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# VIEWPOINT

A Stephens Inc. Economic and Financial Commentary
by Thomas Goho, Ph.D.

JANUARY 2021

Technology visionaries such as Elon Musk are plotting a path to Mars, unlike Earth-bound economists who keep struggling with more mundane issues such as:

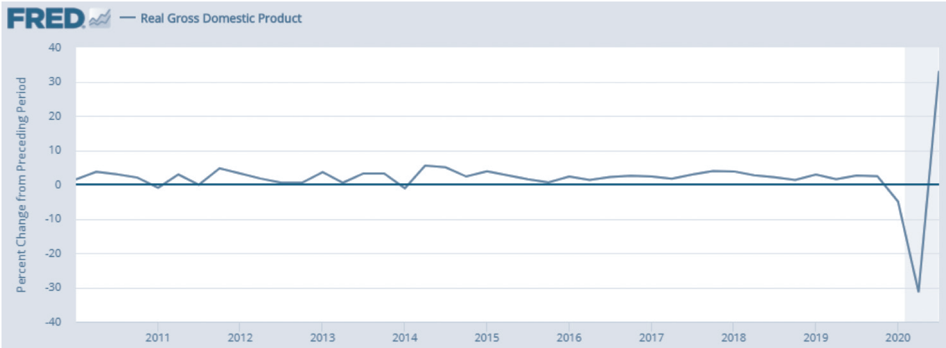
- What is the path of the current economic recovery?
- Did the strong growth of the third quarter of 2020 continue through fourth quarter and into 2021?
- Will the second wave of Covid-19 slow the return to normalcy?
- Is the economy likely headed toward a period of languid growth as forecast by some economists?

No simple answers to these questions are readily apparent. This issue of Viewpoint is focused on unraveling the uncertainties confronting the American economy in 2021.

## Economic Growth

The last decade experienced slow but steady growth of about 2%. Then Covid-19 arrived, and the country and the world went on lockdown in early 2020. The U.S. economy lagged in the second quarter with the worst quarterly growth rate ever recorded in real Gross Domestic Product (GDP). It contracted at an annualized rate of 31.4%. (*See Figure 1.*) The economy rebounded by 33.1% in the third quarter of 2020 aided by the economic stimulus package of $2.1 trillion signed into law on March 27, 2020.

Figure 1:
Real Gross Domestic Product (GDP), Change From Previous Quarter at an Annual Rate (2010 to Present).




The shaded area shows the ongoing recession.

Source: Federal Reserve Bank of St. Louis. Extracted from the Federal Reserve Economic Database (FRED) on December 3, 2020.

The boomeranging economic growth from the second quarter to the third quarter of 2020 hides the true nature of the recovery. Fourth quarter 2019 real GDP of the American economy was $19.2 trillion. (*See Figure 2.*) It is now $18.6 trillion, a drop of $600 billion, or 3.1% lower than the fourth quarter of 2019. The economy has lost one year of economic growth.

Figure 2:
**Real Gross Domestic Product, Seasonally Adjusted Annual Rate in U.S. Dollars (2017 to Present).**


The shaded area indicates the ongoing recession.

Source: Federal Reserve Bank of St. Louis. Extracted from the Federal Reserve Economic Database (FRED) on December 3, 2020.

Under these volatile conditions, forecasting is difficult. Consider two highly respected forecasting groups:

- **The Federal Reserve Bank of Atlanta:** At the end of the third quarter, the Atlanta Federal Reserve's Nowcasting model of economic growth predicted third quarter GDP growth of 35.2%.
- **The New York Federal Reserve:** At the end of the third quarter, the New York Federal Reserve's Nowcasting model predicted real GDP growth of 13.8%.

Both models missed the actual number of 31.4%, with the New York Fed model missing by almost 20 percentage points.

The current weakness in the economy raises a key question about the shape of the current recovery. A partial answer may be provided by the September 2020 survey of 60 economists by *The Wall Street Journal*. These economists were asked to forecast the path of the American recovery over the next several years. (*See Figure 3.*)

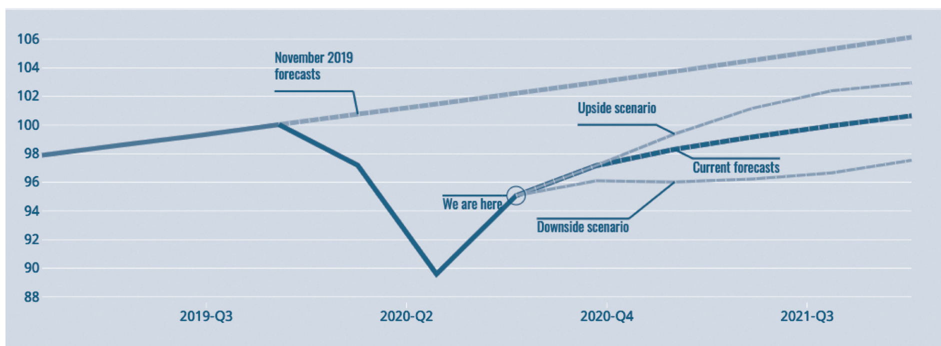
Figure 3:
The Wall Street Journal Survey of 60 Economists Forecast of the Shape of the Economic Recovery.

| Shape of the Recovery | Percent |
|---|---|
| Sharp drop with a gradual recovery | 68.5% |
| V-shaped: sharp drop followed by a sharp rebound | 14.8% |
| W-shaped: a double-dip recession | 11.1% |
| U-shaped: a protracted bottom | 3.7% |
| L-shaped: no recovery for the foreseeable future | 1.9% |

Source: The Wall Street Journal. Economic Forecasting Survey. September 2020.

The essence of the "sharp drop with a gradual recovery" scenario is indicated by Organization for Economic Co-ordination and Development (OECD) model. (*See Figure 4.*) Although the OECD's analysis refers to global GDP, most economists expect a similar rebound in the U.S. and globally in the third quarter of 2020 followed by a slow return to normalcy by 2022.

Figure 4:
OECD Economic Outlook, September 2020.
World GDP Index 2019 Q4 = 100.




Source: Organization for Economic Co-Ordination and Development. "OECD Economic Outlook, Interim Report." September 2020.

Estimates for the American economy by some organizations project a drop in 2020 real GDP followed by a rebound in 2021. (*See Figure 5.*) With the exception of the OECD's forecast, none of the other organizations expect the U.S. economy to recover its 2020 economic losses by the end of 2021.

Figure 5:
Estimates of American Real Gross Domestic Product (Real GDP) for 2020 and 2021.

| Organization. | 2020 | 2021 |
|---|---|---|
| Conference Board | -4.8% | +3.7% |
| Congressional Budget Office (CBO) | -5.7 | +4.8 |
| International Monetary Fund (IMF) | -8.0 | +4.5 |
| OECD | -3.8 | +4.0 |
| United Nations (Economic Analysis Group) | -4.8 | +3.9 |
| World Bank | -6.1 | +4.0 |
| **Average Estimate (for 6 organizations)** | -5.5% | +4.1% |

Sources: Publications of various organizations identified above.

### Best Guess About U.S. Economic Growth

The average growth shown above pinpoints America's recovery prospects. By the end of 2021, the economy will not have recovered all its lost GDP from the 2020 recession. It could be 2022 before the economy returns to the 2019 level. No analyst knows if a second economic stimulus package will pass Congress in 2021, but passage of such legislation will impact the recovery path.

If the economy does return to its 2019 level by 2022, problems will remain. The Congressional Budget Office projects growth will return only to the languid economic rate experienced between 2010 to 2019. The economy is likely to grow at 1.6% per year, less than its economic potential of 1.8%. (*See Figure 6.*) This sub-par growth is linked to weak labor force growth, producing an annual growth rate of 1.1% per capita GDP over the next 10 years.

Figure 6:
CBO's Estimates of Major Economic Variables, 2020-2030 versus 1990-2019.

| | 1990 – 2019 | 2020 – 2030 |
|---|---|---|
| **Growth of GDP** | | |
| Real GDP | 2.5 | 1.6 |
| Real Potential GDP | 2.4 | 1.8 |
| Potential labor force | 0.9 | 0.4 |
| Potential labor force productivity | 1.5 | 1.4 |
| Nominal GDP (Fiscal year) | 4.6 | 3.4 |
| Real GDP per person | 1.5 | 1.1 |

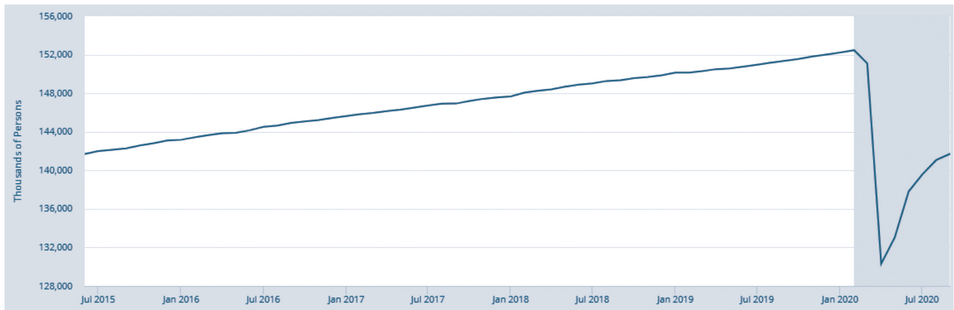
Sources: Congressional Budget Office (CBO). *The Long-Term Budget Outlook*. July 2020. Page 4.

Americans expect a greater improvement in their standard of living than 1.1% per year. At that rate of growth, the U.S. standard of living would double about every 65 years, far less than the doubling time of between 15 and 30 years since World War II.

## U.S. Labor Markets

A weak American economy is inextricably linked to recent paroxysms in labor markets. The onset of the Covid-19 virus crushed labor markets. Employment plunged at a record rate. (*See Figure 7.*) From February 2020 until April 2020, employment fell by 22 million jobs, from 152 million workers to 130 million.

Figure 7:
**All Employees, Nonfarm, June 2015 to Present.**

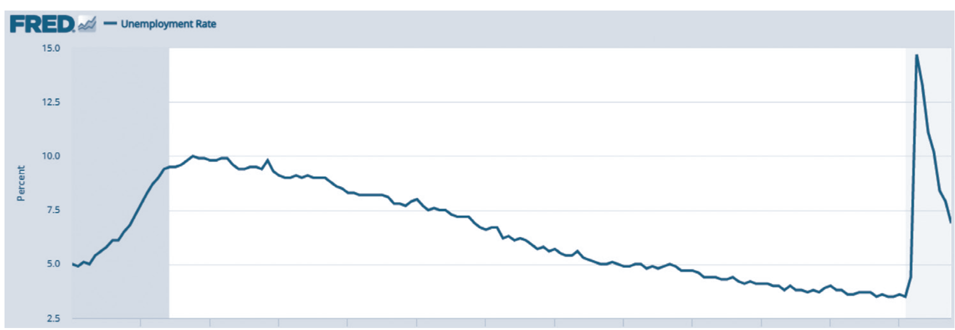



The shaded area indicates the ongoing recession.

Source: Federal Reserve Bank of St. Louis. Extracted from the Federal Reserve Economic Database (FRED) on December 3, 2020.

After the employment rebound in July, there are now only 142 million employed Americans, the same number as 5 years ago and 10 million less than in February 2020. The unemployment rate during the pandemic increased from a near record low of 3.5% in February 2020 to 14.7% in April. (*See Figure 8.*) In October it fell to 6.7%. These conditions suggest that the economy might experience a V-shaped recovery.

Figure 8:
**U.S. Unemployment Rate, 2008 to Present.**

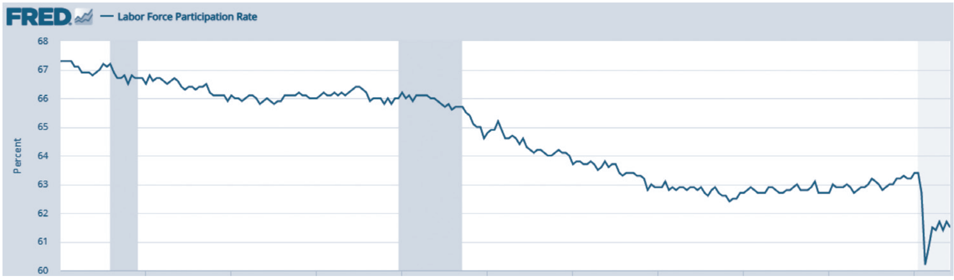



Shaded areas indicate the past recession and the ongoing recession.

Source: Federal Reserve Bank of St. Louis. Extracted from the Federal Reserve Economic Database (FRED) on December 3, 2020.

Yet the unemployment rate for American workers is an incomplete story. The improving unemployment rate disguises the drop in the labor participation rate in U.S. labor markets. This rate is the percent of workers who are currently working or actively looking for employment relative to the pool of potential workers. The labor participation rate plunged to 60.2% in April 2020 as the unemployment rate soared when the country went into pandemic lockdown mode. (*See Figure 9.*)

Figure 9:
**U.S. Labor Participation Rate, 2000 to Present.**

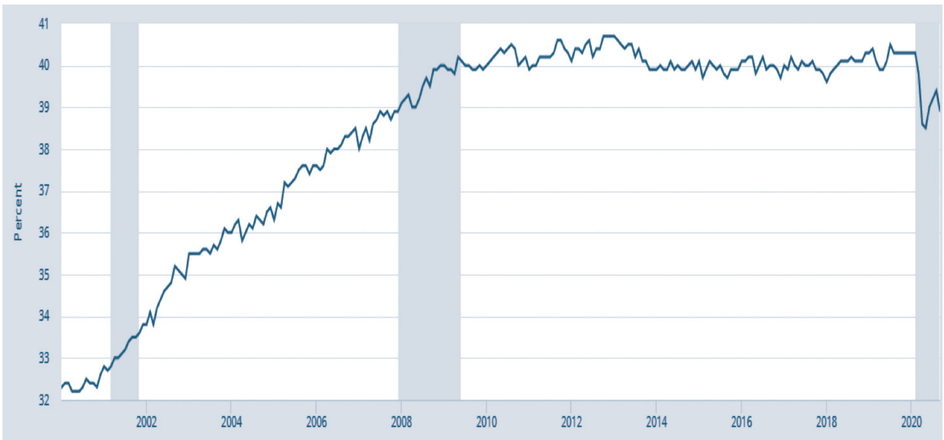



Shaded area indicates the past recessions and the ongoing recession.

Source: Federal Reserve Bank of St. Louis. Extracted from the Federal Reserve Economic Database (FRED) on December 3, 2020.

The labor participation rate rebounded to 61.5% in November 2020, still far below the 63% pre-pandemic level -- or the more than 67% at the start of the new millennium. The longer-term decrease in labor participation rate occurred for all ages, races, and genders with one exception: older workers, those age 55 and above. (*See Figure 10.*) Even after the ill-effects of the pandemic, the labor participation rate for older workers is now 39% compared to slightly more than 32% in 2000.

Figure 10:
**Labor Participation Rate of Workers Age 55 and Over, 2000 to Present**




Shaded area indicates the past recessions and the ongoing recession.

Source: Federal Reserve Bank of St. Louis. Extracted from the Federal Reserve Economic Database (FRED) on December 3, 2020.

This long-run increase in working seniors may be a symptom of the weak financial condition of semi-retired citizens rather than the desire of seniors to extend their working career.

It is significant that the U.S. has experienced this significant drop in the share of American citizens who are in the labor force. Fewer workers relative to the size of the population suggests slow growth in weak aggregate output. Sub-par growth in Americans' standard of living is the inevitable consequence.

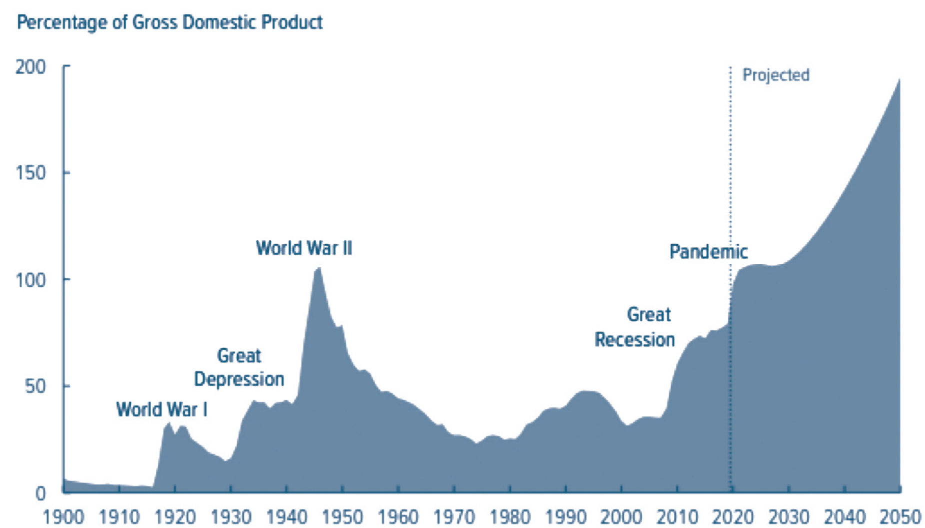
### Best Guess About Labor Markets

The negative impact of Covid-19 will have a long-lasting effect on employment. It will take at least 2 years, if not 4 years, for the unemployment rate and labor participation rate to return to the levels seen in late 2019. Businesses are rethinking established views on the structure of their work environments. This re-assessment of employment models will lengthen the time it takes to normalize employment levels.

## U.S. Fiscal Policy

Over the long run, government spending has played an important role in enhancing GDP growth. Government investments in infrastructure, education, technology, and related endeavors were financed in the last millennium by reasonably sound fiscal policy. However, U.S. fiscal policy now may be headed into a brick wall. America was running massive annual Federal deficits just prior to the 2020 pandemic. Now the Federal government is incurring additional costs as it fights Covid-19. (*See Figure 11.*) By some estimates these incremental expenses amounted to 15% of America's 2020 GDP.

Figure 11:
**The U.S. Federal Debt Held by the Public as a Percent of U.S. GDP, 1900 to 2050.**




Source: U.S. Congressional Budget Office (CBO). *The 2020 Long-Term Budget Output*, September 2020. Page 4.

By 2023 the Federal debt will be at an historic high of 106% of GDP, topping the debt accumulated during World War II. Based on current legislated spending plans, American federal debt will reach almost 200% of U.S. GDP in 2050. The CBO analysis is based on conservative assumptions for inflation, interest rates, employment, and economic growth. The CBO does not factor in the possibility of recessions or wars over the next 30 years.

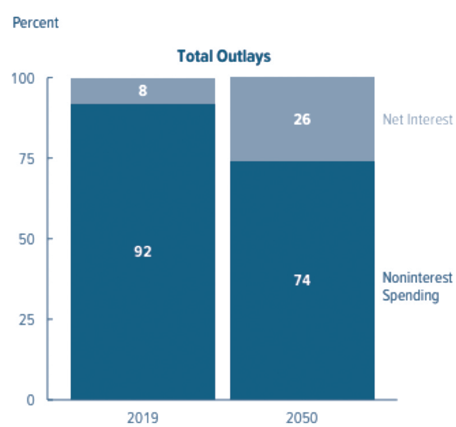
The new Democratic president and many in Congress have bold plans for massive new spending on the environment, education, infrastructure, childcare, housing, Covid-related stimuli and other programs. The estimated cost of these new programs, if passed, will add an additional $7 to $10 trillion in spending over the ensuing 10 years, much of which will not be recouped by higher taxes. The Tax Foundation reviewed the proposed tax and spending plans and, if implemented, they would decrease GDP growth 1.5% over the long run, decrease wages by 1%, and eliminate almost 600,000 jobs. Other organizations doing similar analyses predict a less negative impact on the economy.

### Best Guess About Fiscal Policy

American fiscal policy is probably headed to large increases in federal spending, spending that is in addition to the unprecedented peacetime spending for Covid-19. In other words, U.S. Federal deficits will balloon in the next decade to a level that many economists believe will be unsustainable. Federal deficits per year of at least 5% of real GDP are likely.

In the long run, even without the new spending proposed by the president-elect, the U.S. fiscal condition is dire. (*See Figure 12.*) Using the CBO's conservative assumptions and no significant new programs, net interest on the Federal debt in 2050 will constitute 26% of governmental outlays. The remaining 74% of outlays will be available for all additional programs: including defense, health care, education, Social Security. By comparison, in 2019, 92% of the Federal budget was available for these programs with only 8% of outlays consumed by interest payments.

Figure 12:
Composition of U.S. Federal Outlays, 2019 vs 2050.




Source: U.S. Congressional Budget Office (CBO). *The 2020 Long-Term Budget Outlook*, September 2020. Page 26.

These CBO figures incorporate the "best" case scenario. This best case is not a viable path forward for either the government or the economy. Higher taxes on just a sliver of the tax-paying population will not solve America's fiscal mess. More likely is that taxpayers in the top 50% of the income spectrum will be footing the bill for higher federal spending, not just those earning over $400,000 as indicated by many politicians.

American corporations likely will incur tax increases with a proposal to repeal recent corporate tax cuts, pushing the corporate rate up from 21% to 27%. In addition, the new administration is proposing significant tax increases on the foreign earnings of U.S.-based multinational corporations. **Equity investors need to be aware of these possible tax changes since some tax increases have bipartisan support.**

## U.S. Monetary Policy

In recent years, and especially since the 2008 financial crisis, the Federal Reserve's monetary policy has played a crucial role in stabilizing the economy. Interest rates continue to be at artificially low rates (close to zero) to encourage investment and to fund U.S. deficit spending. The Federal Reserve's accommodation has resulted in a significant increase in the size (and composition) of the Fed's balance sheet. (*See Figure 13.*) The Fed is now a major purchaser of U.S. government debt, pushing its balance sheet up from $700 billion in 2008 to a current level of $7.2 trillion.

Figure 13:
Total Assets of the Federal Reserve System.


Shaded area indicates the past recession and the ongoing recession.

Source: Federal Reserve Bank of St. Louis. Extracted from the Federal Reserve Economic Database (FRED) on December 3, 2020.

Historically, the Federal Reserve has purchased only assets backed by the U.S. government: Treasury debt, U.S. agency debt and mortgages backed by the Federal government. During the most recent Covid-19 crisis, the Fed has added debt instruments of state and local governments as well as various corporate debt instruments to its portfolio. The real economic value of this debt is far less certain than those of the U.S. Treasury and related agencies.

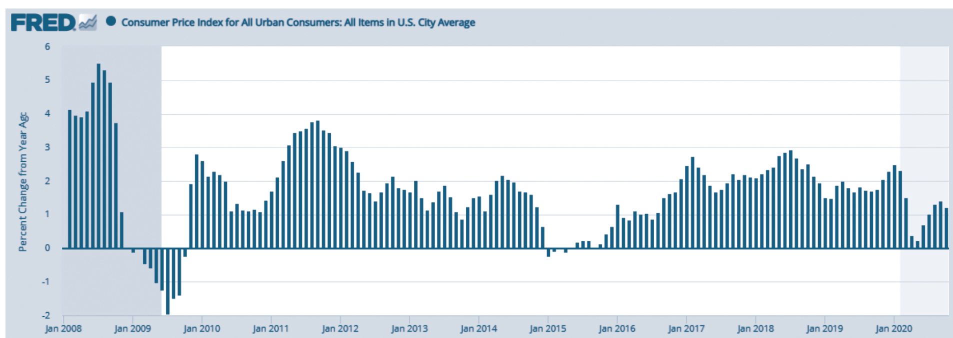
Federal Reserve chairman Jerome Powell has suggested that if the economy is to have a robust recovery in 2021 and beyond, the U.S. government needs to provide even more fiscal stimulus -- more government spending. It seems to be an implicit admission by the Fed that it has done all that it can do to jumpstart the economy, given that interest rates are already artificially low.

## Best Guess About Monetary Policy

The Fed's monetary policy has played a key role in stabilizing the U.S. economy over the past decade. It helped to avert a financial meltdown during the 2008-2009 crisis. During the current Covid -19 lockdowns, the Fed has provided liquidity to keep financial markets operating in an orderly manner. But those actions have incurred high costs. Artificially low interest rates encourage poor investment and speculative activity. More importantly, excessive monetary expansion raises the specter of inflationary pressures at some point in the future but not in the short run.

The consensus among economists is that inflationary pressures, even with rapid monetary expansion, is not an immediate concern. Current price increases are modest and in line with consumer price changes over the past decade. (*See Figure 14.*) The annual rate of change for the consumer price index (CPI) is under 1.5% with the most recent monthly increase of 1.2%.

Figure 14:
Consumer Price Index (CPI) for All Urban Consumer, 2008 to Present.




Shaded areas indicate the past recession and the ongoing recession.

Source: Federal Reserve Bank of St. Louis. Extracted from the Federal Reserve Economic Database (FRED) on December 3, 2020.

In recent years, the Federal Reserve has targeted a 2% rate as its upper bound for inflation. However, in a radical departure from that target rate, the Fed has stated it is willing to tolerate a higher rate provided inflation **averages** no more than 2% over some unspecified period. In other words, the Fed will tolerate inflation above 2%, thereby violating its mandate to keep inflation under tight control.

How long and how much above 2% is unclear. In a world of already low interest rates, this lack of specificity should make investors nervous. In brief, monetary policy is in uncharted territory with little policy clarity for stock and bond investors. The Fed's monetary policy is likely to lack clarity until the economy emerges from the Covid-19 crisis, at the earliest.

## Final Thoughts

Elon Musk may be headed to Mars, but American consumers, taxpayers and investors could be entering an "Economic Twilight Zone" where almost anything can happen. Americans need to be aware of several important facts:

- The Covid-19 crisis has significantly worsened the Federal debt burden adding significant pressure on the Federal government's finances. Hard spending choices will be on the horizon within years rather than decades.
- The United States government has been on an unsustainable spending trajectory for several decades. The Federal debt burden is approaching a level that raises questions about whether global bond investors will retain an appetite for U.S. debt issuances.
- Many members of Congress and the new Presidential administration have proposed and may attempt to implement hugely expensive spending programs that will, if signed into law, increase deficits and the federal debt burden to record peace-time levels even in the relatively short run.
- The Federal Reserve seems to be accommodating this spending explosion fueled by irrationally low interest rates that decrease the interest burden on the federal deficit. Rather than following its dual mandate to foster low inflation and full employment, the Fed is being a willing accomplice in the Federal government's spending.
- State and local taxes are headed significantly higher. Higher taxes will be needed to cover lost tax revenues caused by the Covid-19 crisis. These increases in time will hit both high income and middle-income taxpayers, notwithstanding political promises that middle-income taxpayers will be exempt from higher taxes.
- Significant government spending and an accommodative monetary policy may seem normal these days, but normal GDP growth may not return. The U.S. is likely to experience growth of under 2%, less than its potential long-term GDP growth rate.
- At the time of this writing, Congress is seeking another economic stimulus package. Any such package will mitigate the current recession. A solid recovery will finally materialize in mid to late 2021.

**Happy New Year! And may you have a Covid-free new year.**

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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.

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