



WEEKLY

Economic Commentary

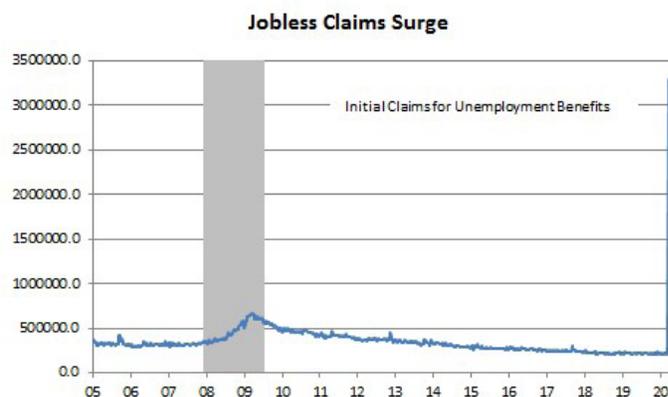
March 27, 2020

If you woke up on Friday with a severe case of whiplash you are not alone. By the close of trading on Thursday, a three-day rally had sent the Dow Jones industrial average up by more than 20 percent, which qualifies it as a new bull market. Just three days earlier, investors were still licking their wounds over the most devastating plunge in stock prices since 1987. But before investors had a chance to uncork the champagne, stocks suffered another setback on Friday, erasing nearly a quarter of the three-day rally. Once again we are reminded of how powerfully the herd mentality can move markets. The question is, how closely does the shifting mind-set of traders and investors line up with reality.

Clearly the nascent V-shaped recovery in stock prices before Friday's setback was not tracking the economy. Indeed, it is still unknown how pronounced the left side of the V for the economy will turn out to be. The abrupt rebound in stock prices suggested that the bad news had already been fully priced in and all it takes is a whiff of good news to start the party all over again. That optimism is somewhat understandable, as never before have the nation's policymakers moved as swiftly and boldly as they have this week. The \$2 trillion stimulus bill approved by Congress on Friday and quickly signed by the president is remarkable in its breadth and depth, accounting for an unprecedented 9 percent of GDP. When added to the avalanche of emergency Fed measures to facilitate credit flows to households and businesses, lower interest rates, keep the financial markets functioning and stimulate the economy, the package of policy actions packs a more powerful punch than seen anytime before in the U.S.

But while desperate times warrant desperate measures, these extreme policy moves are not designed to combat the pandemic wreaking havoc on the economy. Instead, they are meant to contain the economic fallout and provide all the ingredients needed to jump-start growth once the virus is brought under control. Until that outcome is realized, the depth of the economic downturn now unfolding can only be guessed at. The breath-taking toll it is taking on the job market was strikingly revealed in the latest weekly report on claims for unemployment benefits, which shot up to 3.3

million in the week ending March 21. To put this in context, the worst month of job losses during the Great Recession saw payrolls fall by 894 thousand in February 2009. That total was exceeded by a factor of almost four in the latest week alone and the ranks of unemployed are poised to swell considerably in the weeks to come.



The direct payments to households of up to \$1200 plus the expanded unemployment benefits included in the stimulus package are aimed at keeping families solvent and provide them with the wherewithal to sustain spending. No doubt, for the broad swath of the population that lives paycheck to paycheck and has limited savings, those funds will enter the spending stream immediately. But it's doubtful they will have much of a lasting impact once the funds run out. What's more, the one-time payment will do little to spur increased spending by households who are still holding jobs and getting paid. Indeed, the latest personal income report reveals that consumers were already setting aside more of their paychecks in February, as the personal savings rate increased from 7.9 percent to an eleven-month high of 8.2 percent.

Importantly, the climb in the savings rate occurred even as incomes increased by a solid 0.6 percent during the month, powered by a strong advance in wages and salaries. Hence, despite the still robust job market at the time, households reacted to early reports of the coronavirus and turned more cautious. Personal consumption advanced by a slim

0.2 percent in February and by an even tinier 0.1 percent adjusted for inflation. In March, the reading will look considerably worse as the full impact of the pandemic evolved over the course of the month. We expect the spending retrenchment in March will more than erase the gains in January and February and usher in a record plunge in the second quarter, sending the economy deep into a recession.

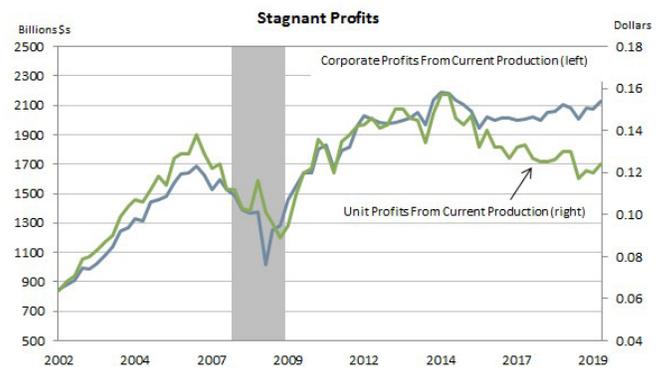
With store closures becoming more widespread and the grip of state lockdown tightening, the consumer retrenchment will likely be back-loaded over the second half of March. Interestingly, the pullback in sales will reflect supply shortages as well as a short-fall in demand. Thanks to the more efficient inventory management practices put in place in recent years, retailers were woefully unprepared for the run on supplies associated with the pandemic. As households rushed into panic buying of toilet paper and other essentials, stores that sell these products have been particularly vulnerable to running out of stock. Industry data are released with a frustrating lag, but as early as January the months supply of inventory at all retailers was the lowest in six years.



Whether or not the stock market has priced in all the bad news relating to the coronavirus remains to be seen. Even if cases of infection accelerate in coming weeks as health experts predict, the shock effects should diminish with each additional awful report. But the damage to the economy could leave long-lasting scars that the markets may not be fully discounting. For example, the unprecedented

plunge in economic activity in the second quarter could obliterate whole industries, such as the shale industry, as well as an army of small businesses that leaves millions of workers unable to find replacement jobs. The market may correctly anticipate a short-term rebound in activity after the virus is brought under control; but it could also be failing to price in the prospect of slower long-term growth that may be the legacy of the coronavirus.

Should that turn out to be the case, investors would soon reassess longer-term prospects for corporate profits. As it is, the long bull market in stocks looks increasingly out of line with the trend in earnings in recent years. The third revision of GDP released this week shows that corporate profits did show a modest rebound in last year's fourth quarter. But that simply returned the level to where it was in the first quarter of 2015. Put another way, corporate profits have gone nowhere for almost five years, even as stock prices have advanced by more than 30 percent over the period. Meanwhile profit margins have come under sustained downward pressure, contracting by 20 percent over the same time span.



As of this morning, the consensus of Wall Street analysts expects earnings to decline in 2020, the most pessimistic outlook for a full year since the Great Recession. It is not hard to see why. The shock to demand from the pandemic will not only take a toll on revenue it will also further constrain the already-weakened pricing power of corporations. What's more, the persistent dis-inflationary trend will

receive an assist from the pending global recession and the collapse in oil prices now underway. Nor is it likely that improving productivity would rescue the grimmer profit outlook. For that to happen, the corporate sector would need to ramp up productivity-enhancing capital spending. But that's not in the cards. Both orders and shipments for nondefense capital goods fell in February even before company fears of the coronavirus reached a boil.

With the trajectory of the COVID-19 pandemic unknown, this is a challenging time for economic forecasts. The near-term outlook is universally grim, albeit the projected severity of the economic setback in the second quarter ranges far and wide. We currently look for a contraction in real GDP of 11 percent at an annual rate and a mild recovery starting in the third quarter. But sentiment on Main Street is deteriorating rapidly; the University of Michigan sentiment index released on Friday fell by a whopping 12 points in March to the lowest level since October 2016. We suspect that the downward trend will accelerate with the April reading falling to recession levels.

To be sure, consumer spending behavior does not always validate changes in sentiment. But with the finances of households coming under assault from massive layoffs, it is almost certain they will succumb to their downbeat mood in coming months. The huge stimulus efforts cobbled together by policymakers will help limit the damage, but the downside risks to the economy continue to grow and will likely prompt a further downward revision to our outlook in the near future. As welcome and necessary as the three phases of government support has been, it is highly likely that a fourth phase will soon be required.

KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

	March 27	Week Ago	Month Ago	Year Ago
INTEREST RATES				
3-month Treasury bill	0.00%	0.04%	1.29%	2.40%
6-month Treasury bill	0.01	0.18	1.13	2.44
3-month LIBOR	1.37	1.20	1.58	2.59
2-year Treasury note	0.25	0.32	0.94	2.26
5-year Treasury note	0.40	0.46	0.94	2.23
10-year Treasury note	0.68	0.86	1.17	2.41
30-year Treasury bond	1.27	1.45	1.69	2.82
30-year fixed mortgage rate	3.50	3.65	3.45	4.06
15-year fixed mortgage rate	2.92	3.06	2.95	3.57
5/1-year adjustable rate	3.34	3.11	3.20	3.75
STOCK MARKET				
Dow Jones Industrial Average	21636.78	19173.98	25409.36	25928.68
S&P 500	2541.47	2304.92	2954.22	2834.40
NASDAQ	7502.38	6879.52	8567.37	7729.32
Commodities				
Gold (\$ per troy ounce)	1630.60	1497.20	1580.00	1297.00
Oil (\$ per barrel) - Crude Futures (WTI)	21.84	19.84	45.24	60.19

ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
New Home Sales (February) - 000s	765.0	800.0	724.0	737.0
Capital Goods Orders (February) - % change	-0.8	1.0	-0.8	0.0
Personal Income (February) - % change	0.6	0.6	0.2	0.4
Personal Consumption (February) - % change	0.2	0.2	0.4	0.3
Savings Rate (February) - Percent	8.2	7.9	7.5	7.8

Millennium Corporate Credit Union
8615 West Frazier Street
Wichita, Kansas 67212