United States Economic Outlook

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Federal Reserve – Current Economic Conditions Commentary

The Federal Reserve publishes a report (known as the *Beige Book*) eight times per year that summarizes current economic conditions throughout the 12 Federal Reserve Districts in the United States. The most recent *Beige Book*, released on May 27, 2020, noted that:[1]

- Economic activity declined in all Districts, falling sharply in most, reflecting disruptions associated with the COVID-19 pandemic.
- Consumer spending fell further as mandated closures of retail establishments remained largely in place during most of the survey period.
- Declines were especially severe in the leisure and hospitality sector, with very little activity for travel and tourism businesses.
- Auto sales were substantially lower than a year ago, but several Districts noted recent improvement.
- A majority of Districts reported sharp drops in manufacturing activity, and production was notably weak in auto, aerospace, and energy-related plants.
- Residential home sales plunged due, in part, to fewer new listings and to restrictions on home showings in many areas.
- Construction activity also fell as new projects failed to materialize in many Districts.
- Commercial real estate contacts noted that a large number of retail tenants had deferred or missed rent payments. Bankers reported strong demand for PPP loans.
- Agricultural conditions worsened, with several Districts reporting reduced production capacity at meat-processing plants due to closures and social distancing measures.
- Energy activity plummeted as firms announced oil well closures, which led to historically low levels of active drilling rigs.
- Although many contacts expressed hope that overall activity would pick-up as businesses reopened, the outlook remained highly uncertain. Most contacts were pessimistic about the potential pace of recovery.

Employment and Wages

The most recent Beige Book reported a further tightening of the labor market:

"Employment continued to decrease in all Districts, including steep losses in most Districts, as social distancing and business closures affected employment at many firms. Securing PPP loans helped many businesses to limit or avoid layoffs, although employment continued to fall sharply in retail and in leisure and hospitality sectors. Contacts cited challenges in bringing employees back to work, including workers' health concerns, limited access to childcare, and generous unemployment insurance benefits. Overall wage pressures were mixed as some firms cut wages while others implemented temporary wage increases for essential staff or to compete with unemployment insurance. Most Districts noted wage increases in high-demand and essential sectors, while wages were flat or declining in other sectors."[2]

[1] *Beige Book* – May 27, 2020, Board of Governors of the Federal Reserve System.
[2] Ibid.

Federal Open Market Committee – Monetary Policy Commentary

The Federal Open Market Committee ("FOMC" or the "Committee") acts as the monetary policymaking body of the Federal Reserve System. The FOMC makes all decisions regarding open market operations, which affect the federal funds rate (rate at which depository institutions lend to each other), the size of the Federal Reserve's asset holdings, and public communication regarding the likely course of future monetary policy.[3] Information received by the FOMC since the Committee met in June indicated that:[4]

- The Coronavirus outbreak is causing tremendous human and economic hardship across the United States and around the world.
- The virus and the measures taken to protect public health have induced sharp declines in economic activity and a surge in job losses.
- Weaker demand and significantly lower oil prices are holding down consumer price inflation.
- Financial conditions have improved, in part reflecting policy measures to support the economy and the flow of credit to U.S. households and businesses.
- The ongoing public health crisis will weigh heavily on economic activity, employment, and inflation in the near term, and poses considerable risks to the economic outlook over the medium term.
- In light of these developments, the Committee decided to maintain the target range for the federal funds rate at 0 to 1/4 percent.
- The Committee 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.

Moreover, it was noted, "The Committee will continue to monitor the implications of incoming information for the economic outlook, including information related to public health, as well as global developments and muted inflation pressures, and will use its tools and act as appropriate to support the economy. In determining the timing and size of future adjustments to the stance of monetary policy, the Committee will assess realized and expected economic conditions relative to its maximum employment objective and its symmetric 2 percent inflation objective. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments."[5]

The FOMC further noted that "to support the flow of credit to households and businesses, over coming months the Federal Reserve will increase its holdings of Treasury securities and agency residential and commercial mortgage-backed securities at least at the current pace to sustain smooth market functioning, thereby fostering effective transmission of monetary policy to broader financial conditions. In addition, the Open Market Desk will continue to offer large-scale overnight and term repurchase agreement operations. The Committee will closely monitor developments and is prepared to adjust its plans as appropriate."[6]

[3] Structure of the Federal Reserve System, Federal Open Market Committee.
[4] Board of Governors of the Federal Reserve System Press Release, June 10, 2020.
[5] Ibid.
[6] Ibid.

Impact of Novel Coronavirus (COVID-19)

On January 21, 2020, the United States reported its first case of the novel Coronavirus in Washington State.[7] Since then, 4.5 million Americans have contracted the virus.[8] The virus has also brought the steady growth of the U.S. economy to a screeching halt. Coronavirus has caused the temporary (and, in some cases, permanent) closure of non-life sustaining businesses across the country. As a result, the United States has seen a record total number of unemployment claims north of 26 million.[9]

The economic impact of the novel Coronavirus has been rapid and has created significant uncertainty relating the future health of the domestic economy. As such, the United States, and its economy is facing unprecedented times. The federal government has worked to pass several relief programs for both individuals and businesses. The "Coronavirus Aid, Relief, and Economic Security Act," or "CARES Act," passed in March, gave taxpayers checks of up to $1,200 ($2,400 for those filing jointly) and an additional $500 for each qualifying child to help to help stimulate the economy.[10]

In late April, President Trump signed legislation providing an additional $484 billion in relief in order to help small businesses and support hospitals and COVID-19 testing amid the Coronavirus pandemic. The measure included an additional $310 billion in funding for the Paycheck Protection Program (PPP), $60 billion of which was reserved for community banks and small lenders; $75 billion for hospitals; $25 billion to support testing efforts; and $60 billion for emergency disaster loans and grants.[11]

Current Employment Conditions

The Bureau of Labor Statistics (BLS) reported that the unemployment rate declined to 11.1 percent in June 2020.[12] Total nonfarm payroll employment rose by 4.8 million in June 2020, with leisure and hospitality, retail trade, education and health services, other services, manufacturing, and professional and business services all recording noticeable gains.[13]

In June, the unemployment rate increased by 2.2 percentage points to 11.1 percent. The number of unemployed persons fell by 3.2 million to 17.8 million in June. The number of unemployed persons who were on temporary layoff decreased by 4.8 million in June to 10.6 million, following a decline of 2.7 million in May. The number of unemployed persons who were jobless for fewer than five weeks declined by 1.0 million to 2.8 million in June. Although unemployment fell in May and June, the jobless rate and the number of unemployed are up by 7.6 percentage points and 12.0 million, respectively, since February.[14]

The BLS also noted:[15]

- Employment in leisure and hospitality increased by 2.1 million, accounting for about two-fifths of the gain in total nonfarm employment. Over the month of June, employment in food services and drinking places rose by 1.5 million, following a gain of the same magnitude in May. Despite these gains, employment in food services and drinking places is down by 3.1 million since February.

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7 Timeline: How Coronavirus got started. ABC News. Schumaker, Erin. July 28, 2020.
8 CDC Report: Cases in the U.S.
9 An unemployment rate of 23%? The real jobless picture is coming together. CNBC. Cox, Jeff. April 23, 2020.
10 White House And Senate Reach Agreement On Stimulus Checks. *Forbes*. Jim Wang. March 25, 2020.
11 Trump signs $484 billion Coronavirus relief package. *The Hill.* Chalfant, Morgan. April 24, 2020.
12 The Employment Situation – June 2020. Bureau of Labor Statistics. News Release, July 2, 2020.
13 Ibid.
14 Ibid.
15 Ibid.

- Employment also rose in June in amusements, gambling, and recreation (+353,000) and in the accommodation industry (+239,000).
- Employment in retail trade rose by 740,000, after a gain of 372,000 in May and losses totaling 2.4 million in March and April combined. On net, employment in the industry is 1.3 million lower than in February. In June, notable job gains occurred in clothing and clothing accessories stores (+202,000), general merchandise stores (+108,000), furniture and home furnishings stores (+84,000), and motor vehicle and parts dealers (+84,000).
- Employment increased by 568,000 in education and health services in June, but is 1.8 million below February's level. Health care employment increased by 358,000 over the month, with gains in offices of dentists (+190,000), offices of physicians (+80,000), and offices of other health practitioners (+48,000). Also in health care, job losses continued in nursing care facilities (-18,000). Employment increased in the social assistance industry (+117,000), reflecting gains in child day care services (+80,000) and in individual and family services (+28,000). Employment in private education rose by 93,000 over the month.
- Employment increased in the other services industry in June (+357,000), with about three-fourths of the increase occurring in personal and laundry services (+264,000). Since February, employment in the other services industry is down by 752,000.
- In June, manufacturing employment rose by 356,000, but is down by 757,000 since February. June employment increases were concentrated in the durable goods component, with motor vehicles and parts (+196,000) accounting for over half of the job gain in manufacturing. Employment also increased over the month in miscellaneous durable goods manufacturing (+26,000) and machinery (+18,000). Within the nondurable goods component, the largest job gain occurred in plastics and rubber products (+22,000).
- Professional and business services added 306,000 jobs in June, but employment is 1.8 million below its February level. In June, employment rose in temporary help services (+149,000), services to buildings and dwellings (+53,000), and accounting and bookkeeping services (+18,000). By contrast, employment declined in computer systems design and related services (-20,000).

The following table contains historical unemployment rates for the United States. The unemployment rate since March 2018 has been between 3.5% and 4.0%, with the exception of March 2020 through June 2020, indicating the economy is at or near full employment. The rising unemployment rate starting in March 2020 is due to the Coronavirus and its effects.

UNITED STATES UNEMPLOYMENT RATE												
	Jan	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**
2016	4.9%	4.9%	5.0%	5.0%	4.7%	4.9%	4.9%	4.9%	5.0%	4.9%	4.6%	4.7%
2017	4.8%	4.7%	4.5%	4.4%	4.3%	4.3%	4.3%	4.4%	4.2%	4.1%	4.1%	4.1%
2018	4.1%	4.1%	4.0%	3.9%	3.8%	4.0%	3.9%	3.8%	3.7%	3.8%	3.7%	3.9%
2019	4.0%	3.8%	3.8%	3.6%	3.6%	3.7%	3.7%	3.7%	3.5%	3.6%	3.5%	3.5%
2020	3.6%	3.5%	4.4%	14.7%	13.3%	11.1%						
Source: YCharts.com												

Current Interest Rates and Market Implied Inflation Compensation

The yields in the table below were reported by the Federal Reserve for constant maturity treasuries (nominal and inflation-indexed) as of June 30, 2020.Taking the difference between nominal yields and inflation-indexed yields provides a market-based estimate for inflation compensation over each maturity period.

MARKET IMPLIED INFLATION					
	5 Year	**7 Year**	**10 Year**	**20 Year**	**30 Year**
Nominal Treasuries	0.29%	0.49%	0.66%	1.18%	1.41%
Treasury Inflation Protected Securities	-0.87%	-0.79%	-0.68%	-0.38%	-0.15%
Market Implied Inflation	**1.16%**	**1.28%**	**1.34%**	**1.56%**	**1.56%**
Source: Board of Governors of the Federal Reserve System, Data as of 6/30/2020					

Economic Forecast – Major Indicators

Gross Domestic Product (GDP) and Inflation

On June 10, 2020, the Federal Reserve released its economic projections for real GDP growth, the unemployment rate, personal consumption expenditures inflation, and the federal funds rate. The projections reflect the individual projections of the Federal Reserve Board members and Federal Reserve Bank presidents under what each individual considered appropriate monetary policy to be moving forward.[16] The following table contains the median forecasts of the participating individuals.

FEDERAL RESERVE ECONOMIC PROJECTIONS (MEDIAN)				
	2020	**2021**	**2022**	**Longer-Run**
Change in Real GDP	-6.5%	5.0%	3.5%	1.8%
Unemployment Rate	9.3%	6.5%	5.5%	4.1%
PCE Inflation	0.8%	1.6%	1.7%	2.0%
Federal Funds	0.1%	0.1%	0.1%	2.5%
Source: Board of Governors of the Federal Reserve System, June 10, 2020				

Real GDP growth is expected to slow starting in 2020. PCE inflation is expected to increase year over year to 2022, while the unemployment rate is expected to decline year over year to 2022, and federal funds rate is expected to remain constant until 2022. These forecasts suggest that in the long term, the economy will experience a slowing of growth and an increase in inflation.

Long-term real GDP growth for the next 10 years is expected to average 1.8 percent, representing moderate expected real growth. The median projections of Federal Reserve data suggest longer-run PCE inflation is expected to be approximately 2.0 percent, consistent with the FOMC's inflation target.

[16] Economic Projections. Board of Governors of the Federal Reserve System, June 10, 2020.

The Bureau of Economic Analysis ("BEA"), an agency of the Department of commerce, produces economic account statistics that enable government and business decision-makers, researchers, and the American public to follow and understand the performance of the nation's economy.[17] In the June 25, 2020 release, The BEA notes real GDP decreased at an annual rate of 5.0 percent in the first quarter of 2020, compared to an increase of 2.1 percent in the fourth quarter of 2019.[18]

The decrease in real GDP in the first quarter reflected negative contributions from PCE, private inventory investment, exports, and nonresidential fixed investment that were partly offset by positive contributions from residential fixed investment, and federal, state and local government spending.[19]

A company cannot expect to achieve growth in excess of that achieved by the economy in which it operates into perpetuity (as implied by the terminal value/capitalization of free cash flow methodology calculation utilized under the income approach). The estimated long-term growth rate for the United States economy will serve as a ceiling for what a company can expect to achieve in the long-term.

Industrial Production and Manufacturing

The Institute for Supply Management's (ISM) Purchasing Managers Index (PMI) can be used as an indication as to whether or not the manufacturing sector of the economy is expanding or contracting. A PMI above 50.0 indicates that the manufacturing economy is generally expanding, while a reading below 50.0 indicates that it is generally contracting. The PMI increased 9.5 points to 52.6 in June of 2020, compared to May 2020. This was the first expansion in activity since April 2019, after three straight months of Coronavirus disruptions.[20]

Timothy R. Fiore, Chair of the ISM, stated, "Demand, consumption and inputs are reaching parity and are positioned for a demand-driven expansion cycle as we enter the second half of the year."[21]

Consumer Confidence

The backbone of the U.S. economy is its consumer base. Consumers influence U.S. economic outlook immensely through their spending and savings decisions. As such, measures of consumer confidence and sentiment may provide valuable information in discerning the expected outlook of the economy.

The University of Michigan's June 2020 *Surveys of Consumers*[22] reported the following results, which indicate a decrease in consumer confidence when compared to both May 2020 and June 2019.

UNIVERSITY OF MICHIGAN SURVEYS OF CONSUMERS					
	Jun-20	**May-20**	**Jun-19**	**M-M Change**	**Y-Y Change**
Index of Consumer Sentiment	78.1	72.3	98.2	8.0%	-20.5%
Current Economic Conditions Index	87.1	82.3	111.9	5.8%	-22.2%
Index of Consumer Expectations	72.3	65.9	89.3	9.7%	-19.0%
Source: University of Michigan, Surveys of Consumers, Preliminary Results for June 2020					

[17] U.S. Bureau of Economic Analysis. Who We Are.
[18] Gross Domestic Product, 1st Quarter 2020 (Third Estimate); Corporate Profits, 1st Quarter 2020 (Revised), U.S. Bureau of Economic Analysis. June 25, 2020.
[19] Ibid
[20] June 2020 ISM Report On Business. Institute for Supply Management. July 1, 2020.
[21] Ibid.
[22] Surveys of Consumers. University of Michigan. Final Results for June 2020.

Surveys of Consumers chief economist, Richard Curtin, noted the key points for the June 2020 results:[23]

- Consumer sentiment slipped in the last half of June, although it still recorded its second monthly gain over the April low. While most consumers believe that economic conditions could hardly worsen from the recent shutdown of the national economy, prospective growth in the economy is more closely tied to progress against the Coronavirus. The early reopening of the economy has undoubtedly restored jobs and incomes, but it has come at the probable cost of an uptick in the spread of the virus.
- The Sentiment Index rose by just 0.5 Index-points among Southern residents in June, and by only 3.3 Index-points among Western residents. In contrast, the Sentiment Index among residents of the Northeast rose by an all-time record of 19.1 Index-points in June, with residents apparently expecting the later, more gradual reopening to produce, at worst, a negligible increase in infections. The resurgence of the virus will be accompanied by weaker consumer demand among residents of the Southern and Western regions and may even temper the reactions of consumers in the Northeast. As a result, the need for additional fiscal policies to relieve financial hardships has risen.
- Unfortunately, confidence in government economic policies has fallen in the June survey to its lowest level since President Trump entered office. The need for new relief programs is urgent and would best be accomplished before the national elections dominate the debate.
- The median expected year ahead inflation rate was 3.0% in June, just below last month's 3.2%, but above last year's 2.7%. The recent rise in inflation expectations reflects a shift in consumer purchases from the full range included in the CPI market basket to be more heavily focused on food purchases, which posted an annual gain of 4.8% in May, reflecting a basic thesis of Mr. Curtin's new book that consumers tailor their inflation expectations to the prices they actually face in the marketplace. Consumers do not expect a sustained increase, as long-term inflation expectations fell to 2.5%, down from 2.7% last month.
- Some consumers view the currently low prices for household durables, vehicles, and homes as strong reasons to act before they vanish, and some consumers judge their future job and income prospects too uncertain at present and, thus, favor postponement. Recent shifts in the balance of opinion has marginally moved concerns from job and income uncertainty, which peaked during the shutdown, to the greater availability of low prices and available credit in the past month. While the ongoing shift will translate into higher month-to-month sales gains, the overall level of discretionary spending will remain depressed. Moreover, those gains are likely to be lessened by a slowdown in reopening the economy in the months ahead.

Housing and Construction

In June 2020, the Dodge Momentum Index dropped 6.6 percent from the May reading of 130.1.[24] The Momentum Index, issued by Dodge Data & Analytics ("Dodge") is a monthly measure of the first (or initial) report for nonresidential building projects in planning, which have been shown to lead construction spending for nonresidential buildings by a full year. The June decrease for the Momentum Index reflected an 11.7 percent decrease by its institutional component and a 3.5 percent decrease by its commercial component.[25]

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[23] Surveys of Consumers. University of Michigan. Commentary by *Surveys of Consumers* chief economist, Richard Curtin.
[24] Dodge Momentum Index Loses Ground in June. Dodge Data & Analytics. July 8, 2020.
[25] Ibid.

Dodge Data & Analytics opined, "The Momentum Index has shifted noticeably lower as the fallout from recession continues to hold its grip on the construction sector. The overall Momentum Index fell 13% in the second quarter from the first three months of the year, with the commercial component 14% lower and the institutional component down 11%. While the recession has ended and recovery underway, the return from one of the steepest downturns in U.S. history will be slow and fraught with risk. This holds true for the construction sector as well. While projects continue to enter planning, the slower pace suggests that recovery in the construction sector will be modest in coming months."[26]

In June, seven projects, each with a value of $100 million or more, entered planning. The leading commercial projects were a $200 million warehouse in Windsor, CT and a $200 million office building in Somerville, MA. The only institutional project over $100 million was a $115 million emergency room addition in Johnson City, NY.[27]

Interest Rates

The Federal Reserve voted in early June to keep interest rates near zero. The Fed also hinted that the rates will stay near zero until the economy recovers from the Coronavirus pandemic.[28]

As of June 30, 2020, the prime interest rate is 3.25 percent.[29] The prime rate is posted by a majority of the top 25 (by assets in domestic offices) insured U.S. chartered commercial banks and is one of the several base rates used by banks to price short-term business loans. While the Federal Reserve does not control the prime rate, many banks base their prime rates partly on the target level of the federal funds rate (the rate that banks charge each other for short-term loans) as established by the FOMC.[30]

In public markets, asset prices continually change with changes in future expectations. Thus, the impact on publicly traded equity valuations is focused not necessarily on the trend of lower future interest rates but, rather, whether or not the current expectations are higher or lower than previous estimates. The anticipated impact of interest rate expectations on the expected overall cost of capital and equity valuations cannot be readily discerned, as other variables necessary to make such a generalization are unknown.

However, in analyzing changes in the expected level of the S&P 500 Index, we are able to discern if economic conditions have evolved in a way that would generally suggest higher or lower equity values.

The Coronavirus wreaked havoc on the stock market in the first quarter of 2020. The S&P 500 recorded its worst start to a year since the recession in 2008, down 20 percent after the first three months of 2020.[31] Similarly, the Dow Jones Industrial Average (DJIA) recorded its worst first quarter of a year in its history, experiencing a 23 percent drop from the start of the year.[32]

However, the second quarter of 2020 was a different story, as the DJIA ended the quarter with a 17.8% gain. That is the average's biggest quarterly rally since the first quarter of 1987, when it shot up 21.6%. The S&P 500 had its biggest one-quarter surge since the fourth quarter of 1998, increasing nearly 20%.[33]

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[26] Ibid.
[27] Ibid.
[28] Fed sees interest rates staying near zero through 2022, GDP bouncing to 5% next year. CNBC. Cox, Jeff. June 10, 2020.
[29] Board of Governors of the Federal Reserve System, Select Interest Rates, Bank Prime Loan.
[30] What is the prime rate and does the Federal Reserve set the prime rate? Federal Reserve Board of Governors, Current FAQs.
[31] Stock Market News for Apr 1, 2020. Yahoo Finance. Zacks Equity Research. April 1, 2020.
[32] Ibid.
[33] Dow rallies more than 200 points to close out its best quarter since 1987. CNBC. Imbert, Fred. June 29, 2020.

A combination of stimulus, positive trends in the virus, economic reopening and hopes for a vaccine drove stocks higher in Q2, wrote Tom Essaye, founder of *The Sevens Report*. Essaye added, “As we begin Q3, only one of those tailwinds is currently in place: Stimulus. That doesn’t mean we’ll see a correction, but be suspect of market rallies until we can add more forces supporting stocks, because we’re one stimulus disappointment away from an ugly day.”[34]

Economic Outlook – Conclusion

The novel Coronavirus continued to plague the United States economy in the second quarter of 2020. The tourism industry was hit especially hard due to occupancy restrictions in many states.

Legislators worked to pass more assistance for small businesses and those hit hardest by the pandemic. On a positive note, the stimulus from the government was a contributing factor to the stock market seeing its biggest quarter-over-quarter increase since 1998.

Therefore, the future of the United States economy moving towards the third quarter of 2020 widely hinges on the severity of the impact of the Coronavirus.

[34] Ibid.