Current Economic Conditions

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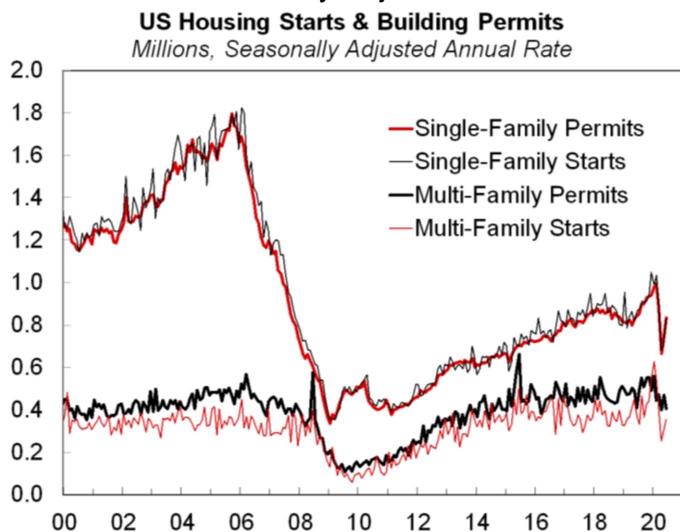
A V-SHAPED RECOVERY FOR GOODS; A "U" OR "L" FOR SERVICES

The U.S. economy rebounded strongly in May and June after April's unprecedented collapse, but the recovery has down-shifted in July in response to a resurgence in COVID-19 cases. Consumer spending on goods has been surprisingly strong, but persistent weakness in the service sector will keep employment and real Gross Domestic Product well below their pre-recession peaks until a vaccine is rolled out.

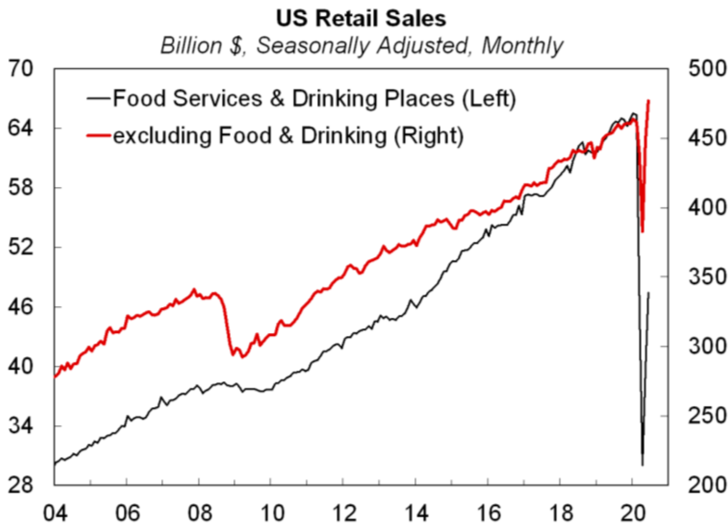
U.S. retail sales, which rose 18.2% in May, rose another 7.5% in June. Light vehicle sales rose to a 13 million seasonally adjusted annual rate in June, up from 12.3 million in May and 8.7 million in April. Industrial production in U.S. manufacturing rose 7.2% in June, the biggest monthly increase since 1946. That followed a 3.8% increase in May. Single-family housing permits rose 11.8% in June after rising 12.0% in May. Nonfarm payrolls grew by 4.8 million June, on top of May's 2.7 million increase. The unemployment rate, which peaked at 14.7% in April, fell to 11.1% in June. Despite the May/June rebound, payroll employment was 14.7 million (9.6%) lower in June than in February. Industrial production in manufacturing was 11.1% lower in June than in February and 12.3% below the cyclical peak reached in December 2018. Worse yet, high-frequency data indicate that growth has slowed. Robert Kaplan, President of the Federal Reserve Bank of Dallas said on July 13, "We were hoping for meaningful double-digit growth in the third and fourth quarters, and I think we were seeing it until, say, the second week in June." But "I think growth is slowing."



The big declines in economic activity in March and April were due primarily to government-mandated lockdowns; the rebound in May and June was due to the lifting of these restrictions. The ongoing resurgence in COVID-19 cases has prompted renewed lockdowns in some states, albeit more focused than the earlier lockdowns. If Governors learn from their mistakes, we could migrate away from a situation where some states restrict activities that could be done safely (e.g., visiting a vacation home, most manufacturing) while others are reluctant to close businesses that cannot be operated safely (e.g., bars) towards a situation where business closures everywhere are governed by what can be done safely. That could arise whether decisions on which businesses are open are made by governments or by individual businesses in response to consumers' decisions about which establishments are safe to patronize.

So far, both Governors and consumers seem to have had trouble evaluating and responding to risks. Nevertheless, the dichotomy between high-risk and low-risk activities shows up in the data. May data on personal consumption expenditures show that spending on goods was stronger than expected while spending on services was weaker than expected. In most recessions, spending on goods falls much more than spending on services, which sometimes doesn't fall at all. This recession is different. Spending on goods is holding up well because the production, distribution, and retailing of most goods can be done

safely without close human contact. The same is true for single-family home construction and home improvement. But that is not the case for many "socially dense" services. In June, retail sales for eating and drinking establishments (included in services) were 27.7% below their January peak. Retail sales excluding eating and drinking establishments (mostly goods) **exceeded** their previous high.



What you see in July is probably what you'll see for a while. Housing construction and home improvement are doing surprisingly well as people move out of cities and build home offices. The goods sector suffered a recession, but spending on goods has rebounded quickly, and lean inventories mean that manufacturing must recover further to meet increased demand. The service sector suffered a depression, and the recovery has paused. The net result is probably moderate growth that leaves real GDP well below pre-recession levels until a vaccine ignites a rapid burst of growth, probably in the second half of 2021, that gets us back to the pre-recession peak, probably in 2022.

The speed of the recovery will depend on how quickly the economy adjusts. The economy will recover more quickly if consumers rapidly shift purchases from services to goods, from onsite to online, from eat-in to take-out, from theatres to video streaming, from travel to home improvement, and from mass transit (including air travel) to auto sales. The economy will also do better if the economy reallocates resources, especially workers, from activities that cannot be done safely to those that can. The sooner waiters and waitresses and bartenders realize their jobs aren't coming back anytime soon and look for other employment, the better the economy will do. Unfortunately, unemployment insurance benefits that exceed what workers were paid before they were laid off keeps many of them from accepting a new job. Combine that with the inability of many working parents to return to work if schools are closed this fall and you could have labor shortages even with 15 million people out of work. (A manufacturer of building supplies recently told me that his entire supply chain was struggling to find workers. He attributed the labor shortage "100%" to enhanced unemployment insurance benefits. These benefits are scheduled to expire at the end of the month. If they do, labor shortages could ease.) Capital is harder to reallocate than is labor. Owners of bars and restaurants and owners of commercial real estate whose tenants can't afford to pay rent will be the biggest economic losers from COVID-19.

Another downside risk comes from the demand side. So far, checks from the government have more than offset the loss in income resulting from the loss of jobs. Real disposable personal income surged in April and was much higher in May than it was in February. Consumers haven't spent all the money yet, so savings rates have risen sharply. But with employment still way down, income is likely to fall sharply in coming months without further stimulus. Savings could cushion the blow for a few months, but once savings have been drawn down, the hit to consumer spending could cause weakness to spread from the service sector to the goods sector. However, with an election coming in November, I expect Congress to vote for further stimulus in the next few weeks. This will be a positive for the economy, at least in the short run, providing it doesn't include unemployment benefits that exceed pre-layoff wages.

New cases of COVID-19 are declining in most of the world but rising in the United States. The response to the increasing case load has already begun to slow the recovery from the worst recession since the Great Depression. Because day-to-day changes don't show up in monthly data until the following month, the slowdown that began in June won't show up in monthly data until July. Third-quarter growth will still be strong because it's calculated off such a low base, but because many service-sector businesses can't be operated safely, growth in the second half of 2020 won't be as strong as I expected a month ago.

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