Capital Risk

USA ECONOMIC OUTLOOK

After the Boom, A Bill Awaits

Photo: Andrew S on Unsplash

A reversal of fortune is in the cards. After a year-long hibernation, the world salivates at the arrival of the vaccines. The summer season may be one for the record books as demand overwhelms supply in the leisure industries. These short-term forces shield from thought the prodigious debt expansion and monetary largesse that saved the economy. While the US was not alone with expansive economic policies, it was unique with the poorly targeted policies. Most assuredly, growing debt service will conspire with higher tax rates to crimp future demand. These lurking threats may impede the economy's return to full employment as the polemic on debt washes over Washington.

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A boom year will follow the devastating prior year with the leisure sector the primary driver. The summer travel season may be the best on record and lift the economy.

Everything has a cost. Higher taxes and debt service in the future. suggest targeted fiscal policy. Invest for future consumption with education, infrastructure, and health care leading.

- *Jason Prole*

Highlights

- **Growth** for the year may approach **4.7%** as the leisure sector returns.
- The **summer** will experience peak growth that may set records.
- A rebound in **services** awaits vaccine distribution and herd immunity.
- **Exports** will return near the back half of the year as borders fully open.
- **State & Local government's** deficits require a fiscal policy response.
- **Inflation** will return to the **mid-2s** as housing and a weak dollar lift prices.

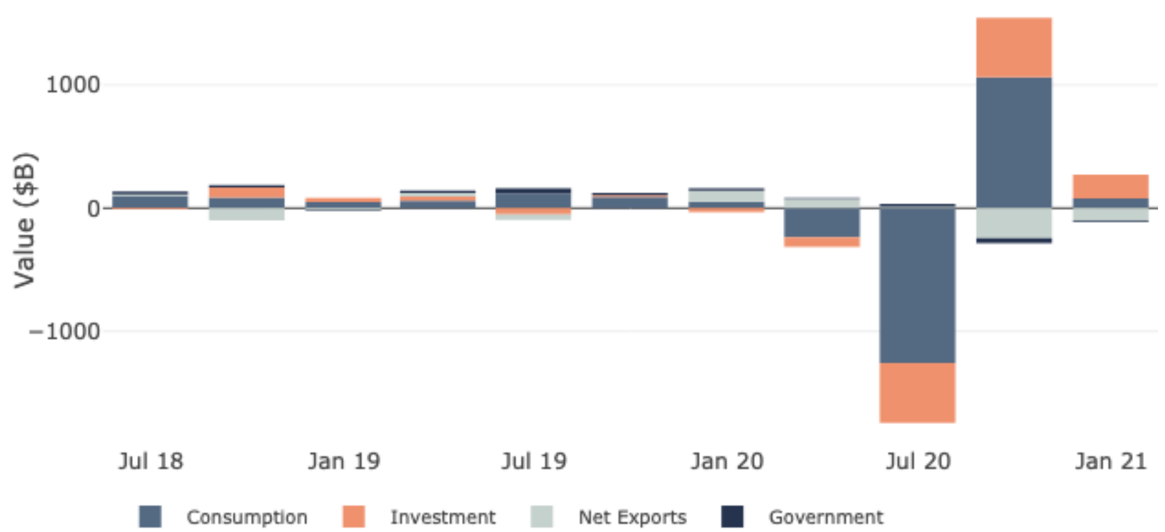
The Outlook

As the year ended, the economy was slowing after its most volatile year on record. While the next year promises less volatility, it also offers continued uncertainty. The fiscal response and, vitally, the vaccine's distribution are essential to a return to normal. The former is necessary (and humane) to help avoid a permanent change in consumer behavior by workers in the leisure sector who are hardest hit by the Pandemic. This policy will create a bridge to herd immunity from the vaccine and the return to some form of *normalcy during the summer season*.

The disguising feature of the forecast is that the growth centers on the second and third quarters. The vaccine program's progression will enable a fuller return of the leisure sector and the workers waylaid by the Pandemic. After a hibernation of more than a year, the summer season may well set records in the leisure sectors as people break free of their internment. The summer pastime may see record crowds as sports return full throttle. All the forces that conspired to doom 2020 should reverse and cause a mini-boom in 2021. Alas, the party will not endure. As fiscal constraint will most certainly take hold and constrain future demand.

Exhibit 1. GDP Contribution by Component

A volatile year will return to normal.



Source: Federal Reserve Economic Database, CRM Calculations.

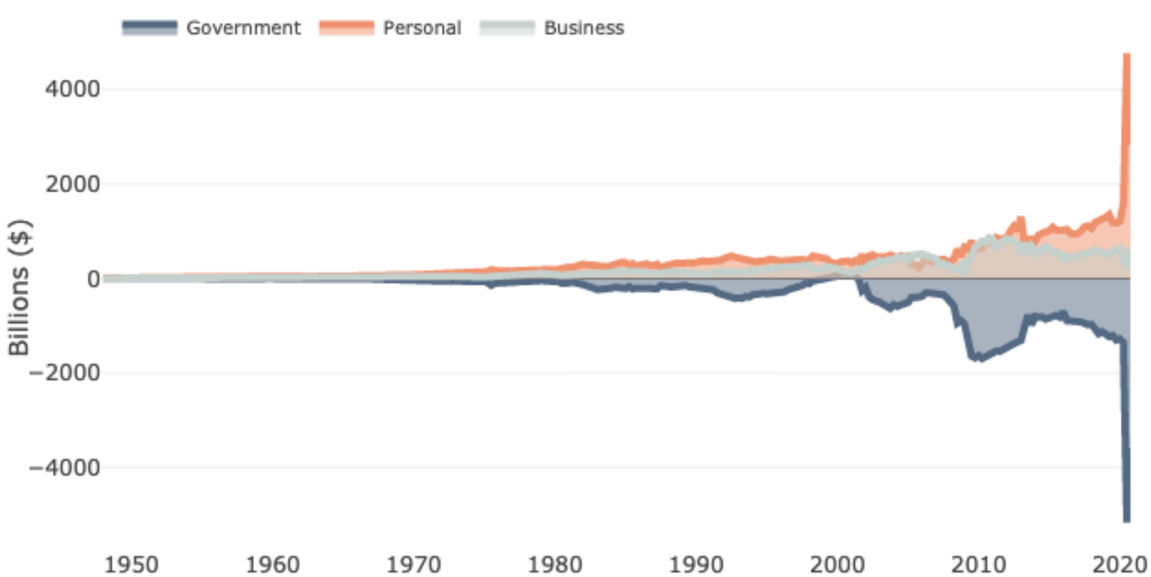
The Outlook

Borrowing from the future. The fiscal policy response to the Pandemic was the most significant US budgetary expansion since the mobilization during World War II. Indeed, the times required the action, despite poor targeting of some of the policy responses. In the presence of a demand collapse, waste is more acceptable than an insufficient policy response. The size of the program in absolute and relative terms was unmatched. While all Keynesian economists will regale in the response, trouble lies in the details.

The fiscal policy response is evident in the savings rates for the US. The government sector, principally the Federal level, ran a deficit exceeding four trillion dollars on an annualized rate, which the household sector's saving rate mirrored (exhibit 2). In the national accounts, money merely moved from one hand to another. The intent, of course, is to spur spending during a period of deficient demand. Unfortunately, good intentions do not necessarily lead to the desired outcome, as the policy design matters. In effect, it was borrowing consumption from the future. The debt will require higher future taxes, which will impair future consumption. Thus, the necessity for precision in the programs.

Exhibit 2. US Savings by Sector

Personal savings mirrors Federal borrowing.



Source: Federal Reserve Economic Database. CRM calculations.

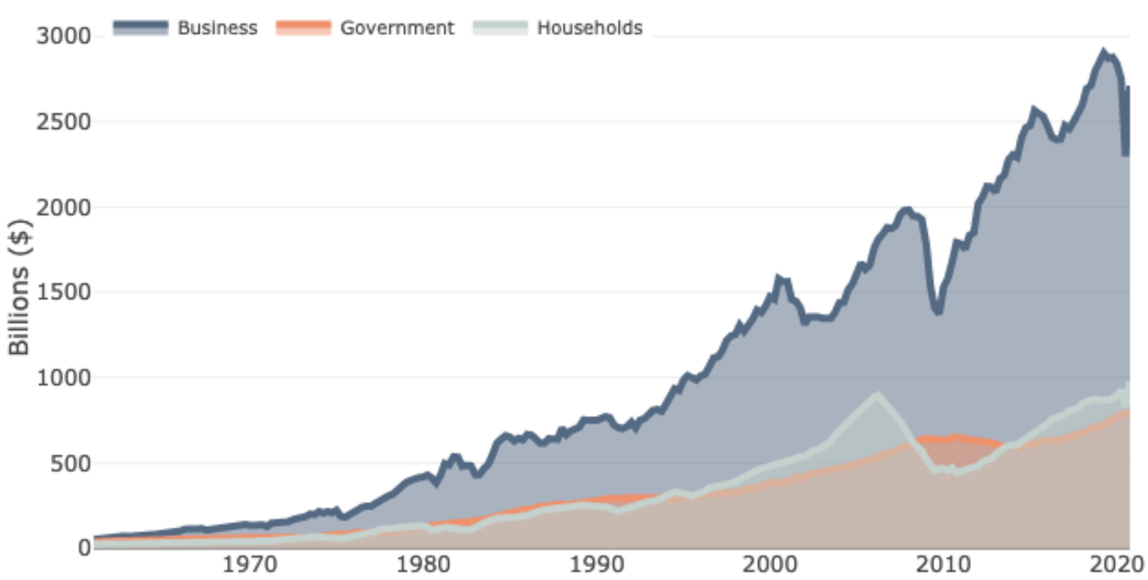
The Outlook

The savings rate was the result of two parallel forces. First, consumer behavior changed in response to a likely recession, if not depression. Conspicuous consumption turned into frugality. This reaction came as no surprise. The second reaction did come as a surprise to the cognoscenti of the ivory tower and designers of the policy response, who argued that rebate checks to the masses would spur consumption during a time of depressed demand. They overlooked the obvious: consumer behavior had changed in response to the pending recession, and lockdowns impaired the ability to consume. While the policy response lacked coherence, it made up for it in size.

With rebate checks hitting the pockets of four out of five people who were still employed, it is not a surprise that the excess capital needed a home. The trouble was that business investment plummeted during the first half of the year. At the same time, government and households made little investment (exhibit 3). The dearth of demand for capital for investment led to excess money entering the stock market. On its face, this is a fair trade, as low-cost capital (e.g., Treasury bonds) finances the acquisition of the higher expected return on equities. The challenge is business does not need capital.

Business drives investment.

Exhibit 3. US Investment by Sector



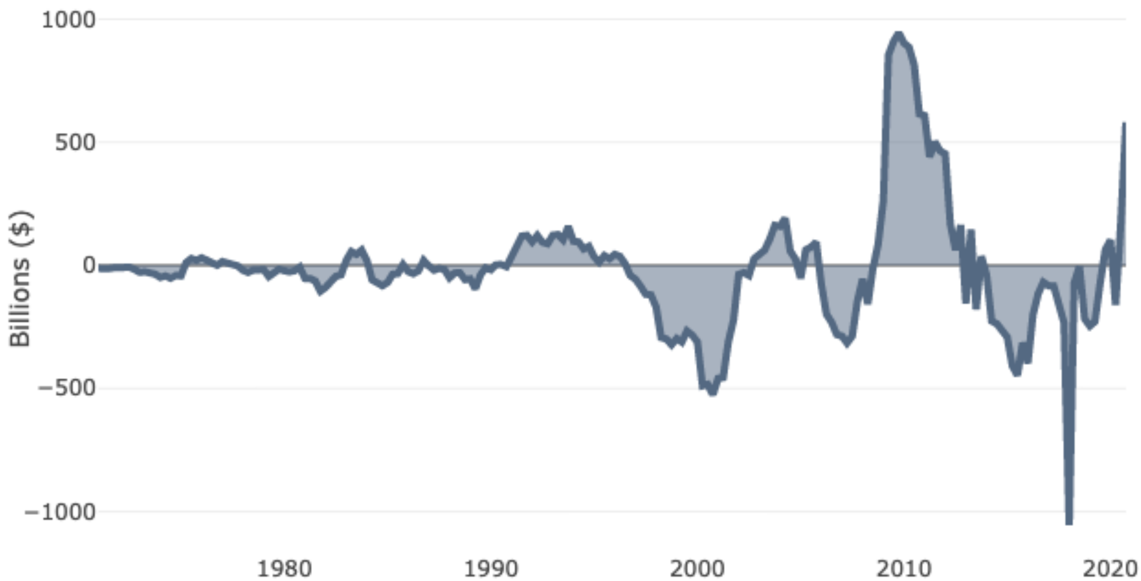
Source: Federal Reserve Economic Database. CRM calculations.

The Outlook

During periods of slowing or declining demand, business pares back investing. This action is readily apparent when viewing net capital investment for the business sector (exhibit 4). During expansions, companies seek capital to finance their investments. In contrast, during retractions, they slow investment and hoard their cash lows as a defensive maneuver. These actions are coherent for a business when faced with uncertain demand in the future, even when the cost of capital is low. Thus, in the absence of new equity issuance, the money must find a home. Enter the equity market.

Business is *lending* money.

Exhibit 4. US Business Net Capital Investment



Source: Federal Reserve Economic Database. Positive values are lending; negative values are borrowing.

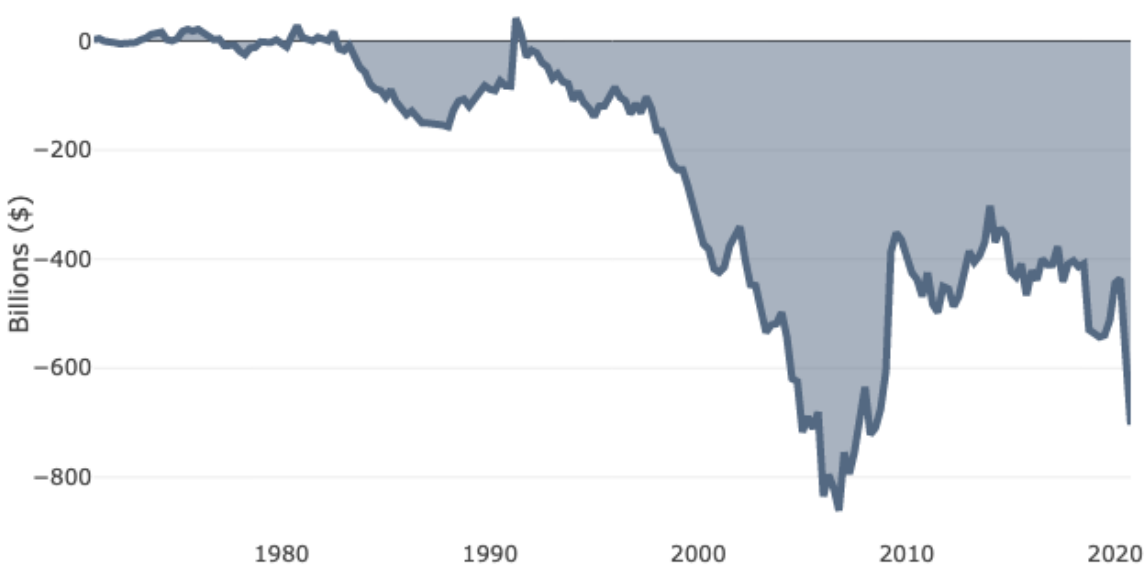
While not all rebate checks entered the equity markets, some amount did speculate on their free money. Hence, the equity market rises. Risk-averse investors with excess capital may have found solace in the Treasury markets' trivial returns, which by all measures needed capital (exhibit 2). This situation is where the trouble arises. Despite the unprecedented accumulation of household and business savings, it was not sufficient to cover the US's aggregate capital needs.

The Outlook

The US is running a net capital investment deficit of over $700 billion (exhibit 5). In more explicit terms, it requires roughly two billion of external capital to balance its *daily needs*. The durability of these inflows into US capital markets requires compelling investment opportunities versus the rest of the world. In the current environment, this requirement seems logical. While US Treasury bonds yields are low, they are positive while offering a premium to most developed-world counterparts. Thus, the fixed income markets argument is that they are the best of a bad bunch.

The US requires massive capital inflows.

Exhibit 5. US Aggregate Net Capital Investment



Source: Federal Reserve Economic Database. Positive values are lending; negative values are borrowing.

The US equity markets also offer compelling relative prospects versus their developed market peers. The technology behemoths dominate global markets in their respective fields and few rivals to erode their monopolies. Thus, it appears that there are few immediate threats to the durability of the capital inflows to finance the US capital needs. Alas, this simple framing excludes one mechanism that can adjust: the exchange rate. This measure is where the trouble may arise for both growth and inflation.

The Outlook

The US's exorbitant privilege as the world's reserve currency has endured since the Bretton Woods accord in the 1940s. The demise of this benefit has been called many times by the cognoscenti with an imminent devaluation of the Dollar the outcome. While the rise of Japan, the Euro, and China, contested the Dollar's reign, it has endured as the preeminent means of exchange.

The Dollar's recent pull-back from its Pandemic peak in March brings new claims of its pending downfall (exhibit 6). Indeed, the US's impact would be material as a lower dollar increases the cost of exports and imports goods inflation into the US. The increasingly smaller composition of goods in the consumer basket suggests the inflationary impact is most likely modest. The uncertainty is the extent of the effect on growth.

Growth is tied to the Dollar.

Exhibit 6. US Trade Weighted Dollar, Broad Goods & Services

Source: Federal Reserve Economic Database.

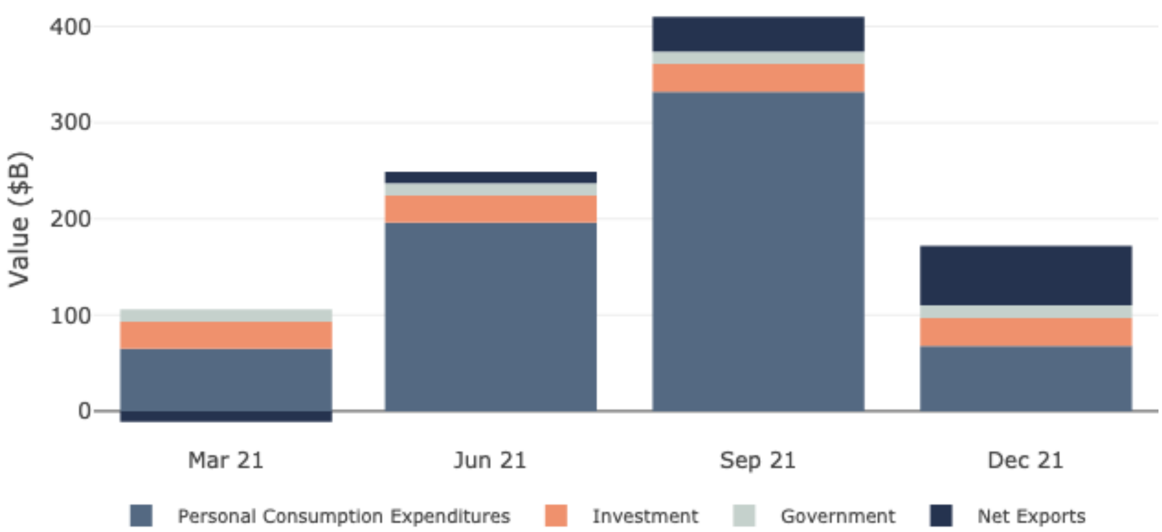
The higher debt service will most certainly reduce future consumption at the Federal level. Higher taxes will eventually lower consumption. In contrast, higher import prices would suggest less demand for imports and improve the trade balance that is accretive to growth. This outcome may stoke further expansion of the domestic industry as companies bring back foreign production. The conclusion is that the net impact on growth is not certain.

The Outlook

The challenge is that no company or country acts in a vacuum. There are competitors. For example, decreased demand for imports may compel the Chinese to weaken their currency to make their products more favorable. Even the Euro region's recent fiscal compact on the currency may not be sufficient to attract capital, given the negative yields on their bonds. These observations suggest that while a further decline of the US dollar probable, it is not foreordained.

A 4.7% rise is forecast for 2020.

Exhibit 7. Forecast for US GDP Growth



Source: CRM estimates. Amounts are annualized rates.

The US economy's outcome is gradually accelerating growth that peaks in the third quarter as the leisure sector returns. For the full year, growth may approach 4.7% and achieve a rate not seen in twenty years (exhibit 7). Exports should begin to climb from the currency's decline and the return of international travel. This action should marginally offset the pullback from the boom in the second and third quarters. As is always the case for the US, consumption will lead the way out of the abyss. The lingering threat for the US is the impact on the currency and the higher debt burdens. Borrowing during times of need is a necessity. Unfortunately, it always has a price, which future consumption will bear.

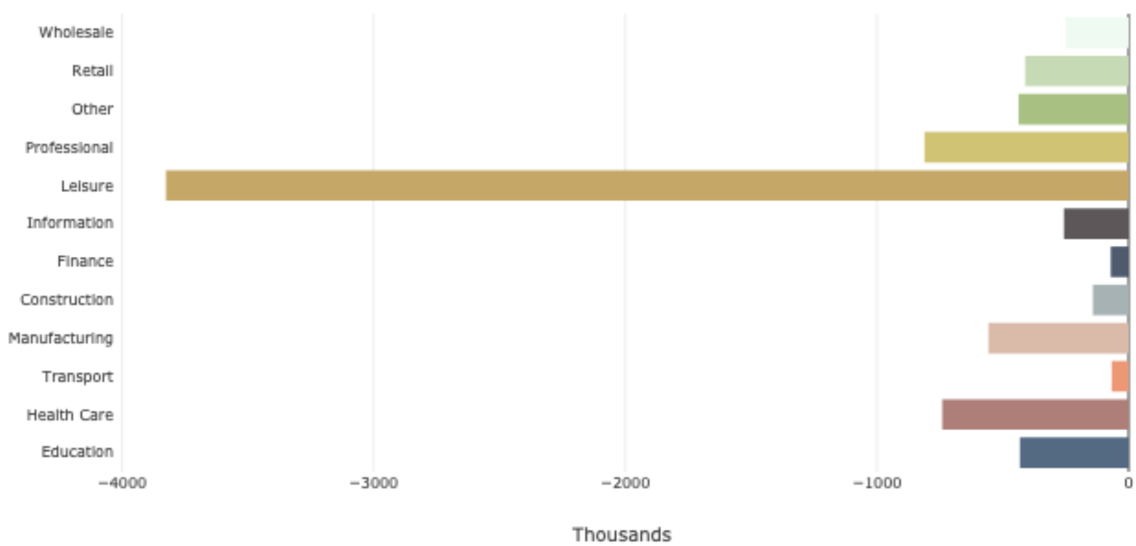
Consumption

It is no surprise that this year exhibited the most volatile consumption on record. A surge to normalcy occurred after the Pandemic-induced contraction passed. The speed of the fall and rebound is unparalleled. The challenge is two-fold. First, the economy was weakening before the Pandemic. Second, sustaining the unprecedented fiscal and monetary stimulus domestically and globally that revived the economy is not possible long-term. The path for consumption is unclear as there is no parallel in the past. While not definitive, deductions are possible about future consumer behavior, particularly this year.

The Pandemic decimated the retail, hospitality, and travel sectors (exhibit 8). This carnage will change when the vaccine reaches a threshold level for a safe return. Current progress on the vaccine distribution is setting up the third quarter as the likely pivot point. This timing is also the summertime. It is conceivable that beginning in June, some of the nearly 10 million unemployed people will return to employment as these business sectors gear up for the consumer's return. It might result in their busiest quarter ever, given latent demand and the pricing power they will possess.

Employment losses are sector specific.

Exhibit 8. US Employment Change by Sector (Thousands)



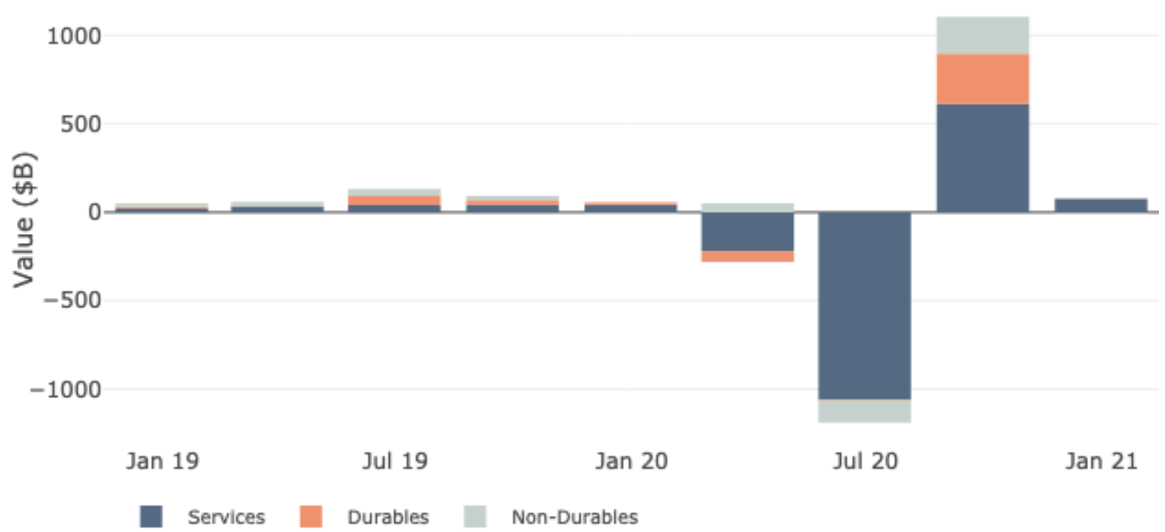
Source: Federal Reserve Economic Database. Change from December 2019 to December 2020.

Consumption

While service consumption (e.g., leisure activities) will see the largest gains, some consumption will revert to an average level. Certainly, durable goods will face a headwind from this return to normalcy (exhibit 9). The boom in exercise equipment may abate as people watch sports rather than dream of their new beach body. In aggregate, gains will occur with the allocation changed from pre-pandemic levels.

Service consumption is not yet back.

Exhibit 9. Consumption Contribution by Component



Source: Federal Reserve Economic Database. Values are an annualized rate.

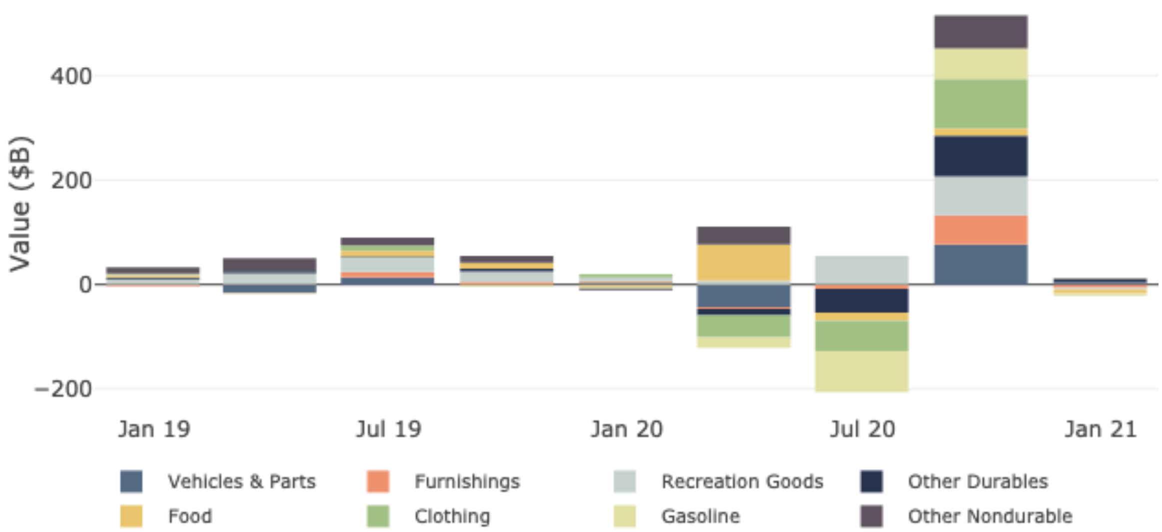
The larger issue will be the diminished desire for conspicuous consumption as a new frugality permeates the population's ethos. The return to full employment will not occur immediately. The employed will fortify their nest egg in case future misfortune finds them. Combining both a lower aggregate number of consumers and a slightly higher savings rate will deliver consumption that does not achieve its usual per capita rate. The impact will vary by sector, with the discretionary sectors facing the greatest short-term tailwinds and long-term headwinds. These forces are the necessary focus for fiscal policy. Otherwise, a generation may bear the cost.

Consumption

The aggregate consumption goods data was mostly unchanged for the quarter (exhibit 10). Yet, there was a clear bifurcation in the underlying components. Both demand and technical features of the calculation methodology drove this result. Seasonal adjustments make the second and third quarters higher during regular times. The large deviations in the first and second quarter altered these calculations for the subsequent quarters. Regardless, there was a modest drop in demand for goods across all the measures, suggesting continued weakness in the economy.

No growth in goods consumption.

Exhibit 10. Goods Consumption Contribution by Component



Source: Federal Reserve Economic Database. Values expressed as an annualized rate.

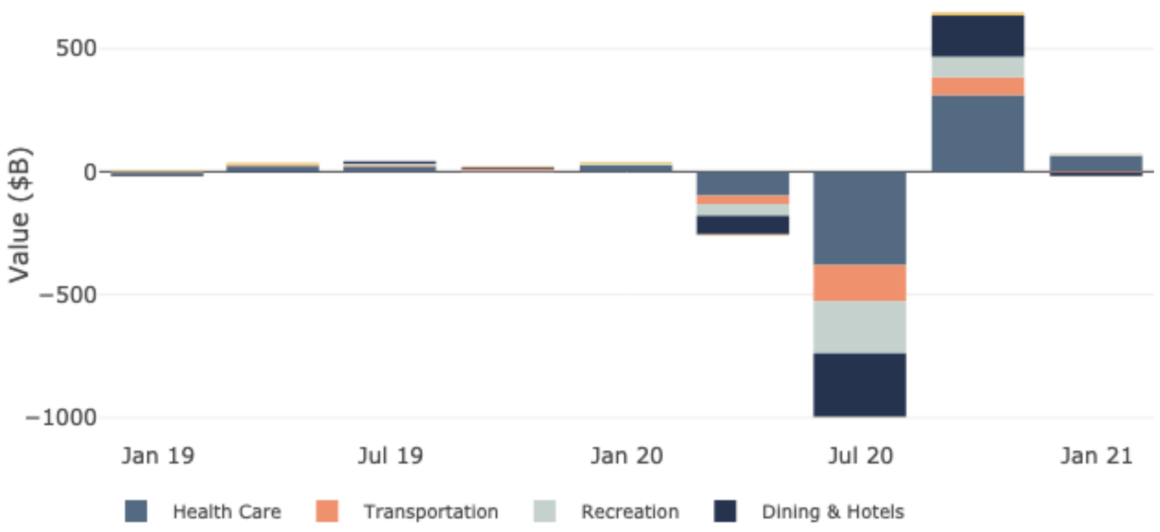
This weakness is not a surprise, with employment still down over ten million people and no further declines of interest rates that enabled consumption from refinancing. As we advance, durable goods face a material headwind as consumers brought future purchases forward during the Pandemic. The question for non-durable goods is the pace of employment growth and the pricing power of retailers. A rapid rebound could see goods consumption accelerate along a parallel path and pricing power driving demand-pull inflation. The vaccine distribution is critical to these outcomes.

Consumption

The broader service sector modestly expanded, yet it remains four percent below its prior peak. Critically health care expenditures, the largest single consumption sector outside of housing, are returning (exhibit 11). The rebound is promising despite transportation, retail, and recreation services all remaining well short of their prior peaks. Their return to peak would add 2.5 percent ($500 billion) to GDP. This potential is the primary reason that some combination of the second and third quarter will show strong growth with their return.

The leisure sectors will bounce soon.

Exhibit 11. Service Consumption Contribution by Component



Source: Federal Reserve Economic Database. Values are an annualized rate.

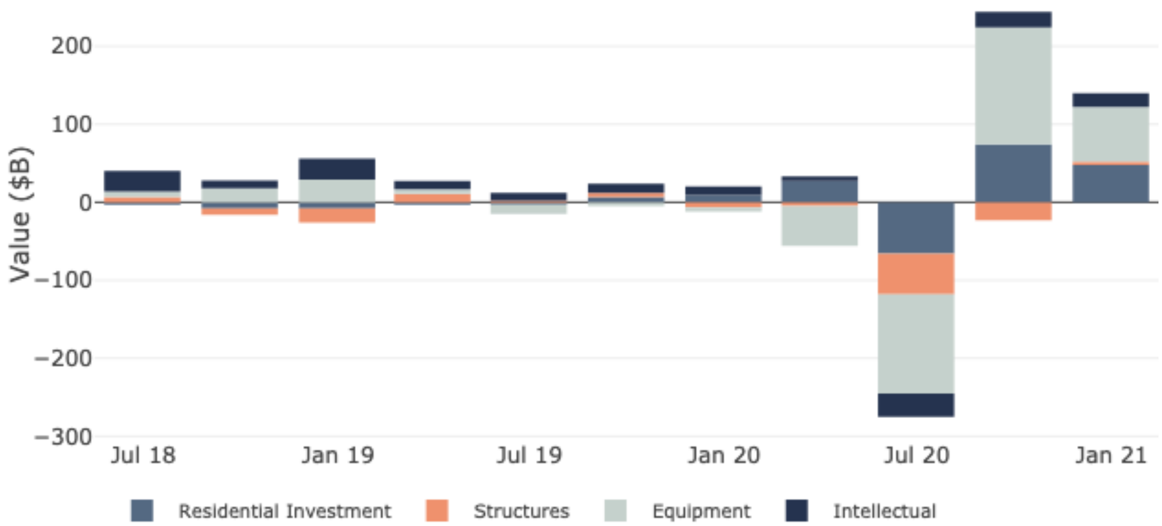
The policy programs envisioned by the new administration should further support their return. Admirably, delivering over 100 million vaccines in 100 days will place the economy on the right footing for its return in the third quarter, if not sooner. Adding three million people back to the leisure sector would boost GDP by 0.2 percent ($31 billion). While the direct economic impact is small, the multipliers are greater than average because of the inclination to spend all their wages. More importantly, getting people back to work is a humane action, and its benefit is immeasurable.

Investment

The investment bust is now a boom, with only commercial structures lagging. After a yearlong decline before the Pandemic, investment outside of commercial structures is exceeding past highs. Residential real estate is the leader with an expansion of *19 percent* ($150 billion) since last year. Certainly, generationally low interest rates and the benefit of employment for most of the workforce enabled them to upgrade their housing. The unfortunate reality is that renters (who are younger) will bear the cost for a generation as the price appreciation of housing places it out of reach for them.

Exhibit 12. Investment Contribution by Component

Commercial structures are the laggard.



Source: Federal Reserve Economic Database. Values are an annualized rate.

The election resolution brought clarity to the business sector. While the sector will face a higher tax burden, it will also benefit from a more stable and less volatile policy environment. As in sports, it's not the rules that matter, only that they are consistently applied so that people can develop their game plan. Business is signaling readiness for the rebound. Notwithstanding the commercial sector, which may undergo a secular change as office and retail demand shifts, investment bodes well for future growth and employment.

Exports & Imports

The deterioration of the trade balance continues (exhibit 13). Whether driven by poor international trade policy or a dearth of demand, it is troublesome for growth. The export drag is about 1.5 percent of GDP ($300 billion), while imports are nearly back to their prior peak. The largest portion of the drag is from export services with a similar deficit on the import side. These should return as borders open to travel again. Nonetheless, it remains worrisome that the trade deficit is at its lowest level in history. It suggests that US demand has run ahead of the rest of the world. The good news is that the deficit should reduce as external demand revives.

Exhibit 13. Net Exports

Exports are *not rebounding.*

Source: Federal Reserve Economic Database. Values are an annualized rate.

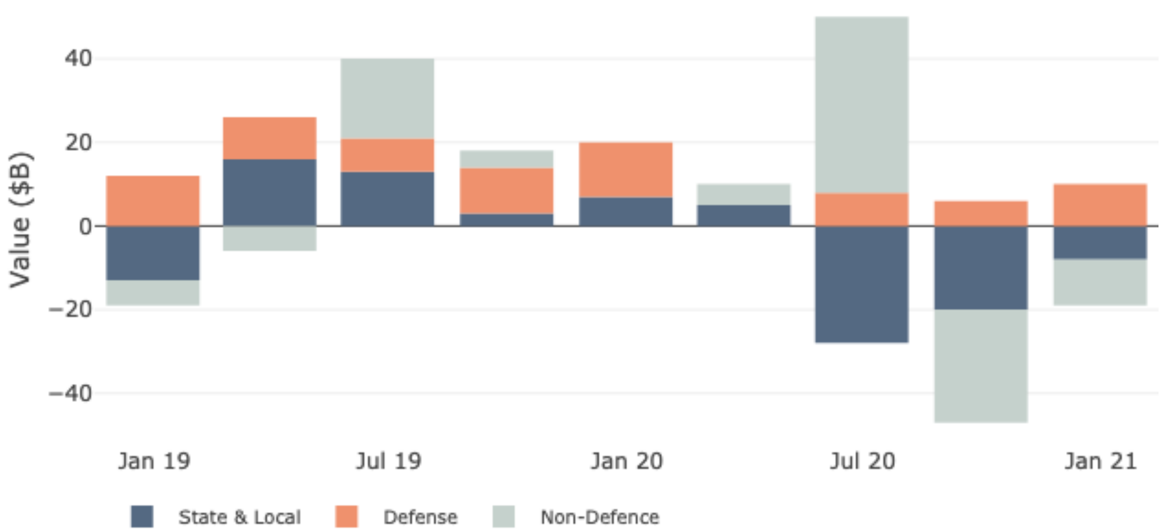
The lower Dollar is helping to buoy exports as the terms of trade become more favorable for exports. Conversely, the lower Dollar should reduce demand for imports and their marginally higher prices. The challenge is not the terms of trade; instead, it is external demand. The US cannot continue its rebound without support from exports. A declining dollar should enable more competitive US exports. After the last four years of xenophobia and chaotic trade policy, the future will show whether foreign demand for US goods and services or international consumer behavior changed.

Government

Fiscal support in the US is desperately trying to rescue an economy and leisure sector workers from their most significant economic challenge in generations. Enactment of new fiscal policy will occur. Its precise composition is yet determined. Critically, addressing the linger leisure sector unemployment and declining State & Local government must take precedence in the hierarchy (exhibit 14). The latter is vital, as the large size of this government sector and its above market wages imply a material impact on the economy. Balanced- budget mandates resulted in furloughs and cuts to staffing at the State & Local levels. Forbearance is required.

Exhibit 14. Federal and State Government

The worry is contracting State & Local government.



Source: Federal Reserve Economic Database.

In the face of demand destruction not seen in a century, the Federal fiscal response should focus on those most in need. While economists argue that this increased spending is helpful during a recession, more important is *who* spends. Support for the middle and lower classes should be the primary focus, which obviates tax cuts and rebate checks for the masses. Any program should target those most impacted by the Pandemic so that consumer behavior is unchanged and conspire with other secular trends to dampen demand further.

Government

As before, addressing the people and sectors in need. First, remove all current programs, then:

Focus the fiscal response on those in need.

- **Health Care:** mandate a temporary national health care program for all the unemployed and those that don't have coverage.
- **Retail Sector:** expand unemployment with full compensation of prior wages until the US reaches herd immunity.
- **Leisure Sector:** mandate a national job retraining program for the hotels, bars, and restaurants to ensure future readiness.
- **Mobility**: ensure the full tax deductibility of moving expenses for relocation to new jobs and a further tax deduction as an incentive.
- **Housing**: provide government-subsidized interest-free loans for housing to those who enter job retraining programs or move for employment.
- **State & Local Government**: remove the balanced budget constraints or provide federal government-backed bonds to prevent further cuts.

The balance between these programs will depend upon the local situation. Some may require a greater focus on retail rather than leisure. The critical objective is to *diagnose and remediate the local challenge* to avoid magnifying the global issues. *E Pluribus Unum.*

Forecast Review

The forecast was a -3.5% real GDP decline for 2020 versus an actual of -3.5% and a consensus estimate of 5.4%.[1] This accurate headline number was also consistent with the underlying components. However, the composition poses a threat in the future as the decline of imports and exports suggest waning demand. At the same time, lower investment indicates a supply slump.

The expected headline CPI Inflation for 2020 was 1.2%, with a realized rate of 1.3% and the consensus rate of 1.9%. The expectation for core CPI was 1.8% versus an actual rate of 1.5% and a consensus rate of 1.6%. While our headline rate aligned with the realized rate, the core rate missed as housing (e.g., rentals) held firmer than expected, most likely because of the national eviction moratorium. The takeaway is that core inflation remains stable as core PCE remains well below the Fed's target of 2%.

A spot-on forecast of GDP.

Exhibit 15. Annual Forecast Versus Actual (%, y/y)

	2021	2020	2019	2018
Real GDP				
Forecast	**4.7**	-3.5	2.5	2.5
Actual		-3.5	2.8	2.3
Consensus	**4.0**	-5.6	2.7	2.9
CPI				
Forecast	**2.8**	1.2	1.0	2.2
Actual		1.3	2.3	1.9
Consensus	**2.0**	0.5	2.3	2.4
Core CPI				
Forecast	**2.5**	1.8	2.3	2.1
Actual		1.6	2.2	2.2
Consensus	**1.9**	1.5	2.4	2.2

Note: all rates are percent change year/year. Consensus is the Survey of Professional Forecaster's.

[1] Survey of Professional Forecasters, *Second Quarter 2020*. https://www.philadelphiafed.org/research-and-data/real-time-center/survey-of-professional-forecasters/ *2020 annual forecast is from the second quarter to reflect the revised forecast from the onset of the Pandemic.*

Data Table

Exhibit 16. GDP Component Data

Component	Value ($B)	Q/Q (%)	Y/Y (%)
Gross Domestic Product	18,780	1.0	-2.5
Personal Consumption Expenditures	13,005	0.6	-2.6
Services	7,998	1.0	-6.8
Goods	5,147	-0.1	7.0
Durable Goods	2,028	0.0	11.9
Non-Durable Goods	3,149	-0.2	4.3
Investment	3,523	5.8	3.2
Fixed Investment	3,458	4.3	2.1
Non-Residential Fixed Investment	2,746	3.3	-1.3
Residential Investment	694	7.5	13.7
Exports	2,277	5.1	-11.0
Imports	3,398	6.7	-0.6
Government	3,317	-0.3	-0.6
Federal	1,333	-0.1	2.5
State & Local	1,985	-0.4	-2.5
Defense	820	1.2	2.9
Non-Defence	513	-2.2	1.8

Capital Risk

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For more insight, please contact:

Capital Risk Management LLC
415-373-7152
contact@capitalriskmanagement.com

www.capitalriskmanagement.com
Los Angeles | San Francisco | Toronto

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