



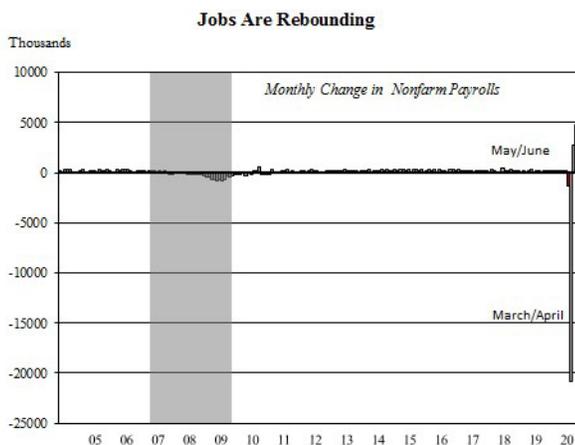
WEEKLY

Economic Commentary

July 2, 2020

Optimists who cling to the notion that the economy is poised for V-shaped recovery should have a festive July 4 holiday, as incoming data continue to exceed expectations. The week began with a report by the Institute for Supply Management revealing that manufacturing activity is rebounding vigorously from its steep decline over the previous two months. For the first time since February, the ISM manufacturing index leaped over the 50 threshold, indicating that activity moved back into expansionary territory after hitting the lowest point in more than 20 years.

The good news on the industrial front follows a raft of other positive news on consumer spending and jobs, confirming the widespread notion that the economy hit bottom in April and is firmly on the road to recovery. That notion received a big boost on Thursday, as the Labor Department reported another sizeable employment gain in June, with nonfarm payrolls expanding by 4.8 million. As was the case in May, when payrolls surged by 2.7 million, the pace of job growth exceeded expectations last month, topping the consensus forecast by almost 2 million.



The June report contained many positive details that describe a healing job market. More than 75 percent of industries added payroll, which is a gigantic share not seen since the 1990s and up from 4.3 percent two months ago. The unemployment rate fell 2.2 percentage points to 11.1 percent and the under-employment rate declined 3.2 percentage points to 18.0 percent. There was an influx of workers into the

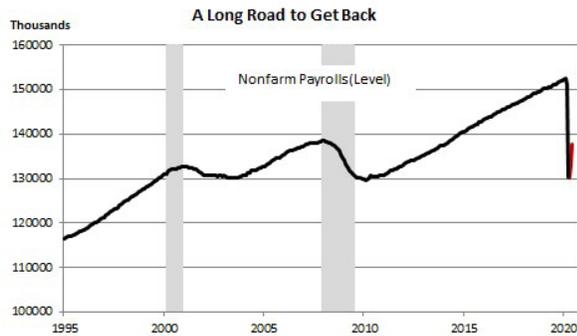
labor force, which rose to 61.5 percent as a share of the working-age population from 60.7 percent in May. And more of those labor force entrants found jobs, as the employment/population ratio rose from 52.8 percent to 54.6 percent.

What's more, the hardest-hit sectors during the Covid-19 recession saw the biggest rebounds in growth. Payrolls at leisure and hospitality firms, which include restaurants and bars, surged by a record 2.1 million and retail establishments rehired 740 thousand workers. These two sectors alone accounted for 60 percent of total job growth last month. But reflecting the aforementioned rebound in manufacturing activity, manufacturing jobs also jumped, increasing by 356 thousand, and 475 thousand workers in healthcare rejoined the ranks of the employed. Other sectors that saw significant increases in payrolls last month included education and health services (+568 thousand), construction (+158 thousand) and transportation (99 thousand).

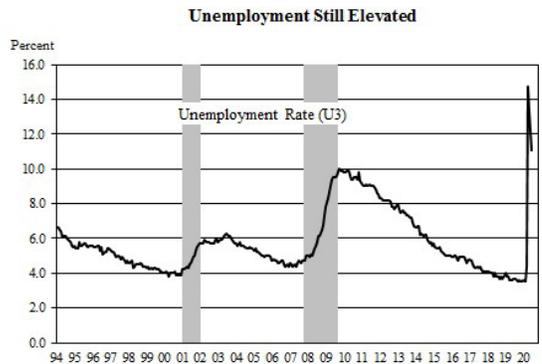
On the surface, therefore, the June jobs report has all the makings of a great summer cocktail. No doubt, the rapid rebound in job growth over the past two months is clearly encouraging and stoking more optimism on Wall Street. Stock prices just came off the strongest quarterly gain in more than 20 years and the latest jobs report provided more fuel for the rally, sending the major indexes up sharply on Thursday. But while the revival of the labor market has gotten off to a rousing early start, we caution that the first stage of a recovery is always the easy part. Importantly, the gains over the past two months give a misleading impression of economic health, as the scars from the Covid-19 recession have far from healed.

As we noted last month when the May jobs report also exceeded expectations, it's important to gauge progress in terms of how much ground has been made up since the virus sent the economy reeling in March and April. The robust data on jobs and manufacturing reported for June does not change that observation. Despite the eye-opening 7.5 million increase in nonfarm payrolls in May and June, only one-third of the 22.2 million job losses in March and April have been recovered. In other words,

the labor market is still facing a net job loss of 14.7 million since February. What's more, layoffs are still running at a historically high pace, with initial claims for standard unemployment insurance totaling 1.43 million in the latest week. That's off from the record high of nearly 7 million in late March but more than six times higher than the pre-coronavirus levels earlier in the year. Another 800 thousand laid-off workers filed for emergency unemployment benefits under the Pandemic Unemployment Assistance program in the latest week, bringing the total new applicants for jobless benefits to 2.3 million.



The same caveat applies to the trend in the unemployment rate. While the 3.6 percentage point drop over the past two months is certainly impressive, the 11.1 percent jobless rate in June is still above the 10 percent peak rate reached during the Great Recession and the highest since the 1930s. The Labor Department also states that the unemployment rate would be 1.1 percentage points higher if workers who were listed as "employed but absent from work" were more correctly classified as unemployed. Simply put, the number of workers negatively impacted by the Coronavirus is staggering. In addition to boosting the ranks of the unemployed by 14.7 million since February, 4.7 million more workers were forced into part-time positions and 3.7 million dropped out of the labor force due to the virus. The latter could reflect health reasons (i.e. people fearing getting infected by returning to work) or parents forced to stay at home because of school closings.



It is worth noting that 74 percent of all job losers were classified as unemployed individuals on 'temporary layoff' in June. That may be an overly optimistic assessment if companies do not continue to rehire workers as rapidly as they did in May and June. From our lens, this is where the rubber meets the road. The burst of rehiring over the past two months was ignited by the reopening of businesses that had been forced into lockdown by the pandemic. The rehiring process was also facilitated by the Payroll Protection Program that disbursed more than \$500 billion of forgivable loans to firms for the purpose of retaining workers. Most important, the massive stimulus provided by the government in the form of direct payments (those \$1200 checks sent to households) and expanded unemployment benefits, (including the additional weekly \$600 Federal payment) provided much-needed support to household spending that drove the hiring spree.

Looking ahead, however, the risks to the labor market are clearly tilted to the downside. Keep in mind that the data used in the latest jobs report were compiled in mid-June, before the recent upsurge in virus infections took hold. With daily cases hitting a record of more than 50,000 this week, a growing number of states are either pausing or backtracking on their reopening plans. The resurgence of the virus is actually having a double-whammy effect. In many states the planned reopening of businesses is being paused, which puts a hold on the rehiring process, or they are being forced to shutdown again, which leads to outright layoffs. Meanwhile, as the virus continues to spread and grab headlines, consumers are turning more

cautious. Many restaurants that were allowed to re-open saw a big rush of returning dine-in customers in May and early June. According to industry sources, however, that return flow has slowed to a trickle in recent weeks. Hotel bookings are seeing a similar drop-off.

Meanwhile, the massive government stimulus that contributed importantly to the two-month revival in activity is in jeopardy. The Payroll Protection Plan may be getting a one-month extension; but Congress is in disarray with regards to continuing fiscal support for laid-off workers or for ailing state and local governments. This “income cliff” is set to occur at the end of July, when the fiscal stimulus expires. And while much of the media is highlighting the struggles of households and small businesses, a bigger catastrophe may be brewing among state and local governments, where massive layoffs loom amidst plunging revenues.

Unlike the private sector, hiring in the public sector has not bounced back in recent months. True, local governments did add to payrolls in June, but state governments continued to shed jobs, laying off 25 thousand workers last month. Collectively, state and local revenues are getting pummeled by the Covid-19 recession. We estimate a revenue shortfall of about \$605 billion through the end of 2021 and that pressures on the spending side related to the recession will add another \$65 billion to the two-year budget gap. Importantly, this is an estimate of the shortfall brought about by the recession and doesn't capture new spending burdens on state and local budgets arising from the spread of Covid-19. Among them with increased costs for health care and for implementing measures, such as statewide shutdowns, to limit the disease's spread.

As the flow of red ink deepens, spending on goods and services will be slashed as most state and local governments are required by law to maintain balanced budgets. As a result, governments will need to operate with smaller payrolls. State and local jobs have already been reduced by 1.6 million since February, with employment in education accounting for two-thirds of the decline. In addition, cuts in state and local budgets will depress employment by contractors or firms that receive government grants.

The drag from struggling state and local governments will persist well beyond the health crisis. As was the case following the Great Recession - when state and local job losses totaled 655,000 - the recovery in lost jobs will lag significantly behind the private sector, reflecting the delayed response of tax revenues. After the Great Recession ended in 2009, state and local employment did not return to its pre-recession peak until 2019, a full five years after the private sector recovered all of its recession losses. Given our sense that this recovery will stumble due to probable flare-ups of the health crises, resulting in a growth path resembling the Nike swoosh rather than a V, it will take considerably longer this time for government payrolls to regain pre-recession levels.

KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

	July 2	Week Ago	Month Ago	Year Ago
INTEREST RATES				
3-month Treasury bill	0.14%	0.15%	0.16%	2.23%
6-month Treasury bill	0.16	0.18	0.19	2.13
3-month LIBOR	0.30	0.31	0.32	2.30
2-year Treasury note	0.16	0.17	0.21	1.87
5-year Treasury note	0.30	0.30	0.48	1.83
10-year Treasury note	0.67	0.65	0.90	2.04
30-year Treasury bond	1.43	1.37	1.67	2.54
30-year fixed mortgage rate	3.13	3.13	3.18	3.75
15-year fixed mortgage rate	2.59	2.59	2.62	3.18
5/1-year adjustable rate	3.08	3.08	3.10	3.45
STOCK MARKET				
Dow Jones Industrial Average	25827.36	25015.55	27110.98	26922.12
S&P 500	3130.01	3009.05	3193.93	2990.41
NASDAQ	10207.63	9757.22	9814.08	8161.79
Commodities				
Gold (\$ per troy ounce)	1787.80	1784.80	1688.40	1403.10
Oil (\$ per barrel) - Crude Futures (WTI)	40.33	38.19	38.94	57.54

ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
ISM Manufacturing Index (June)	52.6	43.1	41.5	47.9
Nonfarm Payrolls (June) - 000s	4800	2699	-20787	-2366
Unemployment Rate (June) - Percent	11.1	13.3	14.7	8.4
Average Hourly Earnings (June) - % change	-0.9	-0.6	4.2	0.6

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