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National Economic Intelligence Report

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Prepared by Beacon Economics, LLC
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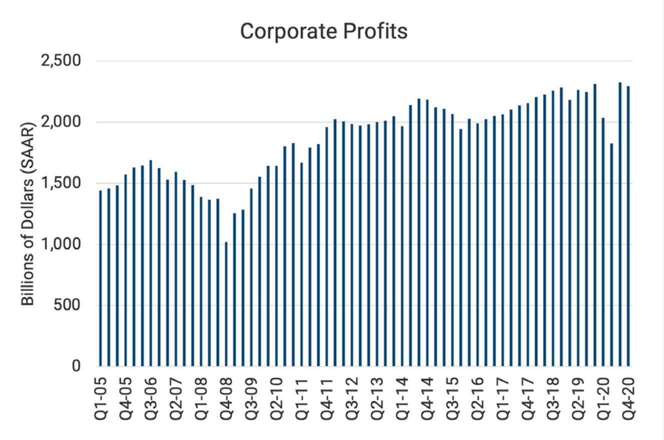
Exiting the Tunnel

A year ago, at the onset of the COVID-19 pandemic, the U.S. economy began to contract at a pace never before seen in recorded history. When observed relative to the slow decline that occurred at the start of the Great Recession (2007-2009), it might have been natural to assume the worst – that the United States was about to suffer from a massive economic downturn. But there were key differences, and this was not a normal recession. This time, the recession was characterized by a supply shock driven by the pandemic – a large part of the economy could not provide goods and services to their clients because of the risks associated with the virus, not because there was a lack of demand.

The difference in outcomes between this recession and the last could not be more dramatic. The demand shock that started in late 2007 caused a general malaise across most of the economy, something that took nine years to fully recover from. This time, the economy began to rapidly recover even as the pandemic was still in full force (businesses and individuals figured out how to mitigate risk). By the end of 2020, the U.S. economy had regained 70% of the activity it had lost in the first two months of the downturn.

One reason for the sharp rebound was because the supply shock reallocated demand within the economy. Frustrated consumers who were denied an opportunity to eat at a favorite restaurant or fly to Disney World spent unused dollars in other parts of the economy such as buying homes, campers and other goods. This is why worker earnings have recovered, job openings have remained remarkably high, and there was a surge in corporate profits – to their highest point ever in the second half of 2020. And this all happened despite the economic output gap and decline in payroll employment.



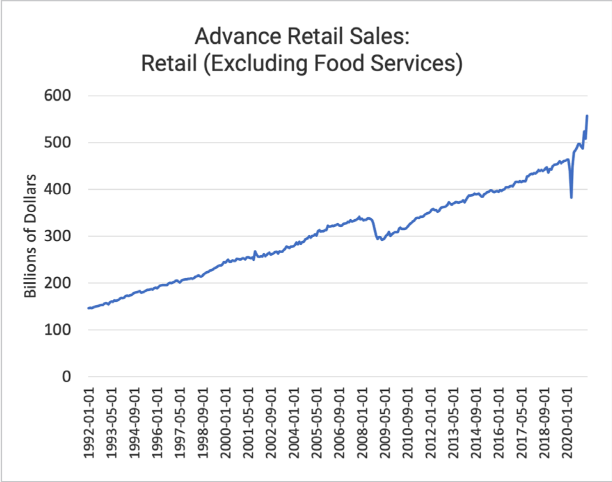
Of course, full economic recovery will be realized only when new cases of the virus are controlled, something that is in process right now with the rollout of effective vaccines. At three million doses per day, the United States is expected to reach herd immunity levels around July, according to the Centers for Disease Control. There will still be flare-ups of the virus, as a significant portion of the population may refuse the vaccine. But overall, economic activity should be mostly returning to normal in the second half of the year. The weakest part of the U.S. economy remains aggregate employment, with 9 million fewer payroll jobs today than pre-pandemic, but 2021 will bring a surge of hiring to offset many of the jobs lost.

If It Ain’t Broke, Why Fix It?

Coming into 2021, there is a lot of evidence that the U.S. economy is rapidly on the mend. Retail sales, excluding restaurants, were 10% higher in February than the year before. The ISM PMI (Purchasing Manager’s Index) for manufacturing was 60.8 in February, matching peaks seen over the past 30 years, as industrial production continues its record pace of recovery. Durable goods orders are at a 10-year high despite the collapse in aircraft production. Imports and exports of goods have already rebounded to pre-pandemic levels creating logjams at ports across the nation. Housing construction and consumer confidence are creeping up even as credit becomes easier to obtain. The U.S. economy is still 3% off its long-run trend, but this gap is shrinking at a record pace.

Source U.S. Census Bureau

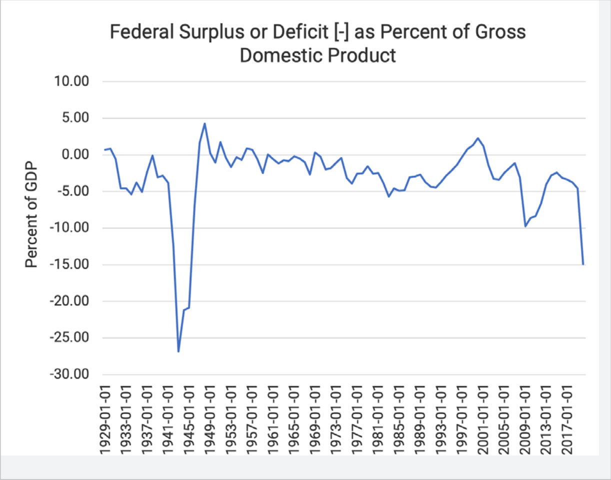
The inability of consumers to spend would have caused a jump in household savings regardless. However, the addition of the massive $3 trillion in Federal stimulus last year – much of it spread widely across the economy rather than focused on sectors specifically impacted by the pandemic – meant that households more than doubled their savings rate relative to 2019, from $1.23 trillion to $2.85 trillion. The U.S. banking system is now flush with almost $3 trillion in excess deposits. Households have taken advantage of this cash and low interest rates to refinance home loans and pay down debt: In 2020, the household debt service ratio dropped below 9% for the first time ever. There is little wonder why the housing market is on fire, the stock market is looking frothy with the second highest P/E ratio on record (beating 1929), and Bitcoin is sitting north of $60,000.



Source U.S. Census Bureau

Amazingly, all this good news seems to have gone largely unnoticed, or perhaps ignored, in Washington, D.C. The national policy conversation continues to be wrapped around the broad theme of “rescuing of the nation.” In March, the U.S. Congress passed another stimulus plan costing the nation an additional $1.9 trillion. President Biden has appointed a “COVID Recovery Czar” to direct the efforts.

2020 started with a $1 trillion deficit already in place, driven by the Trump administration's tax cuts. Throw in the first round of stimulus and, in total, there was a $3 trillion deficit last Federal fiscal year. This year, deficits will be on the order of $4 trillion, between the additional stimulus and the structural gap that was already in place. In two short years, the United States has issued $7 trillion in new Federal debt – an amount equal to 30% of the nation's GDP, or $24,000 for every person in the United States under the age of 70.



Source: OMB, St. Louis FED

The Federal Reserve seems to be following politicians rather than economists and similarly overreacted when they engaged in $3 trillion in quantitative easing. This surely helped calm the market panic that was in play at the start of the pandemic, but times have changed – there have been no spikes in debt delinquencies, the stock market is on a tear, and banks are making loans easier to acquire. Yet, the Fed has made it clear they will continue to maintain their bloated balance sheet for the foreseeable future. The last time the nation saw an expansion of the money supply this rapid was in the 1970s.

The Risks of Excess

That the U.S. economy is going to take off like a rocket in the second half of this year is obvious. Even the Federal Reserve has started to revise its outlook up as the weight of positive data in recent months makes their pessimistic stance unsupportable. The U.S. economy will see a higher than normal pace of growth for at least two years and perhaps more. Unemployment will be back into the low 4's in 2022. While the COVID pandemic will be remembered for decades, the economic ramifications will disappear more quickly than the legacy of the tech bubble collapse in the late 1990s.

Unfortunately, all the good news will be tempered by problems that will arise from the Federal government's excessive monetary and fiscal intervention. We're already seeing some effects, such as a stock market driven to extreme valuations, and a housing market that is experiencing record price increases and incredibly low inventories. However, the fundamentals of the debt markets and real estate are still very good. Even a sizable stock market crash will not create systemic problems. The peril of financial market bubbles will manifest if the huge new supply of wealth starts to overheat the economy and create the types of distortions that made recovery from the Great Recession so long and painful – although this won't be an issue for years.

A more critical and immediate issue is the potential for inflation. The massive increase in the money supply has created an inflation risk unlike any seen since the 1970s. Too many economists have been lulled into a false sense of security – after all, inflation has continued to sit below Fed targets despite years of relatively fast money supply growth, suggesting structural changes in the economy have reduced inflation risks. But the current surge in money expansion is far beyond anything experienced in the past, so this confidence is misplaced. This isn't to say inflation is an immediate threat. Recent trends in interest rates and consumer prices are a function of the recovery – not the excess supply of liquidity. For inflation to kick in, the economy has to be running at close to full capacity and typically experience some external demand shock – such as a large expansion in Federal spending. These conditions will all be in place in 2023. There is time to reduce that loose money supply, but will those efforts begin soon enough? We don't know.

There has been a tendency by many prominent economists to be quite forgiving of these deficits. They are less worried about the potential for a fiscal crisis, even at the high debt-to-GDP levels. But history is clear on two points. First, when making unprecedented moves in deficits and debt expansions, lessons of the recent past are no longer relevant; ergo we should not be so Pollyannaish about the situation. And second, bond markets also seem unconcerned about Federal borrowing. But history shows us that bond markets are very placid – until they aren't. Lessons of the past should serve as a reminder of potential political and economic challenges that could arise.

Prepared By Beacon Economics

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