ECONOMIC OUTLOOK

REGIONS

July 2020

Heading Over The (Income) Cliff?

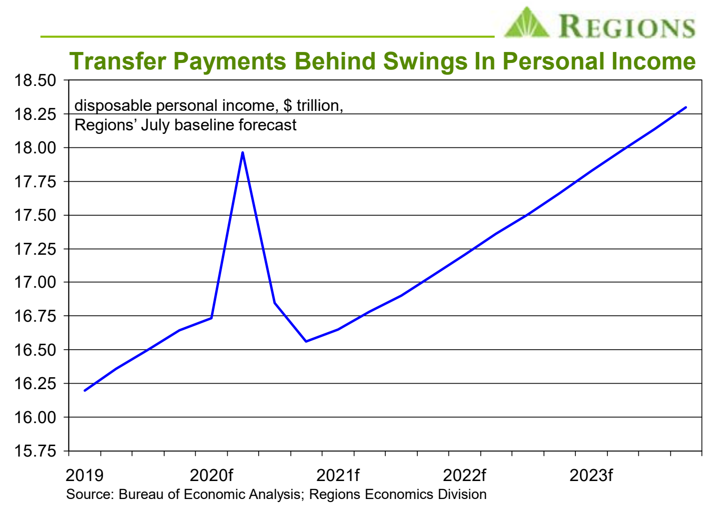
There is no question that the fiscal and monetary policy responses to the sharp and sudden economic contraction stemming from the COVID-19 virus and the efforts to stem its spread have been very aggressive. While there are questions as to how effective much of the aid aimed at businesses, such as the Paycheck Protection Program (PPP) and the Main Street Lending Program (no spiffy acronym), have been or will prove to be, the aid aimed at the household sector has clearly hit the mark. This is evidenced in the data on personal income and consumer spending.

The CARES Act provided for Economic Impact Payments (EIP) – payments of up to $1,200 per adult and up to $500 per child under the age of 17, with a total payment of up to $3,400 for a family of four – and supplemental Unemployment Insurance (UI) benefits of $600 per week to be paid by the federal government. Thanks to these payments, disposable (or, after-tax) personal income is on course to rise significantly in Q2 despite the severe damage done to the labor market. We do not yet have the June data on personal income, but our baseline forecast anticipates annualized growth of 32.8 percent for disposable personal income in Q2.

The transfer payments included in the CARES Act will more than negate what, for Q2 as a whole, will be a sharp decline in total wage and salary earnings, far and away the largest component of personal income. This illustrates what from the start we felt to be the most important goal of the policy response to what, at least at the outset, figured to be a severe but relatively brief contraction in economic activity, i.e., to keep what started as a liquidity crisis from turning into a solvency crisis. Clearly, the odds of the former morphing into the latter would increase along with the length of the disruption in economic activity, but the goal was the same for aid targeted at the household and business sectors.

Recall that the EIP were set up as one-off payments, the bulk of which were delivered in April, while the supplemental UI benefits were given a limited life and, as such, will expire by the end of July. Whether the transitory nature of these payments was based on the premise that the disruption to the economy would be transitory in nature, or whether the intent was always to provide immediate aid and then at a later date assess the need for further aid – we heard both arguments – the reality is that disposable personal income is on course to fall sharply in Q3. At least as things now stand.

Given the one-off nature of the EIP and the looming expiration of the supplemental UI payments, total transfer payments are set to fall sharply in Q3. While the return of growth in nonfarm employment will lead to increases in aggregate wage and salary earnings, the level of labor earnings will nonetheless remain well below the level seen in Q1 2020. The net result will be a deep decline in disposable personal income in Q3. Though some point to the elevated personal saving rate, which stood at 23.2 percent in May (the latest observation), as a buffer against the decline in transfer payments, questions around the distribution of these higher savings should serve as a caution about drawing broad conclusions on the role of savings as a shock absorber.



The chart above illustrates the impact of transfer payments on the path of disposable personal income. We and others have referred to the sudden, sharp decline in disposable personal income in Q3 as an "income cliff," and without another round of EIP and/or an extension of the supplemental UI benefits, many households are heading over that cliff. In addition to the potential effects on consumer spending, keep in mind that, at present, millions of consumer loans – mortgage, auto, credit card, student – are in forbearance, meaning that over the past few months borrowers have been allowed to skip scheduled payments. But, forbearance is not the same thing as forgiveness, which means consumers will have to ultimately make up any payments they've missed in the interim. Many of the forbearance periods now in place will be expiring in Q3, and to the extent this coincides with a steep decline in disposable personal income, there are obvious implications for the performance of consumer credit.

Returning to our earlier point on the elevated personal saving rate, that is a function of two things. One is the spike in disposable personal income in Q2, reflecting the surge in transfer payments, and the other is the pullback in consumer spending. Though total consumer spending increased sharply in May, the dollar volume remains well below the level that prevailed prior to the economy beginning to shut down in mid-March. Most of that shortfall, however, is in discretionary spending, much of which falls into consumer spending on services. Spending on necessities, such as food, has held up much better – while total retail sales rose by 17.7 percent in May, the level of retail sales was 7.9 percent below that of February, but the level of grocery store sales in May was

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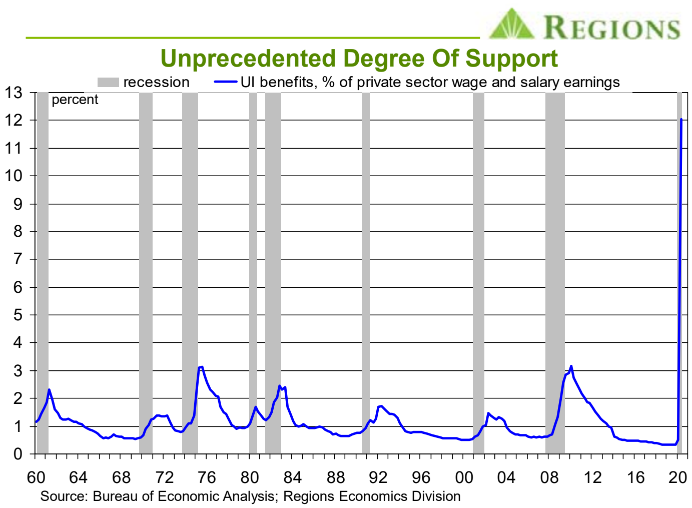
12.8 percent above that of February. The broader point is that much of discretionary spending comes from upper-income households and, as such, it is reasonable to assume the increase in personal saving over the past few months is highly concentrated amongst upper-income households. Tracking data from providers such as Affinity Solutions and Opportunity Insights affirm that discretionary spending amongst upper-income households has yet to pick up. While those households more reliant on transfer payments may have increased saving, they will still bear the brunt of any decline in transfer payments over coming months.



The chart above highlights the extent to which the supplemental UI benefits have supported disposable personal income. To be sure, with the unemployment rate having risen higher than the peak in any of the past cycles illustrated in the above chart, total UI payouts would likely have amounted to a higher share of private sector wage and salary earnings than in past cycles, but certainly to nowhere near the extent we are seeing at present. It should be noted that in addition to the supplemental UI benefits, eligibility rules have been relaxed such that a greater share of those who have lost work due to the pandemic are currently able to draw UI benefits than would have otherwise been the case. This has added to the spike in total UI payouts reflected in the above chart.

While the expiration of the supplemental UI benefits will clearly leave a sizable hole in cash flows for these households, there is nothing approaching a consensus on the question of whether or not the supplemental benefits should be extended. Some argue the expanded UI benefits are creating a disincentive to work. Several different estimates show over two-thirds of those now receiving UI benefits are realizing higher cash flows than was the case when they were employed, which reflects the lift from the extra payments of $600 per week incorporated into the CARES Act. While it would not be plausible to argue there is no such disincentive, we think it unlikely the disincentive is as powerful as many are arguing is the case.

Others are pointing to improving labor market conditions as evidence that an extension of the extra UI benefits is unwarranted. Though it is encouraging that private sector payrolls have risen by 7.999 million jobs over the past two months, that still leaves them 13.192 million jobs below February's level; the unemployment rate did fall to 11.1 percent in June after having peaked at 14.7 percent in April, but it nonetheless remains above the peak rate seen in any prior recession this side of the Great Depression, let alone February's jobless rate of 3.5 percent. Moreover, it is clear that the reported unemployment rate has been understating the true degree of labor market slack over the past four months, as many who have lost jobs have dropped out of the labor force while others have not been counted as unemployed. The broader U6 measure is a better but still not perfect gauge of labor market slack, and stood at 18.0 percent in June, in part a reflection of the more than nine million people working part-time for economic reasons (the number was 4.318 million in February).

While it was never reasonable to assume the rates of improvement seen in the early months of recovery would be sustained in subsequent months, that point is strongly reinforced by the sharp upturn in the rate of positive COVID-19 tests since late-June – after the survey period for the June employment report had ended. Though at this point state and local policy makers have responded with targeted interventions, as opposed to a return to the blanket shutdowns imposed earlier, there will surely be some effects on the labor market, particularly given the extent to which the job gains seen in May and June were driven by leisure and hospitality services. This industry group alone accounted for 43.6 percent of private sector job gains in May and June, and over 84 percent of the jobs added in this broad industry group came from hiring (or, re-hiring) amongst restaurants and bars. This is the industry segment most at risk from the recent upturn in positive COVID-19 tests, and many state and local governments have already taken steps to restrict, if not close, restaurants and bars. This adds to the already high degree of uncertainty around any forecast being made at present.

The broader point is that the economy is by no means out of the woods, and we continue to expect the recovery to be somewhat slow and uneven. As such, to us the question isn't whether or not the supplemental UI benefits should be extended, the question is what form an extension should take. One alternative is to simply extend the current level of payments, $600 per week, for a specified length of time. Such an extension is incorporated into the "HEROS Act" recently passed by the House of Representatives, which would extend the supplemental UI benefits though January 2021 at the present level of $600 per week.

Another alternative is to extend the supplemental UI benefits at a lower amount, with some calling for payments of $300 per week. This option would still provide support but would address the concern that the current level of payments creates a disincentive to work. On average, regular state level UI benefits replace about one-half of the recipient's previous earnings, so lowering the amount of supplemental benefits would put the all-in UI payment (state level plus supplemental) closer to the recipient's previous earnings. Being more precise would require that the amount of the supplemental benefit be tied to an individual's previous level of earnings, or at the very least to industry average earnings based on the recipient's normal occupation. While conceptually this may be a sound approach, operationally it would likely be a nightmare, at least based on the degree to which many states have been overwhelmed in attempting to administer regular UI payments.

An alternative we'd prefer would be one that ties the level and length of benefits to labor market conditions in the recipient's state of residence. From a starting point that would preferably put the all-in UI payment at, or as close to as possible, 100 percent of the recipient's previous earnings, the supplemental payment would be pared down as the state's unemployment rate falls below pre-set thresholds. This would do away with disincentive effects while serving those hit the hardest by the fallout from the pandemic. For those who remain unemployed for extended periods, whether due to a permanent job loss or an erosion of skills, some provision would have to be made for retraining/education that would enable those in this group to ultimately re-enter the labor force.

Granted, our preferred alternative might prove to be just as much of an operational nightmare as the second alternative we outlined, though neither should be ruled out on that basis alone. The reality is that no alternative will be perfect. Rather than arguing over the flaws, real or otherwise, of the various alternatives, however, it helps to keep sight of why we're having these discussions in the first place. Large numbers of people have had their careers and lives disrupted, not of their own doing but by a public health crisis, the outcome of which remains highly uncertain. The goal of policy should be the same, i.e., to prevent what started as a liquidity crisis from turning into a solvency crisis, as the costs of a solvency crisis, in either the household or the corporate sector, would vastly exceed the costs of preventing such an outcome. To their credit, Congress acted quickly and aggressively at the outset of the pandemic. That the public health outcome remains highly uncertain means the economic outcome also remains highly uncertain, with meaningful and persistent downside risks. As such, there is more for policy makers to do; keeping large numbers of households from plunging over an income cliff later this month is a good place to start.

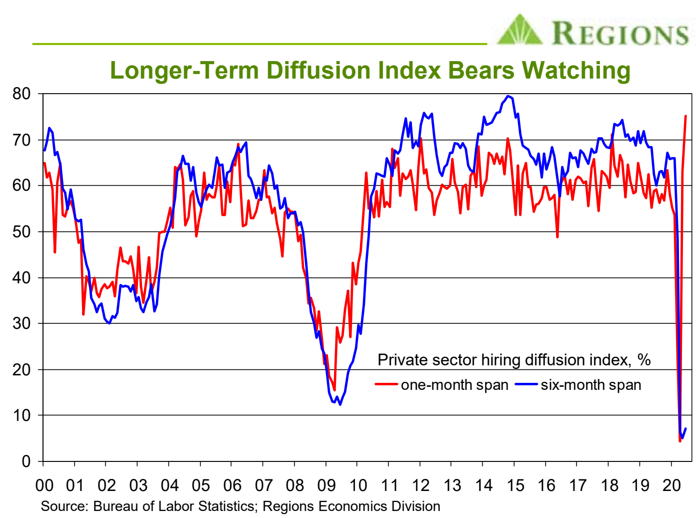
Labor Market: Improving, But Still Fragile

The June employment report brought further evidence of a labor market on the mend. Total nonfarm employment rose by 4.800 million jobs in June, with private sector payrolls up by 4.767 million jobs and public sector payrolls up by 33,000 jobs. Prior estimates of job losses/gains in April and May were revised to show 90,000 fewer net job losses for the two-month period than had previously been reported. Over the past two months, private sector payrolls have risen by 7.999 million jobs, which one can interpret in keeping with how they see life in general: 7.999 million jobs is a nice start on the labor market's road back to health after having been decimated by the COVID-19 virus and the efforts to stem its spread, or, yeah, sure, but 7.999 million jobs still leaves private sector payrolls 13.192 million jobs below February's level.

We'll leave that for each of you to sort out on your own. As for how we view the June employment report, while the job gains of the past two months are encouraging, there are still reasons for concern. First and foremost, the June survey period had ended before the recent spike in positive tests for the COVID-19 virus. Rather than rushing to reimpose the restrictions on economic activity that had been put in place in the early stages of the pandemic, state and local policy makers have responded to the recent spike in positive tests with targeted interventions. That they can do so reflects the considerable improvement in both the quantity and the quality of the testing and tracing data. For instance, tracing shows bars and restaurants have been common grounds for many of those who have recently tested positive, and the demographic data shows a stark decline in the median age of those testing positive. This knowledge has allowed policy makers to respond in very specific manners, such as closing bars and either closing or further limiting eat-in dining establishments.

One way this ties back into the June employment report is that the broad leisure and hospitality services industry group, into which bars and restaurants fall, has alone accounted for 43.6 percent of the increase in private sector payrolls over the past two months, with the vast majority of these jobs coming from restaurants and bars – the establishments most at risk from the recent spike in positive COVID-19 tests. Moreover, tracking and mobility data show that even before the policy response, consumers had begun to pull back in visits to eat-in restaurants after such visits jumped as states eased restrictions on economic activity.

This raises the question of whether or not bars and restaurants will engage in another round of layoffs, which in many cases would impact workers only recently called back to their jobs. If so, this does not suggest job growth will grind to a halt in July, but it does suggest a smaller increase than would otherwise have been the case. At the same time, this reinforces a point we made above, which is that, should rising numbers of positive COVID-19 tests compel policy makers to take further measures to restrict activity, the extent to which they can do so on a targeted basis will be a key determinant of the impacts in the broader economy. For instance, not shutting down factories in the absence of evidence showing factories are "hot spots" for the virus would have much different implications for the broader economy than blanket shutdowns of factories, which then ripple through supply chains. Obviously, target interventions are less than an ideal outcome, but they are at least a less disruptive option.

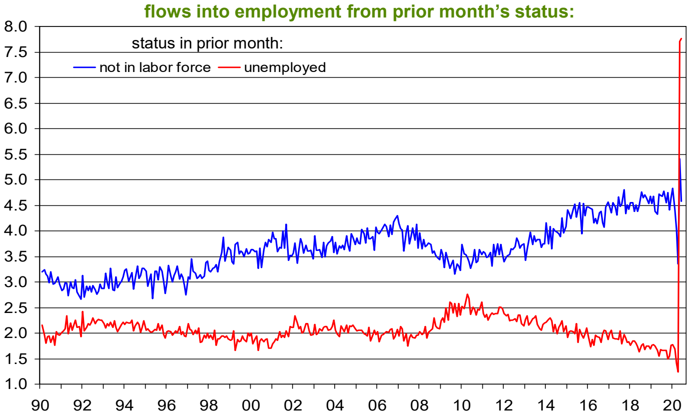


Returning to the employment data, job growth in May and June was notably broad based, at least on the surface. After plummeting to 4.3 percent in April, the one-month hiring diffusion index jumped to 63.0 percent in May and rose further to 75.2 percent in June, indicating that far more private sector industries added workers over the past two months than let workers go. But, three industry groups – leisure and hospitality services, education and health services, and retail trade – have accounted for 69.6 percent of private sector job gains over the past two months. In some sense, this is simply payback, as these three industry groups accounted for 63.6 percent of all private sector job losses in March and April. By way of comparison, over the 2012-2019 period, leisure and hospitality services, education and health services, and retail trade combined to account for 44.1 percent of all private sector job gains.

That the one-month hiring diffusion index has risen so sharply in the past two months tells us that, while other industry groups have added workers, the intensity of hiring across most of the private sector has been somewhat low. Moreover, the six-month hiring diffusion index remains notably low – at 6.4 percent in April, 5.0 percent in May, and 7.2 percent in June. This tells us that, relative to six months ago, far more private sector industries have fewer workers on their payrolls than have more workers on their payrolls. This longer-term hiring diffusion index will be a better gauge of the extent to which the labor market is rebounding over coming months than will the one-month hiring diffusion index.

The unemployment rate fell to 11.1 percent in June, better than our below-consensus forecast of 11.7 percent. As in the prior three months, BLS noted the June unemployment rate was understated due to reporting errors – job losers incorrectly reporting their status as "absent from work" rather than "unemployed." But, BLS noted that the degree of understatement was much lower in the June data than had been the case in the prior three months. Beneath the "headline" unemployment rate, however, the details of the household survey offer more insight into some interesting labor market dynamics.

Labor Force Flows:
flows into employment from prior month's status:



Source: Bureau of Labor Statistics; Regions Economics Division

The monthly household survey includes data on labor force flows, which help track month-to-month changes in labor force status, for instance, people flowing in to and out of the labor force and moving from employed to unemployed. Though they do not typically get much coverage, we find the data on labor force flows offer useful insights. The above chart tracks the flows of people who in one month were either not in the labor force or unemployed and in the following month were employed. One striking feature of the recently ended expansion was the sustained increase in the number of people transitioning from not in the labor force to being employed. At the same time, the number of people transitioning from unemployed in one month to employed in the following month steadily fell, indicative of skills deficits that precluded these people from finding a job in an increasingly tight labor market. But, as the chart shows, the number of people transitioning from unemployed to employed has shot up over the past two months, with over 7.7 million people making this transition in both May and June. This is evidence of large numbers of workers who had been laid off in March/April being recalled. What is unclear, however, is how many of these people were brought back to work and how many were brought back on to payrolls under the Paycheck Protection Program (PPP) but did not necessarily work – people who are paid during the survey period are counted as employed regardless of whether or not they work.

This goes to a concern we have expressed before. There is a body of evidence suggesting the PPP played a large hand in reported job growth in May, when nonfarm payrolls unexpectedly rose by more than 2.5 million jobs. The potential pitfall here is that once PPP funds have been exhausted, if business has not picked back up to a degree that would lead firms to retain these workers, there will be another round of layoffs, with a second round of layoffs more likely to result in permanent job losses. That the original requirements of the PPP regarding how and when businesses utilize PPP proceeds were relaxed between the May and June survey periods suggests the PPP would have had less of an impact on June's job growth, but it does set up the same potential outcome further down the road.

So, while we are encouraged by the 7.999 million private sector jobs added over the past two months, we also worry that measured job growth is overstating the degree of genuine improvement in labor market conditions. Between a suddenly more uncertain outlook for employment in the leisure and hospitality services industry group, concerns that the PPP has exaggerated the degree of job growth, and questions about the intensity of hiring (re-hiring) across most private sector industries, it would not be surprising to see the pace of job growth slow abruptly, as early as the July data. Moreover, the weekly data on Unemployment Insurance (UI) claims remain highly confusing.

Though well off the peak of 6.211 million in the week ending April 4, initial UI claims remain disturbingly elevated, having settled into a range of between 1.4 and 1.5 million per week over the most recent four weeks. To put this in context, prior to February, the run rate of initial claims over the prior two years had been just over 200,000 initial claims per week. That initial claims remain so elevated suggests a still unusually high pace of layoffs, at least if the data can be believed. Some are dismissing the persistently elevated weekly claims data as noise, as some states remain far behind in processing the wave of claims filed between late-March and late-April. While this could be playing a part, we're not willing to simply dismiss the initial claims numbers on this basis alone, even if we don't have a better explanation.

Data on continuing claims, i.e., the number of people drawing UI benefits through all sources – regular claims and special pandemic-related programs – show more than 30 million people drawing UI benefits. It could be that the degree of labor market turnover is simply greater than is typically the case, though this is hard to assess given that the JOLTS data, which offer details on hiring and separations, come with such a lengthy lag. Nonetheless, that UI claims remain so elevated is a source of unease, at least for us. So, while the labor market is on the mend, it is fair to question how solid of a foundation the recent improvement is built on.

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Q4 '19 (a)	Q1 '20 (a)	Q2 '20 (f)	Q3 '20 (f)	Q4 '20 (f)	Q1 '21 (f)	Q2 '21 (f)	Q3 '21 (f)		2017 (a)	2018 (a)	2019 (a)	2020 (f)	2021 (f)
2.1	-5.0	-34.8	18.5	6.1	5.6	4.2	3.4	Real GDP[1]	2.4	2.9	2.3	-5.8	3.3
1.8	-6.8	-37.4	27.3	8.4	5.1	3.9	3.0	Real Personal Consumption[1]	2.6	3.0	2.6	-5.8	4.1
-2.4	-6.4	-37.2	-6.4	-1.0	6.4	7.3	7.6	Real Business Fixed Investment[1]	4.4	6.4	2.1	-11.2	0.0
-4.3	-16.6	-48.9	-8.4	0.0	7.3	6.1	8.3	Equipment[1]	4.7	6.8	1.3	-17.4	-1.4
2.8	1.3	-17.8	3.7	0.6	7.7	8.0	7.6	Intellectual Property and Software[1]	3.7	7.4	7.5	-1.5	4.0
-7.2	2.6	-40.9	-21.5	-7.1	1.3	8.2	5.5	Structures[1]	4.7	4.1	-4.3	-14.6	-5.2
6.5	18.2	-30.3	9.5	1.2	3.1	2.4	1.8	Real Residential Fixed Investment[1]	3.5	-1.5	-1.5	0.2	0.5
2.5	1.1	4.1	12.3	-1.5	-5.5	-2.6	-1.2	Real Government Expenditures[1]	0.7	1.7	2.3	3.4	-0.7
-900.7	-816.6	-904.6	-955.9	-980.0	-974.5	-988.8	-983.1	Real Net Exports[2]	-849.7	-920.0	-953.9	-914.3	-979.8
964	968	706	806	832	846	853	861	Single Family Housing Starts, ths. of units[3]	851	872	893	828	856
469	517	292	346	373	379	377	377	Multi-Family Housing Starts, ths. of units[3]	356	376	403	382	378
16.7	15.0	11.4	13.5	14.0	14.6	15.0	15.2	Vehicle Sales, millions of units[3]	17.1	17.2	16.9	13.5	15.0
3.5	3.8	13.0	9.9	9.2	8.7	8.1	7.6	Unemployment Rate, %[4]	4.3	3.9	3.7	9.0	7.9
1.4	1.2	-11.2	-7.0	-6.2	-5.4	8.2	3.6	Non-Farm Employment[5]	1.6	1.6	1.4	-5.8	2.1
2.1	0.9	35.8	-23.8	-7.8	0.6	1.3	1.8	Real Disposable Personal Income[1]	2.9	4.0	2.9	2.9	-2.3
1.6	1.8	1.2	1.0	0.9	0.7	1.0	1.1	GDP Price Deflator[5]	1.9	2.4	1.7	1.2	1.0
1.4	1.6	0.5	0.5	0.5	0.6	1.6	1.4	PCE Deflator[5]	1.8	2.1	1.4	0.8	1.3
2.0	2.1	0.4	1.1	0.9	1.0	2.5	1.7	Consumer Price Index[5]	2.1	2.4	1.8	1.1	1.7
1.6	1.7	1.4	0.8	0.7	0.7	1.0	1.4	Core PCE Deflator[5]	1.6	1.9	1.6	1.1	1.2
2.3	2.2	1.3	1.1	1.1	1.1	2.0	2.0	Core Consumer Price Index[5]	1.8	2.1	2.2	1.4	1.7
1.71	1.30	0.13	0.13	0.13	0.13	0.13	0.13	Fed Funds Target Rate Range Mid-Point, %[4]	0.97	1.78	2.16	0.42	0.13
1.79	1.38	0.69	0.82	0.90	1.01	1.13	1.20	10-Year Treasury Note Yield, %[4]	2.33	2.91	2.14	0.95	1.15
3.70	3.52	3.24	3.13	3.17	3.22	3.30	3.30	30-Year Fixed Mortgage, %[4]	3.99	4.54	3.94	3.27	3.29
-1.9	-1.7	-2.1	-1.9	-1.8	-1.7	-2.0	-2.1	Current Account, % of GDP	-2.3	-2.4	-2.2	-1.9	-2.0

a = actual; f = forecast; p = preliminary

Notes:
1 - annualized percentage change
2 - chained 2012 $ billions
3 - annualized rate
4 - quarterly average
5 - year-over-year percentage change

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