Capital Risk

USA ECONOMIC OUTLOOK

Demographics, Deficits & Deflation

Photo: Ehud Neuhaus on Unsplash

Secular trends are conspiring with the Pandemic to reduce demand in the US. Favorable demographics should enable higher productivity and constrain inflation. In contrast, expanding debt service and higher tax rates will crimp future growth while declining household formation further slows demand. Future policy choices' precision is irrelevant to the greater need to avoid a change of consumer behavior that a continuing Pandemic may bring. A newfound thrift by consumers from the Pandemic would further slow growth and is unnecessary. Policy action is required to avoid a decade's long impairment of consumption. Best pay now, rather than a higher bill later.

"

Favorable trends in US demographics are placed at risk by the Pandemic response. An effective fiscal response would avoid a debt-deflation spiral and a lost generation.

Accumulating debt is unavoidable in the circumstance: best put it to work investing for future consumption, not the present. Education, infrastructure, and health care should reign.

- *Jason Prole*

Highlights

- Pandemic and political **uncertainty** make fourth-quarter estimates hard.
- Until uncertainty recedes, the expectation is a **flat third-quarter.**
- Growth for 2020 is forecast to fall close to **$700 billion or 4%** of GDP.
- The rebound of **Durable Goods** consumption may be illusory.
- **Weak Exports** suggests a prolonged rebound.
- A fiscal policy response is required for **State & Local government** declines.

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As expected, the third quarter was the most significant increase in growth on record. A low bar augmented this outcome. Yet, this current contraction remains deeper than the Great Recession in 2009. The next few months are pivotal as winter is coming with material implications for the Pandemic. Needlessly constrained fiscal policy and monetary policy without further ammunition implies that a second wave may have little policy support unless the pending election brings an aligned government to Washington. The forlorn economy awaits the election resolution for any policy responses.

Political uncertainty delivers economic uncertainty.

During the interregnum, the economy may get worse before a fiscal lifeboat can arrive. A change of Washington's administration would leave a lame-duck senate and executive office with little incentive to act. Particularly when they can point to a $1.2 trillion rebound in the third quarter (exhibit 1). As with numbers, they require context. A ten percent decline followed by a seven percent increase still leaves you nearly *four percent* below the output's prior peak. Current growth has slowed in recent months, and a high previous quarter will ensure growth is not as rapid again. The challenge is determining the future growth rate, a devilishly hard task.

Exhibit 1. GDP Contribution by Component

Source: Federal Reserve Economic Database, CRM Calculations.

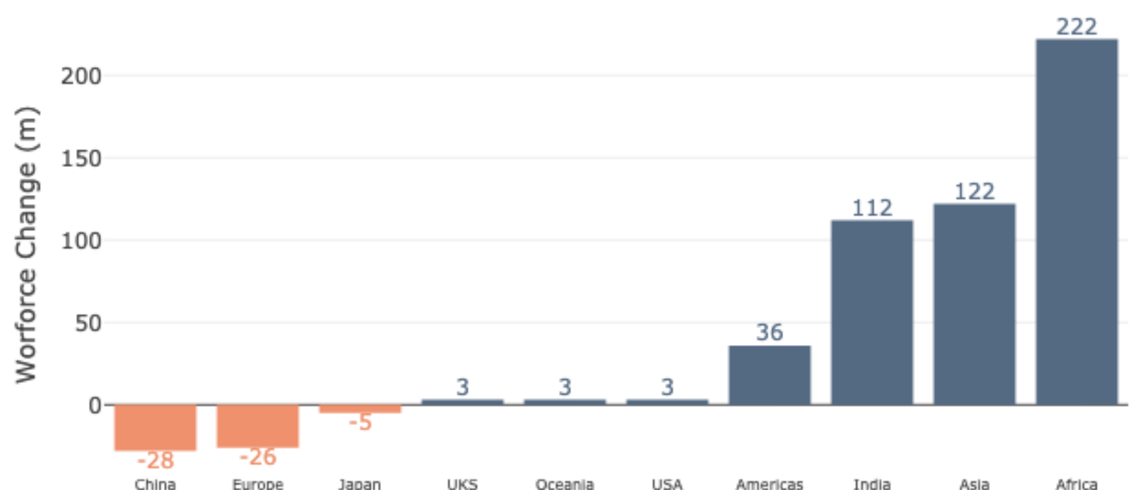
The Outlook

One of the genuinely forecastable figures in economics is demographics. People tend to age simply by continuing to live. While a trite statement, it contains material power for understanding the future economy. For most of the developed world, the malleable ages of 19 to 65 contain their working careers. The implication is that one can understand the economy's productive potential of an economy by measuring the number of people. More people working tends to bring more or faster production. When combined with productivity (e.g., the amount of output for a given effort), they provide a general measure of consumption growth. Peril resides in these measures for most of the developed world.

Japan aged in a slow-moving economic tragedy over the last few decades. Their workforce has declined every year *since 1996*. As technology proliferated, the nexus of increased supply and diminished demand drove price levels lower, and their debt higher as fiscal policy tried unsuccessfully to offset the decline. Continental Europe crossed this Rubicon in 2011 while China broke the threshold in 2016. The US is not far behind.

Exhibit 2. Forecast Workforce Growth (2020-2030)

Falling workforces will lower global growth.



Source: United Nations, Department of Economic and Social Affairs, Population Division (2015). CRM calculations. Asia excludes China & India, Europe excludes UKS (UK & Scandinavia), Americas excludes the US & Canada. The Workforce is prime age between 19-65 years.

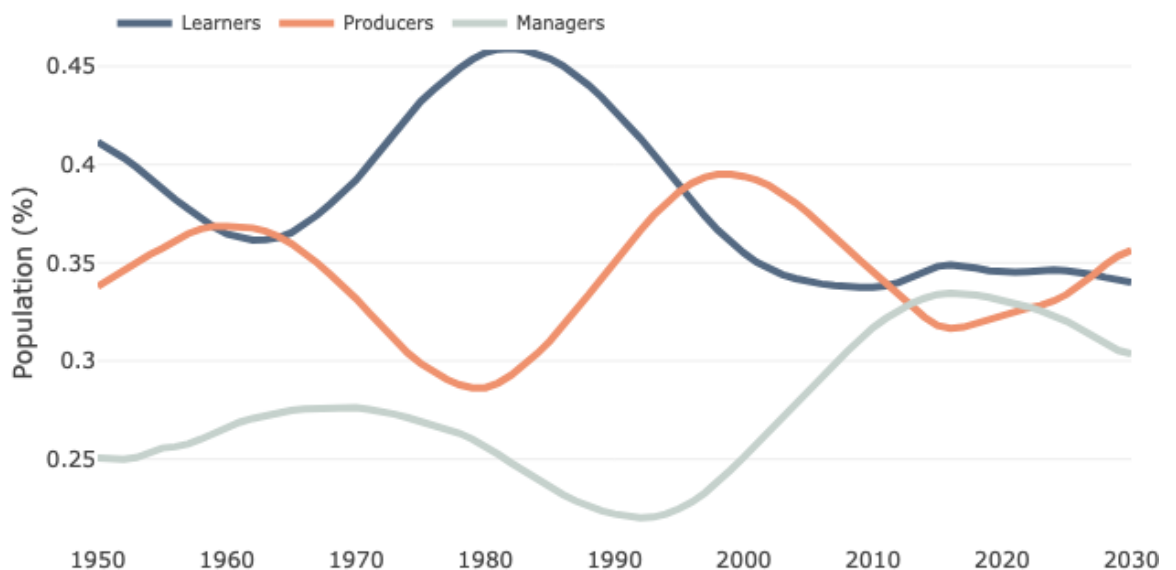
The Outlook

Over the next decade, China, Europe, and Japan will experience declines in their prime-age workforce (exhibit 2). The US and Northern Europe will effectively maintain their current levels. Thus, maintaining the current growth rate requires either higher productivity or fiscal spending to offset the slowing demand growth. This situation is where hope resides for the US.

Understanding human behavior through their life cycle is material to perceiving how the economy will perform. This ability is especially so within a country where behaviors and cultural norms are consistent. The power lies from appreciating how consumer behavior changes during different periods of our working lives. Initially, new entrants to the workforce are full of zest but devoid of experience while learning their craft. As they age, the convergence of knowledge and ability enables higher production. Simultaneously, we spend time transferring knowledge and managing other people and processes as we near the latter parts of our career. This management slows output while making wisdom endure through the organization, a beneficial outcome.

The Millennials may save US growth.

Exhibit 3. United States Workforce Segmented by Age Cohort



Source: United Nations, Department of Economic and Social Affairs, Population Division (2015). CRM calculations. The workforce is prime age between 19-65 years. The Learners are ages 20-34, the Producers are ages 35-49, the Managers are ages 50-64.

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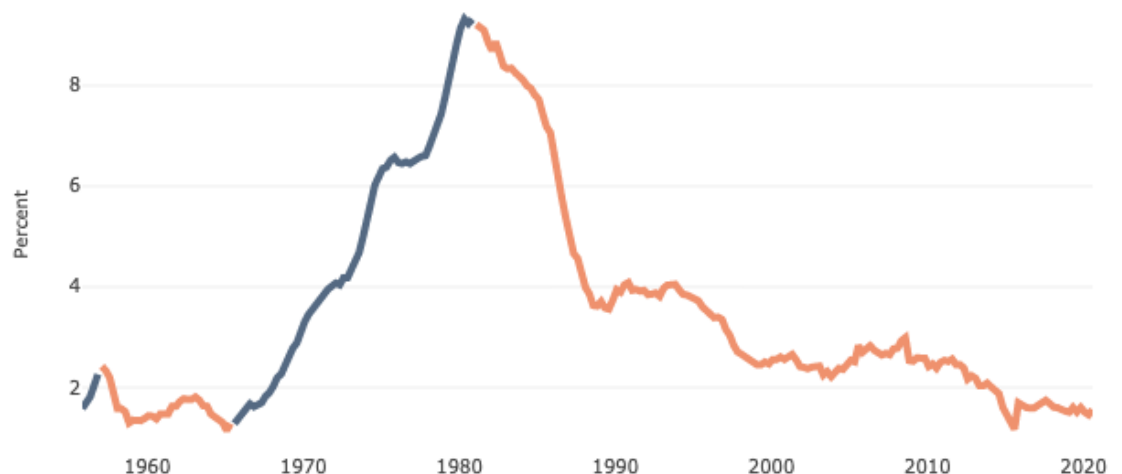
Through this lens of the career cycle, we can infer how the workforce changes, not only its size. When segmenting workers into three equal cohorts between the ages of 19to 64, definitive waves emerge for the US since the 1940s (exhibit 3). The high proportion of Learners through the 1970s focused on household formation and increasing their productivity. Later, the growing size of the Producers enabled higher productivity through the 1980s and 1990s. The challenge is when these cohorts become unbalanced.

Price pressures arise when the key Producers cohort is low in proportion to the Leaners cohort. This outcome results from the convergence of the Learner's higher demand through their household formation with the relatively smaller Producers cohort inability to increase capacity at a rate consistent with the Leaner's needs. This result is particularly relevant in a service-based economy. The coupling of these two forces resulted in the inflationary period during the 1970s (exhibit 4). If this linkage endures in the US (exhibit 3), then the prospect of declining Learners and growing Producers is *disinflationary*.

Exhibit 4. US Consumer Inflation (annualized rate, 7-years)

Lower demand will moderate inflation.



Source: Federal Reserve Economic Database, CRM Calculations. Blue highlights period of growing proportion of Learners (exhibit 3) in the workforce and thus higher inflation from household formation.

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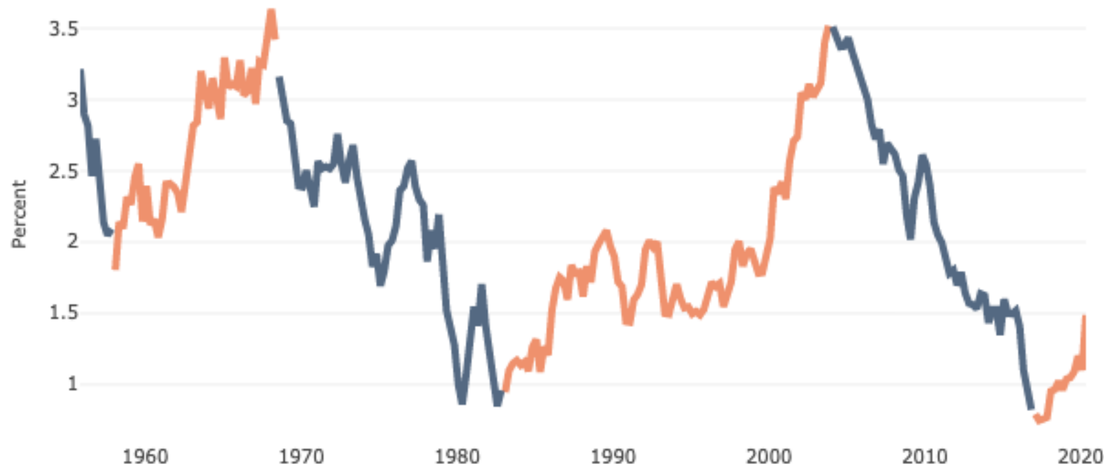
Productivity is another progeny of demographics. As the proportion of Producers grows relative to the Learners, productivity increases. The confluence of experience and capability conspire to increase production. While technology is undoubtedly a contributing factor, the most productive people dominate a service-based economy like the US from their ability to get the most out of *others*. Paraphrasing an adage, it's not what you know but *how you enable people to perform*.

This outcome is evident in the productivity numbers. Periods of expanding productivity coincided with periods of an expanding proportion of Producers, highlighted in orange in exhibit 5. The Boomers in the 1970s and the Millennial children of the 2000s share a similar trait. Irrespective of their capabilities upon entering the workforce, they both had to learn how to contribute *productively*. Herein lies hope for US *growth* and for further *disinflationary* pressure.

Exhibit 5. US Output per Hour (annualized rate, 7-years)

A larger proportion of prime-age workers expands productivity.



Source: Federal Reserve Economic Database, CRM Calculations. Orange highlights period of growing proportion of Producers (exhibit 3) in the workforce and thus higher productivity.

The prospect for productivity growth is self-evident in the data. While an increasing cohort of Producers is beneficial, the difference this time is that they are replacing the Managers, not the Learners. The implication is that the

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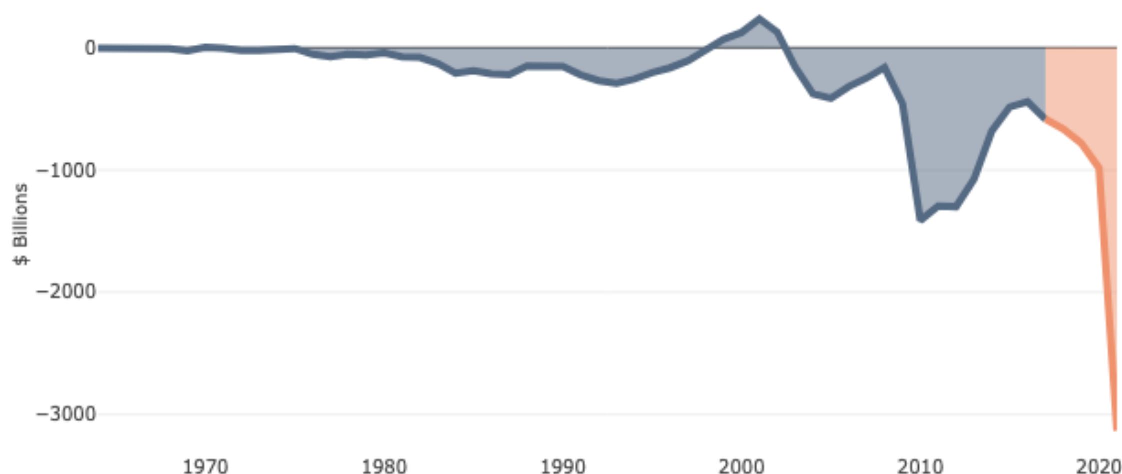
marginal productivity gains will be less than before, while it is uncertain for price levels.

The ratio of dependents (less than 19 and greater than 65) to the workforce will decline. The difference this time is that the retirees, not youth dominate the proportion of dependents. Only the future will determine the extent that retirees need resources more or less than the young and the subsequent impact on demand.

There is one certainty: the US will have to service more debt in the future. For fiscal 2020, the Federal deficit exceeded *three trillion* (exhibit 6). Unless there is a divided government, further stimulus is in the cards. While 2021 may not approach 2020 levels for the deficit, the levels may very well resemble the one trillion-dollar levels of 2008-09 and may add another $2 trillion to the bill. A three-year total may reach $5 trillion and add at *least $50 billion to the debt service*.

Current deficits will reduce future growth.

Exhibit 6. US Federal Deficit



Source: Federal Reserve Economic Database, CRM Calculations.

The target of any fiscal stimulus will determine its efficacy for the economy. Further, tax cuts unquestionably send equity markets higher at the cost of

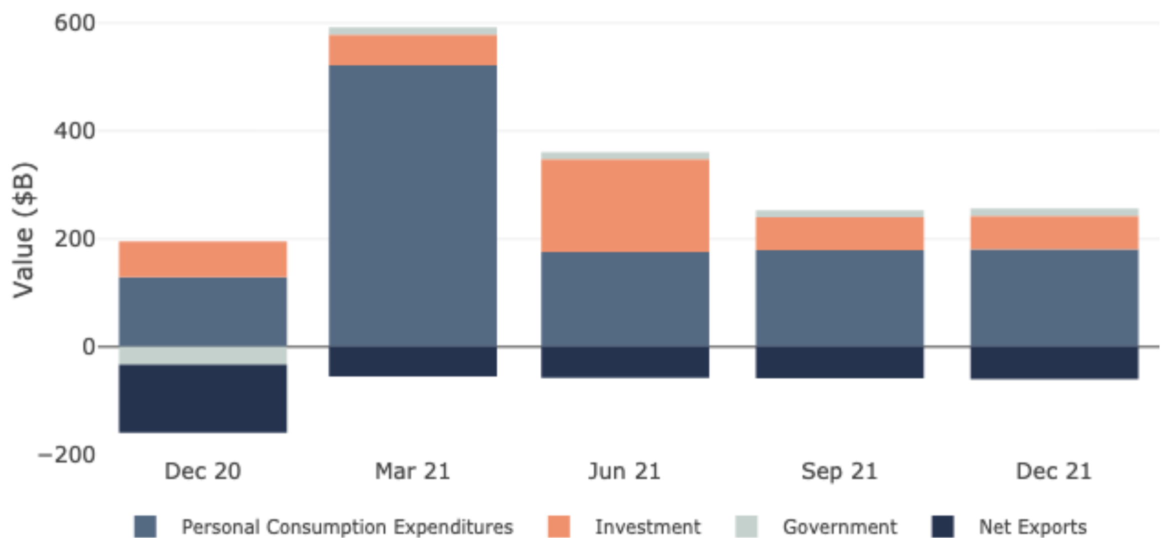
The Outlook

higher interest rates and little growth. Expanding infrastructure, education, and health care are the most probable outcomes. These targets at least have the prospect of long-term efficiency gains that augment growth. The zeitgeist of the time is people over capital. Whether the polemical politicians hear the clarion call is another story.

While the growth expectations remain unchanged with a slow recovery envisioned, the unpredictability of the interval between election and inauguration makes any projection futile. Thus, the presentation includes a brief discussion with alternate facts that accounts for an unstable transition. The current expectation is a continued recovery in the fourth quarter and slower growth through 2021 with a return to peak by the end of that year.

A 3.9% decline is forecast for 2020.

Exhibit 6. Forecast for US GDP Growth



Source: CRM estimates. Amounts are annualized rates.

In the event of an unstable transition and forceful return of the virus, the fourth quarter could see a decline parallel to the first quarter. The expected fourth-quarter growth would disappear and return in the first quarter augmented by further stimulus in that scenario. The greater risk in this scenario is to democracy and an erosion of faith in the government. For that outcome, there is no forecast.

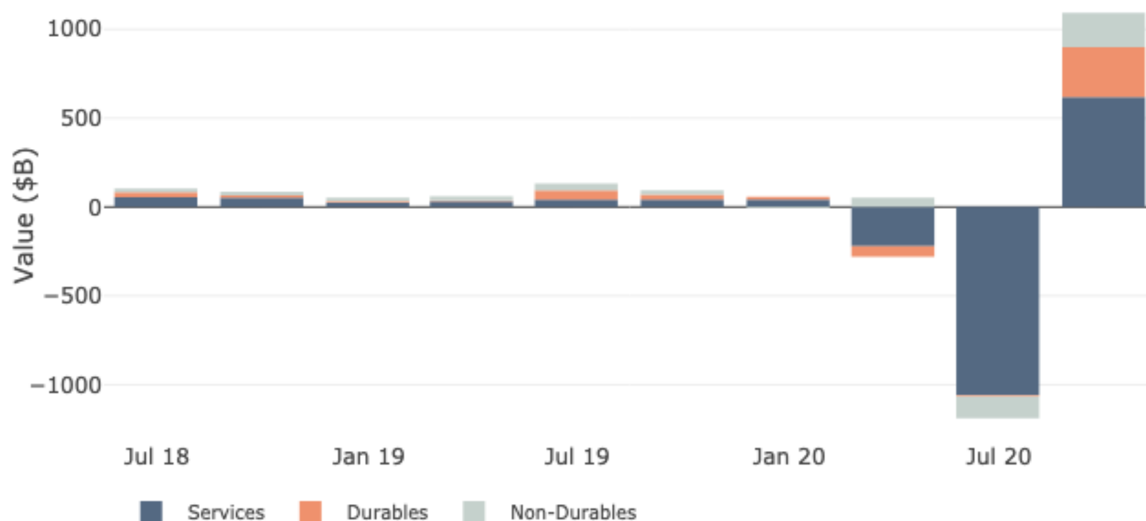
Consumption

The scale of the rebound in consumption is unparalleled. The largest prior fluctuation occurred during the Korean War ramp up in the 1950s and was still only *a third* of the magnitude. The usual occurrence coming out of recession is a rebound of about *one percent*. This time the rate was *nine percent*. Indeed, this time is different. The challenge is in both the magnitude and composition of the rebound. They suggest a less robust future.

The striking size of the changes over the last two quarters is apparent as they tower over the previous changes (exhibit 7). On its face, the robust rebound mirrors the tragic decline. The magnitude of the rebound roughly reflects the prior fall in percentage terms. Unfortunately, expressing the changes in percentage terms hides the reality that consumption is still *three percent* below its prior peak.

Exhibit 7. Consumption Contribution by Component

A large rebound still leaves consumption *three percent* below peak.



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

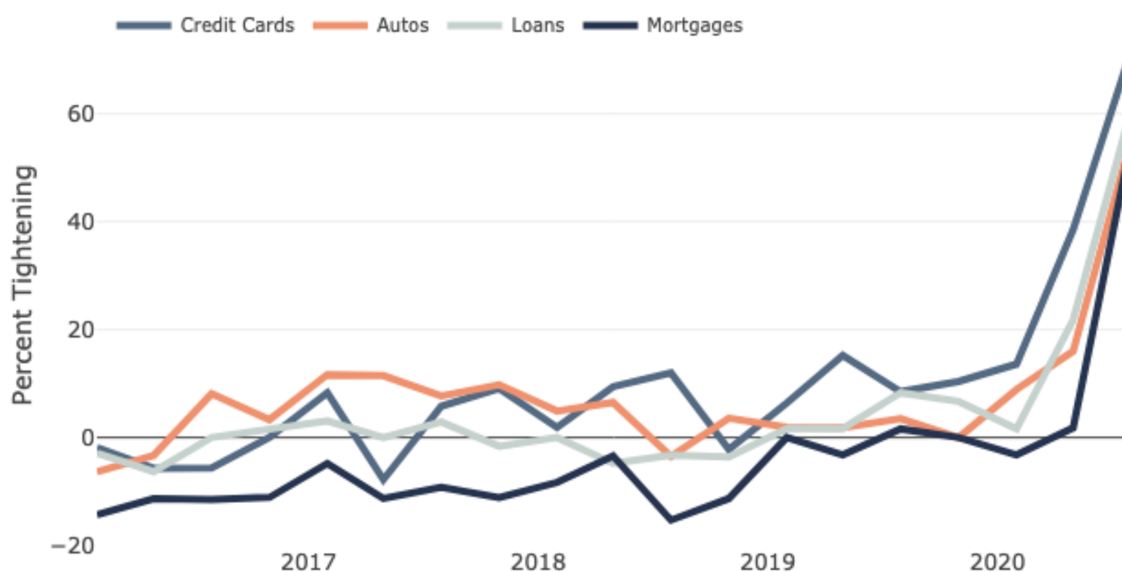
The larger problem is its composition. First, the rebound in durables goods is greater than the last *ten quarters combined*. The explanation for this extraordinary jump is elusive. Undoubtedly, lower interest rates made financing easier for auto, furnishings, and recreation goods. The trouble is that banks are *tightening* the conditions for auto, credit card, mortgage, and

Consumption

installment loans (exhibit 8). Thus, all durables goods categories exceeding their prior comparable seems a bit incongruent with the current economic malaise.

Loans are *contracting*, yet durable goods orders expand.

Exhibit 8. Senior Loan Officers Survey. Percent Tightening Loans Requirements.



Source: Federal Reserve Economic Database.

Equally perverse is the jump in non-durable goods, which is dominated by the grocery category. Indeed, as restaurant patronage reduces, the expectation is for an uptick in grocery expenditures. Further, the expectation was for an uptick in clothing as a rebound from previously missed purchases and the new school year (exhibit 9). As before with durables, the outcome is an *increase greater than the fall*.

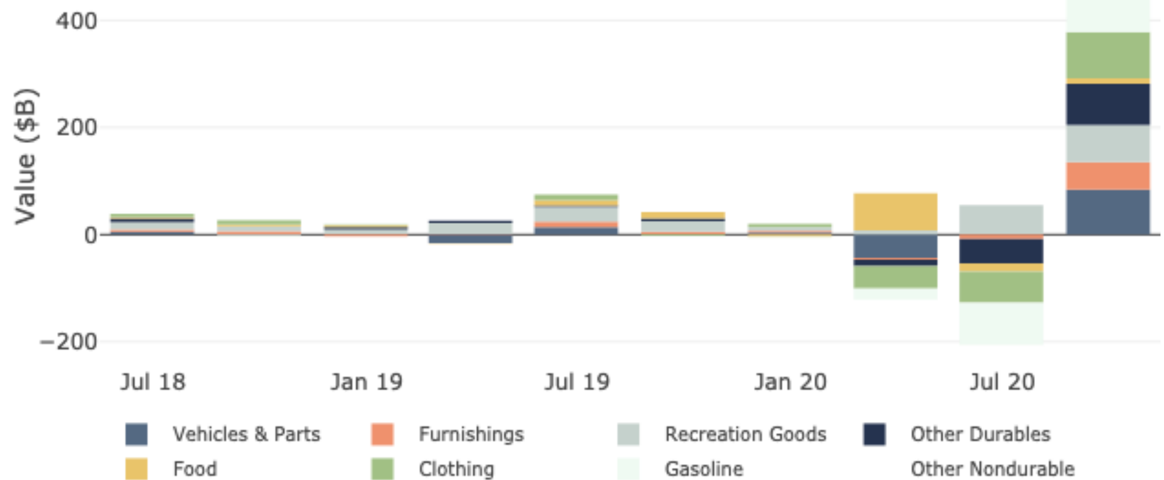
The rebound's incomprehensible magnitude in the third quarter for durables and non-durables goods most likely resides in the measurement tools. First, these are seasonally adjusted numbers. The adjustment measures are highest in the third and fourth quarters for these categories, making the low base numbers of the first and second quarter deliver a higher rebound in the subsequent quarters. Second, the models' autoregressive feature ensures a considerable rebound, particularly during the first release. The conclusion is

Consumption

that modest retracements are likely to occur during the subsequent revisions to the data.

Exhibit 9. Goods Consumption Contribution by Component

Furnishing & gasoline growth are a *one-off event*.



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

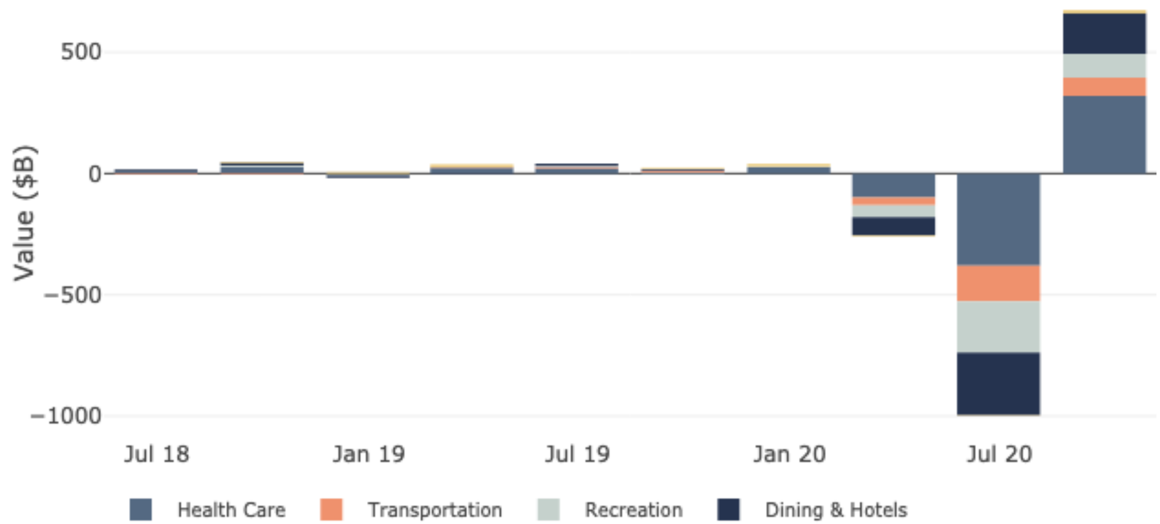
The broader service sector rebounded materially, yet it remains eight percent below its prior peak. Critically health care expenditures, the largest single consumption sector outside of housing, health care, are returning (exhibit 11). The rebound is promising despite all services sectors remaining well short of their prior peaks. Any economic activity in the dining & hotel area is helpful, given the devastation wrought by the Pandemic to that sector. Even the recreation sector returned. As before with the goods category, the challenge is with the season.

Seasonal adjustment most likely aided the measurement of the recreation and dining & hotel services. More significantly, the arrival of winter dampens demand for most of these sectors and provides a vehicle for the Pandemic to regain traction as people stay indoors more frequently. The next few months are crucial to the durability of the rebound in these components.

Consumption

Exhibit 10. Service Consumption Contribution by Component

Durability of the *service sector* rebound is questionable.



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

The enduring challenge for consumption is neither the current variability in spending nor the season. The threat is the permanent change of consumer behavior that may occur as a result of the Pandemic. In the near term, the rapid return to travel and indoor dining is not likely. Eventually, people will return, but the time frame is highly uncertain and contingent upon the future response to the Pandemic.

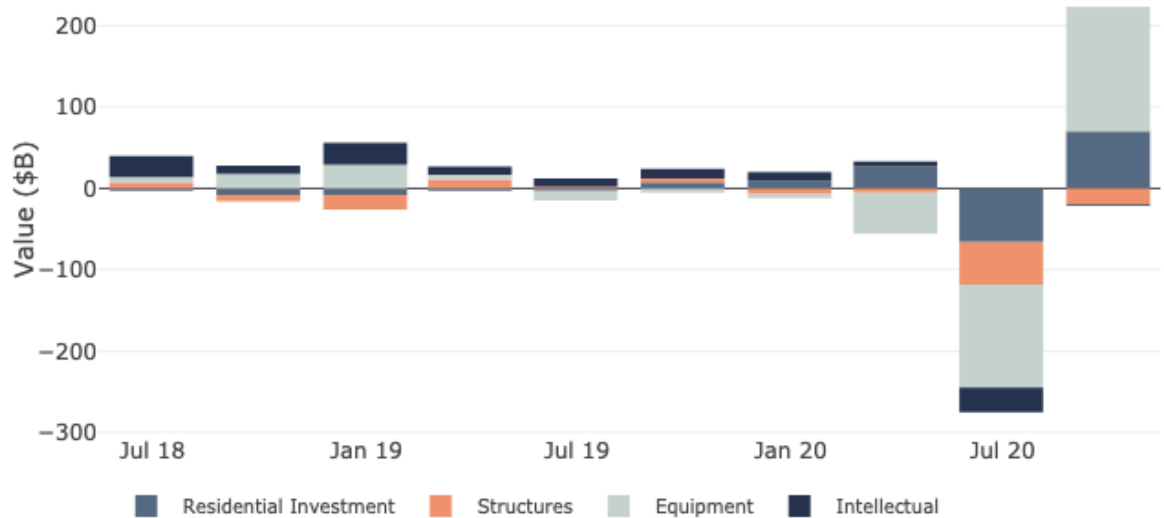
The threat is if people are inclined to save more for fear of future pandemics, then consumption is reduced. Government consumption expenditures are sure to decline as interest payments lower spending. The necessary higher taxes will also reduce consumer spending. These forgone outcomes make it imperative that policies quickly address the issue of consumer behavior. Lower consumer behavior will induce *lower investment* as well. With marginally higher productivity expected to obviate expanding investment, this is an unpalatable headwind. Enacting policy to support consumption should be objective number one of the administration in January.

Investment

Investment is the most volatile component of GDP and usually presages changes in the economy. Every economic contraction in the data since the 1940s shows declining investment before a recession. While the investment component that drives the differences may vary, its primacy as a bellwether for change is renowned. This trait makes the year-long decline of investment before the Pandemic worrisome, as the *business sector did not see robust demand* before the most significant contraction on record.

Business is *not investing* despite the incentives.

Exhibit 12. Investment Contribution by Component



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

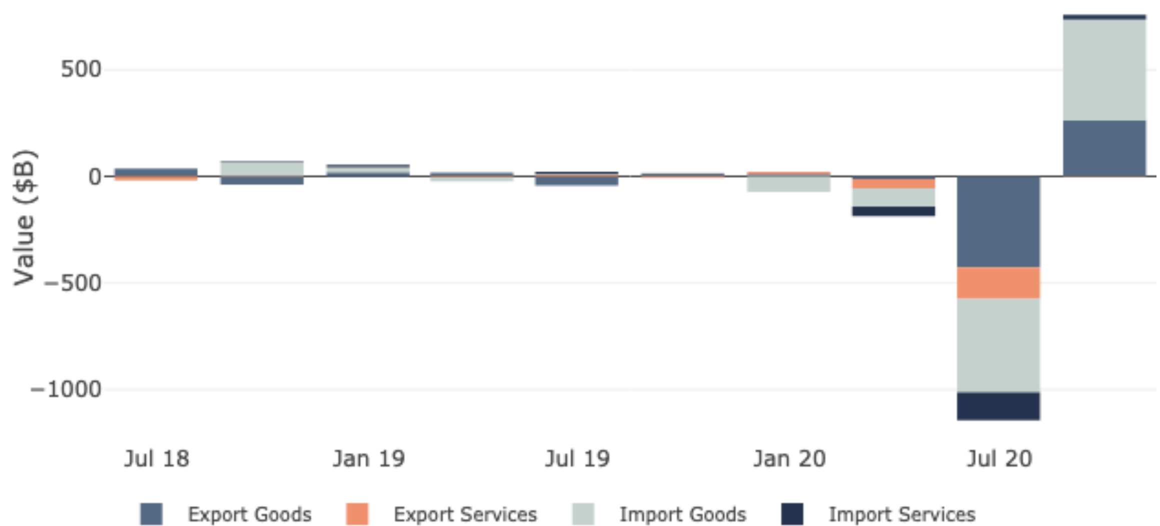
The problem for investment is that commercial structures and equipment were in a year-long decline. While residential structures rebounded after a two-year decline, this result was most likely an artifact of falling interest rates *before* the Pandemic. If not for intellectual property's prior growth, particularly software, the investment category would be deep in recession. The current problem is that intellectual property is not rebounding, and commercial real estate is declining (exhibit 12). Even the restocking of equipment is not exceeding the prior two-quarters decline. Business sector shows a strong indication that they are unwilling to invest until the future is more certain, despite generous fiscal incentives and low-cost debt. Fiscal policy should *incentivize current investment* to avoid further constraints on growth.

Exports & Imports

The deterioration of the trade balance was a surprise. While goods imports rebounded to exceed the first-quarter level, good exports only recovered half their loss (exhibit 13). In isolation, goods exports are one-tenth of domestic output. The services export category is five percent of GDP and saw no change in the last quarter after its material drop in the second quarter. The result was the largest trade deficit in dollar terms in history, which does not bode well for the future.

Exports are *not rebounding.*

Exhibit 13. Net Exports



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

A higher dollar certainly supports imports and impairs exports. The challenge is not the terms of trade; instead, it is external demand. The absence of a return in external demand suggests that the rebound of the economy is illusory. The US simply cannot rebound rapidly without support from exports. As argued in the last economic update, there is a significant implication for US competitiveness and the dollar. With long lag times for retooling global supply lines, this outcome could endure even if the US were to pivot back to open trade. The implication is that export demand may not return quickly, and the US dollar supremacy remains *doubtful*.

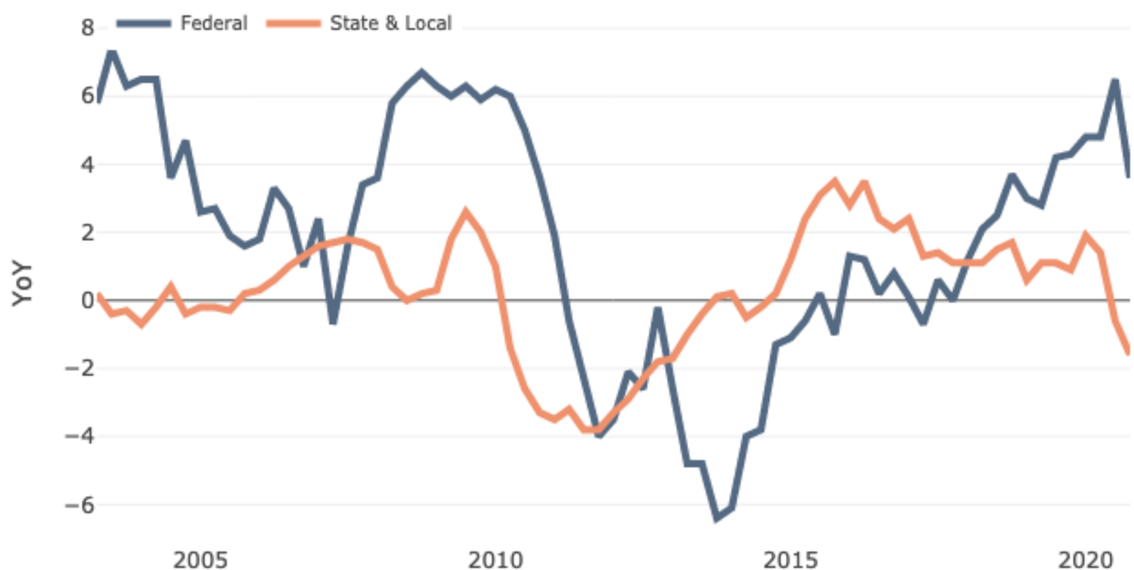
Government

Fiscal support in the US is limited to the Federal government level due to the balanced-budget requirement at the State & Local levels. This constraint is where trouble arises. Total government expenditures are below their first-quarter level due to a contraction at the State & Local level. The materiality is apparent in their relative sizes with the Federal government only *two-thirds* the other levels' size. Thus, any contraction of the State & Local levels will *overwhelm* the Federal response.

State & Local levels mandate cuts as their tax revenue disappears with declining business activity, and increased unemployment lowers tax revenues (exhibit 12). The net result is that total government expenditures *decreased by 1.5%* in the latest quarter. Reducing demand during a recession magnifies the contraction. Critically, as a significant employer, cuts in the State & Local levels will result in multiplier effects in subsequent quarters as their reduced spending hits follow-on businesses dependent upon them for revenue. The impact of fiscal retrenchment at the State & Local levels can endure for years, which would further crimp an already expected lower demand.

The worry is the State & Local contraction.

Exhibit 12. Federal and State Government



Source: Federal Reserve Economic Database. YoY = year-over-year percent change.

Government

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 the consumer behavior does not change and conspire with other secular trends to dampen demand further.

As in a previous outlook, our suggestion addresses the people and sectors in need. First, remove all current programs, then:

Focus the fiscal response to retool for the future.

- **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 that the people are ready for the future since the expectation is for a prolonged return to normal.
- **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.*

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