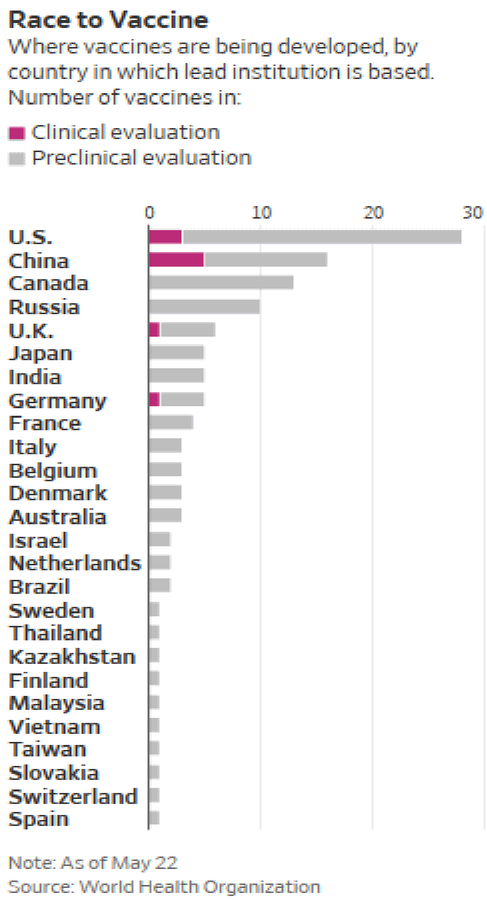
2020 2ND Quarter Economic Update

The lockdown of the economy has created depression like economic conditions. Now that the economy is opening up, we are seeing some improvements, but we need to remind ourselves that the damage is much greater than the improvements. Most economists agree that the economic recovery will be gradual and uneven.

Currently, the market is discounting: a v-shaved economic recovery, there will be a vaccine by the end of the year, the recovery will start in the 3rd quarter, President Trump will be re-elected. In this report, I challenge these views.

An Effective and Safe Vaccine, the Key to a Solid, Sustained Recovery

Many analysts agree the key to a strong sustained recovery is a vaccine that makes consumers safe. Fortunately, there are many global efforts to create a vaccine. Below is a list of some of the efforts:



The U.S. leads the global effort. Some countries have stated that if they come up with a vaccine, the U.S. will have to wait in line.

Because of these global efforts, improved biotechnology platforms, AI and super-fast computers, some analysts and health professionals believe that there is a good probability that we could have a vaccine and treatment within a year. U.S. efforts will be fast tracked so we can have a vaccine by fall or winter, but the vaccine will be for emergencies only such as front line health professionals, and seniors living in group homes.

Also, because the vaccines are being rushed, effectiveness, side effects and dosages will take more time to learn. Because of the uncertainty of these new vaccines, it may take time for the public to adopt the vaccines.

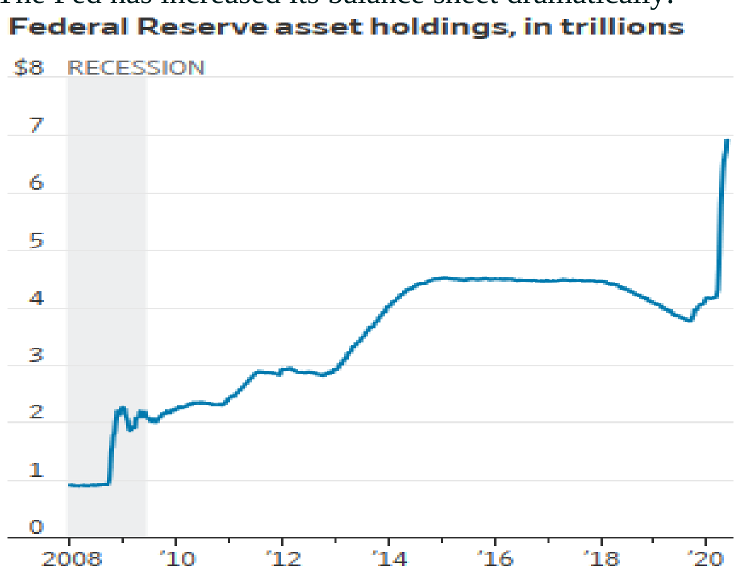
The market has rallied on any positive news regarding a vaccine or treatment. The market is probably up about 10% on vaccine news. If there is a vaccine by the fall, the market could have a powerful rally despite the market has already rallied on such an event. The market has not discounted that there will be no effective, safe vaccine by the fall.

Health professionals were forecasting a second wave in the fall, winter during the flu season. They are now saying a second wave of infections is possible in the near future because of national protests and the President will start having his political rallies. The market has not discounted a second wave of infections, especially if we get the second wave this summer.

Trillions of Dollars in Relief and Aid

Some investors, analysts believe that the massive aid and relief that the Fed and lawmakers are providing will minimize the impact of the economy's lockdown.

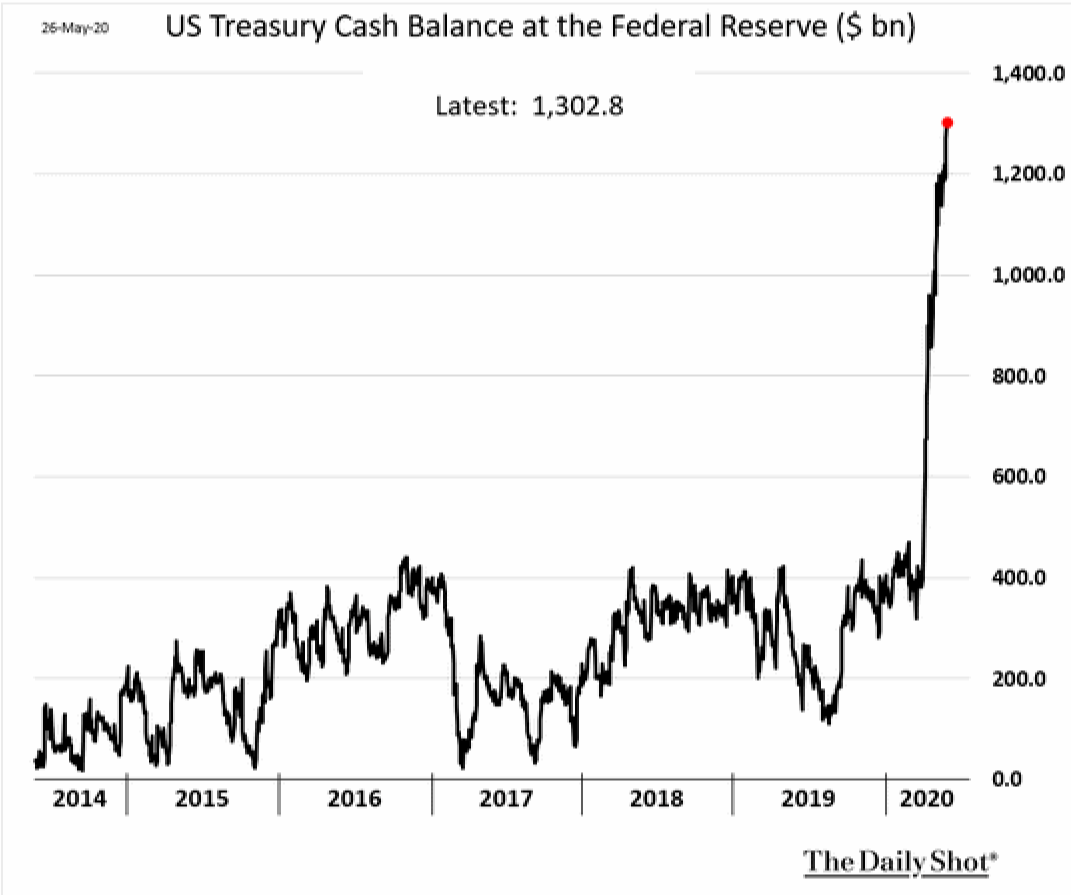
The Fed has increased its balance sheet dramatically:



Source: WSJ, Daily Shot

The Federal Reserve is not legally allowed to lend money directly to the private sector, but the Fed is working with the Treasury so that some of this money can get to small businesses through the Treasury and the U.S. business and financial system.

The US Treasury's cash balances at the Fed exceeded $1.3 trillion as the federal government continues rapid-fire debt issuance.



The Treasury will apply its cash through the banking system so the banking system can leverage this cash to small businesses.

Lawmakers have passed several aid packages totaling about $3 trillion. More is expected.

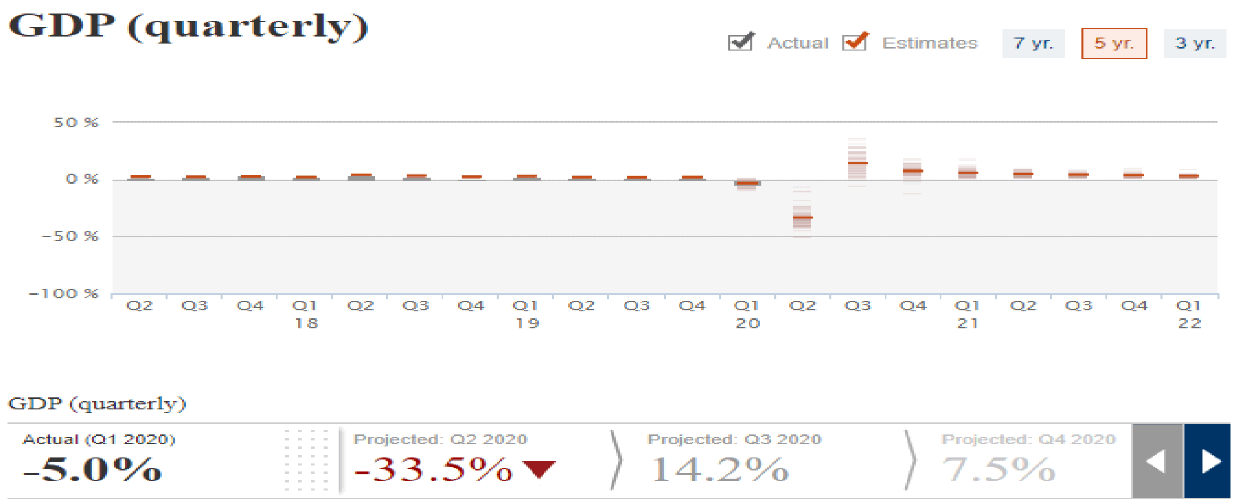
The money from the Fed, the leverage from the Treasury and aid from lawmakers is probably close to $10 trillion.

There has been a strong rally based on all the relief and aid and that the Fed has investors back, also known as the Fed put. If all this money does not get to where it’s needed and quickly, the economy could struggle. The market will eventually reflect a struggling economy, similar to the last cycle with subpar growth.

GDP

The economy grew 2.9% in 2018 and was expected to slow to 1.9% for 2020 (pre virus). In other words, the economy was slowing down before the virus.

For most of the 2020 second quarter, the economy was locked down so economists are predicting a historic downturn:



Source: WSJ

GDP dropped 5% in the 1st quarter and is expected to drop about 33% in the 2nd quarter.

GDP announcements are reported and compared quarter to quarter. Because the downturn is expected to be so dramatic in the 2nd quarter and will probably be the bottom, the improvement off the bottom could be impressive, but GDP is expected to be down about 4% to 10% for 2020.

The International Monetary fund sees the global economy being down as much 5% this year and forecasts for next year is for a small recovery and some believe the global economy may continue to contract next year.

The Consumer: Unemployment, Consumer Confidence, Retail, Housing and Autos

I've written many times that the consumer is 70% of GDP, so it makes sense to focus on the consumer.

Unemployment

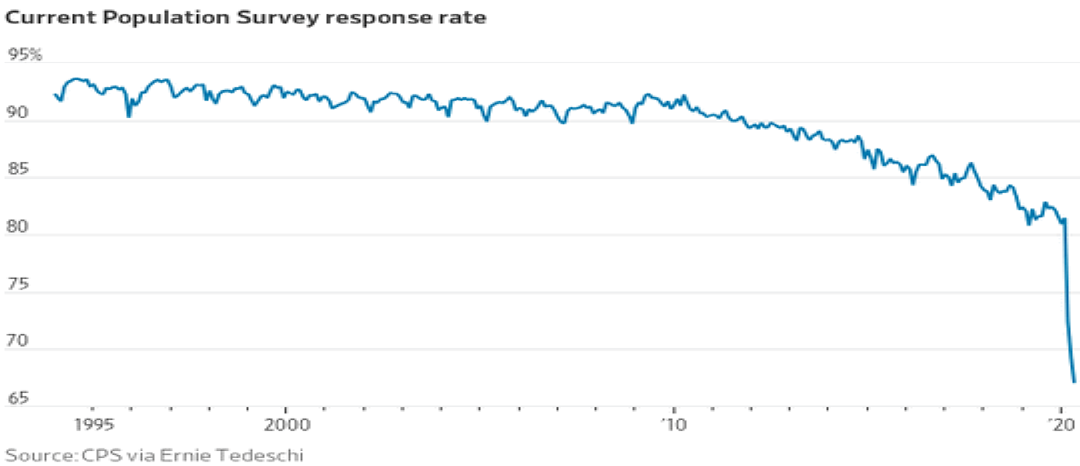
So far over 40 million workers have filed for unemployment benefits. According to the Labor Department, about 20.9 million continue to receive unemployment insurance.

Most economists were forecasting a 20% unemployment rate for May. When the Labor Department's unemployment report was announced recently, unemployment was 13.3%, a pleasant shocker to most economists.

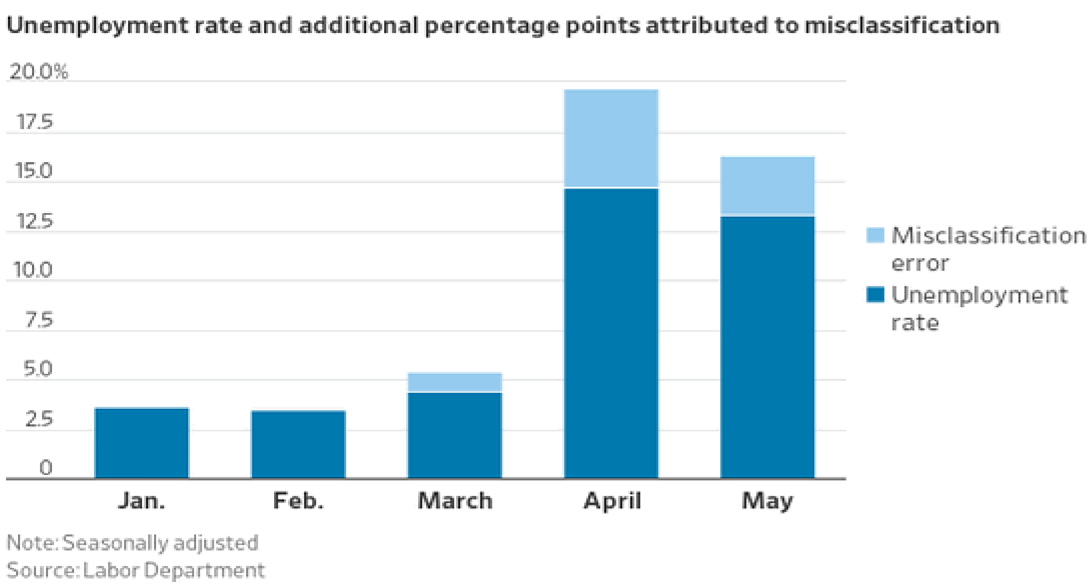
Many economists believe that the unemployment report will be revised higher. Here ae some of the reasons why the unemployment rate was much lower than expected and will probably be revised higher:

- Economists and analysts were quick to point out that the monthly unemployment report is an estimate only and that this report will probably be revised higher.

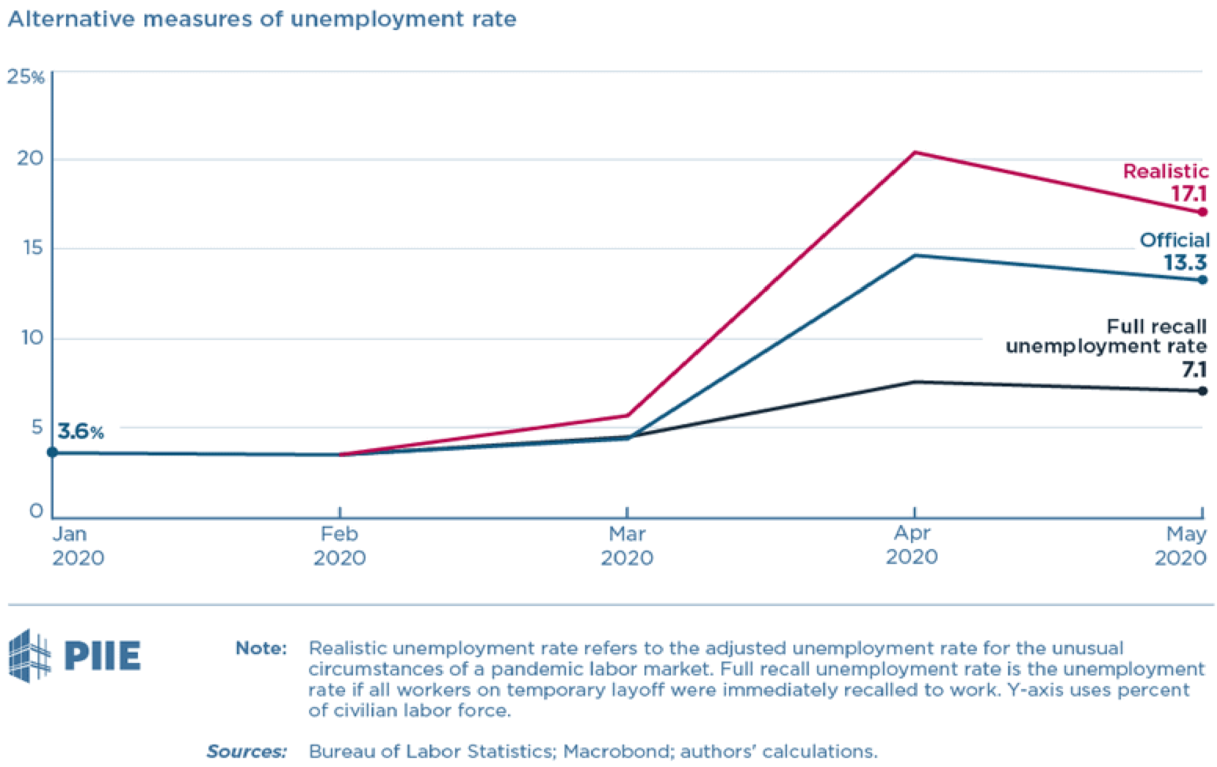
- Because of the virus, employment surveys that the unemployment reports are based on had lower respondents and therefore the employment report was based on insufficient data. The chart below shows fewer respondents:



- Because of PPP (Paycheck Protection Program) some unemployed are considered employed and some economists believe that some of these workers will not be called back overstating the employed. The chart below shows the potential miscalculation and understatement of the unemployed:

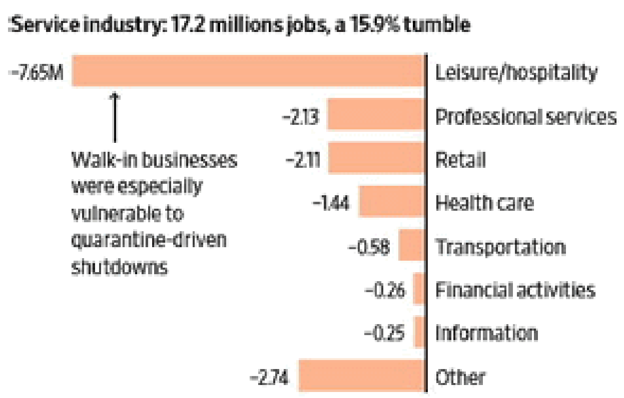


Some economists believe that without the misclassification, unemployment would be closer to 17%.



Even if the unemployment rate was 13.3% that is a lot of people unemployed. The Federal Reserve admitted recently that it will take years for many of these unemployed to find a job.

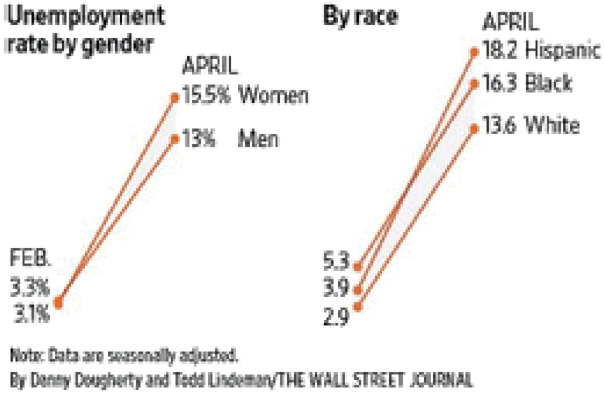
The service sector has been hit the hardest and most economists agree that it will take years for the service sector, especially employment in this sector to recover.



Source: Labor Dept. WSJ

Most of the job losses in the service sector have low wages, few if any employee benefits, and little job security.

Women, Blacks and Hispanics are significant employees of the service sector so now these groups have the highest unemployment:



Source: Labor Dept. WSJ

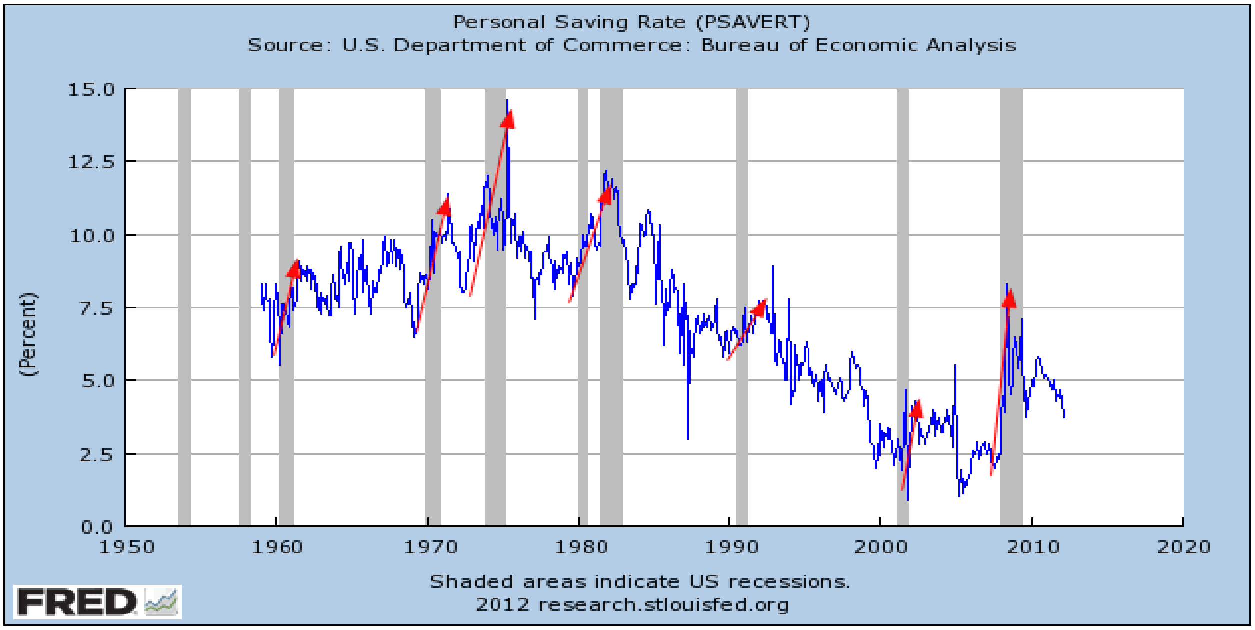
Also, one of the reasons Blacks and Hispanics have higher rates of the covid-19 virus is because many of them work in the service sector, jobs that have high public contact.

Consumer Confidence

Consumer confidence has crashed over 50 points since its peak:

Source: The Daily Shot, WSJ

It is normal for workers to save more during recessions because of the uncertainty and lower consumer confidence. The chart below shows that during recessions, consumers save more:

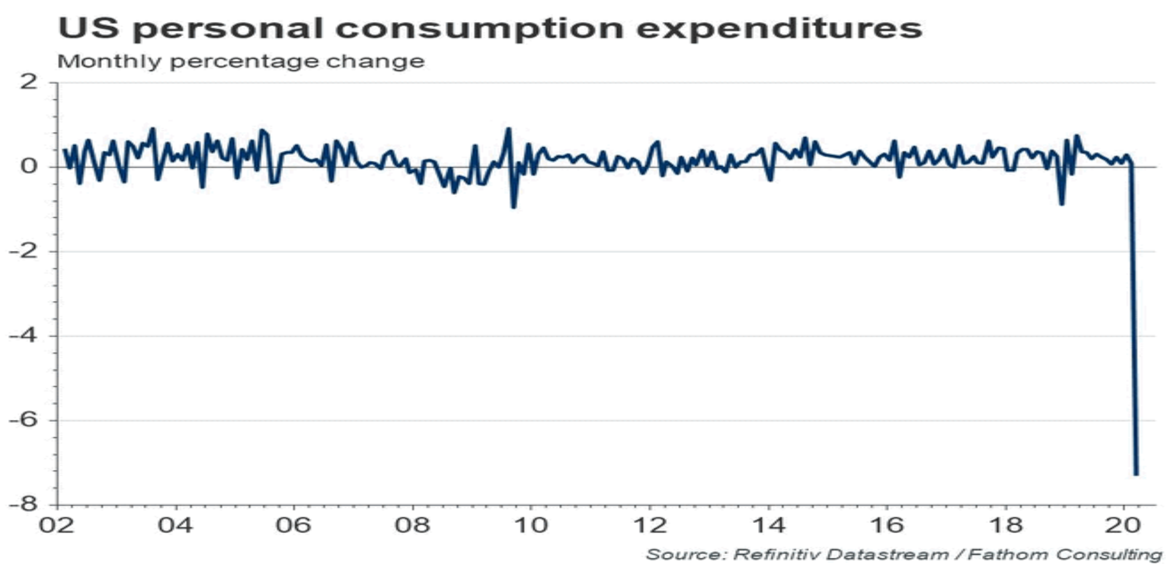


Source: FRED, Federal Reserve Economic Data

The chart does show every recession since 1960 the savings rate increased. This is called the savings paradox: in the short-run higher savings versus spending contributes to a recession, but households are repairing their balance sheets and is financially healthier.

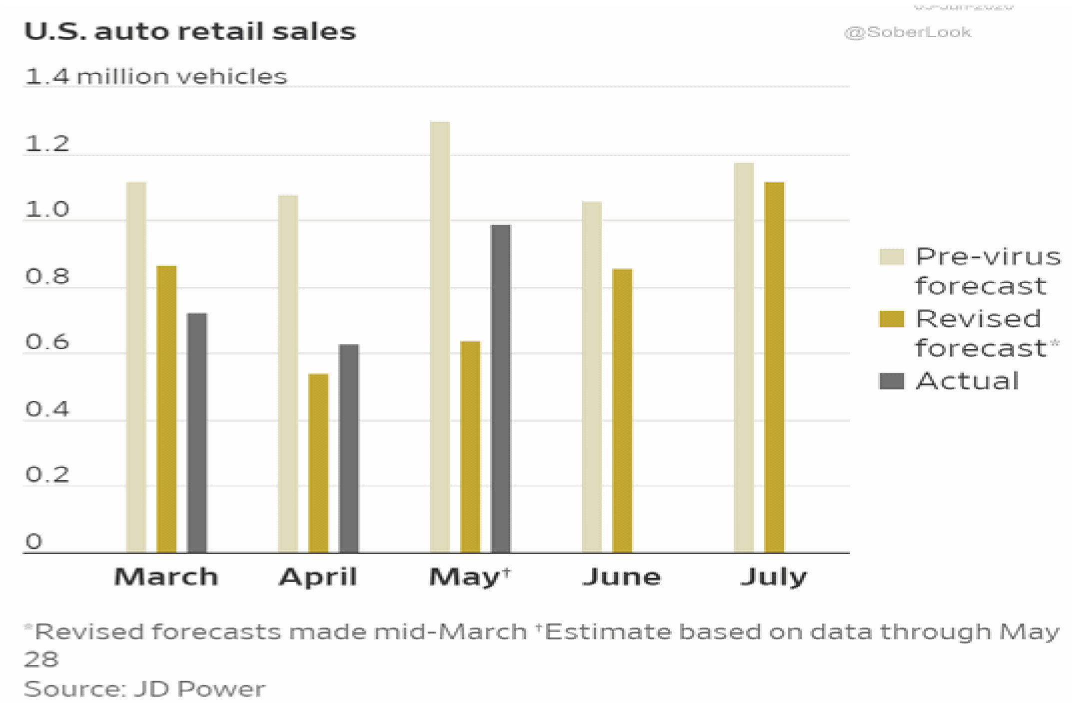
Those that have jobs are worried about their future employment will probably cause them to increase their savings during this recession and this would be normal behavior.

High unemployment, the virus, national social protests, falling consumer confidence, and uncertainty is impacting consumer consumption:



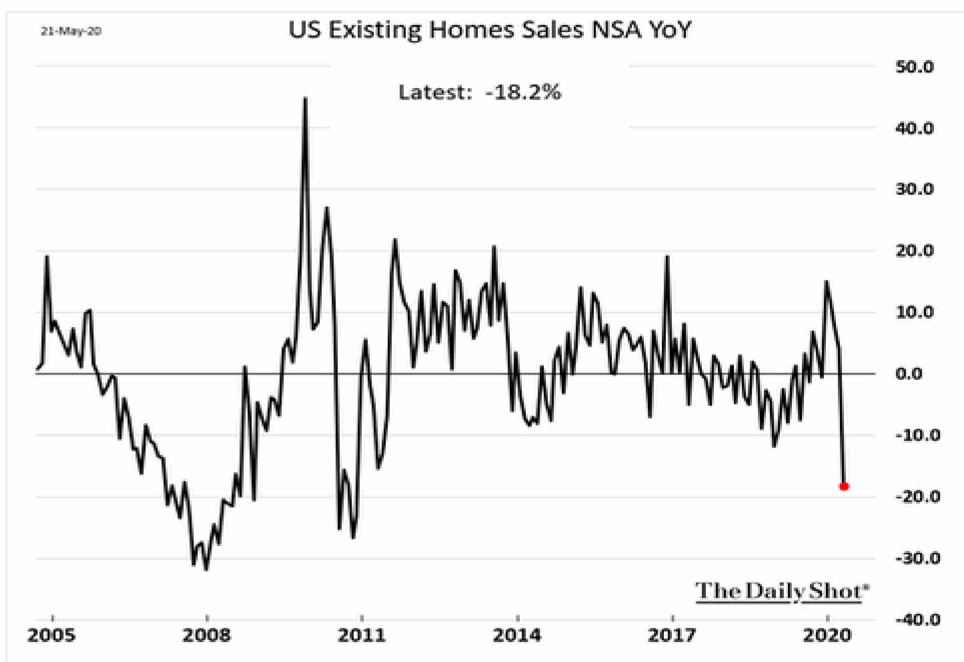
Consumption has also fallen dramatically.

Recently, auto sales have been better than forecasted:



Auto sales did improve from April. Forecasts have been increased. Auto sales did peak several years ago and have been floundering, Auto sales are stabilizing at best.

Housing sales trends have been falling for several years, and have fallen substantially because of the shutdown:

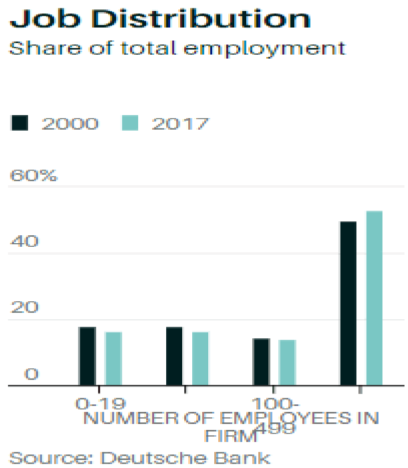


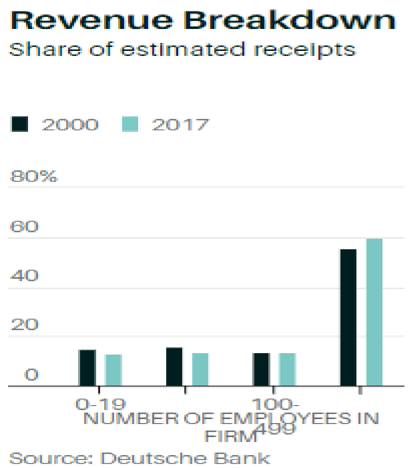
Source: FRED, Federal Reserve Economic Data

Home prices have actually gone up because homeowners are living in their homes longer creating less housing supplies. Less supply equals higher prices.

Small Business

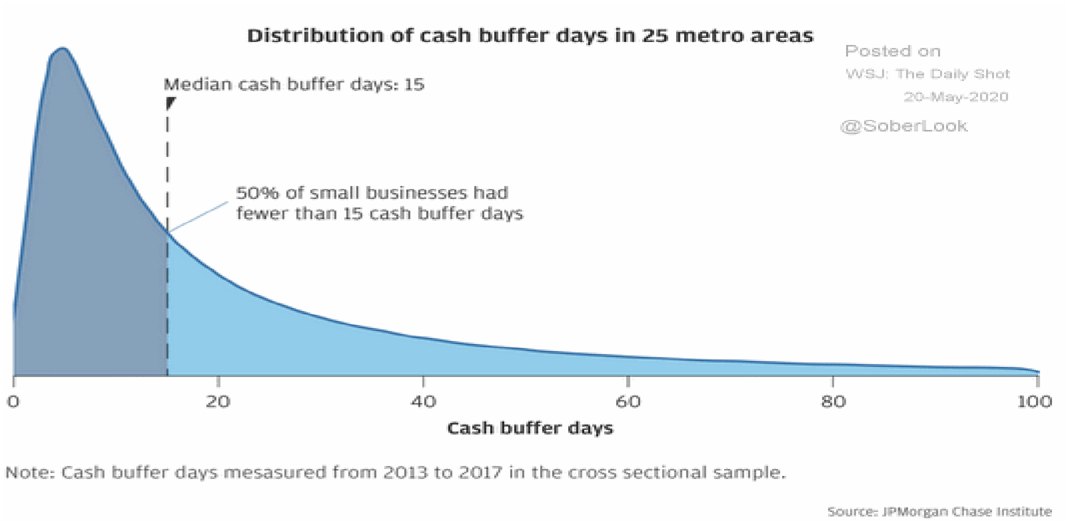
The virus/shut down has hit small business hard. Small businesses are responsible for about 40% of all business revenue and about 50% of U.S. employment.





Early last April, about 43% of small businesses were temporarily closed. Of these businesses, 38% said they were unlikely to survive the shutdown/reopen by the end of the year. Some businesses, big and small are uncertain that even if they do open will demand, customers be there.

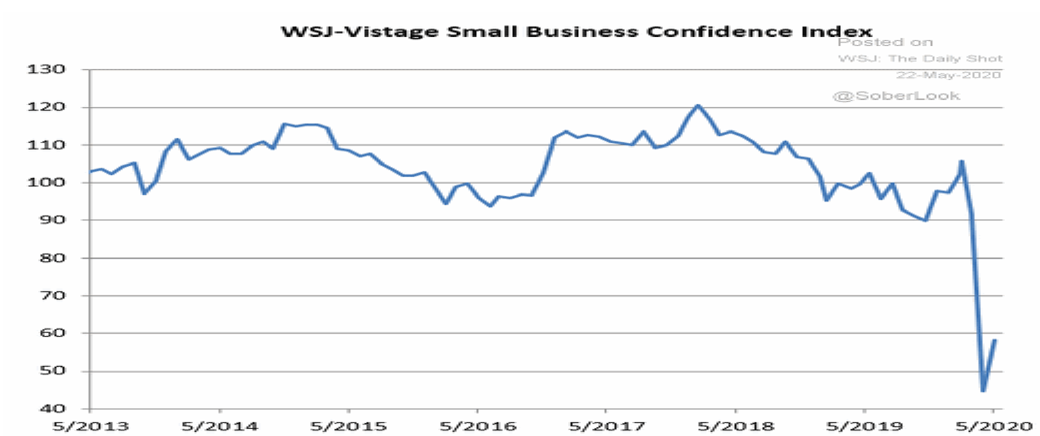
According to a JP Morgan study, small businesses only have about 15 days of liquidity:



The Paycheck Protection Program, PPP, passed by lawmakers was meant to provide small businesses with forgivable loans if small business owners kept workers on their payrolls. The loans were designed to last eight weeks. There may be other loan programs, aid/relief that may be passed that can get small businesses and workers past the eight weeks.

The rollout was flawed for many reasons. There are about 30.2 million small businesses, and about 4 million got loans. Lawmakers are working on changing the rules for loans after learning from the mistakes and getting feedback from small businesses on why more small businesses did not take the loans. More will qualify, the loans will probably have very low interest rates but may not be forgiven.

Small business confidence did spike when President Trump was elected, but because of the lockdown, it has plummeted.

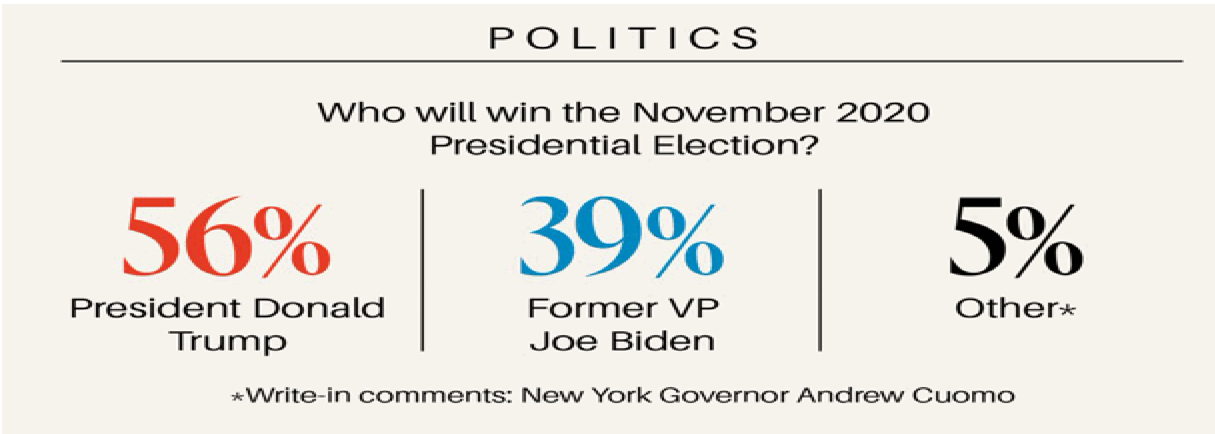


Source: The Daily Shot, WSJ

Small business is also essential to a solid recovery. The market has not discounted how bad small business is doing.

Elections

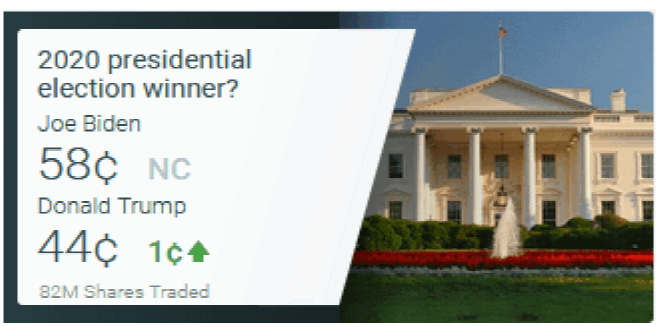
The market believes President Trump will be reelected. Below is a recent Barron's survey of portfolio managers:



Source: Barron's

The average total pay of a portfolio manager is between $300,000 to seven figures, and they are beneficiaries of the Presidents tax cuts. It's believed if Joe Biden is elected, Democrats will repeal President Trump's tax cuts. It is no wonder portfolio managers think/want the President to be reelected.

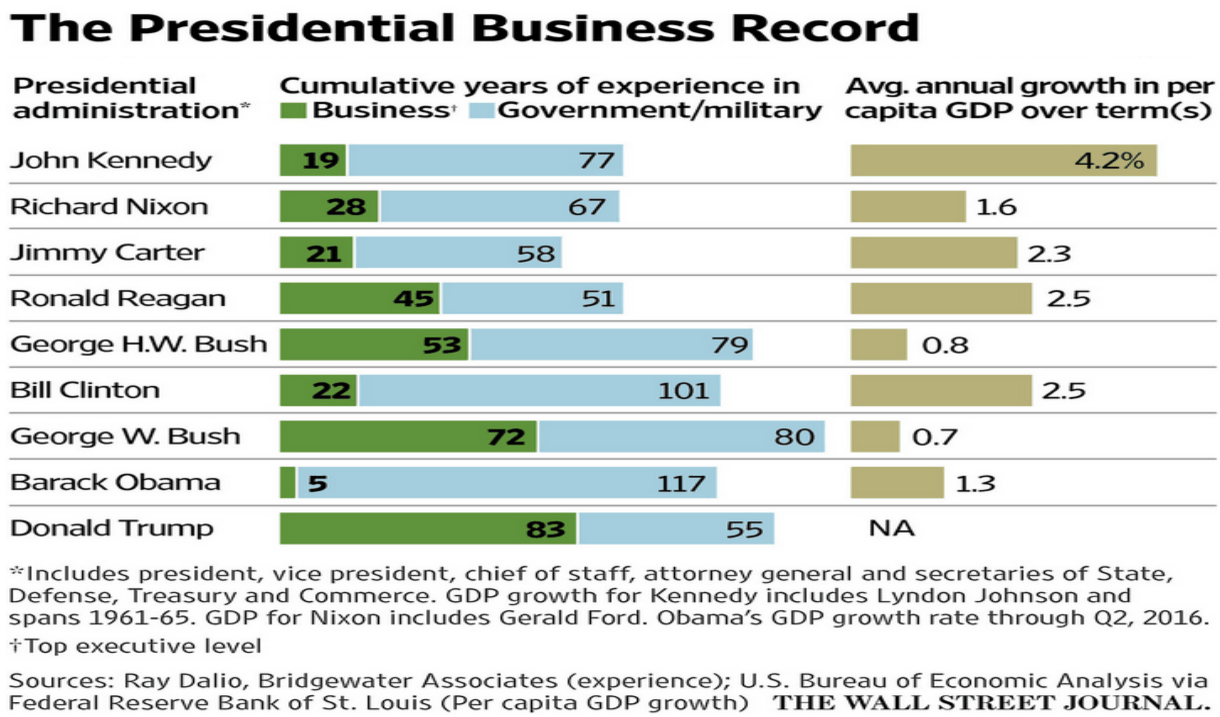
PredictIt, an online betting site provides betting on the U.S. presidential election. Most of the year, bettors saw the President winning. That has changed and now they see Biden winning by a wide margin. Again, these are wagers and not polls and should have more weight because bettor's money is on the line.



Source: PredictIt.org

The market has not discounted a Biden win. There could be a major change in economic policies, focus, and direction. This does not mean the economy and markets will continue to tank.

Democrats tend to hire excellent economists, businesspeople on their teams where the markets and economy historically have done well and just as good or better than Republicans:



If we look at returns of the market going back to President Reagan, the Democrats beat Republicans.

Wilshire 5000 Performance

	First Year	Second Year	Third Year	Fourth Year	Single-Term Total Return**	Two-Term Total Return**
Ronald Reagan 1st term	-7.1%	32.6%	18.8%	5.5%	57.6%	
Ronald Reagan 2nd term	27.2%	21.5%	-8.6%	22.7%	82%	186.9%
George H.W. Bush	20.2%	-2.2%	35.2%	8.0%	71.8%	
Bill Clinton 1st term	12.9%	-0.4%	33.1%	28.2%	92%	
Bill Clinton 2nd term	26.1%	25.7%	20.6%	-9.1%	73.8%	233.6%
George W. Bush 1st term	-14.1%	-17.6%	32.7%	5.5%	-0.9%	
George W. Bush 2nd term	11.8%	15.0%	-6.0%	-37.5%	-24.4%	-25.1%
Barack Obama	46.5%	16.5%	4.3%	10.1%*	91.7%	

*All years start with respective inauguration days; President Obama's fourth year ends as of 09/11/12
**Total return is cumulative, not the sum of the terms
Source: Wilshire Associates

The first term of President Obama the market was up 91.7%. So far, the market is up about 45% since President Trump was elected.

Summary and Conclusion

Currently, there is an optimistic outlook for the economy by many investors, and some analysts and economists. Below I list the optimistic case, and then I provide an opposing view:

- The Fed and lawmakers have poured trillions of dollars into the economy, especially to help small businesses and workers.

  So far, all this money is not getting to where it needs to be and its not happening fast enough. This was the big complaint of QE during the Great Recession.

- There will be a vaccine by the fall, or winter.

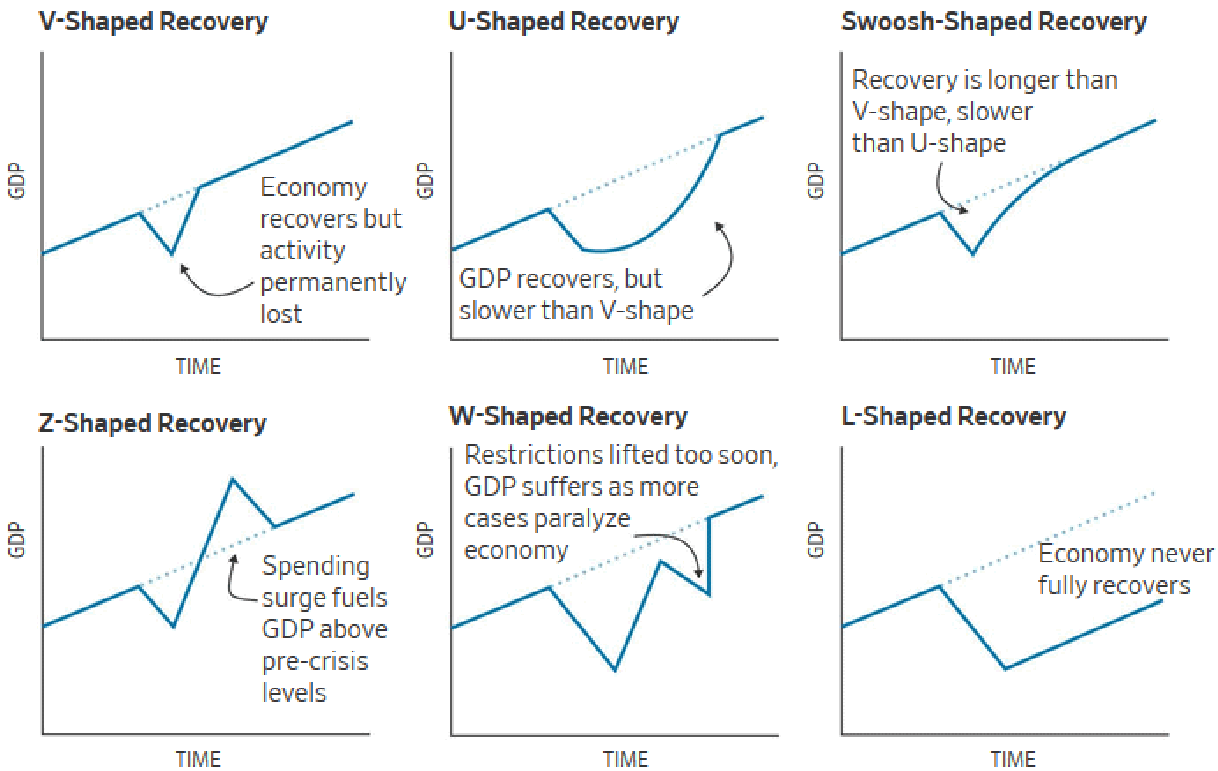
  What will the market, economy do if the vaccine is not effective and has serious side effects and the public is reluctant to get the vaccine. What if there is no vaccine? Also, investors are not factoring in a second wave of infections.

- Many investors and some analysts believe there will be a v-shaped economic recovery.

  This is hard to believe because so many components of the economy are doing poorly: over 20 million people are unemployed, the service sector has been decimated, small businesses confidence has collapsed and they are struggling, consumer confidence has plummeted. Economists have come up with an alphabet of possible outcomes for the economy:

Recovery Alphabet

Economists compare the shape of potential recoveries to letters of the alphabet, and a swoosh



Note: Recoveries are using sample data
Source: Brookings Institution

A w-shaped recovery is likely because of the prospects of a second wave of infections. Many economists believe the recovery will be fragile, uneven and slow.

- Investors believe President Trump will be reelected.

Sites that takes bets on the U.S. presidential election have Joe Biden winning by a wide margin. Historically, when there is a major change of economic policies and direction, the markets must adjust. The markets, investors are not factoring in a Biden win.

I will issue my market outlook in July. I will write about the disconnect between the markets and the economy. A favorite topic among investors and economists.