Economic Outlook

The U.S. Federal Reserve's (Fed) framework review has produced some interesting insights, beyond simply allowing inflation to temporarily run above the 2% target.

The new reaction function of the Fed seems to be out of balance for both employment and inflation.

The new maximum employment goal still lacks a proper definition and structural challenges ahead could well tilt monetary policy further toward accepting moderate inflation overshoots.

The Fed had promised an "… evolution, not a revolution …" and on that, they delivered at the September monetary-policy meeting.

Keep in mind that an evolution is a developmental process from something simple to something more complex and the new framework will get far more complex. Sounds like something from the governments Department of Redundancy Department.

The 2020 forecast for real GDP growth have generally been upwardly modified to -4.6% from -6.4% considering the stronger than expected data in personal consumption, manufacturing and housing and lowered for 2021 to 3.8% from 4.2% due to a stronger base at year-end 2020.

The stronger economic activity of recent months is the result of the massive and timely policy support early in the crisis and a quick pace of reopening.

The momentum of the rebound is slowing and more fiscal stimulus is warranted if mobility restrictions, both regulatory and/or behavioral, are to continue and unemployment remains elevated. The risk of a double dip is increasing with Q4 growth possibly turning negative.

Current GDP forecast trajectory implies that COVID-19 will trim a bit more than 4% of the pre-pandemic output level by year-end 2020. Fiscal policy remains the most important force for the recovery over the short-to-medium term.

The daily average of new COVID cases in the US continues to decline, albeit at a slower pace, having averaged 61K in July, 48K in August and just shy of 40K in September.

Real personal consumption expenditures increased by 0.7% in August, making it the fourth consecutive month of growth, although slowing.

Disposable personal income is also declining, down 3.5% month-on-month in August, a clear indication that the economy needs further stimulus.

Despite the drop in income, the Conference Board's consumer confidence index increased by 15.5 points in September, the sharpest rise in 17 years, attributable in part to the strong, recovery in employment.

Manufacturing output is doing well, with a fourth consecutive month of growth at a more moderate pace. The drop in the manufacturing of motor vehicles and parts was more than offset by the increase in other durable goods.

The Purchasing Managers' Index (PMI), an index of the prevailing direction of economic trends in the manufacturing and service sectors, decreased slightly in August, but was still solidly over the set threshold value indicating an expansion of manufacturing.

The economy added 661K jobs in September and the unemployment rate fell to 7.9%. There were notable job gains in activities related to leisure and hospitality, retail trade and in professional and business services.

High-wage workers are facing 1.6% less jobs than before the pandemic, whereas low-wage

workers a 16.1% drop.

Consumer spending in high-income ZIP codes is 9.6% lower than what it was pre-COVID as the nature of their spending is more focused on leisure activities and travel, while for low income earners it is up 3.6% because of its focus on essential goods and services and an effective income replacement by the various stimulus payments.

These two differing trends point to a split of the labor market and consumer spending specific to their income level.

New and existing houses increased 2.4% in August, fueled by low mortgage rates and consumer desire to move to less densely populated suburbs.

The Case-Shiller home price index increased by 4.8% in July fueled by a substantially reduced inventory and the rapidly increasing demand for houses. After three months of double-digit month-on-month increases, housing starts, decreased in August by 5%.

Despite the fall in housing starts, the National Association of Home Builders (NAHB) confidence index rose in September to an all-time high.

Builders in the survey mentioned that the rising cost of material and delays in delivery of lumber were some impediments they were facing, driving up the cost of new construction.

On the fiscal policy front, this week, the Senate increased its stimulus proposal to a $1.5 trillion stimulus package, still shy of the $2.2 trillion that the House of Representatives was seeking.

Nonetheless, it appears that there will not be any further fiscal stimulus for the rest of 2020 given the increasing hostility of the presidential campaign, but a new package should come through in 2021.

As for monetary policy, stimulus is here to stay and the Fed is expected stay firmly in place until at least 2024, allowing for inflation to run above target for a prolonged period of time and making up for the below target levels of inflation of the past decade.

With the labor-market recovery losing momentum and extended fiscal benefits fading out, the consumer could face some hard decisions in the near term.

Personal-income data shows that some households still enjoy significantly higher than pre-crisis savings, as well as a comfortable income cushion from unemployment transfers, but only through September, before they too face financial issues.

The ultimate relief of the situation would be another round of fiscal support for households, and not just monetary support for the consumer. We need financial support for small and medium-sized businesses, as well as for state and municipalities.

It is somewhat reassuring that the Fed has given itself plenty of flexibility with respect to the resulting uncertainty for financial markets,

The Fed, once again, has promised to utilize all available tools to achieve their dual mandate.