



Stonebridge Economic Outlook

Forecast Update

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Summary: U.S. economy most likely is in a recession or will be very soon, resulting in higher unemployment, lower inflation and near zero risk-free interest rates. A recession will also likely cause considerable anxiety about corporate earnings and credit risk. Such an outlook seems at odds with the economic data reported so far this year but that was before the virus scare. Indeed, the steps taken in an attempt to contain the spread of the coronavirus (COVID-19) and the fear of contracting it will have an obvious adverse effect on the economy. Interestingly, when the Federal Reserve cut interest rates earlier this month, Chairman Jerome Powell noted that the “U.S. economic fundamentals are still strong.” According to the Fed’s more recent press release, the “effects of the coronavirus will weigh on economic activity in the near term and pose risks to the economic outlook.” As a result, “the Fed lowered the target range for the federal funds rate to 0 to 1/4 percent” and expects to “maintain this target range until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals.” My contention is that it will take considerably longer for the economy to recover from the virus effect than hinted at by the Fed. In particular, I remain concerned that affordability and fear will restrain consumer spending through much of this year. In large part, I am relying on the very short list of indicators, including the yield spread between long-term and short-term Treasury yields and the LQ Indicator, that had provided a signal that the economic expansion was about to end before the outbreak of COVID-19. Of course, the outlook is complicated somewhat by the quick response of policymakers to be very accommodative, which at this stage of the business cycle could ease the pain of recession for some but will not prevent a recession from occurring.

The “R” Word

Forecasting turning points in the economy is extremely difficult, as demonstrated by the fact that such turning points have always been officially identified by the experts well after they occur. For example, it was December 2008 when the National Bureau of Economic Research (NBER), which is a private group of leading economists charged with timing the start and the end of U.S. economic downturns, determined that the recession began in December 2007. Likewise, it was September 2010 when the NBER determined that the recession ended in June 2009. The interesting thing is that it never feels like a recession until it is well underway, just like it never feels like a recovery until it too is well underway.

Despite the difficulty of forecasting turning points in the business cycle, economists (myself included) still attempt to do so. At the moment, the question is whether the U.S. economy is at such a turning point. To be honest, I was surprised that the recent expansion lasted as long as it did. One likely reason the expansion survived so long was the stimulus from macroeconomic policies, both monetary and fiscal. Unfortunately, such

aggressive macroeconomic policies eventually create excesses that make the economy vulnerable to a shock. At that point in the business cycle, macroeconomic policies lose their ability to prevent a downturn in large part because they reinforce fear. This causes consumers, even those who still have income, to cut back on spending.

The last recession is a good example of unsustainable excesses in demand that drove prices higher. Interestingly, it was not excess consumer demand for goods and services financed with debt per se that was blamed for the contraction but excess consumer demand for housing financed with mortgages. In 2007, I began warning of a possible economic recession that would be far more severe than the 2001 recession, which was the mildest on record, and most likely more severe than average. Needless to say, it was even more severe than I had expected, in large part because consumers cut spending dramatically regardless of their ability to pay. In addition, my timing was off a bit. I thought the recession would begin in the middle of 2008, not the end of 2007. Interestingly, at the time I was warning of an upcoming



recession, there was very little economic evidence other than house prices that I should be worried. Of course, looking back at the revised data now tells a different story. Indeed, a review of the historical data questions what economists were thinking back then to miss such an obvious downturn. Believe me, at the time it was not that obvious.

As shown in Table 1, the forecast for 2020 shows real gross domestic product (GDP) contracting at least two consecutive quarters this year, which I believe the economists at the NBER will eventually determine as a recession. As usual during a recession, consumer price inflation will slow, the unemployment rate will climb, Treasury yields will fall, credit spreads will widen and corporate profits

Table 1
U.S. Economic Forecast

	2019	2020f				2020f	2021f
		Q1	Q2	Q3	Q4f		
Real Gross Domestic Product	2.3	1.5	-1.5	-1.8	2.0	0.3	1.9
Consumer Price Index, All	2.0	1.8	1.0	1.5	1.3	1.4	2.0
Consumer Price Index, Core	2.3	2.3	1.8	3.0	1.1	2.0	2.0
GDP Chain-Type Price Index	1.6	1.7	1.5	2.1	1.5	1.8	1.8
Civilian Unemployment Rate	3.8	3.9	4.0	4.5	5.8	5.8	5.5
Price of WTI crude oil (\$/bbl)	57.0	46.7	29.0	32.0	42.0	42.0	60.0
Trade-Weighted Dollar Index	116.4	116.8	115.8	115.0	115.0	115.0	116.0
S&P 500 Operating Earnings	157.2	34.0	26.2	30.0	35.0	125.2	145.0
Percent vs. Year Ago	3.7	-10.0	-34.7	-24.6	-10.6	-20.4	15.8
91-Day Treasury Bill Rate	1.6	1.2	0.1	0.2	0.3	0.3	0.5
10-Year Treasury Note Yield	1.8	1.3	0.8	0.8	1.0	1.0	2.0
30-Year Mortgage Rate	3.7	3.5	3.5	3.6	3.7	3.7	3.8
Bank Prime Rate	4.8	4.2	3.1	3.2	3.3	3.3	3.5

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Standard and Poor's, Federal Reserve Board, Department of Energy, and Federal Home Loan Mortgage Corporation.

Annual changes in real gross domestic product (GDP) and all measures of inflation are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. The annual estimates of the unemployment rate, the price of crude oil, the trade-weighted dollar and all interest rates are averages for the last quarter of the year indicated. S&P 500 operating earnings per share are for the period indicated.

Quarterly changes in real GDP and all measures of inflation are percent changes from the previous quarter at annual rates. For the unemployment rate, the price of crude oil, the trade-weighted dollar and all interest rates, quarterly estimates are averages for the quarter indicated. S&P earnings are per share for the period indicated.

f-forecast; bold type reflects a major change from the previous forecast



will decline sharply. However, there are a couple of things that will make this recession a bit unusual.

First, interest rates will drop to zero or near zero very quickly, given that Treasury yields are already extremely low in response to the strong demand for the safety of Treasury obligations owing to the economic uncertainty of a potential virus pandemic. Although I doubt that the Federal Reserve will lower the federal funds rate target below zero, short-term Treasury yields could slip below zero from time to time. Extensive use of quantitative easing is more likely in an effort by the Fed to keep longer-term Treasury yields low in the wake of the added supply of Treasury debt needed to offset the loss of tax revenue in the recession, as well as the automatic increases in government spending during an economic downturn.

Second, the federal budget deficit for fiscal year 2020 was already projected to be substantial by the Congressional Budget Office (CBO), despite the optimistic economic assumptions used. Gross federal government debt, which consists of debt held by the public plus debt issued to various federal trust funds, totaled \$22.7 trillion at the end of 2019 and 104.3 percent of GDP. A recession would mean an even larger budget deficit, both in dollar terms and as a percentage of GDP. Such an outcome would affect the economy two ways: (1) growing federal debt likely will suppress economic growth even more over time and (2) higher interest rates that eventually would be associated with high debt levels would increase interest payments, putting even more pressure on federal budgets as well as increasing payments to foreign holders of federal debt. Clearly, these concerns are not currently apparent in financial markets.

Consumers Pivotal to the Outlook

Consumer spending, after a shaky first quarter, was the key factor behind the very solid 2.6 percent increase in real GDP over the four quarters of

2019. Consumer spending likely will be the key to the U.S. economy's performance again in 2020 but this time the outcome may be in reverse. That is, after a solid first quarter, consumer spending is expected to stumble in the second and third quarters, likely to the point that it will detract from real GDP growth.

At the moment, such a prognostication seems totally out of step with the data. After all, consumers still look to be in solid financial shape and thus able to withstand any likely economic headwinds, such as those resulting from COVID-19. The most recent example of that was the better-than-expected February employment report from the Bureau of Labor Statistics. In particular, payroll jobs in February jumped 273 thousand, combined with upward revisions to payroll jobs in each of the prior two months. More importantly, such a surge in jobs favor another solid increase in real disposable income, which jumped 0.5 percent in January according to the latest report from the Bureau of Economic Analysis. With real consumer spending up just 0.2 percent in January, consumers seem to have a cushion of savings to tap if necessary.

Nevertheless, the consensus forecast seems to be in a state of flux due to the uncertainty about a potential COVID-19 virus pandemic and its impact on economic activity. This was evident recently in the sharp daily swings in equity prices. The consensus seems to be drifting toward the view that most of the adverse effect of the virus on consumer spending and in turn the U.S. economy will be temporary, confined primarily to the second quarter. The implication is that consumer spending will recover in the third quarter and remain solid through the end of the year. This begs the question of whether the "R-word" stands for a recession or a recovery.



I contend that if there is a rebound in consumer spending due to the waning of COVID-19, it may be temporary as well. My major concern is that consumer affordability is being dramatically distorted by the aggregate data. As such, even a minor shock could cause this distortion to manifest into a significant drag on consumer spending. In particular, the bulk of consumers essentially have no cushion to protect against either a drop in income or higher priced expenditures.

To illustrate this concern, I compare the average income, expenditures and savings of the households in the middle 60 percent based on after-tax income, the households in the top 20 percent of after-tax income and all households from the Consumer Expenditure Survey (CE) conducted for the Bureau of Labor Statistics by the Census Bureau for 2007, the year before the previous

recession, and 2018, the latest data available (see Table 2)¹. All of the CE data are reported in current (nominal) dollars rather than constant (real) dollars.

The primary purpose of this exercise was to take a closer look at the incomes and expenditures of the middle class, represented here by the households with incomes in the third to eighth deciles of the distribution of after-tax income (the middle 60 percent). What I found most interesting was that the average expenditures of middle-income households were nearly equal to average after-tax income in 2018 compared to 2007 when expenditures were below income. As a result, the average saving rate for middle-income households in 2018 was near zero, down sharply from the saving rate for this cohort a decade earlier. It is no wonder that the middle class feels somewhat stressed about their financial condition—they essentially live from paycheck to paycheck.

Table 2
Consumer Expenditure Survey Data
Average After-Tax Income and Expenditures

	2007	2018
Households in the Middle 60 Percent of After-Tax Income		
Income (\$)	47,549	54,124
Expenditures (\$)	43,627	53,611
Savings (\$)	3,922	513
Saving Rate (%)	8.2	0.9
Households in the Upper 20 Percent of After-Tax Income		
Income (\$)	150,927	162,023
Expenditures (\$)	96,752	118,805
Savings (\$)	54,175	43,218
Saving Rate (%)	35.9	26.7
All Households		
Income (\$)	60,858	67,241
Expenditures (\$)	49,638	61,224
Savings (\$)	11,220	6,017
Saving Rate (%)	18.4	8.9
BEA Saving Rate (%)	3.7	7.7

Sources: Bureau of Labor Statistics and Bureau of Economic Analysis.



Also shown in Table 2, the bulk of all household savings come from those with the top 20 percent of all income, but even their saving rate according to the CE data was lower in 2018 than a decade earlier—26.7 percent in 2018 versus 35.9 percent in 2007. Interestingly, according to the CE data, the saving rate for this cohort of households slipped to 35.6 percent in 2008 before rebounding to 37.2 percent in 2008. The average income for this cohort trended lower from 2007 to 2009, while expenditures edged higher in 2008 before plunging in 2009. Over the decade from 2008 to 2018, average income for the top cohort increased 8.1 percent, while average expenditures increased 26.1 percent.

Interestingly, there seems to be a huge discrepancy between the saving rate as reported in the CE data and the saving rate reported by the BEA in the Personal Income and Outlays data. That is, the personal saving rate as reported by the BEA was 3.7 percent in 2007 versus a saving rate of 7.9 percent in 2018. As mentioned earlier, it looks as if consumers have a considerable cushion of savings available to use in the event of an economic downturn. Unfortunately, that cushion may not be as readily available to middle-income households as the aggregate saving rate might suggest. The conclusion is that consumer spending, even in current dollar terms, may be more vulnerable to an economic shock than suggested by the comprehensive income and spending data. In prior forecasts, I have suggested that consumer spending may decline in current dollar terms, not just in constant dollars, in the next economic downturn, much as it did in the 2007-2009 recession. I suspect that is still the case.

Recession Indicators

This begs the question of whether we are in a recession or a temporary contraction due to COVID-19? Many forecasters are convinced that it

is the latter, whereas others are convinced it is the former. I lean in favor of the former. I suspect that the COVID-19 crisis pushed the economy into a deeper downturn sooner than might have occurred otherwise but the business cycle was already in position to reset. Recall that the December 1, 2019 forecast, long before we knew of COVID-19, had a recession in the 2020 forecast. This was due to the economic indicators I rely on that were suggesting a turning point was ahead. As usual, the exact timing of such a turn was unclear.

Although there are a host of statistics that economists claim presage recessions, including stock prices, the Index of Leading Indicators, credit market activity, as well as various employment and interest rate measures, only a couple seem to actually work. One such statistic that seems to do a reasonable job as a predictor of future economic activity is the term spread—the difference between long-term and short-term interest rates. This is one of the interest rate measures considered as a possible recession indicator.

Indeed, the term spread (also referred to as the yield curve) is one of the most reliable predictors of future economic activity, especially recessions, among a wide range of economic and financial indicators and, as such, is closely watched by professional forecasters, investment professionals and policymakers. The term spread considered here is the spread between the interest rates on the 10-year Treasury note and the 3-month Treasury bill. A normal yield curve would have the yield on the 10-year note higher than the 3-month bill rate (a positive spread), whereas an inverted yield curve would have the yield on the 10-year note below the 3-month bill rate (a negative spread). Since 1970, an inverted yield curve has presaged every U.S. recession identified as such by the NBER. As shown in Chart 1, the yield curve inverted in May 2019 and remained inverted through mid-October. If the past is any guide, the 2019 yield curve inversion suggests that a recession would follow. Of course, the timing of the recession is unclear because the lead time of an inverted yield curve ranges from 5 months to about 17 months. If the U.S.



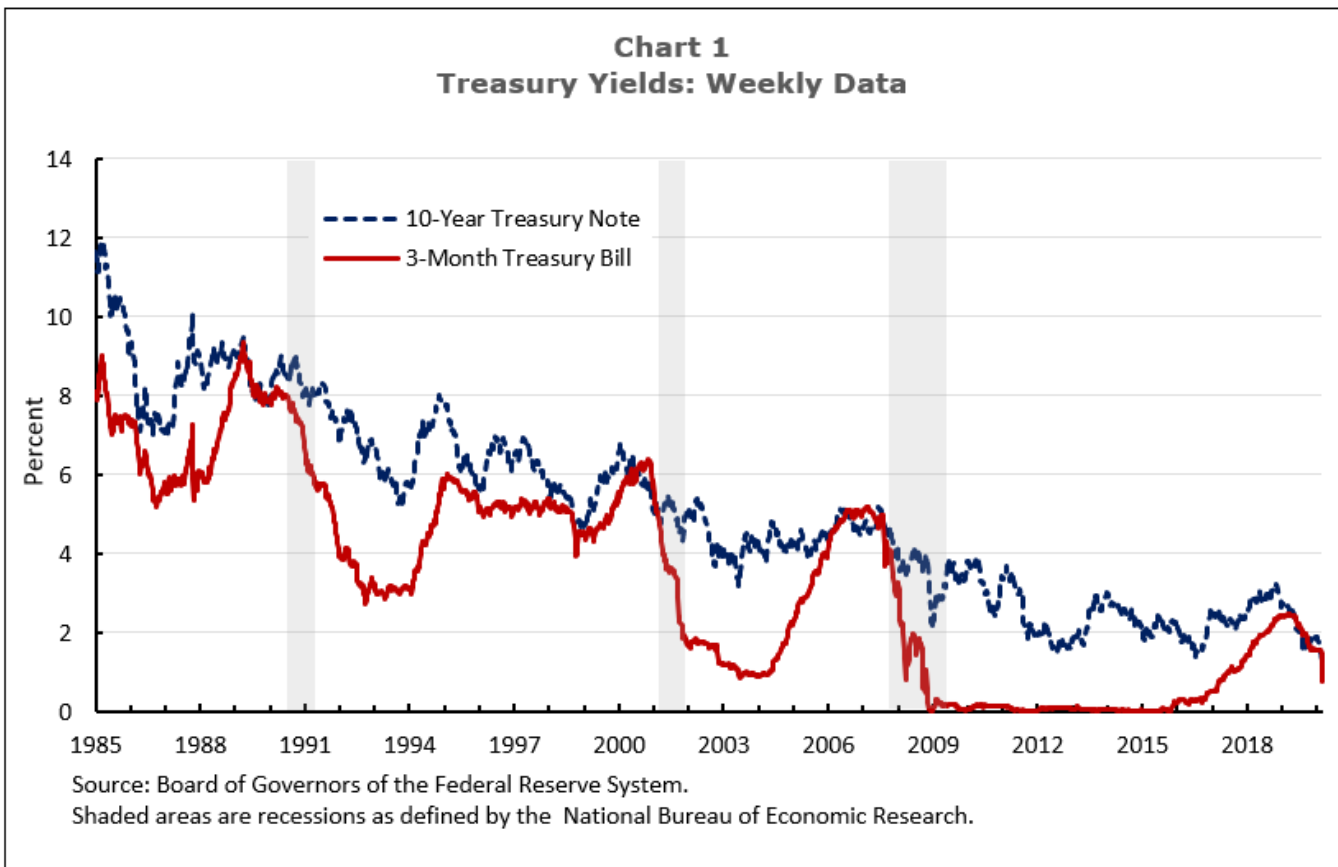
economy slipped into recession this month, as I suggest it has, the lead this time was probably about 10 months.

Another measure that might serve as a precursor to a recession is the trend in job openings—one of the employment measures considered as a possible recession indicator. In each of the last two recessions, when job openings topped out and started to slow, it was followed soon after by a recession. In that regard, job openings in the current business cycle topped out in January 2019, suggesting that a recession may have been underway since late last year. The drawback of this indicator is that the data only goes back to 2000. As a result, there are only two recessions since then, which fails to provide the degrees of freedom needed to claim a statistically significant result.

Finally, the indicator that I rely on most to forecast turning points for the U.S. economy, both up and down, is the LQ Indicator, which is a proprietary indicator of stock price index trends that I stumbled upon over 25 years ago. Recall that bull markets in equities are generally associated with economic expansions and bear markets in equities are associated with recessions. According to the latest reading of the LQ Indicator, the bull market in stocks of the last 11 years is over and a bear market has begun, suggesting that the economic expansion that began in July 2009 is either over or nearly over as well.

A Plunge In Interest Rates to the Rescue—or Not

The Federal Reserve responded to a massive economic slowdown, maybe even a recession, brought on by the efforts of consumers, businesses and





governments to contain the threat of a COVID-19 pandemic, by cutting its federal funds rate target to near zero again. The objective apparently was to allow debt markets to function properly. The problem is that if lenders and borrowers are fearful, lenders will not lend and borrowers will not borrow at any rate. I find it interesting that many market participants wanted the Fed to return to the policy stance used during the last financial crisis immediately. The Fed did what they wanted but it did not provide the immediate elixir for all financial markets that many had hoped. As a result, market participants have discussed and speculated on the possibility of the Fed expanding their purchases in their quantitative easing program beyond long-term Treasury obligations and mortgage-backed securities to include corporates.

Will interest rates go negative? The Fed has argued against a negative federal funds rate but I suspect Treasury bill rates could drift below zero during a rush by investors toward a safe haven. Over the next couple of quarters, there may be times when investors make such a rush.

For the most part, I contend that the Fed is finished for now. The only response available now is more fiscal stimulus. In that regard, the Trump administration is reportedly asking Congress to approve a massive economic stimulus package of around \$850 billion to stanch the economic free fall caused by the coronavirus. This package would be in addition to another roughly \$100 billion package that aims to provide paid sick leave for impacted workers. If both packages are enacted, they would add about another \$1 trillion to the budget deficit for fiscal year 2020, a deficit that was already expected to exceed \$1 trillion. If this stimulus unfolds as expected, a federal budget deficit of over \$2 trillion may be difficult to finance at a near zero rate of interest. The next several months should be very interesting, if not a bit unsettling.

The investment implications are very mixed and will depend on the investment horizon, the objective and individual risk tolerance. As an old guy who is mostly retired, my investment horizon is short, my objective is to preserve capital and my risk tolerance is low. For these reasons, I reduced my equity exposure last December and probably will not buy again until owning risk is back in favor. The LQ Indicator will tell me when. In the meantime, I need to be patient, primarily because despite the likelihood of an economic contraction, we still have not seen an economic report reflecting the virus effect.

¹ The CE is the only national survey by the federal government that provides information on the complete range of consumers' expenditures as well as their incomes and demographic characteristics. The Consumer Expenditure Survey (CE) consists of estimates derived from two separate surveys, the Interview Survey and the Diary Survey. Together, the data from the two surveys cover the complete range of consumers' expenditures. CE data are collected for the BLS by the U.S. Census Bureau. BLS publishes 12-month estimates of consumer expenditures twice a year with the estimates summarized by various income levels and household characteristics. The next CE report covering July 2018–June 2019 will be released in April, 2020.

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