ECONOMIC PROSPECTS and POLICIES

Annual Message to Shareholders
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The respected economist Henry C. Wallich (Federal Reserve System Board of Governors, 1974-1986) once declared, "Economics is simple but never easy." It is simple to merely extrapolate trends but it is never easy to realistically project actual economic prospects and policies during extreme uncertainty, such as the global COVID-19 pandemic. That "black swan" event suddenly shattered the record business cycle upturn that began in July 2009, following the serious economic recession caused by a financial market meltdown.

At the beginning of 2020, the consensus view was that the long expansion would continue through the entire year. But in February, the real and psychological costs of reacting to the lethal virus caused the 12th business cycle recession in the U.S. economy since World War II. The haphazard partial shutdown of the U.S. economy quickly created an unprecedented collapse of normal consumption and investment in that uncertain environment. Although the National Bureau of Economic Research (NBER) will not designate the official timing of the current cyclical recession until more comprehensive statistics become available, it appears that the U.S. economy reached a turning point in May, and now has begun another "long, slow, and erratic" recovery phase of the business cycle.

The GDP statistics, when used as a "measure of change," will report a large turnaround during the third quarter (July to September), as a volatile normalization process proceeds, augmented by the catch-up effects of postponed consumption and investment. The recovery pace may then gradually decelerate, after the initial surge, well into 2021 toward a medium-term real growth trend, in the 2% zone, as transitory effects of consumer spending, and approximately $3 trillion of federal fiscal assistance, quickly dissipate. When potential GDP statistics are used as a "measure of level" total economic activity probably will not return to the "pre-crisis" level reported at the end of 2019 until at least the end of 2021, when the U.S. economy may transition from recovery into the expansion phase of the business cycle. Inflation measures will steadily return to the pre-crisis moderate pace and unemployment and underemployment rates will continue to gradually decline from the temporary crisis peak, but probably will not return to the 50-year low of 3.5% reported prior to this economic recession. The federal government's current role as the "spender-of-last-resort" will add trillions of dollars of deficits and debt and the "whatever-it-takes" forward guidance of the Federal Reserve, serving as the "lender-of-last-resort," will dominate fiscal and monetary policies far into the future. Despite the residual legacy of deficits and debt, and the "moral hazard" of such massive government intervention, most analysts believe those actions were necessary to respond to the unique pandemic recession. Aggressive monetary and fiscal policy actions have mitigated pervasive liquidity and solvency risks creating a strong surge of consumer spending on durable and nondurable goods and new housing construction and sales based on historically low mortgage interest rates. However, this relatively "rosy scenario" forecast is dependent upon the rapid development of COVID-19 treatment options and vaccines that are trustworthy, effective, and widely available to the general public.

WHAT HAPPENED TO MY OPTIMISTIC BASELINE FORECAST FOR 2020?

At our meeting one year ago, I predicted that the business cycle recovery/expansion would continue throughout 2020, despite the slowdown of global economic activity, disruption of international trade and investment, and distortions caused by robust consumption but weak investment. The dependence on private and public consumption made the domestic economy brittle and vulnerable to the negative effects of familiar geoeconomic and geopolitical risks and unpredictable exogenous shocks. My baseline forecast projected real GDP growth at a moderate 2% pace (measured 4th over 4th quarters); modest acceleration of inflation; solid job and income gains; low and stable unemployment and underemployment rates; a large current account deficit; "growth friendly" government spending and tax policies, creating a $1 trillion federal budget deficit--the 55th deficit during the last 60 fiscal years—and monetary forward guidance that the Fed's accommodative policy interest rate would be stable, the revival of "Quantitative Easing" purchases of Treasury and mortgage-backed securities would continue, and liquidity would be supplied to money markets through overnight and term "repo" arrangements. That forecast seemed to be cautious and reasonable. During the 126 months of sustained growth from July 2009 through 2019, real Gross Domestic Product (GDP) had increased at an average annual rate of 2.28%, far below the 3.2% pace from 1950 through 2019, but in line with a potential Optimum Feasible Path (OFP) real GDP target of 1.8% average annual growth, based on the projected changes in the labor force, hours worked, unemployment rates, and labor productivity. My 2020 baseline forecast was then assigned a 65% probability; slower growth a 25% probability; and faster growth a 10% probability. That distribution of possible results tried to recognize the trends and risks, but there did not seem to be any predictable lethal threats.

Strong personal consumption expenditures—nearly 70% of total GDP—were expected to sustain that moderate growth, supplemented by solid business capital outlays, residential construction investment, and federal, state, and local government spending, but negative net exports caused by the erosion of international trade and investment. Fiscal policy was projected to support growth through increased spending and the lagged effects of large personal and corporate income tax cuts. It was assumed that monetary policy would remain accommodative after the Federal Open Market Committee (FOMC) slashed its policy interest rate target three times last year, to 1.50% to 1.75%, and resumed aggressive "Quantitative Easing." But every forecast includes a "tail risk" that actual results may fall outside of the normal range. Analysts refer to such rare aberrations as a "black swan" event three standard deviations from the average of the distribution of results—a range that includes 99.9999% of the observed figures. The global COVID-19 pandemic crisis was a "black swan" event that quickly demolished my forecast.

FIRST QUARTER: THE GATHERING STORM

The impact of the virus on economic activity and efforts to constrain its spread devastated growth. The National Bureau of Economic Research (NBER) business cycle dating committee announced the business cycle had peaked and an official economic recession had begun in February. The partial shutdown of the economy and related global recession caused the real GDP to decline at a seasonally adjusted annual rate of 5.0% during the first three months of the year. Personal consumption expenditures declined 6.9% and business fixed investment 6.7% on an annual basis. Federal spending rose 1.6% and state and local government outlays increased 1.1% at annual rates. Mild winter weather and low interest rates caused residential construction to surge at a 19.0% annual rate. Exports and imports deteriorated as the global economic recession accelerated. As economic activity faltered, consumer price indexes fell in March, net payroll jobs plummeted, the labor force participation rate moved lower, and the unemployment rate began to rise. Beginning in March, Congress passed four emergency spending appropriations of almost $3 trillion for health research and testing, personal cash payments, enhanced unemployment insurance benefits, small and large business grant and loan programs, and income transfer payments. That mandated spending increase, and erosion of personal and business tax revenue raised the federal budget deficit to a higher level. The Federal Reserve System reacted quickly and aggressively by cutting its policy interest rate target back to the zero boundary, expanding "Quantitative Easing" to "amounts as needed," injecting more liquidity into the money markets, direct business lending, and creation of 11 new targeted programs to help alleviate financial, business, and municipal liquidity and solvency risks.

SECOND QUARTER: THE PERFECT STORM

As the virus crisis accelerated, efforts to restrict personal contacts severely reduced economic activity despite aggressive fiscal, monetary, and regulatory actions. Real GDP declined at an unprecedented seasonally adjusted annual rate of 31.4% during the second quarter. Negative figures were reported for personal consumption expenditures (33.2%); business fixed investment (27.2%), residential construction investment (35.6%), and the state and local government sector (5.4%). Federal government outlays did increase rapidly (16.4%) and net exports contributed to real GDP as exports and imports plunged. That once-in-a-lifetime experience quickly eroded consumer and business confidence and created pervasive concern about prospects and policies. The "headline" unemployment rate rose to 14.7% in April and then declined to 11.1% by June. The broader underemployment measure (working part-time for economic reasons and those with marginal attachment to the labor force) increased to 22.8% before dropping to 18.0% by June. Net payroll nonfarm employment fell from a February cyclical peak of 152.5 million to 137.8 million by June and the crucial labor force participation rate (civilian labor force as a percentage of the civilian non-institutional population) declined from 63.4% to 61.5% during the same time period. As workers lost their jobs or were furloughed, and business bankruptcies accelerated, real personal income from compensation of employees, proprietors' income, rental income, and personal income from interest and dividends rapidly declined. However, a prompt bipartisan Congressional legislative response to the dire emergency in March increased personal government transfer payments from $3.2 trillion during the first quarter to $5.7 trillion during the second quarter, so the real personal disposable income actually rose during the severe economic downturn. At the same time, the existing moderate inflation rates moved even lower as energy prices plummeted and total demand for goods and services was reduced. Massive government transfer payments did provide financial assistance, and critical confidence for households during the time period of unusual uncertainty, but the combination of increased spending and reduced tax revenues quickly raised the federal budget deficit to an extraordinary historical level. The Federal Reserve was even more aggressive. Beginning in March, it pledged to do "whatever-it-takes" to sustain growth and suppress interest rates. Cautious "normalization" of monetary policies, which had reduced its balance sheet from $4.5 trillion to $3.8 trillion by September 2019, was reversed when "Quantitative Easing" was resumed. Fed assets then rapidly increased from $4 trillion in March to just over $7 trillion by June 2020. The fiscal and monetary policy responses did help to stabilize financial markets, sustained household spending for durable and nondurable goods, and created renewed momentum in residential construction and the sale of houses. Despite the historic decline in reported real GDP during the spring, most analysts were optimistic about prospects for a cyclical rebound during the second half of 2020.

FORECAST THIRD and FOURTH QUARTERS: THE STORM CHANGES COURSE

When the third quarter GDP estimate is released on October 29th, it probably will report real GDP surged at a seasonally adjusted annual rate of about 25%. A "statistical bounce" always occurs whenever the business cycle changes direction, but the sharp surge during the third quarter only partially reverses the huge decline during the second quarter. Household spending on durable and nondurable goods was the driving force in that turnaround even though the larger services sector remains depressed. The phased reopening of the economy has improved employment conditions, as furloughed workers return to work, and the ability of households to spend has been sustained by large government transfer payments and positive wealth effects created by booming stock market and real estate values. Spending for durable and nondurable goods exceeds the February pre-crisis level, although the pace appears to be fading as Congress has delayed approval of another round of assistance. Several stimulus programs ended in July and future eligibility for extended state unemployment benefits is beginning to expire for beneficiaries after nine months of dependence. The willingness to spend also has increased as households continue to add consumer and mortgage credit and confidence is restored. The University of Michigan Consumer Sentiment Survey index rose to 78.0 in September, from its April low of 71.8, but was still below the pre-crisis level of 89.1 reported last February. Although consumption momentum now appears to be slowing, prospects are generally favorable for this dominant sector.

Residential construction also gained considerable traction during the third quarter, as historically low mortgage interest rates, pent-up demand, low inventory of houses for sale, favorable affordability index levels, euphoric builder confidence, and current "work-at-home" trends continued. After a decade of modest results, and many false signals, this sector finally seems to be moving to a faster pace. Federal budget outlays contributed to real GDP recovery as legislation to ease flexible "caps" on discretionary spending during FY 2020 and FY 2021 was approved in July of 2019 and there are political pressures to support a cyclical recovery. After several quarters of negative capex figures, business fixed investment finally made a positive contribution to real GDP, as new orders for equipment and intellectual property products increased and the pace of inventory spending accelerated as business confidence improved.

The net exports sector had a significant negative impact on the third quarter GDP as the foreign trade deficit continues to rise. State and local governments have experienced severe budget stress as their health and education program costs surge, income and sales tax revenues are curtailed, and rainy-day funds are depleted, while recent federal stimulus programs have not provided major assistance. Gradual restoration of the jobs lost during the serious cyclical downturn has reduced the "headline" unemployment rate to single-digit levels—7.9% in September—and the phased reopening of small businesses, particularly restaurants and bars, has eased the high underemployment figures. The labor force participation rate has edged higher and general employment conditions and expectations have improved despite the continued historically-high new claims for regular state Unemployment Insurance benefits and the new Pandemic Unemployment Assistance program for self-employed and gig workers. Monthly inflation indexes have steadily risen from the initial crisis levels, but they remain far below the moderate pace experienced prior to the cyclical downturn.

On September 2nd, the Congressional Budget Office announced that its estimated federal budget deficit for FY 2020, which ended on September 30th, would be $3.311 trillion, as outlays rose to $6.606 trillion (up from $4.447 trillion in FY 2019), while revenues totaled $3.296 trillion (down from $3.463 trillion last year). Federal outlays in FY 2020 equaled 32.0% of GDP—the highest figure since 1945, far above the 50-year average of 20.4%. Revenues were 16.0% of GDP in FY 2020, below the 50-year average of 17.4%. The federal budget deficit represented 16.0.% of GDP, significantly higher than the 50-year average of 3.5%. Monetary policies followed the Fed's forward guidance during the third quarter, with the federal funds rate anchored at 0.00% to 0.25% and "Quantitative Easing" average monthly purchases of $80 billion of Treasury and $40 billion of mortgage-backed securities. At its September meeting, the FOMC repeated its firm pledge to keep the policy interest rate target at the zero boundary

level until total employment "reaches its maximum level" and to allow future inflation rates to run above the target of 2% based on its new average inflation targeting guideline.

The real GDP during the last three months of 2020 will report a second consecutive positive quarter with solid growth in the 5% to 8% range, well above the medium-term growth rate based on normalization of economic activities and "catch-up" effects of postponed consumption and investment. Combining the two different time periods, an unprecedented contraction of economic activity, linked to "black swan" effects of COVID-19 and efforts to restrain the spread of the virus, followed by the vacillating economic recovery, led by robust household spending for durable and nondurable goods and resurgent residential construction and supported by aggressive fiscal and monetary policies, probably signals a negative real GDP figure in the 4% zone for the entire year, with an erratic rebound after the turning point that probably will eventually be marked from May of this year. Employment conditions have improved as the "normalization" process continues, but unemployment rates are still well above the February level and inflation measures are slowly returning to the moderate pace that prevailed before the recession.

TENTATIVE OUTLOOK FOR 2021

The severe global pandemic recession appears to be evolving into erratic recovery. The Organization for Economic Cooperation and Development (OECD) recently published new projections of a global negative real GDP contraction of 4.5% in 2020 followed by positive growth of 5.0% in 2021. The U.S. economy probably will report a similar swing from 4% decline during 2020 to 4% growth next year, as momentum created by the "normalization" of consumption and investment and the "catch-up" effects of postponed spending gradually returns to the medium-term Optimum Feasible Path (OFP). My baseline 4% growth forecast is a 60% probability; faster growth a 20% probability; and slower growth a 20% probability.

The recovery of personal consumption expenditures for durable and nondurable goods will provide the major thrust, although the services sector will be limited because of personal contact restrictions. The ability to spend will increase as employment and income conditions improve, and the wealth effects of stock market and real estate prices encourage large-ticket purchases. The willingness to spend will be sustained by existing personal savings, increased household debt, and improved consumer sentiment.

The disappointing business fixed investment sector should finally report positive spending outlays for equipment and intellectual property products as companies are forced to replace the aging capital stock to control costs and enhance productivity in a competitive global economy.

Residential construction has surged as the sustained suppression of interest rates has encouraged single-unit new starts in response to pent-up demand after a decade of sluggish activity. Federal government spending will continue to rise as the flexible "caps" on defense and nondefense spending have been conveniently eased as usual.

Both exports and imports will increase, as global economic recovery continues, but the larger inflow of goods and services will create a net exports sector drag on the real GDP. State and local government spending will decline because of serious budget stress and limited federal assistance.

Unemployment and underemployment rates will report modest improvement from existing levels, but uncertainty and record business bankruptcies will eliminate jobs and increase long-term unemployment.

Moderate demand pressures and adequate supply sources will limit price increases for goods and services after the initial recovery surge. Prospects for a fifth fiscal stimulus package and final approval of the FY 2021 federal government budget remain uncertain, but another large deficit in the $2 trillion range, and a commensurate increase in the Gross National Debt, will continue to be ignored. Monetary policy will remain aggressively accommodative far into the future and the Federal Reserve balance sheet probably will remain stable in the $7 trillion zone as "Quantitative Easing" supports private and public borrowing.

CONCLUSION

During this uncertainty, optimists can cite statistics to argue that a typical cyclical recovery has begun and is accelerating; pessimists can refer to negative historical comparisons and serious legacy problems. The phased reopening of the U.S. economy will depend on the timing, effectiveness, and widespread availability of COVID-19 treatment options and vaccines and competing political, social, economic, and health priorities and metrics, including the number of new cases, deaths, testing results, geographical incidence, and public and private health institution guidance.

- The record cyclical expansion, that began in July 2009 following the Great Recession, ended and the current downturn began in February 2020. The official recovery turning point probably will be marked as May 2020. As the economy gradually returns to normal, "catch-up" consumption and investment will amplify the recovery. The expansion phase, moving beyond the previous cyclical peak, probably will not begin until after 2021. The systemic scarring effects will persist.

- The recovery is likely to be "long, slow, and erratic" because of the residual effects of the COVID-19 pandemic; imbalance of consumption and investment; erosion of international trade and investments; large current account imbalances; devaluation of the U.S. dollar; private and public debt risks; possible "asset bubbles"; oil, food, and commodity supply and price shocks; diverging global fiscal and monetary policies; demographic pressures caused by aging societies and refugee flows; environmental trends; social tensions caused by income and wealth inequality; and recurring hot and cold wars, civil unrest, terrorism, and the negative effects of incompetent and corrupt governments.

- Household spending, residential construction, and federal budget priorities will drive the recovery. Business fixed investment, exports, and state and local government spending will be lagging sectors. Consumer and business confidence will be the key factor determining the timing, strength, and pace.

- Unemployment and underemployment rates will gradually decline but long-term problems will persist.

- Inflation will slowly revert to pre-crisis moderate levels but is unlikely to report a sudden breakout.

- The Congressional Budget Office (CBO) projects a decline in the federal budget deficit of $3.3 trillion in FY 2020 to $1.8 trillion in FY 2021 (began October 1, 2020). A fifth fiscal stimulus bill would increase that deficit. Its current ten-year estimate anticipates deficits of over $1 trillion every year through FY 2030.

- Monetary policies will be aggressively accommodative to achieve the Fed's priority employment goals and alleviate liquidity and solvency risks in the financial and real estate markets. The "low-for-longer" zero-boundary policy interest rate target, unlimited "Quantitative Easing" purchases of Treasury and mortgage-backed securities, and new special purpose private and public lending programs will continue with forward guidance emphasizing the stability of existing policies lasting several years.

- Future "black swan" crises will continue to be unpredictable.

- Perhaps the most relevant observation about economic forecasts was made by the legendary economist John Maynard Keynes. In 1921, he wrote his, Treatise on Probability, about the theoretical challenge of mathematical probability theory. After analyzing the complex difficulty of assigning quantitative probability estimates to future output, prices, interest rates, technologies, social trends, and wars, Keynes declared that it is impossible to predict the future because: "About these matters there is no scientific basis on which to form any calculable probabilities whatsoever. We simply do not know." (Keynes 1937, pp.113-114; Collected Works, vol. 14.) However, he also added the optimistic suggestion that, "the necessity for action and for decision compels us, as practical men, to do our best to overcome [uncertainty] and to behave exactly as we should if we . . ." could calculate the prospects and risks. (Ibid.) That combination of realism, diligence, and creativity will be a useful guideline for 2021 health institution guidance.