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Some of the Good News is Bad News

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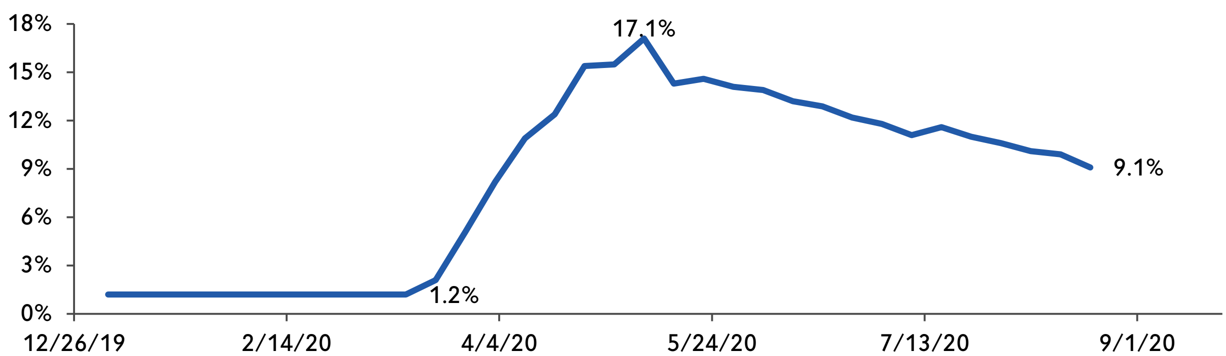
After considerable wrangling, Congress and the White House have finally agreed to stand-alone legislation to fund the government through mid-December. Along with prior legislation suspending the public debt ceiling to around then, this implies that two events that could bring the federal government to a screeching halt—a government shutdown or threat of default—are off the table until after the general election. Normally, cooperation breaking out in a bitterly divided Washington DC should be taken as good news. Except this time. The good news is bad news brought on by other good news.

The Mellon forecast has been that US economic activity would rebound vigorously in the middle part of 2020 and that incremental fiscal stimulus would be provided to reinforce the considerable monetary policy accommodation that the Federal Reserve (Fed) seems determined to leave in place for seemingly time immemorial. Additional action was needed as an important part of the stimulus legislation passed in March, enhanced unemployment benefits, rolled off at the end of July. In the event, the rebound has been even more considerable than expected, seen in the 8 percent decline in the insured unemployment rate from its peak. But the improvement obeys the regressive nature of the pandemic shock. Higher-income workers have disproportionately returned to their white-collar work, leaving lower-income households, with less resources to protect themselves, in need of those enhanced unemployment benefits and another round of stimulus checks.

Insured Unemployment Rate



Source: Bloomberg, accessed 9/8/2020.

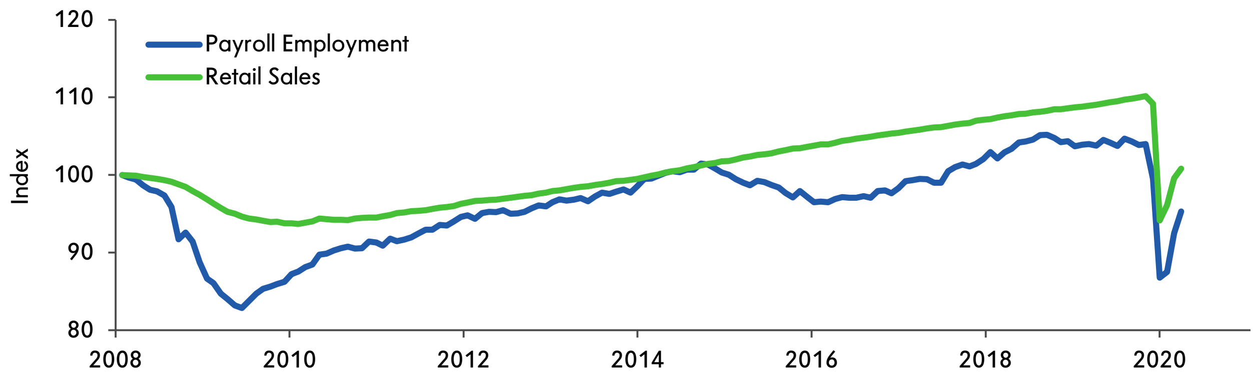
The aggregate improvements apparently turned down the heat on the political class to cooperate. Still, a self-imposed deadline, the end of the fiscal year and the need to fund the next one, would serve to keep the political pot boiling. Our assumption was that the calendar stop would allow a skinny stimulus bill to be paired with government funding to get the government into the next fiscal year. We expected it to combine an extension of somewhat reduced unemployment benefits, another round of direct payments, and aid to states and localities. Congress and the White House proved us wrong, and the odds of additional stimulus this year seem bleak. Sure, the two sides will offer differently designed bills, but it will be partisan positioning offering smoke, not fire. All else equal, the good news from the data would have led us to mark up our forecast for economic growth in 2020. The bad news—an impetus impediment because of that good news—trims that top-off to growth.

The rest of this note 1) puts the incoming data into perspective, 2) explains that the stimulus provided economic lift, and 3) works through the arithmetic of our forecast revision. We now expect real GDP to fall 4.4 percent in 2020, a touch better than the last round, and rebound to 3.6 percent in 2021, a markdown of 0.8 percentage points. Recognize that this represents rebound, not recovery, as the level of real GDP does not return to its 2019 heights until 2023. The Fed's single-minded pursuit of maximum employment will likely pull up consumer price inflation to around 2.5 percent next year in passing to a more significant overshoot in 2022.

The Rebound in Economic Activity

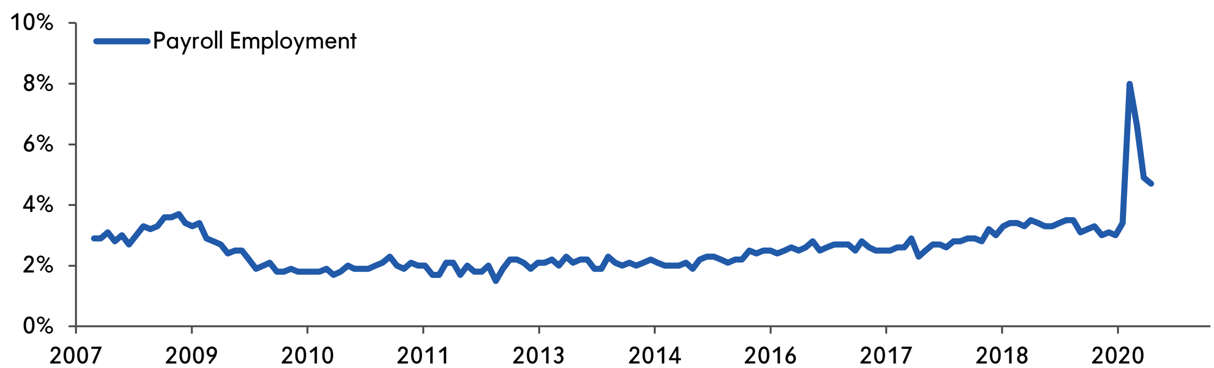
The rebound from the depth of the economic dislocations associated with the pandemic was expected to etch a sharp "V" shape into activity. Mitigation efforts kept workers from their places of business and shoppers from marketplaces. When some of them returned as we got better at social distancing and testing or out of necessity, growth rates were sure to pop up. Levels matter, however, in that the volume of production and employment remains below their pre-pandemic readings. Composition matters, too. High-wage workers perform tasks better suited to operating at home, at the cost of supporting local businesses in the office area. Lower-paid workers need a physical presence on shop-room floors or behind counters. Moreover, they often work at small- and medium-term businesses that do not have much of a cushion to tide over their enterprises. Tellingly, the average of hourly earnings remains above its year-ago level. Wage gains in a pandemic? No, high-wage workers retained their jobs disproportionately relative to low-wage workers, pulling up the average. The latter are more hand-to-mouth spenders and particularly benefitted from extended unemployment benefits. As the easy wins of easing lockdowns ebbs without additional fiscal stimulus, the stresses on households and business balance sheets will impede the further expansion of activity and pose event risk.

Employment and Production
January 2008=100



Source: Bloomberg, accessed 9/9/2020.

Employment and Production
12-Month Change



Source: Bloomberg, accessed 9/9/2020.

Did the Prior Stimulus Work?

Even in a Washington riven by partisanship, events are sometimes in the driver's seat. The crushing contraction in economic activity caused by the pandemic and associated mitigation efforts forced cooperation, for a time. In six weeks starting early March, the insured unemployment rate rose almost 16 percentage points, a backdrop that prompted the Congress to pass three stimulus bills in about as many weeks. The rapid onset of economic distress focused politicians' attention but did not give them enough time to larder the legislation with longer-term ambitions, which tend to have sharp partisan edges.

The result was about additional benefits and tax forbearance directed to the unemployed and small- and medium-sized businesses that were levered by funding new lending and asset-buying facilities at the Fed. Direct aid also took the form of $1,200 stimulus payments to about 100 million households, and grants were sent to states and localities as well as to the health care sector.

Assessing the economic lift as a consequence of these efforts is a fraught enterprise because the other tidal shifts—including the physical losses created by the coronavirus, the shutting and reopening of activity, the rise of economic uncertainty, and unprecedented Fed policy swings.

First, the drawbacks.

Much of the direct stimulus was saved, not spent, as three forces played out. First, households were given payments at a time of limited opportunities to spend them. Second, many people were justifiably worried about their medium-term employment and income prospects and likely wanted to build a bigger buffer stock against future adversity. Third, some more sophisticated households probably did the math to understand that current government largess inevitably implies higher taxes down the road. This created another reason to save.

Extending and enhancing unemployment benefits tilts incentives toward a slower return to the workforce. By some estimates, about four-tenths of those unemployed in the summer fared better by staying out, rather than rejoining, the job rolls. This repeats, with some magnification, the cyclical regularity that increased benefits lengthens unemployment spells, which was part of the reason the recovery from the Global Financial Crisis of 2008-09 was initially "jobless."

The government is inefficient in delivering resources, especially at the retail level. Stimulus checks were sent to the deceased, illegal immigrants received unemployment benefits, and small business lending did not all go to small businesses.

Still, consider the advantages.

Real disposable income increased 10 percent over the four quarters ending in June even as real GDP cratered 10 percent. This was timely, indeed, and helps to explain why consumption was the GDP component that declined relatively least. Enhanced unemployment benefits went to those in need, even though it was delivered in a leaky bucket. Directionally, the three rounds of fiscal legislation helped support the economy, suggesting that the vigorous economic rebound was not entirely the product of easing lockdowns. If so, lessening the impetus represents a drag on second-half spending.

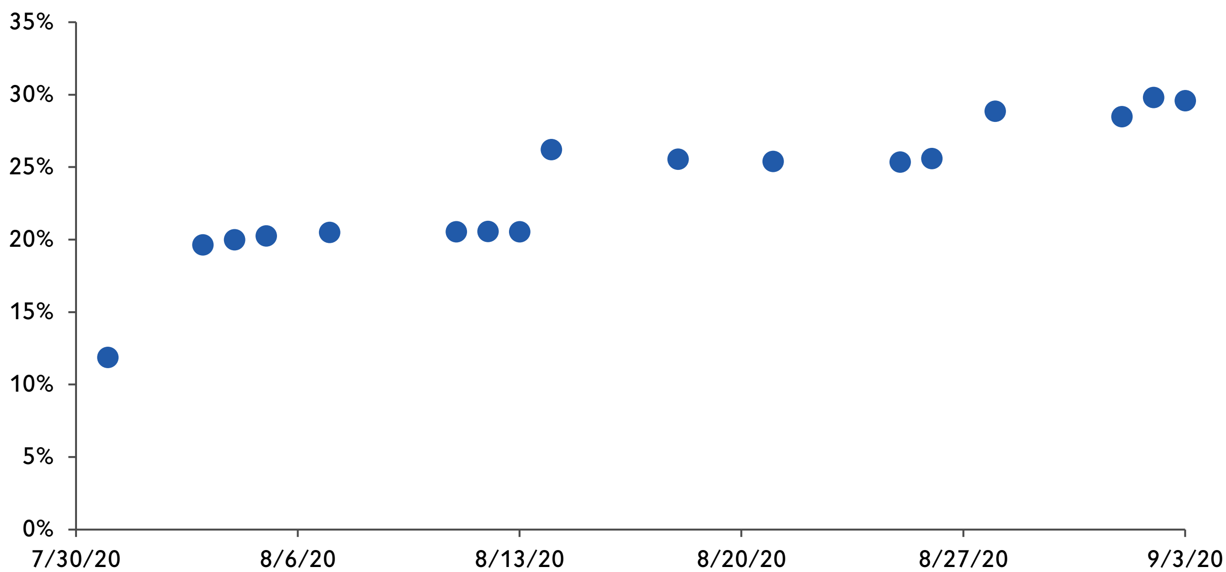
The drop-dead date of July 31, when enhanced unemployment benefits expired and stimulus checks receded into memory, has come and gone. President Trump filled the void created by Congressional inaction with four executive orders. While the Congress alone authorizes spending and taxation, the Executive branch has some leeway as to how already-authorized actions can be allocated in direction and over time. Some emergency funds have been slotted for extending unemployment benefits, but at a stepped-down pace and with the expectation that states will also contribute. The Treasury will direct the Internal Revenue Service (one of its branches) to not require payroll tax reductions for the remainder of the year, delaying but not waiving personal tax liability. The implicit promise is that, if granted a second term, the Trump administration will legislate away the liability retroactively.

Taken at face value, this represents a considerable step down in stimulus. Worse, it probably should not be taken at face value. As for unemployment benefits, the funds will probably run out before December, and beneficiaries may be more inclined to save if they view payments as temporary and uncertain. As a result, the question is no longer whether we go over a fiscal cliff but how deep is the drop.

The Arithmetic of the Outlook

The rebound in economic activity left a widespread imprint on the data. One helpful summary measure is a tracking estimate of the third quarter growth of real GDP, with the one produced by the Federal Reserve Bank (FRB) of Atlanta charter here. Over the course of the forecast derby thus far, real GDP growth has risen from 10 percent to about 30 percent. Essentially, this extrapolates the data in hand for July and August into September. We worry that the lack of legislative follow-through will take a toll in the final month of the quarter, consistent with the slowing of the gains in high-frequency readings on spending, activity, and employment. As a working hypothesis, we plugged in 10 percent, not 30 percent, for September to produce the chart below, which would be consistent with 23 percent growth in real GDP at an annual rate for the quarter as a whole, as measured along the left axis.

FRB Atlanta Tracking Estimate of Real GDP Growth
Third Quarter 2020

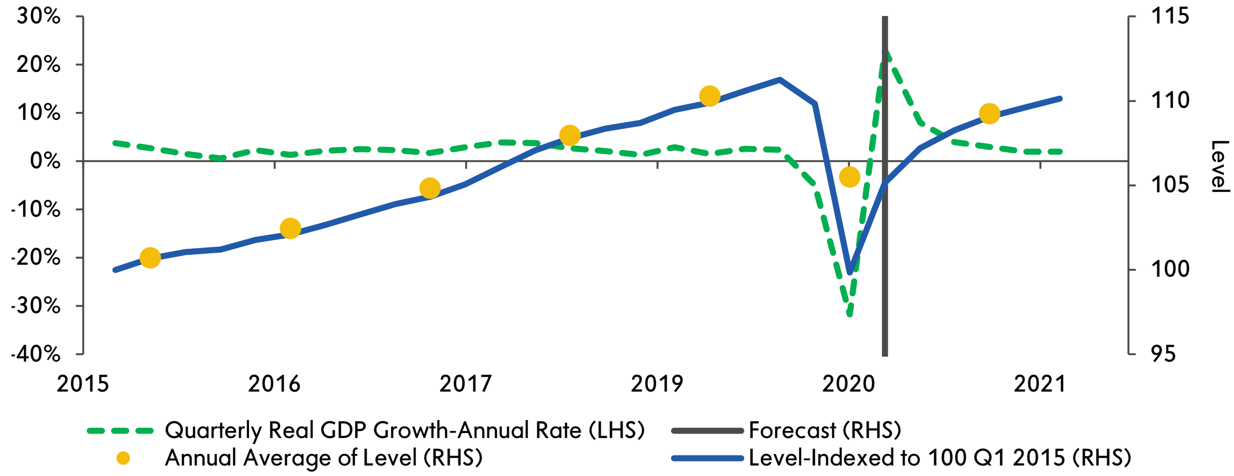


Source: FRB Atlanta, accessed via Bloomberg on 9/9/2020.

Real GDP is measured every other which way as well in the chart. The solid blue line plots the level of quarterly GDP indexed to the first quarter of 2015 and the circles give their annual averages, both measured on the right axis.

Real GDP

Level and Quarterly Change



Source: Bloomberg, accessed 9/9/2020, and Mellon calculations.

Three observations stand out.

1. The record-breaking decline in real GDP in the second quarter pulled its level back to the beginning of 2015, wiping out five years of expansion.

2. Even if GDP growth posts a post-WWII record in the positive direction during the third quarter, as in our outlook, its level will be significantly below where the year started.

3. After six quarters of well-above-trend growth as in our outlook, real GDP in 2021 will be below that of 2019.

The rebound is vigorous, but we believe recovery will not be in hand until 2022.

A few last words on inflation are probably warranted, placed last to be consistent with the Fed's priorities. The Fed's new "Statement of Longer-run Goals and Monetary Policy Strategy" (discussed at length in the latest Fed Thoughts) strongly signals it will focus squarely on unemployment until inflation tracks persistently above 2 percent. We think they will get what they want, and perhaps more, in the fullness of time. Considerable unused resources will offset for a time the forces of a depreciating US dollar and higher commodity prices. With almost three-quarters of the year already in the books, consumer price inflation will not be much more than 1 percent—but on a rising trajectory. Next year begins the sorry process of the waning of the safe-haven status of the US dollar, extending dollar depreciation and commodity price increases. This backdrop will make it easier for the Fed's intent to sink into the general psyche, boosting inflation expectations. If so, actual inflation will rise as well. Consumer price inflation will be at a rate consistent with the Fed's long-run goal of 2 percent for PCE inflation (that is, 2.5 percent), but only in passing on the way higher beyond the forecast horizon. This is a little less of a pickup than in the prior forecast round, mostly on the view that weakness in the rest of the world puts US assets in a more favorable light, for a time. Still, even after pulling the inflation forecast in a touch, the Mellon forecast is at the high end of consensus expectations.

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Vincent is Mellon's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

Disclosure

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