VIEWPOINT

A Stephens Inc. Economic and Financial Commentary

by Thomas Goho, Ph.D.

JULY 2021

Independence Day celebrations will wind down shortly, but many officials in Washington, D.C. want to continue the party. They propose massive displays of pyrotechnics, never seen in the United States except in wartime. Washington's fireworks, of course, are in the form of huge budget-busting government spending.

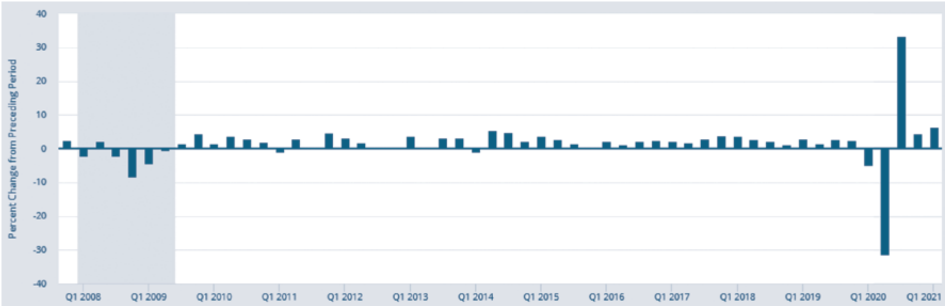
Monetary and fiscal issues normally have been somewhat predictable, but more than a year of Covid turmoil has jettisoned predictability right out the window. Further, Congress and the Federal Reserve charged with controlling government spending and monetary policy seem to have abdicated that control. Their absence raises difficult questions for investors. This issue of Viewpoint seeks to provide very tentative answers.

- How large will federal government outlays be in the coming years?
- Will tax increases be used to fund this spending? If so, who pays and how much?
- What impact will significant spending increases have on economic growth in late 2021 and beyond?
- What are the implications for inflation, and will be the Federal Reserve honor its mandate to control inflation?

Economic Growth

American economic growth as measured by real gross domestic product (real GDP) experienced record-setting moves over the past 12 months. (See Figure 1.) The growth sequence for the four quarters of 2020 was as follows: -5.0%, -31.4%, +33.4, and +4.1%. The historic GDP moves, particularly in the second and third quarters of 2020, were disorienting for many Americans.

Figure 1:
Real Gross Domestic Product, Q4 2007 to Q1 2021 (quarterly data).

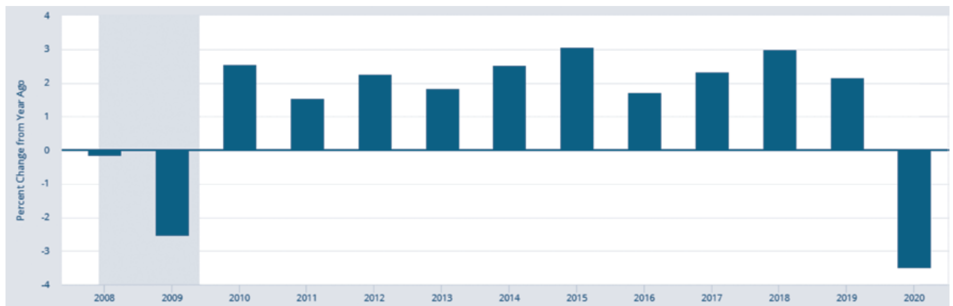


Note: Shaded areas show recessionary periods; the most recent data is undecided.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Data (FRED), retrieved June 20, 2021.

Real GDP was down 3.5% for 2020, better than estimates made at mid-year 2020. (See Figure 2.) This relatively small negative growth rate fails to capture the economic hardships of business failures and high unemployment for tens of millions of Americans caused by government-imposed regulations and lockdowns.

Figure 2:
Annual Rate of Real Gross Domestic Product, 2008 to 2020.



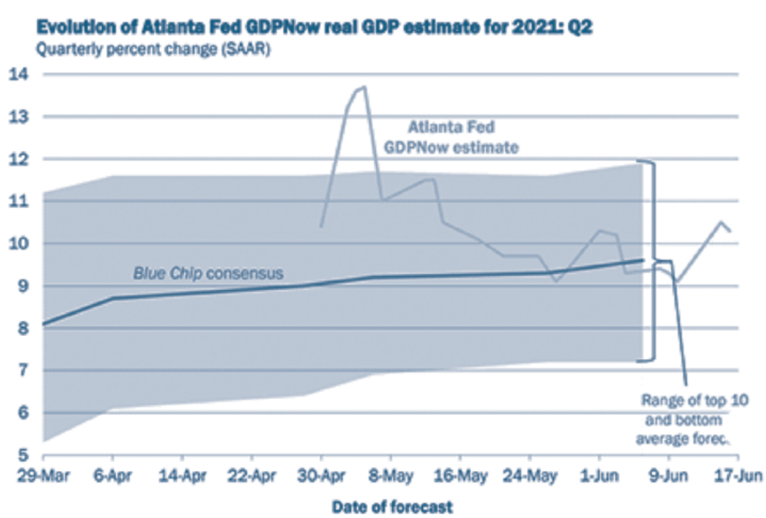
Note: Shaded areas show recessionary periods; the most recent data is undecided.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Data (FRED), retrieved June 20, 2021.

Americans, in recent years, had become accustomed to an anemic but steady 2% annual growth. This 2% growth rate added about $400 billion of goods and services each year to the economy. Clearly that did not happen in 2020. The economy in an aggregate sense is about as well off economically in mid-2021 as it was at the end of 2019.

Hopeful signs for continuing growth are on the horizon. First quarter real GDP grew 6.4%. The Federal Reserve Bank of Atlanta is now forecasting solid growth of 10.3% in the second quarter of 2021 (see Figure 3), down from a May projection of 13.6%.

Figure 3:
Federal Reserve Bank of Atlanta Forecast of Second Quarter 2021 Quarterly Percentage Change in Real GDP and Blue Chip Economist Consensus Growth.



Source: Federal Reserve Bank of Atlanta. GDP Nowcasting. June 20, 2021.

The Federal Reserve Bank of New York, using somewhat different economic variables, estimates second quarter real GDP will be slightly more than 3.7%, down from an early estimate of 5.3%.

Both Federal Reserve Banks' estimates are significantly above the long-term growth trends for the U.S. economy.

Best Guess About Economic Growth

Economic forecasters have a difficult job making predictions about growth even in normal times. But 2021 makes predictions more difficult as the Covid epidemic slowly comes under control and as states expand or contract behavioral restrictions. But the bigger forecasting problem emanates from Washington, D.C.

What will the final real GDP growth rate be for 2021? It seems quite likely that it will be between 5% and 7%, a far wider range than one expects under "normal" conditions.

Forecasts of annual economic growth are consistent with that range. (See Figure 4.) Estimates by major business and international organizations range from as low as 4% to as high as 8.0%. Again, current estimates are fraught with uncertainty.

Figure 4:
Forecasts on 2021 Annual Growth in U.S. Real Gross Domestic Product.

Organization	Annual Growth Rate
Bank of America	4.6%
Conference Board	5.5
Fannie Mae	6.7
Federal Reserve (Open Market Committee)	6.5
Goldman Sachs	8.0
International Monetary Fund	5.5
OECD	6.5
S & P Global	6.5
Wall Street Journal Survey of 69 Economists	6.4
Average	**6.2%**

Source: Various publications from the organizations above.

We at Stephens expect growth for 2021 to be about 6.5%, an impressive rate of growth in the short run. Beyond 2021 growth will slowly revert to a pre-Covid growth rate of about 2% which is inextricably linked with 2 factors in the American labor markets: slow growth in labor productivity and minimal growth in the size of the potential U.S. labor force.

Labor Markets

The aggregate data suggest a rapid economic rebound, but these data disguise the huge impact that the Covid crisis had on labor markets. On the surface, the employment numbers look very encouraging for job seekers. The unemployment rate that peaked during 2020 at 14.8% is now down to 6.0%. (See Figure 5.) This 6.0% rate is high relative to the pre-Covid unemployment rate which was under 4%, but it is trending downward.

Pre-Covid labor markets were especially robust for minorities and less-educated workers. In the current recovery, these workers are experiencing unusual labor market conditions. Jobs have again become plentiful, but workers are hesitant to return to work given the generous unemployment benefits in many states, as well as concerns about health conditions in businesses.

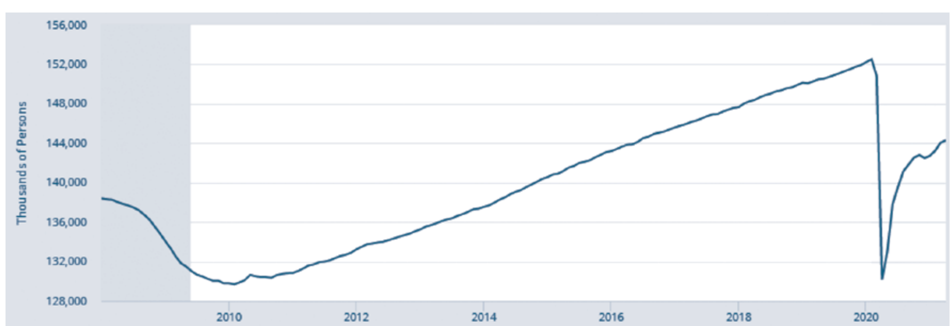
Figure 5:
Unemployment Rate, 2000 to Present.

Note: Shaded areas show recessions; the most recent end data is undecided.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Data (FRED), retrieved June 20, 2021.

Notwithstanding the dramatic improvement in unemployment, the total number of employed workers is still almost 8 million fewer than before the Covid crisis: 144 million workers now versus 152 million before the Covid outbreak. (See Figure 6.)

Figure 6:
All Employees, Nonfarm, 2008 to Present.

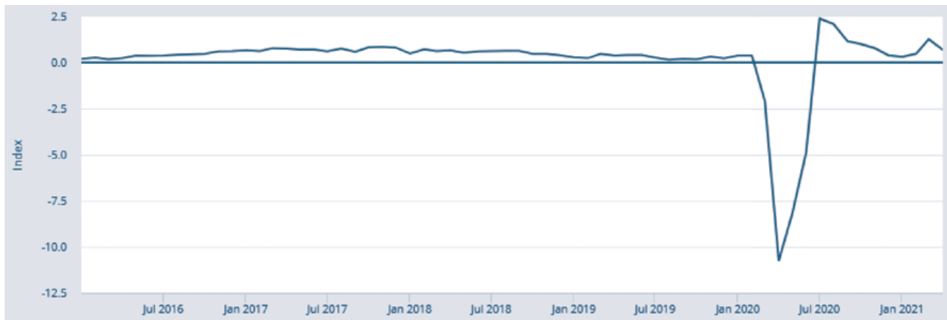


Note: Shaded areas show recessionary periods; the most recent data is undecided.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Data (FRED), retrieved June 20, 2021.

Labor markets are in a recovery. The labor market momentum indicator of the Kansas City Federal Reserve is signaling positive conditions compared to the long-term conditions of labor markets. (See Figure 7.) The straight line in the graph is the base (or normal) condition over many years. When the indicator is above the line, it signals expansionary labor conditions. Rarely in the past decade have labor market conditions for prospective workers been stronger than they are now.

Figure 7:
The Kansas City Federal Reserve's Labor Market Condition Index, Momentum Indicator, 2016 to Present.



Note: Shaded areas show recessionary periods; the most recent data is undecided.

Source: Federal Reserve Bank of Kansas City. KC Fed Labor Market Condition Index, Momentum Indicator retrieved from Federal Reserve Economic Data (FRED), June 20, 2021.

Best Guess About Labor Markets

The unemployment rate will continue to fall, and by the end of 2021 is likely to be about 5.5%. This rate is elevated compared to the rate from 2015 to early 2020. Labor markets in the longer run will continue to improve so that by early 2023, the unemployment rate should be between 4.0% and 4.5%, good news for jobseekers. In many industries, employers will continue to scramble to find qualified workers, thereby putting upward pressure on wage rates.

This wage pressure will be caused in part by the changing composition of the labor force. Now and in the coming decade large numbers of experienced workers will be retiring while a relatively small pool of new workers will be entering labor markets. Low birth rates 20 years ago produced a small number of new potential workers in 2021 and beyond.

Inflation

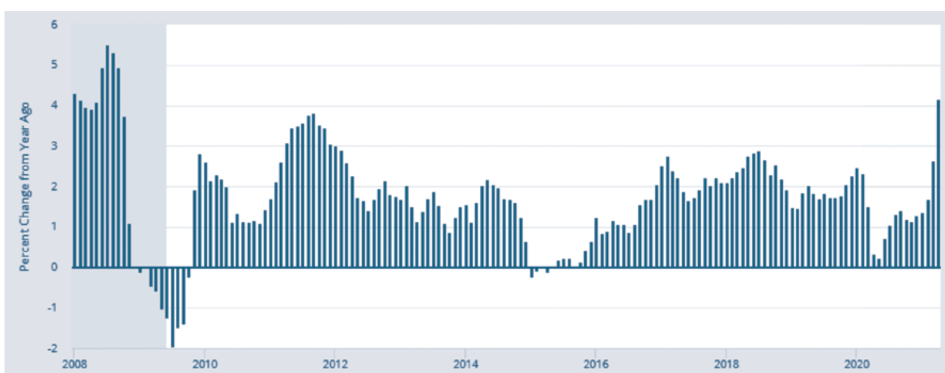
The leading economic questions on investors' minds involve the prospects for inflation:

- Is inflation returning?
- If wage and price pressures return, when will they arrive?
- If inflation resurges, how significant will it be?

Unfortunately, no one really knows the answers to these questions. Stephens and prominent economists are in uncharted territory. Lawrence Summers, a distinguished economist and former Treasury Secretary in the Clinton Administration, sounded an inflation alarm several months ago. He told Bloomberg TV that the idea that inflation cannot suddenly spike "is just plain wrong." He added that inflation risks could resemble those of the 1970s. His warning should not be ignored although progressive politicians in Washington, D.C. are brushing aside such risks.

The low inflation of recent years and even the current data have lulled investors into a sense of complacency. Little inflation is evident in widely quoted prices. The consumer price index during the whole Covid epidemic reveals that the consumer price index (CPI) is running at an annualized rate of less than 2%. (See Figure 8.) The index below excludes measures of the volatile food and energy prices. April and May's inflation reports were a wake-up call when it indicated that prices are now increasing at an annualized rate of 4.2% in April and 5% in May. The April 2021 inflation rate looks frightening, but that is because of the comparison to April 2020 when inflation had plunged to almost zero with the onset of Covid. (Again, see Figure 8.)

Figure 8:
Consumer Price Index for All Urban Consumers Excluding Food and Energy, 2008 to Present.

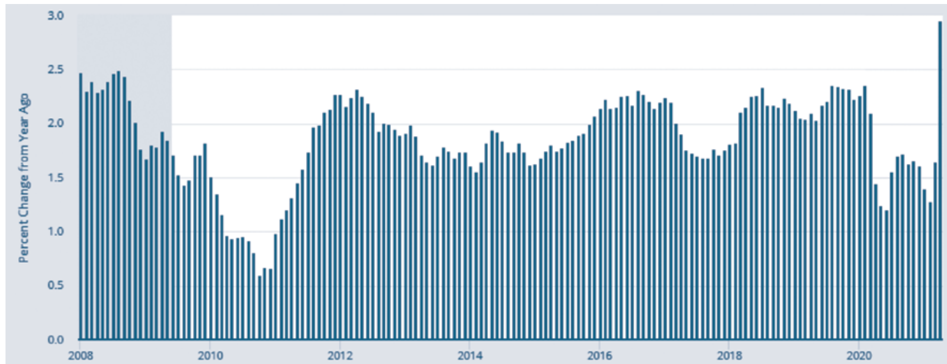


Note: Shaded areas show recessionary periods; the most recent data is undecided.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Data (FRED), retrieved June 20, 2021.

The more dynamic and accurate measure of inflation, the personal consumption expenditures index, excluding food and energy, (PCE) indicates a more modest annual inflation rate of 1.4%, less than that of the CPI. (See Figure 9.) Neither the CPI nor the PCE annual rates are alarming in the short run, except for the CPI and PCE inflation rates in April and now May.

Figure 9:
Personal Consumption Expenditure Price Index Excluding Food and Energy, 2008 to Present.



Note: Shaded areas show recessionary periods; the most recent data is undecided.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Data (FRED), retrieved June 20, 2021.

The Wall Street Journal Survey of 69 economic forecasters projects the broad measure of inflation, the CPI including food and energy, peaking at 3% in June 2021 and then slowly tapering off, but still above the Fed's inflation target of 2%.

Let us repeat, the CPI including food and energy is not the preferred measure of inflation. The core measure of inflation, the PCE which excludes food and energy, is relatively quiescent at the present time but trending in the wrong direction.

Best Guess About Inflation

The news about inflation in the relatively short run is slightly negative. Inflation is slightly above the decade-long average of recent. A temporary pop in inflation after a recession is a common occurrence. But annual inflation is running at about 2% per year. Investors should heed the longer-term prospects for higher core inflation as hinted at by recent inflation data. Lawrence Summers is correct that policies within the Beltway are inflationary.

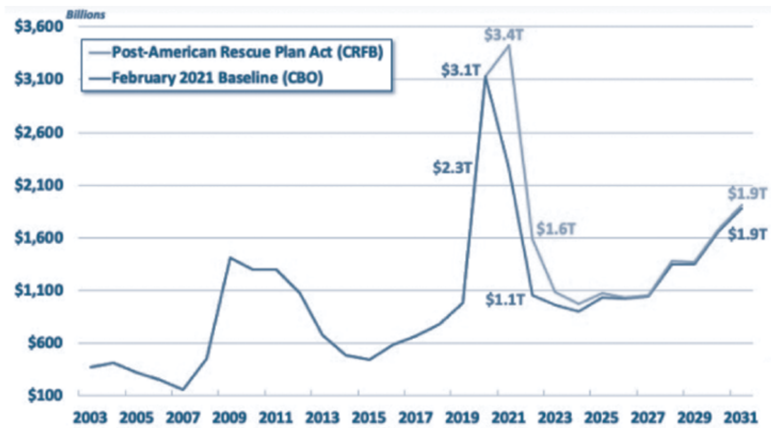
Nouriel Roubini who coined the term "black swans" stated recently "Over the next few years, loose monetary and fiscal policies will start to trigger persistent inflationary…pressure."

The magnitude of that inflationary pressure is unknowable since so much depends on Congress and Federal Reserve policies. However, inflation is likely to consistently exceed the Federal Reserve's 2% target rate within the investment horizon of most investors. No one at this time knows what rate of inflation will induce the Fed to take tightening actions. Might it be 3% to 4%? Quite possibly.

U.S. Fiscal Policy

It is a stretch to posit that the U.S. has a clear fiscal policy. An outgrowth of the pandemic is spending without any serious attempt to balance current government expenditures with federal tax receipts. Annual federal deficits are massive by any peacetime standard. The bipartisan Committee for a Responsible Federal Budget (CRFB) adjusted a recent estimate by the Congressional Budget Office (CBO). The CRFB forecasts budget deficits increasing in 2021, instead of decreasing as the CBO had forecasted in February 2021. (See Figure 10.)

Figure 10:
Committee for a Responsible Federal Budget's Forecast of the U.S. Federal Deficit, 2003 to 2031.



Source: Committee for a Responsible Federal Budget. "New Budget Projections Show Record Deficits and Debt." March 11, 2021, page 1.

The Federal deficit will expand from $3.1 trillion to $3.4 trillion due to the most recent stimulus package in March 2021. These higher annual deficits will continue at least until fiscal year 2024.

Neither the CBO nor the CRFB deficit projections consider the possibility that Congress and the Administration will approve some infrastructure spending.

The CRFB now projects, without new infrastructure spending, that the federal deficit will grow from 108% of U.S. GDP in 2021 to 113% in 2031. This represents an increase in the federal debt from $16.3 trillion in 2021 to $37.4 trillion in 2031. The federal debt will grow at an annual rate of close to 8% while the economy will grow at approximately 2%, according to most economists and the CBO.

It is noteworthy that neither the CBO nor the CRFB forecast incorporates the prospects of recession, wars, nor the likelihood that the pandemic will reemerge in some new form.

Best Guess About Fiscal Policy

There is no coherent fiscal plan in Washington, D.C. to handle the emergent fiscal problem the U.S. will face, nor has there been one since the start of the financial crisis in 2008. The basic strategy seems to be spending on poorly thought-out programs and then raising taxes on corporations and high-income households to cover at least a small portion of the dramatically higher government spending.

An additional $400 billion in taxes on large corporations may slow the growth of the federal deficit and the national debt, but in the process U.S. corporations will face some of the highest tax rates in the developed world. This component of fiscal policy is short-sighted and unlikely to generate the desired Treasury revenues. Politicians seem to forget that corporations and many high-income households will find ways to thwart politicians' plans. Legal tax strategies will help postpone or avoid the $400 billion in increased taxes proposed by the new administration.

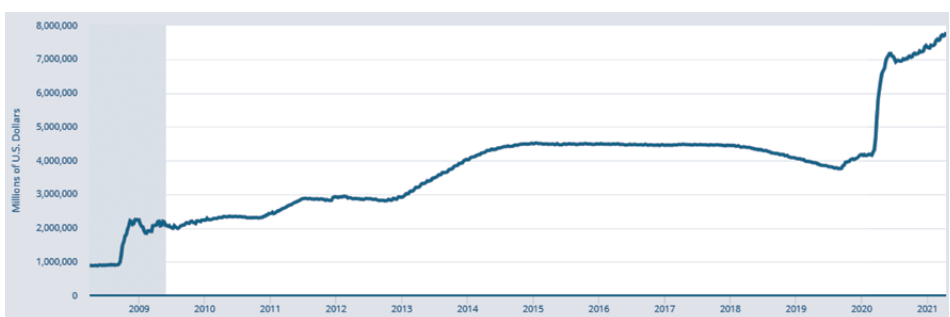
Fiscal policy needs serious rethinking, but neither Democrats nor many Republicans seem motivated to deliberate on the topic in mid-2021.

U.S. Monetary Policy

In normal times the Federal Reserve's policymakers play a central role in guiding and directing the forces that shape the American economy, but these are not normal times. Instead, the Federal Reserve appears to be a cheerleader for the passage of budget-busting spending and aggressive fiscal policy.

The Federal Reserve continues to support expansionary fiscal policy by holding down interest rates at levels not supported by normal economic analysis. Short-term interest rates are set close to zero in a world of rising anxiety of higher inflation. And the Federal Reserve continues its monetary expansion. This expansion is evident in the ballooning of the Fed's balance sheet. (See Figure 11.)

Figure 11:
Federal Reserve Total Assets, 2008 to Present.



Note: Shaded areas show recessionary periods; the most recent data is undecided.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Data (FRED), retrieved June 20, 2021.

The Fed's balance sheet has increased from approximately $4 trillion before the pandemic to almost $8 trillion today. In addition, the Fed has committed to monthly purchases of $120 billion of Treasury debt and mortgage-backed securities. The balance sheet will continue to grow in the coming months and years.

Purchases of these instruments guarantee that interest rates will remain artificially low thereby holding down the cost of the massive federal debt and thus the size of the interest expense for the U.S. government. A lower total interest expense means a smaller federal deficit, which noted above is already quite large by historical standards.

The worst part of this monetary situation is the uncertainty surrounding the Federal Reserve's path to monetary normalcy. The Federal Open Committee (FOMC) continues vague statements about any changes to its current stance. Will higher inflation cause it to act? It is unclear what rate of inflation would prompt the Fed to rethink its monetary easing. Nor is it clear at what point the Fed would choose to act.

Best Guess About Monetary Policy

In normal times the Federal Reserve acts as a counterweight to excesses that emerge in the economic system, such as high inflation, and weak growth. Now the Fed appears to be taking a backseat to fiscal policy. The Federal Reserve is accommodating the government spending spree.

Do not expect the Fed's monetary policy returning to its normal role of balancing economic growth with the maintenance of price stability until at least mid- to late 2022.

Final Thoughts

In mid-2020 the U.S. economy was in a disastrous situation with high unemployment and rapidly contracting growth. Officials responsible for monetary and fiscal policy acted rapidly to the unfolding Covid disaster, providing rounds of stimulus checks and a highly accommodative monetary policy. The process was not executed perfectly, but the economy started its recovery.

In mid-2021 most of the major ill-effects of the Covid crisis are receding. Signs of normalcy are apparent.

- GDP growth for 2021 will be about 6%. Headlines may read "The Biden Boom" continues. However, growth will taper off after this initial surge. Toward the middle of the decade growth will return to a rate of 2%, held down by small increases in the size of the American labor force and modest productivity gains.
- Unemployment is about 6% and headed downward, but it will not reach the 2019 level of under 4% in the current year nor by mid-2022.
- Inflation will average about 3.0% for 2021. But investors need to be wary because inflation risks are clearly to the upside. Any sustained inflationary pressures are likely to start in the second half of 2021 or early 2022 fueled by higher prices, including in energy, food, and services.

Holiday merrymaking may be winding down where you live but not in Washington where legislators are cheerfully proposing more spending fireworks.

Here is what we should watch for from our legislators:

- Will an infrastructure bill pass? If so, how large will it be?
- Are other massive spending programs headed to enactment?
- Will tax increases be imposed on corporations and/or high-income households?
- Will tax increases be expanded to middle-income households, and if so, at what point?
- If taxes increase, when will they take effect? 2021, 2022 or beyond?

Find a comfortable seat to watch the fireworks. But beware pickpockets abound.

Postscript

Federal Reserve decisionmakers, at the time of this publication, are making veiled statements that the Fed's monetary policy may be too passive. Maybe the Fed will indeed honor its mandate to dampen inflationary pressures before it loses control.

Thomas Goho, Ph.D. is formerly the Chief Economic Consultant for Stephens Inc. He also served as the Co-Director of Stephens University at Wake Forest University. Tom enjoys a successful career in both education and business. He served as a professor of finance, Wayne Calloway School of Business and Accountancy, Wake Forest University for 30 years. Before retiring in 2007, Tom was the first to hold the Thomas S. Goho Chair of Finance. Tom also served on the Board of Directors of the Wells Fargo Family of Mutual Funds for 20 years, and also was on the Board of Directors of Lifepath Funds of Barclay's Bank. A former Certified Financial Planner, Tom earned his BS and MBA from Pennsylvania State University and his Ph.D. from the University of North Carolina-Chapel Hill.

Stephens

111 Center Street
Little Rock, AR 72201
501-377-2000
800-643-9691
stephens.com

linkedin.com/company/stephens-inc-
@Stephens_Inc
facebook.com/about.stephens

INVESTMENT BANKING • PRIVATE WEALTH MANAGEMENT • INSURANCE
INSTITUTIONAL EQUITIES & RESEARCH • FIXED INCOME • CAPITAL MANAGEMENT
PUBLIC FINANCE • PRIVATE EQUITY