Weekly Economic Update—December 21st, 2020

Along with pandemic-related headwinds, a severe nor'easter battered a major region of the economy this week, providing Covid-wary households with another excuse to avoid the perils of outdoor activity. Fortunately, the outburst from Mother Nature is a transient headwind that will not leave long lasting scars as are likely to prevail in a post-Covid world. But while the coronavirus legacy is still taking shape, the government reached a deal on a fiscal package that will dilute its near-term impact.

That said, amidst a dreary landscape of economic data, the prospect that a deal was close to becoming a reality brightened the mood on Wall Street, notwithstanding a technically-driven slide in stock prices on Friday. Nothing was put on paper as of Friday; but legislators worked through the weekend and reached an agreement Sunday. What's more, the size of the package of around $900 billion, while still less than what is needed to jump-start the economy's engine, should put a floor under the free-fall that would otherwise occur. Importantly, the components of the bill that have come to light will help protect the most vulnerable segments of the population – the millions of laid-off workers whose financial resources have been depleted, and small businesses that are struggling to stay afloat as the pandemic and renewed restrictions vaporize revenues.

Unfortunately, the relief bill fails to provide direct funds to state and local governments, which have already laid off 1.3 million workers since the pandemic struck and are likely to cut headcounts even more as reduced tax revenues and increased health costs adds to the strain on budgets. What's more, the enhanced unemployment benefits component that is in the package is no more than a partial bridge that carries jobless workers over to a post-Covid world. The bill extends benefits by an additional 11 weeks with a weekly supplement of $300. But there are around 10 million fewer workers with jobs than there were in February and it would take years to fully recover that loss at the current pace of job growth. 11 weeks would be a fragile band-aid for those still left behind.

That said, the temporary extension of benefits comes in the nick of time as the pandemic's grip on the economy is tightening and causing the unemployment lines to swell. New claims for unemployment benefits surged to a three-month high of 885 thousand in the second week of December, marking the fourth increase in the last five weeks. The upward trend is primed to continue for a while, as tougher government restrictions force more businesses to scale back operations, cold weather sends households indoors and escalating virus cases leads to more cautious consumer behavior. The full impact of these influences will show up in next quarter's aggregate data, but it is already taking a toll on the broader economy.

Importantly, the economy 's main growth cylinder, consumer spending, is sputtering. Retail sales fell by 1.1 percent in November, the weakest reading in seven months. What's more, the slim 0.3 percent increase reported for October was revised down to a 0.1 percent drop. Not surprisingly, the biggest hit was felt by sectors most vulnerable to the impact of the virus, namely bars and restaurants, which were subject to renewed restrictions, department stores, as customers resisted crowds, and clothing stores, as remote work reduced the need for new apparel. Meanwhile, weakening labor conditions and rising unemployment prompted consumers to pull in their purse strings for discretionary items, leading to lower sales of autos, electronics and appliances.

Conversely, some sectors continued to thrive under the pandemic. Since households were forced to stay indoors, they stepped up purchases of food and beverages as home cooking replaced eating out at restaurants. Likewise, purchasing over the Internet also continued its relentless climb, although the growth in e-commerce sales slowed in November. Like the headline number, the control group of sales that feeds

directly into personal consumption in the GDP accounts, fell for the second consecutive month, slipping by 0.5 percent in November. That too was the worst showing since April; before then you would have to go back nearly two years to find a deeper monthly slide. Given the darkening health and job market backdrop, the Christmas shopping season is not shaping up to be a cheerful occasion.

One bright spot amidst the gloomy picture unfolding continues to be the housing market. Bolstered by low mortgage rates and households seeking larger homes to accommodate remote working – which will persist even after the health crisis ends – home sales and construction activity are surging. Demand is also getting a boost from urban dwellers buying second homes to escape more densely populated areas linked to Covid-19. This week, mortgage rates plunged to another record low, which is keeping a fire under loan applications for home purchases. Since mid-year, these applications have surged, pointing to sustained momentum in home buying over the coming months.

The down side is that the supply of homes is not keeping up with demand, causing inventories to shrink and driving up home prices. As homes become ever-more expensive, many first-time homebuyers will be driven out of the market, putting a crimp on demand. Homebuilders are ramping up construction to close the demand/supply gap and take advantage of more profitable sales opportunities. In November, housing starts surged to a 1.547 million annual rate, just a tad under the 14-year high reached in January. Although multifamily starts paced the increase last month, single-family home construction continued to forge higher, with starts reaching the highest level since April 2007.

Importantly, the near-term future looks bright as building permits for future construction of single-family homes jumped to the highest level since January 2007. This is meaningful for the broader economy, as single-family home construction is more labor intensive than multi-family construction and makes a bigger contribution to GDP growth. It is also noteworthy that housing is one of the most credit-sensitive sectors of the economy, as its fortunes are tightly linked to changes in mortgage availability and mortgage rates. Both are expected to remain favorable for the foreseeable future.

For one, banks are awash in funds and channeling a major portion to real estate loans. For another, interest rates are expected to remain historically low. At this week’s policy-setting meeting Fed chair Powell reaffirmed the central bank’s intention to keep short-term rates at the zero boundary for at least three more years. And while mortgage rates are linked to the bond market, the Fed is also committed to purchasing $120 billion of Treasury and agency-backed mortgage securities a month and could readily step up purchases of longer-term securities to keep bond yields in check.

By keeping rates low, the Fed is also stoking refinancing activity as well as home purchases. This proved to be a harmful development leading up to the 2008 financial crisis when homeowners used their housing equity as ATMs, taking out cash for frivolous consumption and leaving them underwater in their mortgages. When the housing bubble burst, foreclosures and loan defaults soared, contributing to the Great Financial Crisis. However, homeowners are in far better shape now, retaining a 65.5 percent equity stake in their homes. That’s the highest equity share since 1990, and the risk of a housing bust taking down home prices, as was the case in 2008 is remote. In contrast to the speculative home-construction boom in the years leading up to crisis, the current housing market is not burdened with a vast oversupply of unsold homes as was the case then. The main problem now is that the supply of homes for sale is too lean.

As welcome as a healthy housing sector is, it does not carry enough weight to propel the economy through the pandemic-related headwinds looming ahead. The good news, aside from the long awaited agreement of a coronavirus relief bill, is that vaccines are already being distributed and a sliver of the population is getting inoculated. But the process is just beginning, and widespread inoculations are not expected until late in the second quarter of next year. This bolsters our expectation the economy will stage a significant rebound over the second half of 2021. However, conditions will get worse before they get better as the path of virus is running through a broader swath of the economy. In California, which accounts for 15 percent of total GDP, the infection rate has escalated to the point of prompting the governor to issue shelter-in-place orders across several counties. As president-elect Biden opined, the nation faces a dark winter. But the

ebbing of the health crisis combined with some fruitful policy support should usher in a brighter spring and summer.

FINANCIAL INDICATORS

INTEREST RATES	December 18	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.08	0.08	0.07	1.57
6-month Treasury bill	0.11	0.08	0.10	1.58
3-month LIBOR	0.24	0.22	0.21	1.93
2-year Treasury note	0.12	0.13	0.16	1.64
5-year Treasury note	0.38	0.37	0.37	1.73
10-year Treasury note	0.95	0.90	0.83	1.92
30-year Treasury bond	1.69	1.63	1.52	2.35
30-year fixed mortgage rate	2.67	2.71	2.72	3.73
15-year fixed mortgage rate	2.21	2.26	2.28	3.19
5/1-year adjustable rate	2.79	2.79	2.85	3.37
STOCK MARKET				
Dow Jones Industrial Index	30,179.05	30,046.37	29,263.48	28,455.09
S&P 500	3,709.41	3,663.46	3,557.54	3,221.22
NASDAQ	12,755.64	12,377.87	11,854.77	8,924.96
COMMODITIES				
Gold ($ per troy ounce)	1,886.40	1,843.50	1,869.70	1,482.40
Oil ($ per barrel) - Crude Futures (WTI)	49.06	46.56	42.17	60.36

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Retail Sales (November) - % change	-1.1	-0.1	1.7	1.9
Industrial Production (November) - % chg.	0.4	0.9	-0.1	2.1
Housing Starts (November) - 000s	1,547	1,528	1,437	1,430
Building Permits (November) - 000s	1,639	1,544	1,545	1,491

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