U.S. Outlook

SCOTT ANDERSON, Ph.D. | Chief Economist | 415.765.8020 | bankofthewest.com

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Date	Indicator	For	Estimate	Consensus*	Previous Period
24-Aug-2020	Chicago Fed Nat Activity Index	Jul	NA	3.88	4.11
25-Aug-2020	FHFA House Price Index MoM	Jun	0.3%	0.4%	-0.3%
25-Aug-2020	S&P CoreLogic CS 20-City MoM SA	Jun	0.10%	0.10%	0.04%
25-Aug-2020	Conf. Board Consumer Confidence	Aug	90.6	93.2	92.6
25-Aug-2020	New Home Sales	Jul	780k	775k	776k
25-Aug-2020	Richmond Fed Manufacturing Index	Aug	7.0	10.0	10.0
26-Aug-2020	Durable Goods Orders	Jul P	1.0%	4.0%	7.6%
26-Aug-2020	Durables Ex Transportation	Jul P	1.8%	2.5%	3.6%
27-Aug-2020	GDP Annualized QoQ	2Q S	-31.9%	-32.5%	-32.9%
27-Aug-2020	GDP Price Index	2Q S	-1.8%	-1.8%	-1.8%
27-Aug-2020	Initial Jobless Claims	22-Aug	1090k	NA	1106k
27-Aug-2020	Pending Home Sales MoM	Jul	9.0%	5.8%	16.6%
27-Aug-2020	Kansas City Fed Manufacturing Activity	Aug	2.0	NA	3.0
28-Aug-2020	Advance Goods Trade Balance	Jul	-$72.7b	-$71.0b	-$70.6b
28-Aug-2020	Wholesale Inventories MoM	Jul P	-1.0	NA	-1.4%
28-Aug-2020	Personal Income	Jul	-1.9%	-0.1%	-1.1%
28-Aug-2020	Personal Spending	Jul	1.5%	1.5%	5.6%
28-Aug-2020	PCE Deflator MoM	Jul	0.5%	0.4%	0.4%
28-Aug-2020	PCE Core Deflator MoM	Jul	0.5%	0.5%	0.2%
28-Aug-2020	PCE Core Deflator YoY	Jul	NA	1.2%	0.9%
28-Aug-2020	U. of Mich. Sentiment	Aug F	72.9	72.8	72.8

*Consensus from Bloomberg

Financial Stability Concerns On The Rise

The most sobering section of the July Federal Open Market Committee Minutes, for me, was the description and discussion on financial system stability. We are already in the midst of an economic recession that appears at least twice as bad as the worst days of the Great Recession, yet after a brief initial period of financial market panic followed by aggressive intervention by the Federal Reserve to stabilize financial conditions an eerie calm has returned to credit, money market, and equity markets almost as if nothing untoward ever occurred to the economy or the markets.

Equity prices have gone ballistic, in many cases surpassing all-time highs in just a few short months, and financial risk taking is on the rise across many markets. However, a close read of the FOMC minutes for July show that the Fed has become even more alarmed not less that another severe financial shock could be brewing beneath the surface of these calm financial waters.

The Fed staff described the financial vulnerabilities of the U.S. financial system as “notable” today. For the normally understated Fed, using the word “notable” to describe financial vulnerabilities is equivalent to a fire station ringing the alarm bells on a 5 alarm fire in the middle of the night.

They go on to say that asset valuation pressures themselves are “notable”. In non-Fed speak, the Fed is worried stock and bond prices may be too high given the fundamentals. They single-out high-yield and investment grade corporate bond yields for being within historical norms when credit quality of nonfinancial corporates has clearly deteriorated further over the intermeeting period. A sizable volume of speculative-grade debt was downgraded in June, while defaults in May and June were at their highest level since 2009 and future default expectations deteriorated as well. Moreover, the credit quality of municipal debt continued to show signs of weakness.

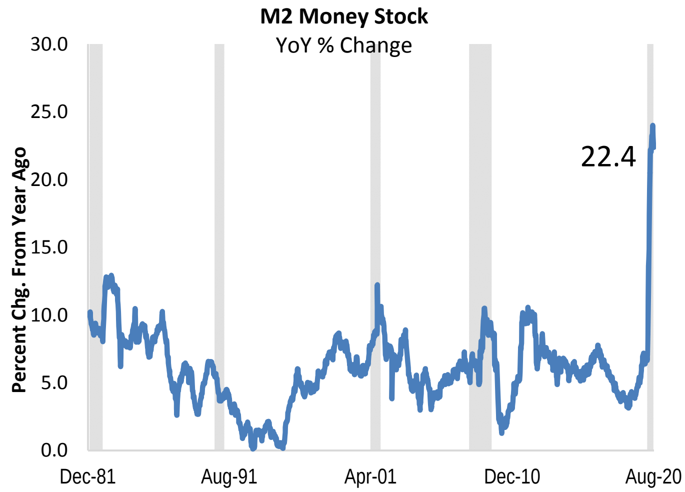
On commercial real estate prices, the Fed staff noted that CRE prices were continuing to increase despite rising vacancy rates. This reminds me to the pre-financial crisis period before the Great Recession, when investors couldn't get enough of CMBS and MBS in late 2006 and early 2007 and were bidding up prices when housing demand was already on a clear decline.

And the Fed doesn't stop there, they are also concerned about rising leverage almost across the board. Non-financial leverage has risen as household incomes and business profits have declined, creating less resilient borrowers. Household debt and corporate debt to GDP ratios are on the rise, and were already at historically high levels on the corporate side to begin with. Financial leverage risk was upgraded to moderate from low as banks face higher business loan losses and leverage increases among the non-bank financial institutions.

A number of FOMC participants commented on various potential risks to financial stability, especially if one of the more adverse scenarios regarding the spread of the virus and its effects on economic activity was realized. Nonfinancial corporations carried high levels of indebtedness going into the pandemic, increasing their risk of insolvency.

The Fed's aggressive actions early in this pandemic to expand their asset purchases, and create emergency liquidity and lending facilities has been instrumental in restoring investor confidence and risk taking and kept vital capital and credit flowing to consumers and business. These monetary policy changes have been so successful that they have largely restored near-normal functioning across a broad cross-section of funding markets.

A Money Driven Financial Bubble???



Source: Federal Reserve System

But they have also allowed investors to overlook the insolvency and default issues still very much lurking beneath the surface of the water. And without significant further economic improvement backed by full-throated government stimulus, I fear the leverage, insolvency and default problems will soon begin to break the surface of the calm financial waters investors have been sailing in. As anyone who lived through the 2007 and 2008 financial crisis knows, once the deleveraging starts and defaults begin to surge, it will be difficult if not impossible to stop the chain reaction in asset valuations and shield the economy from the collateral damage. In short, the delay and downsizing of the next Federal fiscal rescue package not only puts the unemployed at risk, but the stability of our entire financial system that appears more vulnerable today than it was when this pandemic began.

Key Economic and Interest Rate Forecasts

	History						Forecast						Yr/Yr % chg or Annual Avg.			
Economic Data	**2019.1**	**2019.2**	**2019.3**	**2019.4**	**2020.1**	**2020.2**	**2020.3**	**2020.4**	**2021.1**	**2021.2**	**2021.3**	**2021.4**	**2018**	**2019**	**2020**	**2021**
Real GDP*	2.9	1.5	2.6	2.4	-5.0	-32.9	26.0	4.1	4.8	4.2	3.3	3.3	3.0	2.2	-4.3	4.0
Personal Consumption Expenditures*	1.8	3.7	2.7	1.6	-6.9	-34.6	36.8	5.8	3.4	3.1	2.6	2.5	2.7	2.4	-4.0	4.8
Non-residential Fixed Investment*	4.2	0.0	1.9	-0.3	-6.7	-27.0	-0.2	-4.7	1.4	2.5	3.2	3.0	6.9	2.9	-7.4	-1.5
Private Housing Starts (000s units)	1,204	1,257	1,288	1,433	1,484	1,064	1,210	1,160	1,190	1,195	1,210	1,230	1,208	1,296	1,230	1,206
Vehicle Sales (mill. Units, annualized)	16.9	17.0	17.0	16.8	15.0	11.4	14.3	14.5	14.7	15.0	15.2	15.3	17.2	16.9	13.8	15.1
Industrial Production*	-1.9	-2.3	1.1	0.4	-6.7	-43.2	22.0	8.0	6.0	5.3	4.5	4.4	3.9	0.9	-8.6	3.9
Nonfarm Payroll Employment (mil.)	150.2	150.6	151.2	151.8	151.9	133.7	140.1	141.1	142.9	144.5	146.2	147.8	146.6	150.9	141.7	145.3
Unemployment rate	3.9	3.6	3.6	3.5	3.8	13.0	10.0	9.5	9.2	8.5	7.4	6.3	4.4	3.7	9.1	7.9
Consumer Price Index* (percent)	0.9	3.0	1.8	2.4	1.2	-3.5	2.0	1.2	1.0	1.0	1.3	1.4	2.4	1.8	0.8	0.9
"Core" CPI* (percent)	2.2	2.2	2.8	2.0	2.0	-1.6	1.2	1.2	1.3	1.4	1.4	1.5	2.1	2.2	1.3	1.1
PPI (finished goods)* (percent)	-2.7	4.7	-1.2	3.0	-3.4	-10.7	5.0	2.0	0.1	0.9	1.6	1.7	3.0	0.8	-1.5	0.8
Trade Weighted Dollar (Fed BOG, major)	114.5	115.4	116.5	116.4	117.9	122.2	118.5	118.0	117.5	117.3	117.0	116.5	91.1	115.7	119.1	117.1
Crude Oil Prices -WTI ($ per barrel)	55	60	56	57	45	28	40	39	38	38	39	39	51	57	38	39

*Quarterly Data Percent Change At Annual Rate; Annual Data Year-on-Year % Chg, or Annual Average.

	History						Forecast						Annual Average			
Financial Data	**2019.1**	**2019.2**	**2019.3**	**2019.4**	**2020.1**	**2020.2**	**2020.3**	**2020.4**	**2021.1**	**2021.2**	**2021.3**	**2021.4**	**2018**	**2019**	**2020**	**2021**
S & P 500	2,721	2,882	2,958	3,083	3,056	2,932							2,449	2,911		
Dow Jones Industrial Average	25,147	26,096	26,676	27,537	26,554	24,571							21,745	26,364		
Federal Funds Rate (effective)	2.40	2.40	2.20	1.65	1.23	0.06	0.13	0.13	0.13	0.13	0.13	0.13	1.00	2.16	0.39	0.13
Treasury-3 Month Bills (yield)	2.44	2.35	2.03	1.61	1.10	0.14	0.10	0.11	0.12	0.13	0.13	0.14	0.95	2.11	0.36	0.13
Treasury-2 Year Notes (yield)	2.49	2.13	1.69	1.59	1.08	0.19	0.15	0.16	0.18	0.20	0.21	0.23	1.40	1.97	0.39	0.20
Treasury-5 Year Notes (yield)	2.46	2.12	1.63	1.61	1.14	0.36	0.29	0.31	0.34	0.37	0.40	0.42	1.91	1.96	0.52	0.38
Treasury-10 Year Notes (yield)	2.65	2.34	1.80	1.79	1.37	0.69	0.61	0.68	0.75	0.78	0.85	0.90	2.33	2.15	0.83	0.82
Treasury-30 Year Notes (yield)	3.01	2.78	2.29	2.25	1.87	1.38	1.30	1.41	1.52	1.56	1.64	1.70	2.90	2.58	1.49	1.60
Prime Rate	5.50	5.50	5.31	4.83	4.43	3.25	3.25	3.25	3.25	3.25	3.25	3.25	4.10	5.29	3.54	3.25
Libor 3-Mo. U.S. Dollar	2.69	2.51	2.20	1.93	1.53	0.60	0.27	0.28	0.29	0.29	0.29	0.29	1.26	2.33	0.67	0.29
Mortgage-30 Year (yield)	4.37	4.01	3.66	3.70	3.52	3.24	3.15	3.20	3.25	3.25	3.25	3.30	3.99	3.94	3.28	3.26
BAA Corporate (yield)	4.97	4.60	4.03	3.91	3.91	3.91	3.36	3.58	3.75	3.88	4.15	4.20	4.44	4.38	3.69	3.99

Source: Bank of the West Economics, Bloomberg, Federal Reserve