1919 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

December 7, 2020

Looking across the abyss

Equity Markets

Investors continued to push equity prices to new and record highs this past week. After reading Ryan Schutte's monthly review of economic indicators, readers could be forgiven if they think, as our title suggests, investors are looking across the abyss rather than into the abyss. Perhaps.

The Dow rose 1.03%, the S&P 500 rose 1.67% and the NASDAQ rose 2.12%. A remarkable performance in the face of a resurgence of the pandemic and political disarray.

Economic Indicators

The U.S. economy continued to progress in November but lost some momentum. As case counts continue to mount, it seems clear that the short-term path of the economy will depend largely on virus trends.

While growth has slowed in some sectors of the economy, the housing market has continued to power ahead. The NAHB Housing Market Index[1] logged another record, while new and existing home sales remain an area of strength. Additionally, the FHFA Home Price Index recorded its fourth consecutive all-time high, and the S&P/Case-Shiller Home Price Index signaled rising home values, as they have since June.

Manufacturing and goods-producing sectors have also continued to improve. The ISM Manufacturing Index notched its seventh consecutive month of growth with a reading of 57.5%,[2] while 16 of 18 industries reported expansion. Although lower than last month's reading of 59.3%, production and new orders remained in expansion territory, and an overall positive sentiment persisted among the purchasing managers panel. The employment component was worrisome and signaled contraction, while absenteeism, labor shortages, and short-term shutdowns increased the costs of maintaining the labor force.[3]

Retail sales increased 0.3% in October and 5.7% year-over-year—a deceleration from the growth rates seen thus far in the recovery. Non-store retailers gained the most, followed by building materials, autos and gas. For the year, non-store retail sales have increased 33% compared to a 16% decline in restaurant sales, further emphasizing the unequal nature of the recovery—a detail we have highlighted in the past. Excluded from the November retail report were the results of Black Friday shopping. As expected, there was a large decline in in-store spending, but online sales helped to offset some of the difference. More timely economic data from RetailNext reported in-store foot traffic on Black Friday decreased by 48% from a year earlier while online spending jumped 22%. Spending per shopper increased 36%, however, so those who ventured to stores on Black Friday made the most of it.[4]

[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] A PMI above 50 indicates an expansion of the manufacturing segment of the economy compared to the previous month.
[3] Institute for Supply Management (ISM). 2020. "November 2020 Manufacturing ISM Report on Business." https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/pmi/november/https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/pmi/november/.
[4] RetailNext, Inc. 2020. "RetailNext Announces Black Friday Sales and Foot Traffic Data as Shoppers Show Strong Intent to Buy When Venturing Out." https://retailnext.net/en/press-release/retailnext-announces-black-friday-sales-and-foot-traffic-data-as-shoppers-show-strong-intent-to-buy-when-venturing-out/.

Consumer-related indicators faltered in November with consumer confidence declining to 96.1 from 101.4 and consumer sentiment remaining largely unchanged. While consumers' appraisal of current conditions declined slightly, their short-term outlook for incomes, businesses, and labor market conditions fell substantially. Personal income fell 0.7% from the prior month but still remains above pre-pandemic levels due to transfer payments and increased savings. Despite the hit to income, consumption expenditures increased 0.5% month-over-month, slowing from 1.2% growth in the month prior. Year-to-date, low-wage earners[5] continue to outspend their high-income counterparts, with spending increasing 1.8% and declining 5.7%, respectively.[6] While an elevated savings rate suggests there may be continued room for increased spending, renewed virus concerns, dampened sentiment, and waning stimulus present significant headwinds.

There are still roughly 10 million jobs missing from the labor market, down from over 20 million in April, and employment gains have been harder to come by as uncertainty surrounding the virus remains. Unemployment insurance claims were mixed, as initial claims increased mid-month but turned lower in the most recent report. Continuing claims sustained their gradual decline but remain elevated at 5.5 million claimants. The unemployment rate edged lower to 6.7% from 6.9%, and an underwhelming 245,000 were added to the economy. We have seen job additions in each month since April's unprecedented drop but at a declining rate. It is also troubling that the improved unemployment rate was helped largely by a declining labor force participation rate rather than job gains.

November's economic indicators were positive, but momentum is fading. To this point, the Federal Reserve's most recent Beige Book report indicated that the U.S. economy picked up to a moderate pace; however, growth began to slow in November in regions where virus cases have increased the most. As lockdown measures again take hold, struggling areas of the economy like small businesses, restaurants, and the unemployed will require further support. Stimulus talks have picked up once again as Washington attempts to fulfill the need for a bridge to the vaccine in 2021. We are watching closely as a bipartisan bill is reportedly gaining support.

The Economy

There are many topics that deserve some time in this space. Alas, there's only so much room. This week we will look at how the economy might recover from the second wave of the pandemic and how damaging the growing U.S. debt burden could be.

We have argued in the past that an economy's recovery from a recession is dependent on what caused the recession in the first place. The two most common causes are a mistake such as the Federal Reserve miscalculating the economy and tightening too soon in an expansion, or the expansion reaches a point where pressures build, imbalances occur, and the economy collapses of its own weight. In both of these cases, recovery tends to be slow and drawn out. Neither is the cause in the present case.

This recession was caused by a noneconomic factor, the pandemic. Therefore, the recovery should be different. As the pandemic subsides, the recovery most likely will be V shaped and more rapid than most other recoveries. Both new and existing economic stabilizers kept many who lost their jobs, as well as many small businesses, afloat. The economic building blocks remain firmly in place.

[5] Low wage earners deemed those making less than $60,000 annual salary.
[6] Opportunity Insights. 2020. "Economic Tracker: Percent Change in All Consumer Spending." https://tracktherecovery.org/.

Weekly Market Insights (cont'd)

For the most part, both corporate and consumer finances appear to be sound, so at the first sign of the defeat of the coronavirus, the economy should be able to move ahead. Although the economic indicators are not particularly encouraging, they may be a bit misleading. We, of course, remain concerned. It's always a bit disconcerting to say, "it's different this time."

Deficits and the Budget

"For every subtle and complicated question, there is a perfectly simple and straightforward answer, which is wrong."—H.L. Mencken.

Government debt and budget deficits are now and have always been of great concern and for good reason, but as Mr. Mencken observed many years ago, it's not that simple. Government spending and its associated debt can be good or bad. The unsatisfactory answer is, it depends.

The U.S. along with most of the governments around the world have issued far more debt than in the past, creating record deficits. It is of great concern to many because it implies inflation and economic crises in the future. This is possible but not inevitable. In fact, a powerful argument can be made that it is beneficial now and in the future. It all depends on why, how and what the circumstances are.

It is hard to dispute the argument that extraordinary government spending along with Federal Reserve financial infusions were both necessary and beneficial for the economy and a large portion of the population. The need for this borrowing came after a multi decade-long decline in interest rates. This is fortunate because the carrying charge or interest expense will be very low, and if interest rates do go up, the government, as all debtors, will be paying back principal in depreciated dollars. Remember, inflation is the debtor's friend.

What about future deficit spending? Again, the unfortunate answer is, it depends. In the absence of another economic catastrophe, deficits should be used to enhance the country's economic capacity. In other words, use borrowed capital to create projects that have a return. Of course, the Treasury doesn't directly get repaid, but is a secondary beneficiary. An expanding economy increases the tax base and significantly lowers expenditures for economic stabilizers.

There are plenty of projects that are waiting. A prime example is infrastructure—our roads, bridges, harbors and train facilities are in truly bad shape. We have pointed this out in the past, but scientific advancements have paid enormous dividends. Perhaps the most significant return is the investment in education. It increases efficiency, reduces unemployment, makes U.S. industry more competitive in world markets, and significantly reduces welfare costs. It has something for all economic persuasions. No one objects to a company borrowing to make a sound return. It is admired. The same goes for a nation.

There is a lot of interesting work being done on this topic. In this Sunday's *New York Time*s there is an interesting article on page 5 of the Business Section titled, "The Double-Edged Sword of Low Interest Rates," and in last week's copy of *The Economist* is a really fascinating piece on flows of credit and savings, "Free Exchange: An Unbalanced debate." Perhaps not the easiest read but truly interesting.

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Please click here for the updated Economic Release Calendar - December 2020.