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2021 Q1 Economic Recap and Rate Outlook

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The path of the Covid-19 virus dictated the direction of the economy in 2020, and the first quarter of 2021 was no exception. GDP growth was expected to begin the year at a crawl before breaking into a run by mid-summer as virus fears eased and businesses fully reopened. However, the first month was frighteningly bleak. New Covid-19 cases, hospitalizations and deaths all surged to record highs in early January. Under the threat of another round of company shutdowns, vaccinations became a high priority for most Americans. On January 19th, 15.7 million doses had been administered. By the end of March, that number would climb above 150 million, while the current average of 2.8 million shots administered daily, equates to almost 90 million future doses per month.

According to CDC data, 99.6 million Americans had received at least one dose by quarter end, including 74% of the 65 and older crowd. Roughly 110 million, or one-third, of the U.S. population is over 50 years old. Members of this demographic group, *accounting for 95% of U.S. Covid deaths*, should all have an opportunity to be vaccinated (if they aren't already) by the end of April. Once a majority of the most vulnerable are vaccinated, the heavy lifting is done. Herd immunity may still technically be months away, but the darkest days are likely behind us.

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Once Americans sensed light at the end of tunnel, airline bookings began to increase. TSA data showed 1,574,000 travelers passing through airport checkpoints on the final Sunday in March, nearly double the weekend average for January. Although air travel numbers ended the quarter more than 35% below pre-pandemic levels, anecdotal evidence suggests this shortfall is filling quickly. American Airlines announced in late March that with average bookings back to 90% of pre-pandemic levels, it expects to reactivate the majority of its fleet in the second quarter.

A recent survey from tourism research firm Longwoods International, showed eight in 10 Americans plan to travel within the next six months while 60% had already begun arranging travel plans. CNBC reported that domestic hotel bookings had more than tripled since February, while Carnival Corp reported first quarter cruise bookings were 90% higher than in the fourth quarter.

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As the outlook rapidly improved, lawmakers began to question the dollar amount of the next round of pandemic support. It wasn't so much the proposed assistance to unemployed workers, struggling small businesses and schools attempting to safely reopen, but whether the third round of stimulus payments to individuals, employed or otherwise, was necessary. As it turned out, President Biden kept his election promise, signing the $1.9 trillion *American Rescue Plan* into law on March 11th, exactly one year after the World Health Organization declared Covid-19 a global pandemic. For the most part, the provisions of the bill were focused on Americans feeling the brunt of the virus impact. Some of the highlights include:

- Extending the Pandemic Unemployment Assistance and Pandemic Emergency Unemployment Compensation programs through early September
- Extending the $300 /week federal unemployment supplement through early September
- Extending the 15% increased food stamp amount
- Expanding the child tax credit, earned income credit and child and dependent care credit
- $411 billion in combined payments to 90 million individuals
- $350 billion for state and local governments to patch budget shortfalls
- $170 billion for schools and universities to safely reopen and address "learning loss"
- $29 billion for restaurants and bars to meet expenses as the economy gradually reopens
- $22 billion in direct rental assistance

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The Fed's actions 12 months ago were swift and decisive as the nation braced for what then appeared to be a long and painful recession. As it turned out, the recession was technically the shortest on record, although recovery has been wildly uneven. The question for Fed members, with the economy now poised to accelerate well beyond pre-pandemic levels, is *when to begin reeling in their super-accommodative interest rate policy*.

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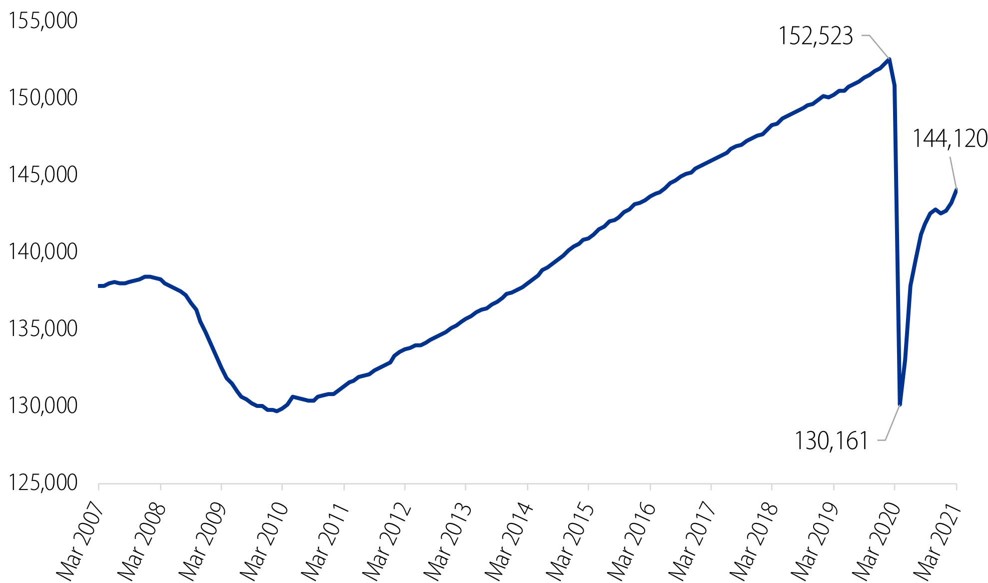
The March FOMC meeting gave no hint of a policy shift. However, committee members boosted their 2021 GDP forecast from +4.2% to +6.5% and now expect inflation will climb above their +2.0% target this year and remain above target for at least two more years. Despite stronger anticipated economic growth and higher prices, the dot plot from the March FOMC meeting indicated committee members, on the whole, don't expect to begin hiking the overnight rate target before 2024. Fed Chair Powell has repeatedly said the Fed will base its policy on actual data rather than forecasts. He has also made it clear the FOMC is willing to allow the economy to run hot for a time in order to return to full employment.

The labor market began heating up in February after two months of net job losses, and by March the outlook had improved dramatically. The March employment report, released two weeks after the FOMC meeting, showed a 916k rise in non-farm payrolls, while revisions to the previous two months added another 156k to the count. With the exception of a four-month stretch last summer when the economy emerged from lockdown, the March payroll gain was the biggest in 38 years and the second highest total since 1946. The average workweek rose, factory overtime increased, and the number of temporary jobs on company payrolls fell. All of these labor market indicators signal future hiring.

With the exception of a four-month stretch last summer when the economy emerged from lockdown, the March payroll gain was the biggest in 38 years and the second highest total since 1946.

Total Nonfarm Payrolls (thousands)

Despite a sharp rebound, non-farm payrolls remain 8 million jobs shy of the pre-pandemic peak.



Source: Bureau of Labor Statistics.

Consumers, on the whole, were in good position to spend, with household wealth reaching progressively higher highs in the second, third and fourth quarters of 2020. According to the Federal Reserve, U.S. household wealth ended the year at a record $130.2 trillion, with stocks adding a combined $4.9 trillion during the final quarter and increased real estate values adding another $900 billion. During the virus-tainted calendar year, household wealth actually increased by $12 trillion. The first quarter of 2021 is likely to keep the wealth steak alive as the median price for an existing home was up +15.8% year-over-year in February, while both the S&P 500 and DOW hit new highs in late March.

During the virus-tainted calendar year, household wealth actually increased by $12 trillion.

The housing market cooled during the quarter, hampered by harsh winter weather, lean inventories and slightly higher mortgage lending rates. However, 2020 was the best year for home sales since 2006, and the outlook is still quite solid. According to Pew Research, Millennials have recently overtaken Baby Boomers as the largest generation, and in 2020 accounted for over 50% of new mortgages. Census Bureau data indicates home purchases in the 30-49 year old demographic group will grow significantly through 2039. On a related note that speaks both to lean inventories and the hot market, the Wall Street Journal reported the number of licensed real estate agents now exceeds the number of homes for sale in the U.S.

The pace of new vehicles sales in March was the strongest in over three years, well above pre-pandemic levels. Similar to the housing market, historically light supply is a problem. According to Wards Intelligence data, the total number of cars and trucks on dealer lots or in transit was 2.7 million at the end of February, down 900,000 units from a year ago. The Conference Board reported in March that consumers planned to significantly increase vehicle purchases over the next six months, but new production will be hamstrung by disruptions in global supply chains and a severe semiconductor chip shortage.

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Treasury yields on the long end of the curve rose sharply along with economic growth forecasts and concern over a corresponding rise in future inflation. If GDP growth accelerates as many expect, long yields could easily drift even higher. At the same time, the short end grappled with a severe supply/demand imbalance which drove short Treasury-note yields negative out to July. With the Treasury continuing to slash T-bill issuance in the second quarter, the negative yield story on the short end isn't over.

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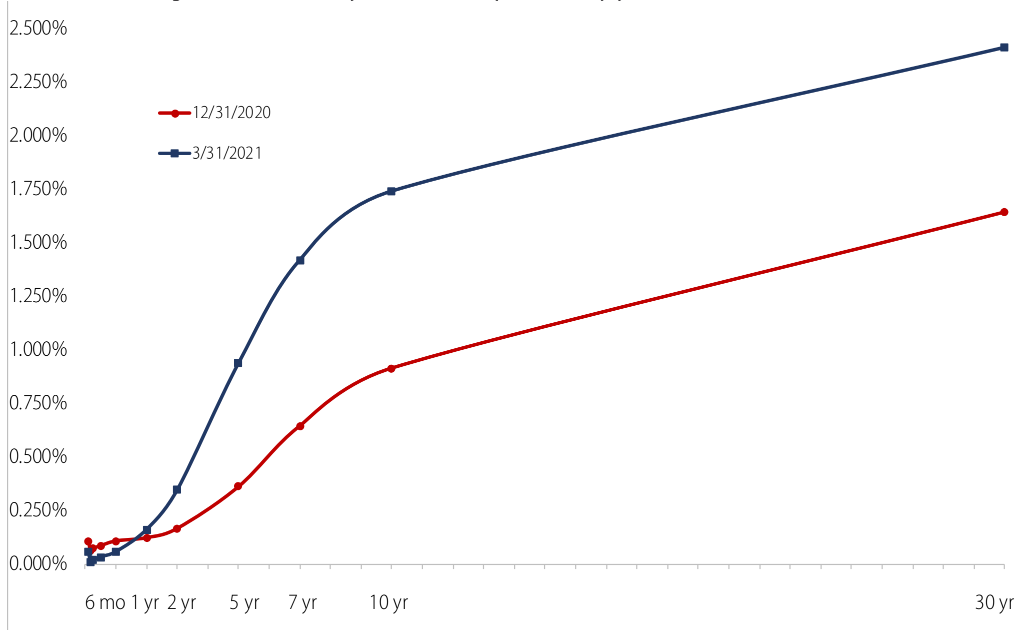
Treasury Yield Curve

As the outlook brightened in Q1, the yield curve steepened sharply.



Source: U.S. Department of the Treasury.

The first quarter ended on a high note with significant economic momentum stemming from vaccine progress, a receding Covid spread, and extremely accommodative monetary policy. The second quarter will be further fueled by proceeds from the $1.9 trillion American Rescue Plan and what is expected to be a summer travel and recreation boom. At this point, the market is bracing for what could be the most robust GDP growth since 1984 (+7.2%), when Ronald Reagan was in the White House and the overnight fed funds rate averaged over 10%.

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Q1 Interest Rates

		Fed Funds	3 mo. T-bill	12 mo. T-bill	2 yr. T-note	5 yr. T-note	10 yr. T-note
Last	12/31/2020	0.00%-0.25%	0.06%	0.10%	0.12%	0.36%	0.92%
High			0.08%	0.10%	0.17%	0.94%	1.74%
Low			0.00%	0.04%	0.10%	0.35%	0.91%
End	3/31/2021	0.00%-0.25%	0.01%	0.05%	0.16%	0.94%	1.74%

Source: U.S. Department of the Treasury.

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Economic and Interest Rate Outlook

In the 10-year expansion preceding the pandemic, annual GDP growth averaged just under +2.3%. The virus battle of 2020 resulted in a -3.5% year-over-year contraction. This year, after what appears to be a surprisingly solid first quarter, GDP is expected to accelerate sharply. Fed officials are now forecasting 2021 GDP will increase by +6.5%. This may be overly conservative as the Atlanta Fed's GDPNow estimate for the first quarter registered +6.0% as of April 1st, roughly triple the median Q1 forecast when the year began. The prevailing thought at that time was that second half growth, unencumbered by the virus, would make up for any early shortfall. As it turned out, there really wasn't a shortfall and growth is coming much sooner than expected.

The overall Economic Outlook Index increased by 21 points to 107, the highest reading in two years, and the fifth highest since the survey began 15 years ago.

Surveys don't paint a complete picture, but they can sketch a pretty good outline of what's likely to develop. Most of the major surveys are flashing extreme optimism. Business Roundtable released its Q1 2021 CEO Economic Outlook Survey in March, showing capital spending, employment and sales expectations over the next six months. (This diffusion index ranges from -50 to 150, with any number above 50 indicating expansion.) The overall Economic Outlook Index increased by 21 points to 107, the highest reading in two years, and the fifth highest since the survey began 15 years ago. Hiring plans increased from 58 to 88, the biggest single month jump on record, while capital investment plans and expected sales both recorded significant gains.

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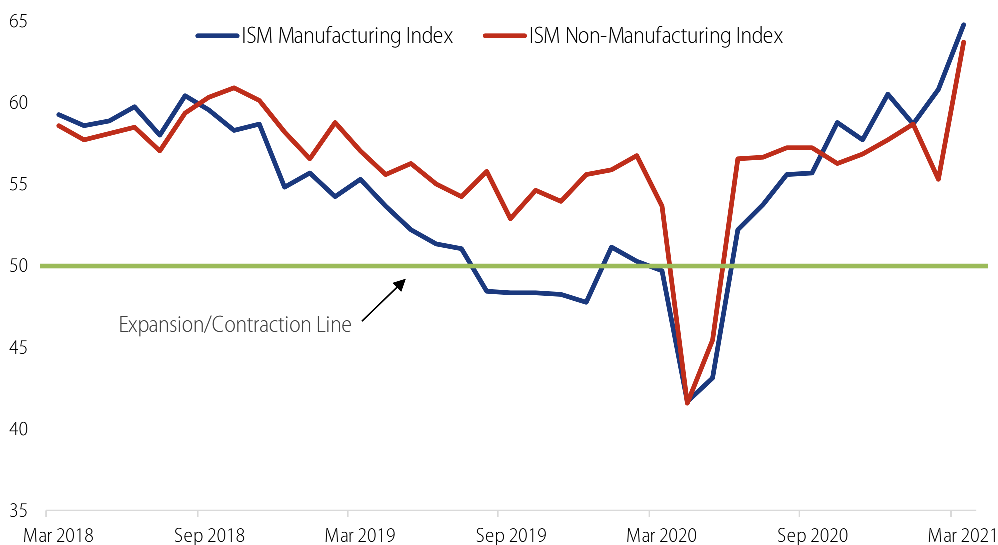
ISM Index

Purchasing managers have become very optimistic.



Source: Institute for Supply Management.

The ISM manufacturing index for March registered the highest reading since 1989. One of the consistent comments made by factory managers in the survey was

challenges in hiring and retaining employees. The ISM survey also highlighted historically low inventory levels and extremely elevated materials prices.

The consistent overriding message from U.S. companies, both large and small, is that demand is rising quickly, but workers are scarce.

The ISM non-manufacturing index for March unexpectedly jumped from 55.3 to 63.7, the highest level in the 24-year history of the service sector survey. The business activity index rose from 55.5 to 69.4, while forward-looking new orders index rocketed from 51.9 to 67.2. Service managers also expressed hiring issues as well as concern over rising input prices.

The consistent overriding message from U.S. companies, both large and small, is that demand is rising quickly, but workers are scarce. It's a curious issue because the labor market still has considerable ground to make up. Through the end of March, company payrolls were still 8.3 million below pre-pandemic levels. In addition, another 6.9 million sidelined workers remain outside the workforce. The likely problem is that large numbers of unemployed workers are satisfied with the level of pandemic relief they're receiving. It's unclear how this unintended consequence will play itself out, but anyone who's historically had trouble finding work is more likely to find something between now and September, when federal benefits expire.

Fed officials cut the overnight rate to zero and reinitiated QE purchases more than a year ago. At that time, monetary policy was the only game in town. Since then, fiscal policy has stepped forward with $5.3 trillion in government support to unemployed workers, families and small businesses. Americans have paid down debt and tucked away double digit savings. Home values have soared along with the stock market driving household net worth to progressively higher highs in each of the last four quarters. According to the Wall Street Journal and Federal Reserve data, U.S. households ended the year 2020 with $14.1 trillion in combined checking and savings accounts, an increase of $2.7 trillion from the same period a year ago. These eye-popping numbers will be even higher after the first quarter. At the same time, debt-service burden, the percentage of income required to pay monthly bills, dropped to its lowest level in 40 years.

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All in all, it's an untried recipe for extreme growth. Bloomberg Economics is now forecasting quarterly GDP growth of +11% for the second quarter and +10% for the third, with year-over-year growth of +7.7% in 2021. This would be the strongest growth in seven decades. Fed officials aren't concerned, but the market is. *It's really hard to make the argument that overnight rates should remain at zero for another three years.*

Chief Economic Advisor at Allianz and former PIMCO CEO Mohamed A. El-Erian questioned whether the Fed was losing control of the bond market, pointing to the growing contradiction between steadfast monetary policy and evolving economic realities. Former Treasury Secretary Larry Summers cautioned that current U.S. macro-economic policy was the "least responsible" in four decades, warning "what was kindling, is now igniting," and that the U.S. could face a "pretty dramatic fiscal-monetary collision."

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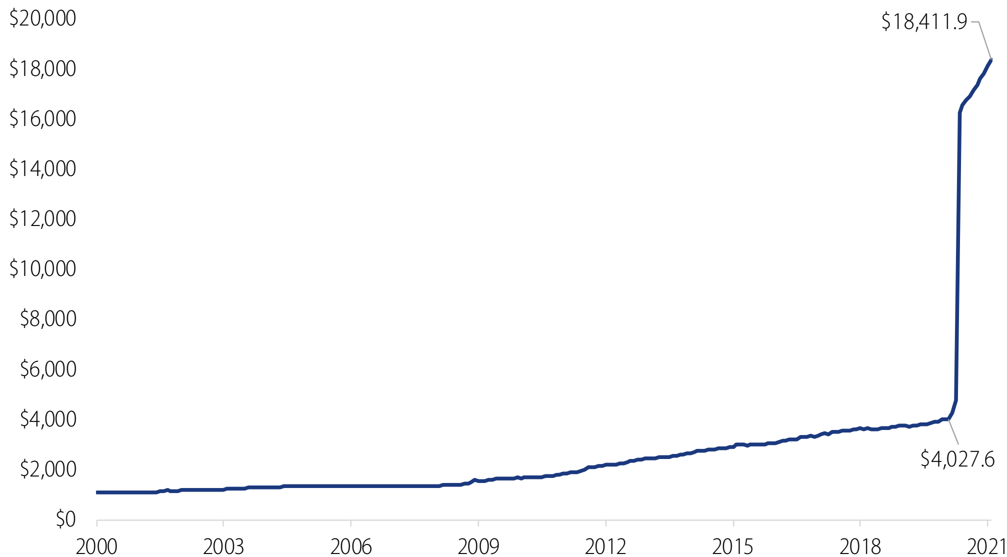
M1 Money Supply ($ billions)

The M1 money supply, which includes cash and liquid deposit accounts, exploded higher thanks to both fiscal and monetary stimulus.



Source: Federal Reserve.

Hopefully, the expected surge in future economic growth will result in a broader V-shaped recovery that eventually lifts Americans on the lower rung of the ladder.

Sadly, the flat part of the K-shaped recovery is still intact. Pulse survey data shows huge numbers of American households continue to struggle, with roughly 13 million adults reporting little confidence in their ability to make next month's rent or mortgage payment. For these folks, stimulus checks are a necessity rather than a windfall. The CARES Act paused payments on student loan debt and enacted a moratorium on home foreclosures and rental evictions. These passes were recently extended through September, but eventually the bills will come due. Hopefully, the expected surge in future economic growth will result in a broader V-shaped recovery that eventually lifts Americans on the lower rung of the ladder.

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Fed officials are in a wait-and-see mode, maintaining policy (and credibility) as long as possible in hopes of a more inclusive labor market recovery. The near-term economic outlook is extremely bright. investors are likely to react to a booming economy and rising inflation by demanding higher yields, and in doing so, could ultimately force the Fed's hand.

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