ECONOMIC UPDATE

November 25, 2020

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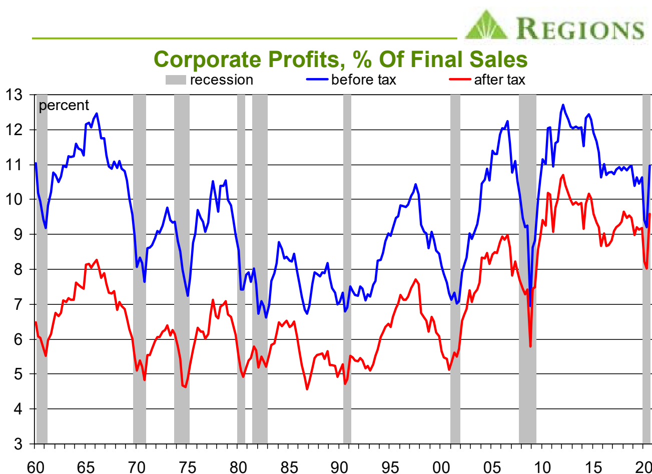
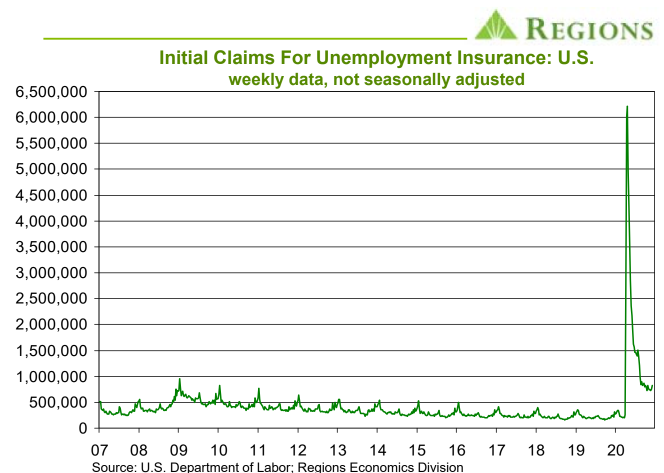
Real GDP: Revised and more complete source data show real GDP grew at an annualized rate of 33.1 percent in Q3, matching the BEA's initial estimate. It is almost never the case that the BEA's first and second estimates of GDP in any quarter yield the same rate of growth, that this happens at a time when there has been added volatility in the economic data makes it even more unusual. In any event, while the Q3 growth rate is the same, the underlying details did change. For instance, growth in real consumer spending was revised slightly lower, from 40.7 percent in the initial estimate to 40.6 percent (annualized rates) in the second estimate. This is at odds with our expectation that there would be an upward revision, and while growth in spending on goods was revised higher, growth in spending on services was revised lower – spending on services accounts for roughly two-thirds of all consumer spending. Growth in business fixed investment was revised higher, which reflects an upgrade to the BEA's initial estimate of investment in intellectual property products, which includes spending on computer software and on research/development. Growth in residential fixed investment was also revised upward. The contraction in real government spending is now reported to be slightly larger than the initial estimate, thanks to a downgrade in state and local government expenditures, while the Q3 trade deficit is now reported to be slightly larger than the initial estimate. These changes, most of them fairly small, netted out, thus leaving the annualized Q3 growth rate unchanged at 33.1 percent.



Included in today's release is the first look at Q3 corporate profits – the measure of corporate profits in the NIPA is much broader than the measure reported for the S&P 500 and, as such, is our preferred measure. On a before-tax basis, corporate profits rose by 27.12 percent in Q3, after declines of 11.95 percent in Q1 and 10.26 percent in Q2, which leaves before-tax profits up 3.34 percent year-on-year. After-tax corporate profits rose by 27.54 percent in Q3 following two straight quarterly declines, which leaves after-tax profits up 3.24 percent year-on-year. Profits in the nonfinancial corporate sector were up by 43.78 percent in Q3, while profits in the financial sector were up by 5.35 percent. Note that a detailed breakdown of profits on an industry basis will be released with the third estimate of Q3 GDP, but it is reasonable to assume profit growth amongst services providers will have lagged overall profit growth. The chart to the side shows profit margins, or, corporate profits as a percentage of final sales (GDP less inventories), and with the increase in Q3, after-tax margins are at their highest point since Q3 2018. While profit margins remain well below the prior cyclical peaks, note that they remain elevated by historical standards, which helps give context to the recent performance in the equity markets.

Initial jobless claims: Initial claims for unemployment insurance (UI) benefits rose to 827,710 in the week ending November 21 from 749,338 in the week ending November 14. Note that we are referencing the not seasonally adjusted claims data, which we have seen as more reliable over the course of the pandemic than is the case with the seasonally adjusted data. Continuing claims, or, the number of people drawing regular UI benefits, fell to 5,911,965 in the week ending November 14 from 6,079,582 in the week ending November 7 (data on continuing claims come with a one-week lag from the data on initial claims). Unadjusted initial claims have risen in each of the past two weeks and stand at their highest level since the week ending September 5. The number of people filing for benefits under the Pandemic Unemployment Assistance (PUA) program, which covers the self-employed and others not eligible for regular UI benefits, fell to 311,675 in the week ending November 21. Keep in mind that while part of the decline in continuing claims reflects people going back to work, part of the decline is due to people having exhausted their regular benefit terms, which in most states run for 26 weeks. Those exhausting regular benefits are eligible for 13 weeks of extended benefits under the Pandemic Emergency Unemployment Compensation



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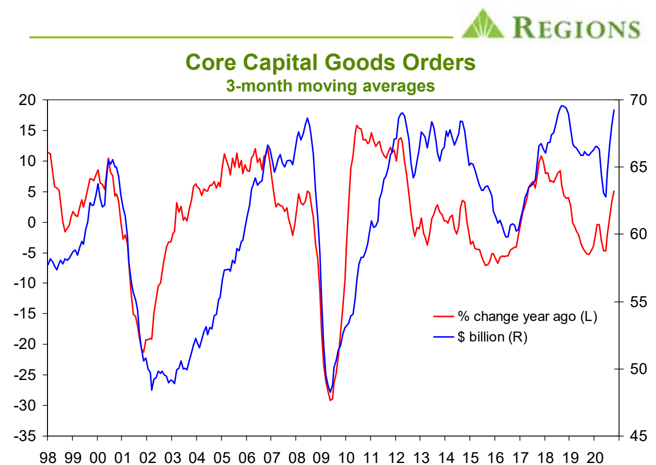
(PEUC) program, and 4,509,284 people filed for benefits under this program in the week ending November 7 (the latest observation). Filings under the PEUC program have trended higher over the past several weeks, which goes to our point that not all of the decline in continuing claims reflects people going back to work. That claims for UI benefits have risen over the past two weeks could be a sign that the ongoing spike in COVID-19 cases and several state and local governments imposing new restrictions on economic and social activity, even if not as biting as those seen last spring, are acting as a drag on economic activity, which in turn is impacting the labor market. With the spike in cases showing no signs of letting up, it is possible that the pace of layoffs will accelerate in the weeks ahead. Note that between the October and November reference weeks for the BLS's establishment survey, from which estimates of nonfarm employment are drawn, initial claims for UI benefits rose which, along with other indicators, points to a weak November employment report (due December 4). A decline in nonfarm payrolls in November is within the realm of possibility, particularly given that the November seasonal adjustment factors will be most unfriendly to the headline job growth number. Either way, that initial claims remain at almost four times the pre-pandemic run rate is an unwelcome reminder of how far the labor market is from being fully healed.

October Durable Goods Orders: In stark contrast to the signals being sent by the labor market data, the data on business investment continue to outperform expectations. Durable goods orders rose by 1.3 percent in October, with ex-transportation orders also up by 1.3 percent and core capital goods orders, a key barometer of business investment spending, up by 0.7 percent, also above expectations. Shipments of core capital goods, a direct input into the GDP data on business investment, rose by 1.3 percent in October which, aside from making 1.3 a wildly popular number in the world of durable goods, gets Q4 growth in business investment off to a solid start after a strong performance in Q3. Orders for core capital goods are easily above the pre-pandemic peak (note that our chart shows the 3-month moving average, as this series can be quite volatile), and this is in line with other data showing the manufacturing sector is recovering at a healthy pace from the shutdowns seen in the spring. Demand for computer equipment continues to grow at a rapid rate, which in part reflects firms adjusting to changing work arrangements. More broadly, firms may be investing in machinery and equipment as they adapt to changes in how they operate brought on by the pandemic. It is reasonable to wonder, however, how much longer the manufacturing sector can outperform, particularly if a step backward in the labor market leads to weakening demand for goods. Also, to the extent firms are investing now to position themselves for a post-pandemic world, it could be that as the rest of economy picks up over the back half of 2021, assuming the arrival of an effective vaccine, the manufacturing sector will flip from a leader to a laggard.



October Personal Income: Total personal income fell by 0.7 percent in October, less harsh than the 1.4 percent decline our forecast anticipated but more severe than the consensus forecast of a 0.1 percent decline. As we noted in our weekly *Economic Preview*, our forecast was predicated on declines in government sector wage and salary earnings, nonfarm proprietors' income, and transfer payments more than offsetting a solid increase in private sector wage and salary earnings, though we admitted to a good deal of uncertainty in our forecasts of the magnitude of the declines in the above components. As it turns out, the 0.6 percent decline in government sector earnings and the 2.9 percent decline in nonfarm proprietors' income matched our forecasts, and the 6.2 percent decline in transfer payments was larger than we anticipated. Yet, our forecast of total personal income was still too low, which reflects growth in private sector wage and salary earnings (the largest single component of personal income), rental income, farm income, and asset-based income all topping our expectations. The decline in nonfarm proprietors' income in part reflects the BEA's accounting of funds from the Paycheck Protection Program (PPP). PPP loans that were converted into grants had been treated as subsidies in the personal income accounts, spaced out over a six-month period (April through September) and added to nonfarm proprietors' income. That sequence of subsidies will be reversed over a six-month period (October through March), leading to deductions from nonfarm proprietors' income. As such, this category, which is a proxy for small business profits, will be noisy through March and will act as a drag on growth in total personal income. The decline in transfer payments in part reflects a reversal of the supplemental unemployment insurance payments made in September under the Lost Wages Assistance Program – the September payments in many states included retroactive payments for August. With funds from this program having been exhausted, it followed that this would leave a hole in October transfer payments. The October personal income data highlight, if that is the proper word to use in this context, the two-tiered nature of the recovery from but brief but violent downturn associated with the pandemic and the efforts to stem its spread. While the recovery in the labor market is leading to steady gains, at least for now, in private sector wage and salary earnings, for those yet to return to their old job or find a new job, conditions continue to worsen. Any savings built up from funds provided by the CARES Act are rapidly drying up, and that claims for unemployment insurance are on the rise, and will likely rise further, points to the need for further support for those displaced from the labor market. Keep in mind that funding for the pandemic-related unemployment benefit programs cited above expires on December 26 in the absence of action by Congress, while the CDC's eviction moratorium expires on December 31.

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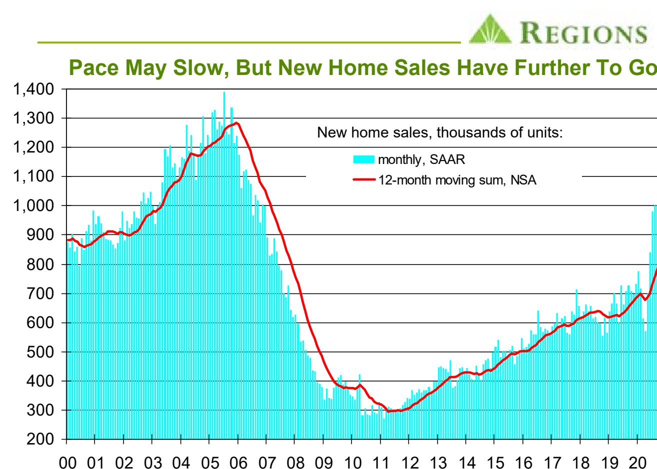
October Personal Spending: Total personal spending rose by 0.5 percent in October, matching our slightly above-consensus forecast. As we anticipated in the wake of soft retail sales data for October, spending on goods was flat in October, with higher spending on consumer durable goods offset by a decline in spending on nondurable consumer goods. Spending on services rose by 0.7 percent, supported in part by higher utilities outlays, but this is considerably smaller than the increases seen over the prior several months. As of October, the level of consumer spending on goods is 7.8 above the pre-pandemic peak, while the level of consumer spending on services is 5.8 percent below the pre-pandemic peak. With spending on services accounting for roughly two-thirds of all consumer spending, this leaves the level of total consumer spending 1.6 percent below the pre-pandemic peak. While the economy has partially reopened after the widespread shutdowns seen in the spring, the reality is recoveries in travel, tourism, recreation, dining out, sporting events, live arts performances, and movies, amongst others, have been either partial or nonexistent, which accounts for the remaining gap in services spending. The danger now is that the ongoing spike in COVID-19 cases and new restrictions on economic and social activity threaten to further suppress spending on services – the flip side of which is the corresponding damage to the labor market. With the PCE Deflator having been unchanged in October, real personal spending rose by 0.5 percent, and while this gets Q4 growth in real consumer spending off to a solid start, it remains to be seen whether, or to what extent, spending on services will falter in November and December, posing a downside risk to Q4 real GDP growth. Also, with personal income having fallen sharply and personal spending having risen, the personal saving rate fell from 14.6 percent in September to 13.6 percent in October and is likely to fall further in the months ahead.

October New Home Sales: Total new home sales slipped to an annualized rate of 999,000 units in October, better than the 975,000 pace the consensus expected but short of our forecast of a sales rate of 1.042 million units. At the same time, however, prior estimates of sales over the July-August period were revised meaningfully higher, with revisions now putting the August and September sales rates at over 1.0 million units. Recall that when Census released the initial estimate of September sales, showing an annualized sales rate of 959,000 units, our reaction was that seemed an oddly low number, as it was out of line with not only all of the other September housing market data but also with industry reports and commentary from the builder community, and we noted we expected the initial estimate of September new home sales to be revised higher. The initial estimate of October new home sales is more in line with the rest of the housing market data, though still seems lower than implied by reports on builder orders. Either way, on a not seasonally adjusted basis, there were 80,000 new home sales in October, falling short of our forecast of 84,000 sales. As of October, the running 12-month total of not seasonally adjusted new home sales, which we consider the most reliable gauge of the trend rate of sales, stands at 802,000 units, the highest such total since November 2007. Our forecast of not seasonally adjusted sales would have put this total at 800,000 units, that the actual total is higher despite unadjusted October sales falling short of our forecast goes to our point about the upward revisions to estimates of sales over the prior few months. In our weekly *Economic Preview*, we pointed to two other numbers to look for in the report on October new home sales. One was spec inventories, which we anticipated would fall further in October. This turned out to be the case, and spec inventories are at the lowest level since April 2017. The other metric we pointed to was the share of sales accounted for by units on which construction had not yet started, and we expected this share to rise in October, as turned out to be the case, with such units accounting for 35 percent of total sales. Both metrics point to the degree to which builders are pressed to keep pace with demand, and backlogs of unfilled orders continue to grow. Though not to the same degree as is the case in the market for existing homes, lean inventories are a growing issue in the market for new homes, and builders are taking advantage of pricing power. We have said that, barring another downturn in the broader economy, the biggest threat to the for-sale segment of the housing market is diminishing affordability. Even if mortgage interest rates don't budge, rapid price appreciation will ultimately erode affordability, which will in turn eat into sales. We do not think the market is at that point yet, but it is moving in that direction. At the same time, however, while demand for new home purchases remains strong, the labor market data serve as a cautionary note. We do see further upside room for new home sales, but the downside risks are becoming more pronounced.



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