Economic Outlook

Shortly after the UK gave emergency authorization to a Covid-19 vaccine, the U.S. Food and Drug Administration (FDA) followed suit and the first vaccine shots have been administered, both in the UK and the United States.

We believe that this marks only the beginning of the end of the pandemic and there is still a long and a challenging road ahead.

The initial amount of vaccine shots available will be limited and most of the population may have to wait until the middle or end of 2021.

Other promising vaccine candidates, currently awaiting authorization, will not change this. Furthermore, it is probably safe to assume that a large-scale project like the roll out of a new vaccine is likely to encounter some hiccups along the way.

The labor market is showing signs of moderation. The U.S. Bureau of Labor Statistics reported another decline in the November headline unemployment rate to 6.7% from 6.9%, but only 344,000 new jobs were created in the private sector.

Total nonfarm payroll employment also declined by 140,000 in December and the unemployment rate was unchanged at 6.7%.

The high correlation of the service sector to the negative forces of the pandemic has been the main driver. Hiring in services, especially restaurant workers and retail sales help, dropped to 289,000 from 770,000.

Additionally, weaker hiring in manufacturing and a fall in jobs in the government sector are adding momentum to the downbeat picture.

U.S. retail sales are projected to fall by as much as 4% in December, according to consulting firm Berkeley Research Group (BRG). The top driving factors include earlier holiday shopping in October and November, rising Covid-19 cases nationwide and dropping consumer sentiment.

This view might well be largely shared by the U.S. Federal Reserve (Fed). The Fed Chair, Jerome Powell, emphasized in the December Federal Open Market Committee (FOMC) meeting that the outlook remains highly uncertain.

While welcoming the emergence of vaccines, he downplayed their likely impact in the truly short term but expects that vaccines should enable the economy to perform strongly only in the second half of 2021.

The updated Summary of Economic Projections therefore do not indicate a change of Fed policy in the medium run.

Despite more optimism on growth and employment in 2020 and 2021, inflation is forecasted to remain below the 2% target.

Only by 2023 are inflation and unemployment forecasts at levels that most likely reflect what the Fed would currently see as a full recovery. There was a wide range of growth expectations for 2021 among the participating economists.

Overall, however, most economists judge the risks to gross-domestic-product (GDP) growth broadly balanced, though some still see them weighted to the downside.

Our take, given the short-term uncertainties, is that the Fed will remain in a reactive mode, standing ready to act should financial conditions deteriorate. An increase of asset purchases

or maturity extension remains in the cards if the situation requires it, as Powell hinted during the FOMC press conference on December 16.

Fiscal spending restraint is unlikely from the new administration with a single party in control of Congress and an economy so injured by the pandemic.

Additional economic support and stimulus programs are likely within the first 100 days, including more assistance for those unemployed, state, and local government agencies and medical response.

More stimulus checks to households and grants to businesses are likely, but perhaps on a greater need basis than before.

It is projected that this expected additional pandemic spending could exceed an additional 1 trillion U.S. dollars, bringing total 2020-2021 pandemic spending to over 4 trillion dollars or 20%+ of gross domestic product (GDP).

This crisis spending is before the new administration and Congress explore new programs ranging from infrastructure investment to stronger social safety nets and more entitlements.

Spend now and tax later, or until the bond market objects, will probably be the advice of President Elect Biden's economic advisors.

The bond market will assess how effective this spending promotes strong economic growth versus waste and the credibility of backing off crisis spending and/or hiking taxes in the future to restore fiscal health.

Interest rates might move higher on inflation expectations, if the Federal Reserve (Fed) is not clear in its commitment to limit inflation's climb, or on higher real interest rates if budget deficits burden the savings pool.

Kicking the fiscal can down the road does not necessarily lead to high inflation if the Fed eventually acts to contain inflation when it gets to target.

However, there is still risk that overly expansive fiscal policy, brings significantly higher real interest rates. If overnight rates stay too low for too long, the curve will steepen.

The ascent in Treasury yields started on January 6, 2021 and should be slow, but it could quicken if deficit spending is excessive.

Federal Reserve actions have a fundamental influence on long-term inflation, but not on long-term real interest rates.

If the Fed attempts to fight rising real yields from fiscal excess or rising yields from rising inflation expectations risk with more asset purchases, it would likely further raise inflation expectations and inflation risk and eventually could cause a vicious upward rate spiral.

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