Weekly Economic Update—November 2nd, 2020

GOVERNMENT PORTFOLIO ADVISORS

Now that it is abundantly clear there will be no pre-election stimulus bill even as cases of infections are hitting daily records, the markets are homing in on the potential damage the ongoing health crisis could have on the economy. The range of prospective effects is wide, depending on several variables that are still up in the air. First and foremost is the election outcome, which has been the biggest source of market uncertainty and volatility in recent weeks. Most market participants expect some form of stimulus after the elections, but its size, composition and timing would depend on who ultimately controls the purse strings in Congress and the White House. The most aggressive bill is expected from a Democratic sweep, the least aggressive from a split verdict with Trump retaining the White House, and something in the middle if Biden wins and presides over a split Congress.

Perhaps the biggest negative weighing on market psychology is the prospect of a contested election. That would not only throw a wrench in the legislative gears until it is settled; it would heighten fear and uncertainty among investors as well as on Main Street, something that was amply demonstrated during the 2000 presidential election. Recall that the Supreme Court settled the Florida recount dispute on December 12, more than a month after the November 7 election. During that unsettling waiting period, stock prices fell by 5 percent and consumer spending slowed to a crawl before rebounding vigorously after the court's decision. Whether events follow a similar pattern this time remains to be seen. Even if the election outcome is unambiguous soon after voters go to the polls, the question is whether a relief bill would emerge from a lame-duck Congress and includes stimulus checks in time to boost holiday sales.

One thing is sure: the 401K plans that had been a rallying cry for President Trump throughout the campaign is providing less ammunition for his tweets. The stock market has been sagging over the past two months and the S&P 500 is ending October with a 2.8 percent loss. That said, the market is still up by more than 45 percent from its March 23 low, so it is hard to shed tears over the recent slump. More important is how the underlying fundamentals are holding up and what the future holds. With regards to the former, recent data suggest that there is little to complain about. Indeed, some reports are downright bullish. This week, the headlines featured an eye-popping increase in the broadest measure of economic activity during the third quarter, which has replaced the stock market as the President's biggest ally in his quest for reelection.

In its first estimate for the period, the Commerce Department reported that real GDP surged by a record 33.1 percent annual rate in the third quarter. In normal times, that would appear to be earth-shattering news, implying that the economy was off to the races. Of course, these are not normal times and the news elicited more of a yawn than a yelp; indeed, the surge in activity was one of the most highly telegraphed events in recent memory, as it was virtually baked in once the economy fitfully reopened from lockdown restrictions that crushed activity in the second quarter. As we know from the monthly data, consumers came roaring back from enforced hibernation in March and April. Armed with trillions of dollars in stimulus checks and enhanced unemployment benefits, households unleashed a torrent of pent-up demand on goods as they become available when lockdown restrictions eased and businesses were able to reopen.

The bundle of funds from fiscal stimulus together with the rebound in job growth over the summer months sustained consumer spending throughout the third quarter, resulting in a record 40.7 percent annual rate of increase in personal consumption. As astounding as that increase was, it was exceeded by an even more superlative 59.3 percent growth rate in residential outlays. The combination of these two growth drivers starkly illustrates the positive impact on the economy that occurs when fiscal and monetary policies operate in concert. The fiscal stimulus fed the consumption surge by putting funds directly into the hands of consumers, allowing them to spend immediately and to set a considerable sum aside into savings for

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future purchases. Meanwhile, the Federal Reserve's low interest rate policy stoked a wave of home sales and ignited a burst in housing construction.

But the harmonious relationship in policies sounded a discordant note at the end of the third quarter, when the $600 top-up to weekly jobless benefits expired and was replaced by a watered down Federal subsidy that provided only a $300 supplement from a pool of funds that is now depleted. The Federal Reserve has kept its foot on the monetary pedal, but without the companion lever from the fiscal side, its influence on economic activity is poised to weaken considerably. Importantly, the data coming in still reflects the positive influence of the two policy levers operating in tandem. That's particularly so for consumer spending, which has held up well in the two months following the expiration of the $600 weekly unemployment supplement. In September, real personal consumption increased by a better-than-expected 1.2 percent, nearly half again larger than the 0.7 percent advance in August.

But the September gain in spending was still juiced by the earlier fiscal stimulus, as households tapped into their bloated savings accounts to help finance purchases. On the surface, it appears that there is still a considerable amount of juice left to sustain spending for a while longer. The personal savings rate is well off its peak of 33.6 percent hit in April; but at 14.3 percent in September, it is still highly elevated relative to normal yardsticks. However, odds are the high savings rate primarily reflects the unspent funds of upper-income individuals who would normally spend more on restaurants, travel and entertainment – all options that continue to be constrained by social-distancing mandates.

Conversely, the earlier bulge in savings likely contains a higher fraction from lower income people who put aside funds from their income supplements, either as a precautionary measure to cushion the blow from extended unemployment or as windfall gains from income that might have exceeded the earnings they received from their jobs. More than likely, those savings have already been spent, accounting for most, if not all, of the decline in the savings rate over the past five months.

As it is, the consumer-spending increase that drove GDP to its record-setting advance in the third quarter was front-loaded. The outsize gains in May, June and July established a high launching pad that fueled the quarterly growth rate off of a severely depressed second quarter. That contour also applies to GDP, which benefited from an early spurt and is entering the fourth quarter with fading momentum. Indeed, all of the third quarter's data reflects activity before the current upsurge in virus cases took hold. With daily infection rates hitting new highs and no replacement stimulus bill to jump-start growth around the corner, the economy will be navigating a tougher road in the fourth quarter. As impressive as the third-quarter rebound was, it still only recovered two-thirds of the output losses suffered in the second quarter. That remaining one-third will be difficult to regain in the face of headwinds from the health crisis and election uncertainty.

Just how long it takes for the economy to recover all the ground lost during the recession will depend in large part on the amount of fiscal stimulus that ultimately comes out of Washington. Clearly, the larger the stimulus, the quicker will be the recovery process. But fiscal policy is only one of the key variables that will determine the economy's performance next year. The other is the path of the virus and progress towards containing it. Indeed, the uncertain fate of the health crisis stands as the biggest headwind facing the economy. Its impact on household behavior is readily apparent. Less obvious is the drag it is having on the business sector. According to a recent survey by the Atlanta Federal Reserve, business capital spending plans over the next two years have been slashed by 20 percent due to Covid-19 uncertainty. From our lens, it will be a long slog ahead for the U.S. economy, with a full recovery to pre-crisis levels not expected until late next year.

FINANCIAL INDICATORS

INTEREST RATES	October 30	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.10	0.10	0.09	1.52
6-month Treasury bill	0.12	0.12	0.11	1.54
3-month LIBOR	0.21	0.21	0.23	1.90
2-year Treasury note	0.18	0.17	0.13	1.56
5-year Treasury note	0.38	0.38	0.28	1.54
10-year Treasury note	0.88	0.84	0.70	1.72
30-year Treasury bond	1.66	1.64	1.49	2.19
30-year fixed mortgage rate	2.81	2.80	2.88	3.78
15-year fixed mortgage rate	2.32	2.33	2.36	3.19
5/1-year adjustable rate	2.88	2.87	2.90	3.43

STOCK MARKET				
Dow Jones Industrial Index	26,501.60	28,335.57	27,682.81	27,347.36
S&P 500	3,269.96	3,465.39	3,348.44	3,066.91
NASDAQ	10,911.59	11,548.28	11,075.02	8,386.40

COMMODITIES				
Gold ($ per troy ounce)	1,878.80	1,904.40	1,904.50	1,516.20
Oil ($ per barrel) - Crude Futures (WTI)	35.72	39.77	36.99	56.09

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Durable Goods Orders (Sept) - % change	1.9	0.4	11.8	3.1
New Home Sales (Sept.) - 000s	959	994	965	838
Real GDP (Q3) - % change, Saar	33.1	-31.4	-5.0	0.5
Personal Income (September) - % change	0.9	-2.5	0.9	1.0
Personal Consumption (Sept.) - % change	1.4	1.0	1.5	1.1

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