Trend Macro™

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MACROCOSM

Do We Need More Stimulus?

Monday, December 14, 2020

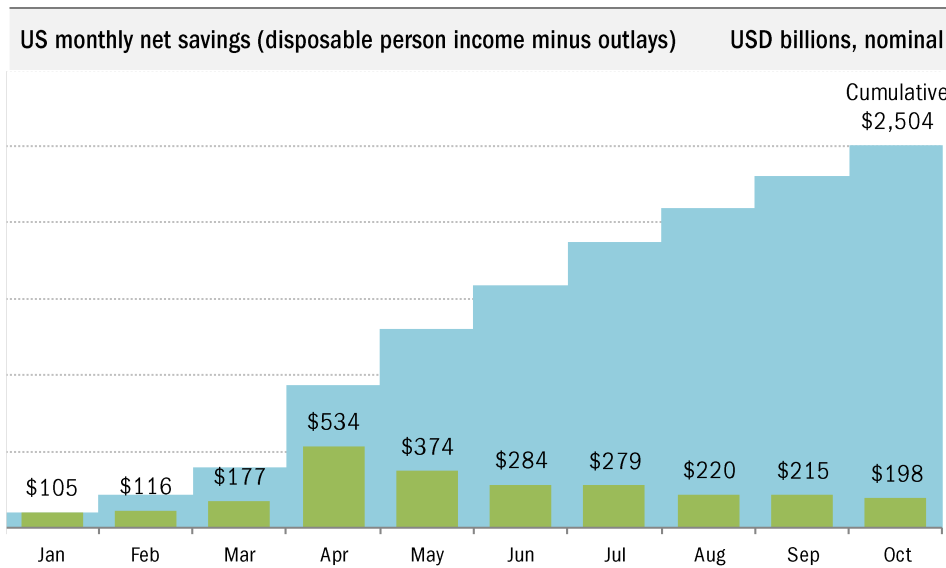
Donald Luskin

Nice, yes. Need? No. Either way we're winning World War "V" and 2021 could be a boom.

In client calls this week, we're hearing a strong consensus that the economy is in a sustainable V-shaped recovery, and that 2021 will be a very good year. *We're not going to say this consensus is wrong*. Indeed, it's what we were nearly alone in predicting all the way back in March and April (see "Video: What you're not hearing about the third wave of Covid-19 and the V-shaped recovery" December 3, 2020). And we don't mind being in-consensus with our clients, who are the smartest people in the world (seriously).

- *Will there be short-term setbacks? Of course, and the formation of a consensus is what usually provokes one.* With equities at all-time highs and Treasury yields near new recovery highs, the S&P 500 equity risk premium is below the post-Global Financial Crisis mean, and about as narrow as it's been this year, despite a strong forward earnings resurgence (please see the chart on the following page). Good time for a long-overdue post-election correction, leading to a buyable dip. More on this in a moment.
- *If anything, our biggest difference from the optimistic consensus is that we're now thinking past recovery to expansion, and we don't see it as a stretch that 2021 could be a downright boom*.

US monthly net savings (disposable person income minus outlays) USD billions, nominal



Source: BEA, TrendMacro calculations

Update to strategic view

US MACRO, US STOCKS, US BONDS: There's a strong client consensus that the V-shaped recovery from the lockdown recession is on track, following months of pessimism. We don't disagree, though such a consensus, coming as the S&P 500 equity risk premium is at new post-recession lows, probably means a short-term buyable dip is coming. Many think further recovery is contingent on more stimulus from Congress. We don't expect any, but the resolution of the two Georgia Senate run-offs in January might change the dynamic of gridlock. But US households have accumulated $2.5 trillion in personal savings this year, unable or too cautious to spend the prior stimulus money. That's a money-bomb of pent-up demand equal to 11.8% of GDP, and it will detonate next year when the "third wave" of Covid-19 tops out and 50 million inoculations with the new vaccine are administered through January. 2021 should complete the recovery and could embark on a boom as the world celebrates…

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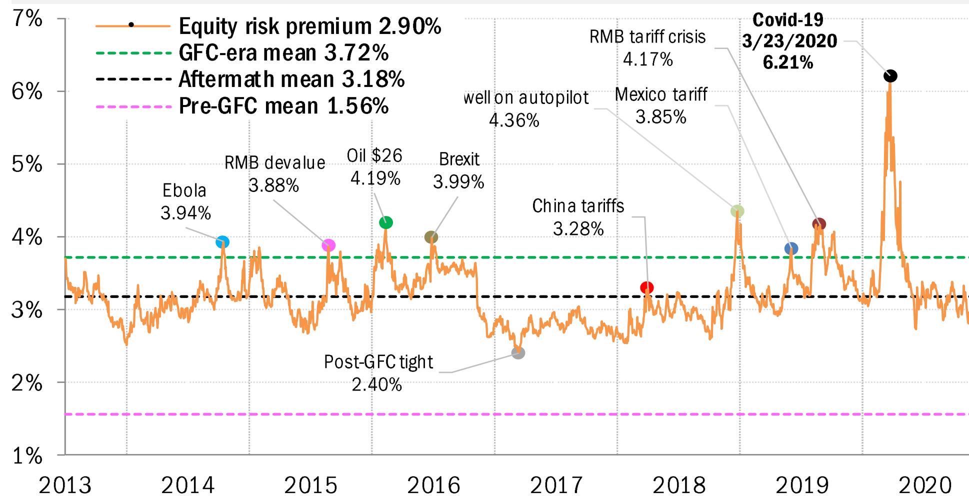
S&P 500 equity risk premium versus 30-year US Treasury in the post-GFC era



Source: Various, TrendMacro calculations

- *And many clients make their upbeat view contingent on a belief that Congress will agree on more stimulus. We don't think there will be new stimulus – but negotiations are ongoing (legislative summaries of new versions will be released this afternoon), so who knows. If negotiations are abandoned, as we expect, it would likely trigger that correction we mentioned. But it would be a buyable dip, because we don't think the economy needs any stimulus.*
- We predicted a stimulus "bidding war" in early March, before the scope of the economic devastation from lockdown was widely appreciated, and the Fed's response was still small and tentative (see "Powell Not to the Rescue" March 4, 2020). Our bet was that in the face of sufficient need, partisan self-interest would drive the GOP and the Democrats to compete to show how responsive they could be – and that's what happened. *Now, despite some economic wobbles induced by some resurgence of social distancing* (see "On the November Jobs Report: Payrolls vs the Third Wave" December 4, 2020), *the need probably isn't sufficient to overcome the politics of mutual assured destruction between the GOP Senate and the Democratic House, with the priority being for each to deprive the other of a victory. If dire need materializes, which we don't expect, so will stimulus. In that sense it's an efficient self-regulating equilibrium.*
- One reason we don't think sufficiently dire need will materialize is that the V-shaped recovery is already something like three-quarters complete *without* March's stimulus having even been used by consumers. *Personal savings have grown by an utterly unprecedented $2.5 trillion this year – just through October, compared to $1 trillion last year – and are still growing at almost twice the monthly rate seen before the pandemic* (please see the chart on the previous page).
- Of the $1.5 trillion by which this year's growth in savings exceeds last year's, we estimate about $640 billion came from stimulus payments (both under the CARES Act and extended

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…winning the war with the virus. A spending surge will trigger a transitory bump in inflation which will support higher Treasury yields. Near-term data is weak, driven by increased social distancing in the "third wave." S&P 500 forward earnings are looking through that, with moderate upgrading even in the present quarter, validating that the virus experience will have created a lost year, but nothing worse. Looking ahead, forward EPS estimates suggest greater than 22% earnings growth next year.

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unemployment benefits paid under President Donald J. Trump's executive orders – see "On Trump's Executive Action Stimulus" August 9, 2020), $400 billion from curtailed personal outlays, and $360 billion from banking non-stimulus disposable personal income gains.

- Whatever the sources, savings are savings, and this is an historic amount of it. *So what would be the point of another round of $1,200 checks or federal unemployment benefit top-ups that pay people more to not work than to work, when the first round hasn't even been spent yet, and the economy is rebounding despite it?*
- This is analogous to the situation with the Federal Reserve's emergency lending programs. They were announced on March 23, the very day of the stock market bottom, so self-evidently they were a big success. Yet while in aggregate they offered $2.3 trillion in credit support across eight separate facilities, there was never even $200 billion in uptake by potential borrowers. We might surmise that markets were so comforted to have the credit *available* that they didn't need the credit. These programs all end at year-end, so we'll see how the world reacts to no longer having them available. *But it would seem that it wouldn't help matters now to prolong them and increase the level of credit support to, say, $4.6 trillion when $2.3 trillion was more than anyone wanted. So, again what would be the point of another round of stimulus when the first round hasn't even been spent?*
- This analysis focuses on the *need* for *stimulus*. But *need per se* isn't the only criterion, and *stimulus per se* isn't the only thing that Congress might provide.
- For example, businesses don't *need* a shield from tort liability arising from Covid-19 safety, but it would help get the economy re-opened more rapidly.
- For example, it's *relief*, not *stimulus*, to give federal assistance to states facing a $121 billion tax collection shortfall for fiscal year 2020.
- We concede that such things would help the economy recover even more quickly than it already is. But these are not *needs* – we think the V-shaped recovery will get accomplished on schedule with our original forecast – by Q1-2021 (see, earliest, "On the March Jobs Report, and Being in Recession (Whatever that Means)" April 3, 2020) – without these things.
- The two non-needs we mentioned – a tort shield, and state relief – are and always have been the thorniest sticking points in negotiations between the GOP and Democrats. *These issues have acted simultaneously as poison pills and as minimum conditions*. Negotiators have not been able to agree to a bill that either accepts both or accepts neither. *That defines the edges of the solution-space absent some new economic shock that would demand redress, so there probably isn't a deal to be done.*
- Democrats may see it as a free option to wait to see the result of the two Georgia Senate run-off elections on January 5. If the GOP candidates lose both, Democrats will have control of the Senate and the House and can pass whatever bill they like – presumably embracing relief for states and offering no tort shield. *We think the*

GOP will win both seats, so in January we'll be right back to the deadlock we have today. But the Democrats' free option will be gone, and potentially that changes the dynamic a bit.

- We could be wrong to be so pessimistic about it (we're certainly out-of-consensus versus seemingly eternal hopes for stimulus). *We hope we're wrong, because a big stimulus bill would be just more upside for the economy* – at least abstracting from long-term costs and unintended consequences. *But it's not necessary.*

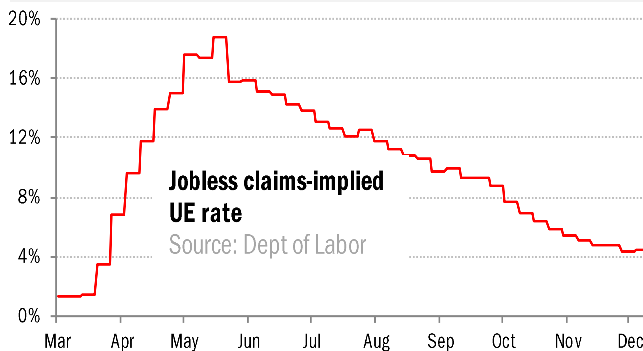
But there's plenty of upside without a new stimulus bill. The $2.5 trillion of new savings is an unexploded money-bomb. The stimulus payments were made when consumers were locked down and couldn't spend it. It still hasn't been spent, as a summer "second wave" and now a winter "third wave" of Covid-19 have kept consumers afraid and cautious.

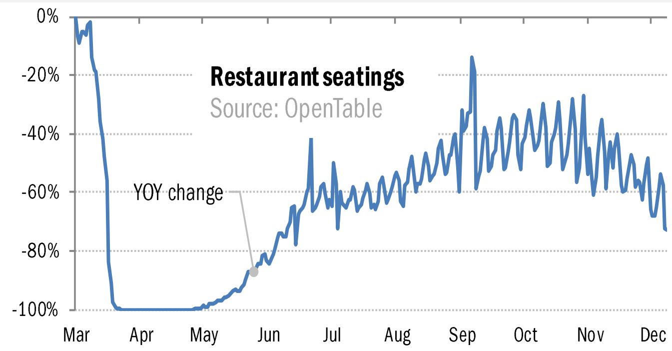
- *This unexploded bomb will detonate when the present "third wave" of Covid-19 tops out – that should be any day now – and vaccines start to be administered en masse. The narrative of fear will suddenly transform into one of pride. The entire world will be a new "greatest generation," having won World War "V" – V for virus. It will be like our boys coming home in 1945, ready to cash in their war-time savings and prove all the pessimistic economists wrong.*
- This year's $2.5 trillion of savings is 11.8% of nominal GDP. By way of comparison, that compares to $557 billion accumulated year-to-date through October 2009, the last time there was a large-scale stimulus program. That was 3.9% of then-current GDP. Subsequent economic performance after 2009 suggests that was insufficient fuel then, because it took an agonizing 51 months for the unemployment rate to fall from a peak of 10.0% to 6.7% (where it is now), and in this cycle we've already gotten to 6.7% from a far higher peak of 14.7% in just 7 months. We think spending some of that 11.8% of GDP saved up this year ought to be able to get us back to the prior cycle low unemployment rate of 3.5% without having to wait too long, and without Congress adding even more to the stock of savings.
- *When the money-bomb detonates, we would expect a temporary bump in consumer inflation due to both time-shifting of deferred demand, and likely lockdown-driven supply-chain bottlenecks that will persist into next year.*
- This may come as a surprise to markets and central bankers who have had to endure more than a decade of getting used to the idea that inflation seems to be an impossible dream, no matter how low interest rates go or how much quantitative easing is done. But as we've said all along, the last decade-plus of low interest rates is not due to central bank financial repression – in the post-GFC world, interest rates are naturally low, and central banks have merely tracked them lower, making ultra-low policy rates not stimulative. At the same time, QE does nothing but de-risk markets, taking duration risk off the private sector balance sheet and putting it on the central bank's balance sheet (in what amounts to a vast fixed-for-floating swap). That helps risk-averse markets find their footing,

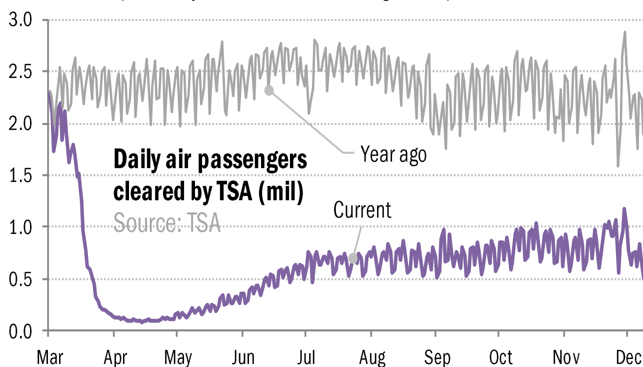
but it doesn't create new money, and there's nothing inflationary about it.

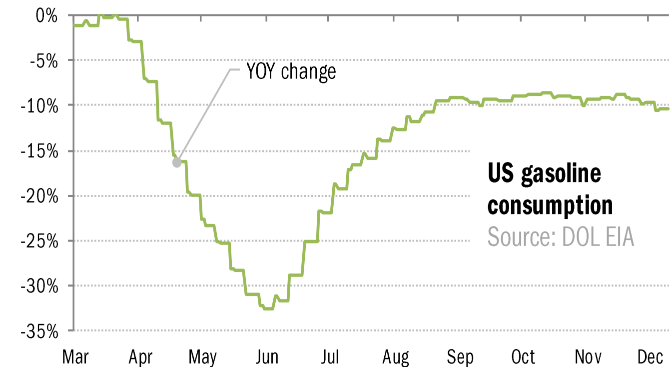
- *Today's savings money-bomb will be inflationary because, unlike prior central bank interventions, it is fiscal stimulus rather than monetary stimulus. It is a true helicopter drop of money, not a helicopter drop of credit incentives (which is all that low rates and QE really are).*
- *When the bump in inflation comes, a great hue and cry will arise that, at last, the inflationary genie is out of the bottle – and the timing couldn't be worse, with the Fed just having changed its inflation-targeting policy to allow overshoots, and only because they never thought they'd actually get one* (see "Powell at Jackson Hole, and the Inflation Makeup Strategy" August 27, 2020). But it will only be a bump, a pig in a python that will smooth itself out once the pent-up spending is exhausted. Long-term inflation expectations should improve, but they shouldn't come unmoored.
- *Treasury yields will be headed higher anyway next year, as the V-shaped recovery matures into an outright expansion, and an inflation bump will provide some tailwinds. Many expect that this will trigger a "yield curve control" program by the Fed, but we doubt that – we think the Fed will welcome anything but the most extreme back-up in yields as a sign of growth and recovering risk-tolerance.*
- *That will give rise to another hue and cry: that equities are suddenly overvalued with higher bond yields, at last, offering at least a little competition. But we're really not worried about that – growth supports recovering earnings expectations as much as it nudges*

High frequency US economic data









Source: As indicated, TrendMacro calculations

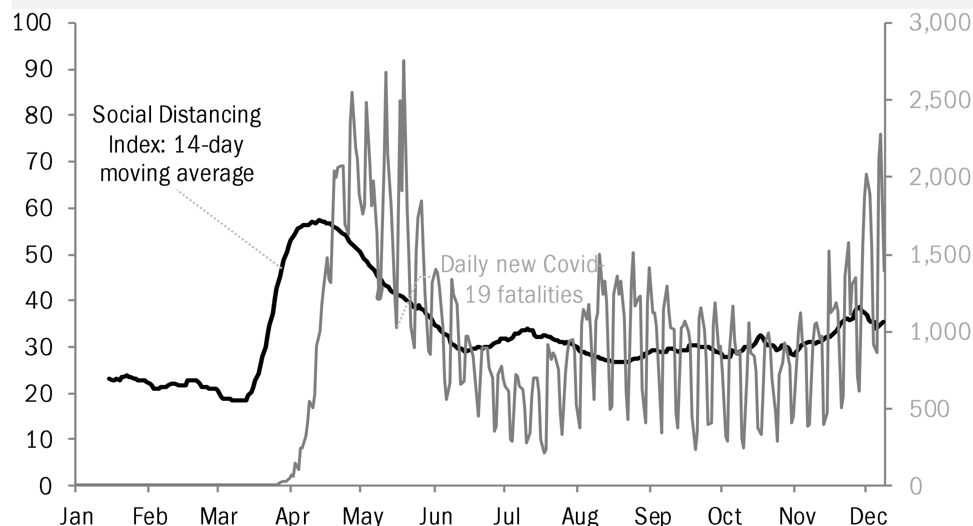
yields higher – so valuations can stay approximately in equilibrium.

- Historically, back-ups in long-term yields have been strongly associated with above-average equity returns (see "It's Just the Reflation Trade, People!" February 5, 2018).

The subject of earnings is a good segue into the matter of a possible near-term correction, as we mentioned on the first page of this report. Recent incoming data is definitely showing a bit of a wobble in the V-shaped recovery. *But S&P 500 forward earnings, the best indicator of where the data is headed in the intermediate-term future, not only haven't faltered, but have actually improved*.

- Let's start with the data. The note of caution in the disappointing November jobs report (see "On the November Jobs Report: Payrolls vs the Third Wave" December 4, 2020) was ratified late last week by jobless claims. The rise in both new and continuing claims moved the implied unemployment rate up to 4.5% from 4.3%, the first uptick since early September (please see the first chart on the previous page, and "Data Insights: High Frequency Post-Virus Recovery Monitor" December 10, 2020).
- *Other high-frequency data has slipped a bit too, especially daily indicators of mobility* such as airline passengers, restaurant seatings and gasoline consumption (please see the charts on the previous page).
- The cause is surely the winter "third wave" of Covid-19, which has triggered a "bear market rally" in social distancing, that is, in withdrawal from the mobility that is essential to participating in the economy (please see the chart below). As we said earlier, this is the result of a combination of government fiat and individual choice – but that hardly matters: people have pulled back from economic activity at the margin, and it's showing in the data.
- Who's to say where this will go? It's the joint product of an

US economic mobility versus Covid-19 fatalities

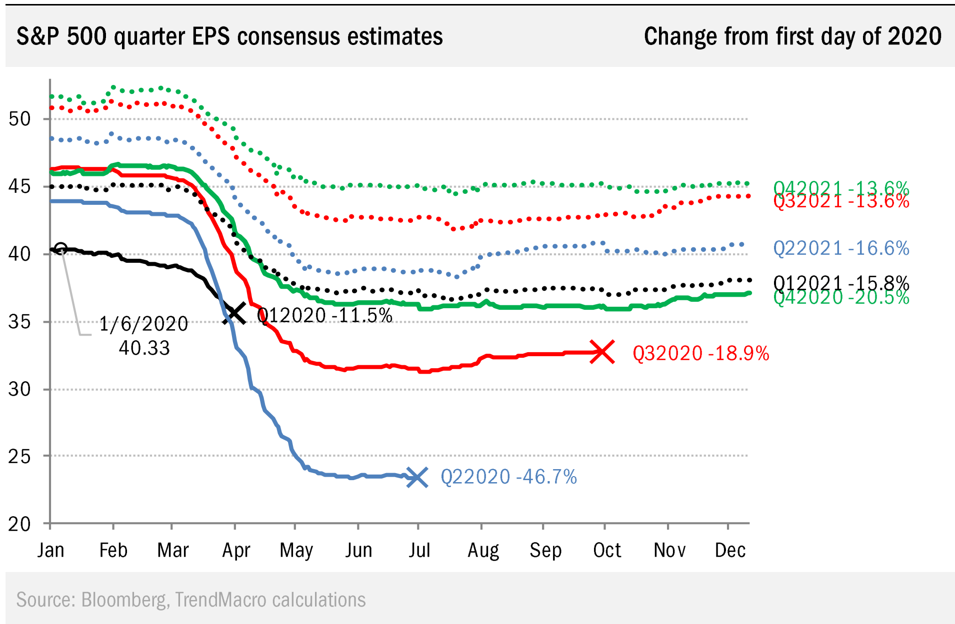


Source: University of Maryland Transportation Institute, Covid Tracking Project, TrendMacro calculations

unpredictable pathogen, unpredictable whims of government officials and unpredictable preferences of individuals. With humility about the uncertainties involved, we think the "third wave" is peaking in the US (as it peaked already in most of Europe several weeks ago), and be that as it may, attitudes of policy-makers and ordinary people will be loosened up by vaccines becoming available for millions starting right now (20 million inoculations in December, 30 million in January).

- S&P 500 forward EPS are not registering the present wobble in the data (please see the chart below).

S&P 500 quarter EPS consensus estimates — **Change from first day of 2020**



Source: Bloomberg, TrendMacro calculations

- _Over the last several weeks EPS estimates for Q4 have actually steadily improved, even as incoming data has weakened_. The trajectory of improvement is not especially impressive, but any improvement at all follows months of absolutely none and comes at a time when the data would seem to point the other direction.
- _The four quarter estimates for 2021 have also begun to very modestly improve after months of flat-lining_.
- The durability of earnings estimates through 2021 validates our early forecast for a rapid downturn followed by a traditional V-shaped recovery. Specifically, it means one quarter of recession and three quarters to get back to where things started (again, see "On the March Jobs Report, and Being in Recession (Whatever that Means)").
- The evidence: the EPS estimate for Q4-2021 is basically the same as Q4-2020 was at the beginning of the year, before the virus hit. _That is telling us we've simply had a lost year._ Not a good thing in and of itself, but a very good outcome considering that the world was thrown into what can only be called a depression in March and April, and it was generally assumed it would take literally years to get out of it.

- To look at the same data another way, *Q4-2021 EPS are estimated to be 22.4% higher than Q4-2020 earnings. That's one hell of a year, and it's dead ahead*.

Bottom line

There's a strong client consensus that the V-shaped recovery from the lockdown recession is on track, following months of pessimism. We don't disagree, though such a consensus, coming as the S&P 500 equity risk premium is at new post-recession lows, probably means a short-term buyable dip is coming. Many think further recovery is contingent on more stimulus from Congress. We don't expect any, but the resolution of the two Georgia Senate run-offs in January might change the dynamic of gridlock. But US households have accumulated $2.5 trillion in personal savings this year, unable or too cautious to spend the prior stimulus money. That's a money-bomb of pent-up demand equal to 11.8% of GDP, and it will detonate next year when the "third wave" of Covid-19 tops out and 50 million inoculations with the new vaccine are administered through January. 2021 should complete the recovery and could embark on a boom as the world celebrates winning the war with the virus. A spending surge will trigger a transitory bump in inflation which will support higher Treasury yields. Near-term data is weak, driven by increased social distancing in the "third wave." S&P 500 forward earnings are looking through that, with moderate upgrading even in the present quarter, validating that the virus experience will have created a lost year, but nothing worse. Looking ahead, forward EPS estimates suggest greater than 22% earnings growth next year.