized and puts fresh funds into household bank accounts.

It is true, however, that the vigor of the rebound in the third quarter has surprised most forecasters, including the Federal Reserve. What’s more, some sectors continue to outperform expectations, most notably the housing market. Home sales are on a tear, with purchases of existing homes surging to the highest level since 2006 in September. These transactions do not directly boost GDP (aside from the modest influence from additional broker fees), as they represent the shifting of an existing asset from one owner to the next rather than generate additional output. But they indirectly influence the broader economy in a positive way by stoking the demand for goods and services associated with a home purchases, including home furnishings, appliances and moving services.

Importantly, the surprising strength in demand for homes has depleted inventories, which is contributing to two other developments that have broader economic consequences. For one, it has galvanized homebuilders as never before, driving their confidence to record highs and sparking an eye opening increase in home construction. Hence, single-family housing starts surged 8.5 percent in September to the highest level since June 2007. What’s more, this is one trend that is likely to be sustained for a while as

building permits for single-family homes – a reliable indicator of future construction activity – also spiked by nearly 8 percent to a 13-year high. Inventories in both the new and existing home markets are historically lean even as demand remains strong, a combination that should keep builders busy and spur hiring of construction workers.

For another, the combination of strong demand and weak supply is having the time-honored impact on prices. The median price on an existing home sale in September surged by 14.8 percent from a year ago. You would have to go back to October 2005 to see prices rising at a faster annual clip. Recall, that was the tail end of one of the most speculative housing booms in U.S. history, when homeowners were using the bloated equity in their homes as ATM machines to purchase everything from cars to cruise vacations. Nothing like that experience is happening now, which thankfully will enable the economy to avert another meltdown if the housing market runs into hard times.

That said, the surge in property values is clearly having a positive influence on household balance sheets. At the end of the second quarter, homeowners saw the equity share in their homes climb to 65.6 percent, the highest since 1990. Even allowing for the roughly 30 percent of homeowners who are mortgage free, the rapid increase in home prices has clearly provided a windfall in equity gains for the majority of property owners over the past year. The question is, what impact has this had on household behavior? No doubt, there has been some wealth effect, reflecting the inclination of households to spend some fraction of their newfound wealth on goods and services. Historically, however, the wealth boost on consumption from home equity gains has been quite modest (excluding the outsized influence seen during the aforementioned housing boom) and the spill over this time may have been further limited by the supply constraints imposed by the pandemic.

However, the surge in turnover in the housing market indicates that many homeowners are trading up into larger homes, which may be another consequence of the health crisis. Not only has the trend towards remote work become more firmly entrenched and likely to be maintained after the crisis ends, it is also possible that laid off homeowners are trading up into larger homes and using the profits from the sale to accommodate startup businesses. Keep in mind that many of the 11 million workers who have still not recovered their jobs from the devastating 22 million purge that took place in March and April are in better financial shape than unemployed workers in earlier recessions. Not only are the ones with homes flush with more housing equity, but the vast majority of households – including laid-off renters – benefited from direct stimulus payments and enhanced unemployment benefits during the spring and summer. A big fraction of those funds has been saved, lifting the personal savings rate to a record 25.6 percent in the second quarter.

Armed with a surfeit of funds in an uncertain job market and living in a technology-driven economy that enables most work functions to be performed remotely, the ingredients for jobless workers to start a business are firmly in place. How many of them are following through is unclear, but it is more than just coincidence that during these precarious times there has been a record surge in applications for new businesses. According to Census Bureau data, over 1.5 million applications have been filed in the third quarter, about double the normal quarterly pace seen in recent years. A corresponding increase consists of so-called high propensity applications, which are viewed by Census as most likely to result in wage-paying companies. Ironically, this trend coincides with an ongoing high volume of new applications for unemployment benefits, indicating perhaps that the pipeline for future startups is being replenished.

On the surface, this trend also suggests that job growth may not slow as much as generally expected next year, with new businesses taking up some of the slack of more established companies that are likely to be adding fewer workers than they were prior to the pandemic. Time will tell if this occurs; but its prospects would certainly improve if Congress provides a helping hand with a stimulus package that injects more funds into the hands of jobless workers. History shows that most new startups fail within a short period of time, partly because owners run out of operating funds. An infusion of fiscal aid would help tide them over that fragile stage of development.

Indeed, there is some evidence that the surge in savings from the direct stimulus payments last spring provided the seed money for budding entrepreneurs to start their businesses. To the extent that was the case, those funds will not last much longer. The savings rate has already receded from its April peak of 33.6 percent to 14.1 percent in August. More than likely it fell further in September, the second month of reduced government transfer payments following the expiration of enhanced jobless payments at the end of July. Not surprisingly, a drop in filings for new business applications has also accompanied the drop in savings, highlighting a probable link between the two developments.

To be sure, the more current weekly data on business applications provided by the Census Bureau are not seasonally adjusted as are the quarterly data. But the noise can be removed by looking at year-over-year comparisons, and the receding trend is clearly evident. The good news is that filings are still almost 40 percent higher than a year ago, so there is still time to continue turning a negative (the high level of layoffs) into a positive (spurring new businesses). Better still, a timely fiscal stimulus relief bill would go a long ways towards closing the spigot that feeds the unemployment lines, as it would fuel the economy's growth engine and spur hiring at established companies.

FINANCIAL INDICATORS

INTEREST RATES	October 23	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.10	0.11	0.10	1.67
6-month Treasury bill	0.12	0.12	0.12	1.66
3-month LIBOR	0.21	0.22	0.23	1.94
2-year Treasury note	0.17	0.15	0.14	1.63
5-year Treasury note	0.38	0.32	0.27	1.63
10-year Treasury note	0.84	0.75	0.66	1.80
30-year Treasury bond	1.64	1.53	1.40	2.29
30-year fixed mortgage rate	2.80	2.81	2.90	3.75
15-year fixed mortgage rate	2.33	2.35	2.40	3.18
5/1-year adjustable rate	2.87	2.90	2.90	3.40
STOCK MARKET				
Dow Jones Industrial Index	28,335.57	28,606.31	27,173.96	26,958.06
S&P 500	3,465.39	3,483.81	3,298.46	3,022.55
NASDAQ	11,548.28	11,671.56	10,913.56	8,243.12
COMMODITIES				
Gold ($ per troy ounce)	1,904.40	1,902.90	1,863.30	1,507.30
Oil ($ per barrel) - Crude Futures (WTI)	39.77	40.78	40.08	56.62

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Housing Starts (September) - 000s	1,415	1,388	1,487	1,255
Building Permits (September) - 000s	1,553	1,476	1,483	1,342
Existing Home Sales (September) - 000s	65,400	59,800	58,600	5,220

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