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2020 Q4 Economic Recap and Rate Outlook

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The third quarter of 2020 lived up to lofty expectations with GDP expanding at a remarkable +33.4% annualized pace. The record growth was fueled by massive government support and a receding virus tide. The fourth quarter story has been quite different. Much of the federal aid had been consumed and COVID-19 came roaring back as the weather turned cooler. Americans essentially had less money to spend during the quarter and with increased COVID restrictions on businesses, fewer opportunities to spend what they did have.

The rapid spread of the virus during the quarter was dramatic. From October 1 to December 31, according to COVID Tracking Project data, the number of Americans hospitalized for the coronavirus quadrupled from 30k to 120k, while the number of fatalities climbed by nearly 70% to 340k. Fortunately, the fourth quarter also ushered in hope in the form of vaccines from Pfizer/BioNTech and Moderna, both with efficacy rates of around 95%, well above the FDA's 50% threshold for emergency use authorization.

The first two COVID-19 vaccines are unique in that they represent the first use of synthetic messenger RNA technology in humans. According to the CDC, unlike a flu shot, the mRNA vaccine doesn't carry a live virus, nor does it affect or interact with a person's DNA. The mRNA simply instructs the body's cells to create the same protein that exists on the outside of the virus itself. The body then destroys the protein, and in the process develops immunity. If and when the virus shows up, the body recognizes the protein and neutralizes it.

After the two successful vaccines were approved for use, the administration doubled the number of doses ordered to 200 million from each company, meaning the supply could eventually vaccinate 200 million of the nation's 250 million adults. Federal officials estimated 20 million doses had been made available by the end of December and expected another 30 million in January and 50 million in February. The doses, purchased through "Operation Warp Speed," will be offered at no cost. Initial indications were that a substantial percentage of Americans might opt out, but a recent survey by the Kaiser Foundation indicated more than 70% of Americans would "definitely" or "probably" get the vaccine. This percentage is expected to rise as an increasing number are successfully vaccinated. Administration officials believe there will be enough doses starting in the second quarter for everyone who wants a vaccine to receive it. If this proves true, it's reasonable to expect a return to normality sometime this summer.

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However, as the new year begins, it's unlikely we've experienced the worst of the virus. TSA data indicated nearly 1.3 million travelers passed through airport screening the Sunday after Christmas, the highest number since March 15, while over 10 million boarded planes during the week before Christmas. This was roughly a third higher than the pre-Thanksgiving week and suggests that the surge in January cases could exceed the December spike and potentially force additional business and school closures, which would in turn slow Q1 GDP growth.

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The COVID resurgence in the fourth quarter had already impacted much of the key economic data. Headline retail sales fell by -1.1% in November after a revised -0.1% decline in October. Although still up by +2.5% on a year-over-year basis, consumer spending was clearly moderating as the holiday approached. Personal income dropped by -1.1% in November following a -0.6% decline in the previous month as government benefits gradually evaporated. The decline in income bled into personal spending, which

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fell -0.4% in November.

The rehiring of workers was brisk in the late spring and summer months as 10.8 million of the 22.1 million jobs that had been lost returned to company payrolls. However, recent gains have been much tougher. Nonfarm payrolls grew by just 245k in November and early forecasts suggest the December count could be significantly lower. The weakening labor picture probably contributed to the deterioration in consumer spending.

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The 2020 housing boom finally moderated. Existing home sales slipped by -2.5% in November, breaking a five-month string of advances. However, the 6.69 million annualized rate of sales was still +25.8% *above* the same period a year ago according to data from the National Association of Realtors. Available inventory decreased to 1.28 million in November, indicating a record low 2.3-month supply. The lean inventory combined with strong sales since late spring have boosted the median price for an existing home to $310,800, a +14.6% increase over the same period last year. New home sales dropped -11.0% in November to an annual pace of 841k, registering the fourth straight decline. Despite the late year slowdown, new home sales are still up more than +20% year-over-year and on track for the best showing since 2006. The months' supply rose from 3.6 to 4.1 as fewer sales combined with a rebuilding of inventories. Housing starts are up +27% on an annual basis through November and elevated building permits point to replenished supply in early 2021, and a favorable outlook for the housing sector.

The housing story is one of bifurcation, however while millions of employed Americans seek more spacious homes in more favorable locations, others are praying they won't be evicted for nonpayment. Almost 18 million Americans have fallen behind on their rent or mortgage payments according to a November survey by the U.S. Census Bureau, and nearly a third expect to face eviction or foreclosure in the coming months. An estimated 12.4 million renters (1 in 6) were unable to make payments, and the CDC eviction moratorium was scheduled to terminate at year end.

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U.S. census data also revealed that nearly 83 million adults in the U.S. are finding it "somewhat" or "very difficult" to cover basic monthly expenses such as food, rent or mortgage, car payments, medical expenses, or student loans. This is in sharp contrast to the surge in overall household wealth. The Federal Reserve reported the net worth of households in the United States climbed to new record high of $123.5 trillion in the third quarter, an +8% increase from the same period a year earlier. Real estate appreciation accounted for $400 billion while stock market gains added $2.8 trillion. But *only 55% of Americans own stocks and about 67% own homes*.

The economy may have slowed in the final quarter of the year, but home prices continued to increase while the equity markets continued to reach fresh highs, signaling household wealth will likely end the year higher still. Stocks embraced the Biden victory and shook off Trump's steadfast refusal to concede while posting record gains in November. Leading the charge were small cap stocks with the Russell 2000 index up a stunning +18.3%, the biggest single month advance in its 40-year history. Both the DOW and S&P 500 closed the year at record highs.

Stock market investors had quite a bit to be excited about. In addition to ongoing expectations for a vaccine and the promise of another round of stimulus dollars, corporate profits jumped +27.4% in the third quarter to a new record high and were actually up +3.5% year-over-year.

On the Monday before Christmas, the House finally passed, by an overwhelming majority, a relief package totaling just over $908 billion as part of a $2.3 trillion spending bill. Later that day, the Senate approved the bill by a 92 to 6 margin. What Congress didn't count on was for President Trump to label the long-anticipated deal a disgrace, asking congressional leaders to increase government payments to individuals making up to $75,000 from $600 to $2,000 and remove unnecessary waste from the government funding portion. The President ultimately signed the bill into law three days after Christmas. It may have been

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a relief to pass *something* after six months of failed negotiations, but for many it will be woefully inadequate.

About 30%, or $284 billion of the new package will go to replenishing the Paycheck Protection Program. The two pandemic unemployment programs created under the CARES Act will be extended and supplemented with a weekly unemployment benefit of $300 through March 14. The CDC eviction moratorium was extended by…one month, and $25 billion was set aside for rental assistance, well below the $100 billion required to keep low income renters housed during the pandemic according to the National Low Income Housing Coalition (NLIHC).

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Bond yields were essentially unchanged during the quarter on the short end of the curve, while gradually moving higher at the intermediate and long end. With Fed officials making it clear they don't expect to tighten policy before 2023, short yields are anchored.

Q4 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	9/30/20	0.00%-0.25%	0.09%	0.11%	0.12%	0.26%	0.65%
High			0.10%	0.13%	0.18%	0.45%	0.98%
Low			0.06%	0.08%	0.11%	0.27%	0.68%
End	12/31/20	0.00%-0.25%	0.06%	0.10%	0.12%	0.36%	0.92%

Source: U.S. Department of Treasury.

Economic and Interest Rate Outlook

In 2019, U.S. GDP growth was +2.3%. This year, although there are plenty of numbers yet to be crunched, the economy is expected to contract by -2.7% according to the December Wall Street Journal economist survey and -3.5% according to the December Blomberg survey. However, a little context makes this relatively minor drop look much better. In June, Fed officials were expecting a -6.5% decline for all of 2020. The better-than-expected GDP result owes much to a *persistently hopeful outlook*.

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The major stock indexes are the most obvious reflection of this hope. All three major indexes ended the year at or near all-time highs. On a related note, the Business Roundtable CEO confidence survey indicated business leaders are entering 2021 on an optimistic note. The composite index of six-month sales projections, capital spending and hiring plans jumped 22 points in the fourth quarter to over 86, well above the 81.5 historical average.

However, big company optimism isn't the best indication of the overall outlook. According to the MetLife & U.S. Chamber of Commerce Small Business Index for the fourth quarter, 62% of small business owners believe the worst of the pandemic is still ahead, 74% say they'll need additional government assistance to weather the storm and only 40% are confident they'll be able to continue operating in the current environment.

Yelp reported roughly 100,000 small businesses had permanently closed by the end of the third quarter, and any promise of a holiday boom for the hospitality industry has been dashed. As a result, another wave of closures is likely. Some evidence of this has already shown up in the form of a rise in filings for new unemployment benefits. Initial claims climbed to 892k for the week ending December 11, over four-times the number of filings from nine months ago. And, the November labor market report revealed that almost 4 million people have been jobless for more than six months, more than doubling over the

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last three months. Moody's Analytics doesn't expect employment to return to pre-crisis levels for another three years. Government assistance has soothed the pain for much of the year, but state unemployment benefits end after 26 weeks, and the most recent aid package provides federal benefits for just the first 11 weeks of 2021. Whether another round of support is provided to small businesses and unemployed workers in the spring will probably depend on which party holds a majority in the Senate. With the national debt rising by an estimated $4.5 trillion in 2020 to over $27.5 trillion, Republican leadership is pivoting to a more conservative fiscal approach.

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The wildly uneven K-shaped recovery, whereby many Americans continue to struggle while others have flourished, is particularly evident in the money supply. The M2 measure, which includes currency in circulation, savings and checking accounts and money market funds, has ballooned from $15.6 trillion to a record $19.3 trillion since the pandemic asserted itself in March. *Very simply, this is accumulated cash waiting to be spent*. Many of those expecting the economy to take off in the second half of the year point to this dormant source of economic fuel. Since cash holdings are likely to earn next to nothing for several more years, it isn't a stretch to expect some of those sidelined dollars to eventually find their way into the equity market.

At the same time, many cash-strapped Americans are actually accruing liabilities to be paid. According to Moody's Analytics, an estimated 12 million renters will owe an average of $5,850 in unpaid rent and utilities by January.

Inflation hasn't been on the radar for years, but the overall rise in the money supply hints that price pressure could be a story in 2021. Too much cash chasing anything is likely to inflate prices, whether stock values or the cost of goods and services. Compounding the future inflation discussion is "the base effect," whereby prices in the second quarter of 2021 relative to the same period in 2020 (when the economy was largely shuttered) will appear much higher than they would otherwise. Although Fed officials should see right through this temporary blip, market participants might not. Rising inflation expectations normally push long yields higher.

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So, yet again, the outlook is murky at best. The path of the virus will still determine when we return to "normal." It's been a bifurcated economic recovery that promises more of the same in the first half of the new year. The gamechanger is the vaccines, and more are on the way. *Johnson & Johnson* could have approval as early as February, followed by *Novavax* and *AstraZeneca*. One unanswered question as the shelves fill is exactly how the shots will be administered. There doesn't seem to be a set of instructions given to the states, which are individually responsible for their own rollout. There is no national strategy for an extremely complex logistical operation which includes required storage of Pfizer's drug at 94 degrees below zero. Early recipients have been medical workers, but the issue could grow more obvious when the general public begins lining up. This begs the question of how long it will take to administer the more than 500 million shots estimated to achieve herd immunity when just 3 million had received their first dose in December. It also calls into question Biden's goal of 100 million shots during the first 100 days of his administration. It'll be an early test for the incoming administration, prominently played out in the public space.

As public health officials have repeatedly warned, things could get worse before they get better. Optimism won't beat the virus. We're getting closer to normal…but we're not there yet.

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