Center for Finance and Economics
Economic Outlook Report - Fall 2020

Economic Summary

Going into 2020, many economists predicted growth between 2 to 3 percent. Coming out of 2019, the economy was performing well with year-to-year quarterly and average yearly growth above 2 percent. Employment was strong throughout the economy, with all subgroups participating and those traditionally with the highest unemployment seeing the greatest gains. Inflation remained relatively stable between 2 to 2.5 percent.

Towards the end of January, news regarding COVID-19 began to surface with pandemic lockdowns announced in Wuhan and surrounding areas in China. As the virus spread, additional lockdowns in China were announced and the rest of the world began taking notice. By the middle of March, the lockdowns had extended to many other parts of the world, including the United States. As the first quarter came to a close, the U.S. economy was beginning to slow. Economic output for the quarter fell by $243 million, or 1.26 percent quarter-to-quarter. The inflation rate was falling and the unemployment rate was on the rise.

The full force of the economic lockdowns took hold during the second quarter of the year. The unemployment rate increased dramatically from 4.4 percent in March to 14.7 percent in April, the largest month-to-month increase on record. The labor force participation rate decreased from 62.7 percent to 60.2 percent, its lowest rate since 1973. Nonfarm payrolls decreased by 20.5 million workers, the worst decrease since World War II. Especially hard hit were the leisure and hospitality industries, with a reduction in employment of 47 percent.

The inflation rate declined significantly from April to May, with year-to-year headline inflation bordering on deflation due to sharp reductions in prices of food and energy. June saw a stabilization in the energy markets and food prices began to rise as demand for out-of-stock items precipitated an increase at both the wholesale and retail levels. By the end of June, headline inflation stood at 0.6 percent and core inflation at 1.2 percent.

The lockdowns began to ease through May and June, but the damage had already been done. Economic output decreased by 9 percent quarter-to-quarter and 31.4 percent on a yearly seasonally-adjusted basis. Consumption declined from the first quarter by 9.5 percent, but the most affected component was investment, which fell by 14.5 percent. While all three major areas of private fixed investment were affected, significant decreases were recorded in structures and equipment, which continued decreases already experienced from the first quarter.

As hard hit as the economy was in the second quarter, the third quarter experienced a similar dramatic change, except in the opposite direction. The Bureau of Economic Analysis advanced estimate indicated a 7.4 percent increase in quarter-to-quarter real GDP and 33.1 percent on a yearly seasonally-adjusted basis. Consumption increased by 8.9 percent and investment by 16.3 percent quarter-to-quarter. During the quarter, prices rose gradually from July into August, but settled at 1.4 percent and 1.7 percent in September for headline and core inflation, respectively. The employment picture improved as well. Beginning in May, the unemployment rate continued to decline month-to-month, falling below 8.0 percent in September. Nonfarm payrolls continued to increase and short-term unemployment decreased throughout the quarter.

Thus far, the fourth quarter has seen continued improvements in unemployment, with the national rate falling below 7 percent in October. Real average weekly earnings have shown some improvement as worker hours begin to increase and overall inflation remains unchanged with only slight increase in food and energy. With low interest rates, rising consumer credit scores, and growth in real wages, the quarter is expected to produce around 2 to 3 percent growth on a annual seasonally-adjusted basis. Barring any additional lockdowns through the end of the year, the economy should be able to make significant gains against the decline in economic output that was experienced during the first half of the year.

Economic Output

Though the economy rebounded in the third quarter, and appears to be headed to continued improvement in the fourth quarter, albeit at a slower rate, there are still some significant concerns regarding long-term growth into 2021. Looking back at the previous recession which began in 2008, long-run exponential trends were running at about 0.76 percent growth on a quarter-to-quarter basis. Most peaks and valleys experienced in the economy from 1970 settled back along the general trend line. However, the recovery from the 2008 recession did not produce the same results. The recovery was much more gradual and much less robust. By the time the economy reached the beginning of the most recent recession in 2020, failure to revert to historic patterns wound up costing between 12 to 16 percent in lost growth, or $9,000 to $11,000 of income per person. The primary reason was the slow recovery in investment spending. Compared to previous recessions, investment spending took the longest time to recover after the 2008 recession, by three quarters, from its pre-recession levels. The 2020 recession seems to have had a far smaller impact on investment spending, but this is an area that must be watched closely to get an accurate gauge of the length of time for the economy to experience a full recovery.

Re-trending GDP from the end of the 2008 recession yields a quarterly exponential growth rate of 0.57 percent. Given the performance of the economy thus far, in order for the economy to return to its current growth trend, fourth quarter growth would need to be approximately 6 percent, or 24 percent on an annually seasonally-adjusted basis. Our current forecast does not envision this type of recovery, but we do expect fourth quarter growth between 2 to 3 percent, annually seasonally-adjusted.

Overall, our primary concern regarding growth is 2021. In our view, investment is the key component to long-run, sustainable economic growth. Though consumption makes up approximately 70 percent of GDP, the correlation between changes in consumption spending and changes in GDP since 2000 is +0.06, or relatively no correlation at all. Consumption is its own engine. It has grown consistently over the past 50 years with very little variability. Investment, on the other hand, has a correlation with changes in GDP of +0.61 and a variability of 3.28 percentage points. Since 1970, of the four major components of GDP, investment spending has the highest average quarterly growth rate (0.99 percent) and has overtaken government spending as the second highest contributor to overall GDP. In some sense, while consumption spending keeps the ship afloat, investment spending determines its direction. Thus far, most government spending focused on pandemic relief has been geared to the consumer, which is understandable, but without due consideration to investment spending, it may be a rehash of the 2008 recovery.

Employment

The employment picture has improved significantly since April. Since the high of 14.7 percent, unemployment has fallen each month to its current rate of 6.9 percent. However, there are still some lingering concerns with the overall employment picture. African Americans, as a group, had made some significant gains in employment. Prior to the recession, the unemployment rate for African Americans had fallen to its lowest level since unemployment data had been collected. In addition, in comparison to Whites, African American unemployment was more than 3 percentage points below its 20-year comparable average. Unfortunately, the 2020 recession wiped out most of the gains African Americans had made in this area, which was also true for Hispanics as well. While both ethnic groups have recovered some lost ground since April, continued improvement in the labor market will be important to recoup gains in the long run.

Inflation

Prices have shown some improvement over the last few quarters and are expected to stabilize into the coming year. The depressed energy markets are improving and, barring a rapid increase in oil production in the Middle East, should continue to gain traction. However, two competing forces could determine the overall position of the market going forward. A second round of government shutdowns due to rising Covid-19 cases would likely increase the supply of oil on the market, adversely affecting prices. On the opposite end, the Biden Presidency would almost certainly lead to some level of increased limitations and/or restrictions on fracking, which could have a significant impact on oil production in the United States. How these two factors play out will determine much about the course of energy prices.

Notwithstanding the issues related to the energy market, prices in general seem to be stabilizing. Although year-to-year measures of inflation are still below their long-run trends, month-to-month measures for headline and core CPI and PCE are now at trend. If the economy can maintain its expected growth in the fourth quarter, there should be some price inflation going forward. A return to 2 to 2.5 percent price inflation on a year-to-year basis should be a reasonable expectation for 2021.

Economic Outlook

There are many uncertainties facing 2021. A second wave of the virus, more restrictive lockdowns, an emphasis on shoring up short-term consumption spending at the expense of long-term investment spending, are all concerns facing the new year. In addition, a new Biden presidency may bring with it higher corporate taxes and increased regulations. Because of the number and significance of these unknowns, we are predicting a very conservation 2 percent growth in 2021. We expect price inflation to stabilize around 2 percent; somewhat lower than long-run trends, but certainly not deflation. Government stimulus and Federal Reserve action should help buoy prices into the near future. We also expect the unemployment rates to continue to fall, but not to the levels under the previous Trump administration. A U.S. unemployment rate of 5.5 percent is our prediction for the coming year. With so many unknowns, it’s hard to be too optimistic. We would rather err on the side of caution, and be pleasantly surprised, than overestimate and wind up with another 2019.

- The Economic Outlook Team