First Trust
Monday Morning OUTLOOK

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Can the US "Fully Recover"?

In early 2020, when COVID hit, the unemployment rate in the United States was 3.5%, wages for low-income earners were rising faster than wages for high-income earners, living standards were rising…the economy was on a roll.

Then, because scientists said lockdowns would stop COVID, they turned the light switch off. Real GDP fell at a 5.1% annual rate in the first quarter of 2020 and then an annualized 31.2% in the second quarter.

Since then, because of re-opening, Federal Reserve money printing, and massive Treasury debt issuance to fund pandemic loans and benefits, the economy has rebounded. Real GDP hit at an all-time high in Q2 this year, 0.8% higher than it was at the pre-COVID peak at the end of 2019.

But this is not very comforting. Not only would the economy have grown roughly 3% in the absence of COVID, the economy has been boosted by over $800 billion in direct payments to individuals. That $800 billion is roughly 4% of annual GDP. Without this borrowing from the future, the economy would be smaller today, not larger.

We estimate that the lockdowns have cost the US economy 6% (4% from stimulus growth + 3% growth absent COVID – 0.8% all time high from pre-COVID peak) in lost output. Of course, it doesn't appear this way because borrowing from the future allowed more spending today. It's like giving morphine to an automobile crash victim. No pain, but underlying injuries.

So, how long will it take to fully recover? Factors that will boost growth include the general waning trend in COVID (yes, in spite of Delta, the death rate is running well below levels last winter), the natural process of economic recovery, faster productivity growth, entrepreneurs – who have packed many years of innovation into the past eighteen months – and the loose stance of monetary policy.

It's important to pause for a moment and recognize that monetary policy, with short-term interest rates set near zero, has effectively become <u>*looser*</u> as inflation has moved upward. In the past year, the consumer price index is up 5.3%, which means that a short-term interest rate target of 0.1% generates a "real" (inflation-adjusted) interest rate of -5.2%. By contrast, the lowest real short-term interest rate in 2020 was -1.4% in March 2020. To put this in perspective, the lowest real rate in the aftermath of the Financial Crisis was -3.8%.

However, at least a few factors will also weigh on economic growth in the year ahead. First, the removal of fiscal stimulus compared to what was done in 2020 and early 2021. Take away the pain medication and the economic pain will become even more evident.

This underlying damage is reflected in the many small businesses that have been destroyed by COVID lockdowns that will not be there to help the economy rebound like they would have after prior recessions. This problem is made worse by excess unemployment benefits. Not only do these benefits slow the recovery, but they translate into an erosion of worker skills and know-how.

We think we're seeing these negatives at work in some recent tepid economic reports. Nonfarm payrolls grew only 235,000 in August, far below consensus expectations. Yes, there is evidence that the Delta variant (and related policy responses) were responsible for a significant portion of the slowdown in job creation. Restaurants & bars reduced payrolls by 42,000 in August versus a gain of 290,000 in July. But Delta wasn't the only factor. Just look at auto sales. Cars and light trucks were sold at a 13.1 million annual rate in August, the slowest pace in fifteen months and far below consensus expectations.

As recently as August 17, the Atlanta Fed's GDP Now model was tracking 6.2% annualized real GDP growth in the third quarter. Now, three weeks later, it's tracking 3.7%.

The next several weeks are important. It looks very likely that the bipartisan infrastructure bill, boosting spending by about $550 billion over the next decade, will pass. What's unclear is whether President Biden and his legislative allies can pass a partisan bill of up to $3.5 trillion in extra spending, along with tax hikes. The odds still favor the Democrats getting something through on partisan lines, but the odds of a total failure to pass the partisan bill are growing, and recent comments by Senator Joe Manchin (D-WV) suggest that if something passes it will be substantially less than what the far left wants.

In the end, a "full recovery" of the economy is possible, but damage from past or future shutdowns – and a large partisan bill that once again, like New Deal or Great Society legislation, significantly increases the influence of the government over the economy – threaten its pace.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-8 / 2:00 pm	Consumer Credit– Jul	$25.0 Bil	**$25.0 Bil**		$37.7 Bil
9-9 / 7:30 am	Initial Claims – Sep 7	335K	**335K**		340K
9-10 / 7:30 am	PPI – Aug	+0.6%	**+0.6%**		+1.0%
7:30 am	"Core" PPI – Aug	+0.6%	**+0.4%**		+1.0%