1919 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

August 31, 2020

Another record, a new Fed mandate, Russia, and "wu wang guo chi"

The Markets

U.S. equity markets continue to make record highs in the face of mixed signals concerning the progress or regress of the pandemic. As you will read in Ryan Schutte's review of this past month's economic indicators, there are grounds for optimism but also caution. The Dow rose 2.59%, the S&P was up 3.26% and the NASDAQ increased 3.39%. U.S. equity markets have shown remarkable resilience as the country battles the pandemic.

August Economic Update

We saw mixed economic reports in August, telling the story of an unequal recovery. Coming off of the historically depressed levels seen in April, even modest improvements in economic data appeared as a V-shaped bounce. We are past the "easy" portion of the recovery, and sectors of the economy more sensitive to the impacts of COVID-19 have struggled to improve at the same pace we saw in weeks past.

Reports concerning the housing market were the bright spot in August with Housing Starts increasing 22.6% month-over-month and the NAHB Housing Market index[1] rising to 78—matching an all-time high. We also saw new and existing home sales continue to surge, rising 13.9% and 24.7%, respectively, beating expectations handily. Housing is typically an early cycle indicator and has been the sector in the U.S. economy to experience the closest thing to a V-shaped recovery thus far.

Economic data from the goods sector has also been encouraging. Durable Goods Orders increased 11.2% in July, marking the third consecutive month of growth, while the ISM Manufacturing index signaled continued expansion with a reading of 54.2. More timely data from the Flash U.S. Manufacturing PMI index indicated that the recovery in manufacturing has continued into August. Driven by expansions in output and new orders, the overall rate of improvement from July to August was the fastest in 19 months.[2]

Service sector businesses experienced a sharp bounce off of the April lows, but have struggled to sustain that rate of growth. After monthly growth rates of 18.3% and 8.4%, July's Retail Sales grew at 1.2%. These businesses are more heavily impacted by COVID-19 and the restrictions in place to stop its spread. While the initial reopenings in May and June helped to boost service sector sales, spikes in cases and subsequent closures have hampered their recovery. Furthermore, service sector businesses are more heavily dependent on consumer strength. Personal Income rose 0.4% in July and consumption spending 1.9%, but these increases have been largely buoyed by government transfer payments. Stimulus checks have long been spent and unemployment benefits expired in August, leaving lower income consumers in a weaker position. August's Consumer Confidence reading indicated as much dropping 7 points to 84.8. For reference, the Confidence index stood at 132.6 in February.

Given the importance of the consumer to the U.S. economy, the labor market has been one of the most important pieces of the recovery.

August began on a positive note with Initial Unemployment Claims falling below 1 million for first time since mid-March. More encouraging news came with the employment report showing employers added 1.8 million jobs in July and another drop in the unemployment rate to 10.2%. The employment picture has since gotten foggier with initial claims rising back above the 1 million mark while continuing claims have remained mostly stagnant. Despite improving from the

March peak, unemployment numbers are still highly elevated compared to pre-pandemic levels. So far, layoffs have been concentrated among mostly lower income positions, and while fiscal stimulus has helped to offset the impact to this point, most of this support has been exhausted. Furthermore, higher frequency jobs data indicates subdued hiring in the latter half of August, pointing to the long-term uncertainty facing businesses across the country.

We have certainly seen improvements in economic indicators since April's lows; however, we are far from a full economic recovery. It seems evident that there are pockets of the economy needing further support. To this point, discussions in Washington are currently at a stalemate, but we will continue to monitor the situation closely.

The Fed

The Federal Reserve being in the news is certainly not unique but this time it is a bit different. Chairman Powell and the Fed indicated a greater concern about the economy, which, of course, influences their interest rate outlook. Mr. Powell announced that the Fed would abandon its two percent inflation target in the nascent recovery in order to allow inflation to drift higher to play economic catch-up. There are also proposals that Central Bankers should take racial justice into account. Both are interesting, and both can be controversial. The problem with Mr. Powell's proposal is first, it can lead to a serious bout of inflation. It makes it very difficult to determine when to tighten, or at least stop easing. Second, if an error is made, high inflation will ensue. This will strengthen the argument for a rule-based monetary policy.

Adding racial justice as a consideration is fraught with difficulties. The Fed is already an important part of this important effort. The Fed has a mandate to maintain full employment. Full employment is an important factor in achieving economic racial justice and equality. During the most recent expansion when the unemployment rate was at three percent and heading lower, employment of black Americans was at record levels and incomes were rising. Two other problems exist with an explicit mandate. The first is it will make the bank far more political. Its non-political status is an important reason the U.S. dollar is the world's most important currency. The entire country benefits mightily from this. The second is also political. As we have seen time and time again, when faced with unpopular decisions, elected officials will shift that responsibility to unelected bodies. This is a frequent occurrence with monetary policy. Solving these very serious problems is the role of elected officials.

International

There hasn't been much change in what is happening in the European Union nor Great Britain. The E.U continues to grapple with the arguments between the have and have not countries. The other interesting friction is what exists between the elected officials within each country and those representing the same countries in Brussels. It should come as no surprise that the disagreements come over the role of sovereignty.

In the midst of a global pandemic, a political crisis in Belarus has caused a distraction for the E.U. in managing their economies. As readers know, there is a serious political problem in Belarus. That in itself would not be a large distraction. Alas, it has been seriously escalated by Mr. Putin injecting himself and Russia into the fray. This occurs at a time when the E.U. should be putting its undivided attention to its economy.

Just a quick word about our title's attention-getting device, *wu wang guo chi.* The English translation from Chinese is, "Never forget national humiliation." We bring this up because the constant friction between the United States and China is heating up again. When U.S. representatives are negotiating with China, they should keep an index card in their pocket with this phrase in bold letters. This is why presidents have a State Department to help them with in depth country knowledge. Negotiating with a foreign country is difficult enough, but China is a special case. The phrase harkens back to mid- eighteenth century through the Mao era. It refers to what China believes is the time when foreign powers stole her sovereignty and humiliated the country. Avenging this effrontery is one of the main goals of Chinese foreign policy. This phrase is drilled into every Chinese child from the time they start school. If a negotiator enters negotiations with the Chinese and thinks that the talks will center purely on economic trade issues, it will end unsatisfactorily for both sides. There is an enormous amount of sovereign prestige at stake, which is often more important than economics.

Just a reminder that we welcome comments, particularly from our Chinese readers this week.

Thank you.

[1] The National Association of Home Builders (NAHB) Housing Market Index (HMI) is a gauge of builder opinion on the relative level of current and future single-family home sales.

[2] ISH Markit Flash U.S. Composite PMI, Strong expansion in U.S. private sector output in August," IHS Markit, August 21, 2020, https://www.markiteconomics.com/Public/Home/PressRelease/b8fe1953311a43c795488641e8b75bb7.

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