FHN FINANCIAL

NOVEMBER 13, 2020
ECONOMIC WEEKLY

CONTENTS

Vaccines and (Economic) Recovery

V-shaped or K-shaped? That is the essential question as the recovery from last spring's lockdowns continues this winter. The V-shaped strength of the rebound is evident in macro data including the 33.1% rise in third quarter GDP as well as the ongoing drop in jobless claims and six-month drop in the unemployment rate from 14.7% to 6.9%. The K-shape is evident in the 25 million still collecting unemployment benefits, from the grinding climb in permanent layoffs since April and — if you live in a city — the visible increase of the homeless. There's no question people are being left behind.

Many of our customers, not surprisingly, want to know what the Pfizer news means for interest rates next year. In a best-case scenario, K-shaped worries will quickly fade and everyone will enjoy the V. But it's not that simple, in part because things are going to get worse before they get better. In other words, forget about the K as the worst case. We might be in for a W, where everybody shares the pain.

Pfizer's recent vaccine announcement was an incredible bolt of optimism, but it does not yet signal the end of the pandemic, even if other vaccine producers announce similar results.[1] For one thing, the vaccine will not be available until the end of the month at the earliest, if the FDA gives early approval. Once approved, it will take time to distribute and, once administered, immunity takes 28 days. There are three weeks between the first dose and the second, and another week for the body to produce enough antibodies. Hence, the earliest recipients would not achieve immunity until late January.

There are other potential problems.

1. COVID is spreading in the United States at an alarming rate. According to CDC Director Robert Redfield, small gatherings have become a primary vector. People are getting sick when family and friends meet for drinks or dinner, not realizing one of their number is sick. It will be much more difficult to regulate this kind of activity than big public gatherings. As a result, COVID case numbers could climb considerably in the next few months, though people will self-isolate if things get bad enough. For what it's worth, in NYC in April, when an estimated 20% of the population had COVID, most people stopped leaving their homes except for absolute emergencies even before the city and state clamped down.

[1] Better than 90% effective, no significant side effects, according to the press release.

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2. An alarming number of people say they will decline vaccination when vaccines are first released. A survey of money managers conducted after the Pfizer announcement found only about half plan to get the vaccine when it is available, 30% plan to wait, and 20% say they don't know, despite the absence of side effects in the trial. Even if the vaccine is 90% effective, herd immunity is only possible at greater than 50% acceptance. Note, too, this survey was conducted among a relatively educated group. Aversion is likely higher still in the general population.

3. Two members of Joe Biden's COVID advisory team publicly favor a six-week national shutdown. It's not clear a shutdown is constitutional, Biden himself suggested it might not be, and even then, this particular taskforce won't have authority until late January. Still, if the economy is fully shut for another six weeks, the result is likely to be about as bad for the economy as the shutdown in March and April, which is to say it will be very bad indeed.

What it means for rates

The Pfizer announcement was a big deal for yields, causing a bigger reaction than the news of a likely regime change in Washington. It's understandable, because faster growth and a faster decline in unemployment imply i) a faster shot at a higher inflation rate; and ii) revised thinking by the Fed about how long to stay at the effective lower bound.

Still, a sustained increase in rates requires not just a faster return to inflation but a return at the pace now expected by the market. Remember, the FOMC is already committed to keeping rates unchanged until the economy is back at maximum employment — think of a sub 4% unemployment as a useful, though incomplete, proxy — and inflation has risen to 2% and there is a high probability inflation will moderately exceed 2% for some time.

There's no indication of expected rate hikes in fed funds futures, but distant fed funds futures contracts have very little volume and are less indicative than cash Treasuries. The yield curve suggests traders expect the Fed will start raising rates as soon as 2022. See the lead article in *The Weekly Report* for a more complete explanation of the math. There are ample reasons to think this is not going to happen.

First, despite a clear need for aid for those left behind by the recovery, it's not likely they will get it. The latest from Speaker Pelosi is that there is a $2.4 trillion deal on the table and she is not willing to change it. If there is no room for compromise, there's little chance of a bill before or after the end of the current Congress.

Even without aid, if COVID is gone by the middle of next year and the economy — not just in the US but globally — comes roaring back, unemployment will drop even among the lowest paid. Still, it will take time for wage inflation to generate inflationary pressure, in part because those left behind without jobs and without help from Congress will need to repair balance sheets before they start spending in earnest.

This is the best imaginable case for COVID. Even if everything goes smoothly — implying vaccine production is extraordinarily rapid, distribution is nearly immediate, and vaccine anxiety disappears (not really likely, but again, we're trying to envision the best case here) — millions of businesses will be gone after a year of lost output. The rapid economic rebound to date reflects existing businesses reopening. Already, we are transitioning to a slower expansion at the underlying trend rate, estimated by the Fed to be slightly less than 2%, which will take hold when we need new businesses to generate new growth.

Hence, even if everything proceeds optimally, Fed tightening by 2024 is unlikely.

Now, consider what might go wrong. One of the insidious aspects of COVID is the way people become contagious before they even know they have it. That's one reason, once it establishes a foothold, COVID is so difficult to eradicate. This week's CDC warnings about people unwittingly spreading it through small social gatherings struck a chord with anyone who has lived in an area with high COVID numbers. We know people who caught it that way. Unfortunately, COVID is spreading through communities with no such experience. They are learning now what Wuhan learned last December and what New York learned last April.

Next, add a slow rollout of vaccines and a slower adoption rate. Add another economically devastating lockdown in the first quarter and another fight over pandemic aid. The economy will still recover, of course, but it could easily add another year or two to the period of super-low rates, especially if the President slows the recovery with a rapid re-regulation of industry and executive orders aimed at eliminating the competiveness of US oil.[2]

Under this scenario, tightening is unlikely before 2027-28.

Considering the yield curve, it's easier to boil this range down to a forecast for 5-yr yields than 10-yr yields. On balance, 5-yr yields at 0.40% are too high, because the average overnight rate is unlikely to be that high over the next five years even under the best of circumstances.

Ten-year yields at 0.90% are easier to justify, because the fed funds rate is bound to rise at some point between now and 2030 and therefore, the average overnight rate will be higher than the current 0.1%. But it would take considerable tightening to get rates high enough to average 1% over the next decade if they don't rise at all for the next four or five years. Hence, there is still room for curve flattening next year even if vaccines are approved by December.

The added uncertainty of Fed second guessing

In each of the last two expansions, it took much longer for the Fed to start raising rates than just about anyone expected, including the FOMC. In fact, the Yellen Fed likely prevented inflation and rates from rising as much as they might have by over-selling the need for rate hikes, just as the Powell Fed prevented inflation and rates from reaching desired levels by tightening too much in 2018. This time, FOMC participants are determined not to repeat these mistakes. Or, at least, most of them are.

[2] The purpose of this hypothetical is to imagine the best- and worst-case for economic growth and reflation, not to predict policy of a President who is still in the formative stages of putting together an administration. This example isn't a policy prediction, it is a policy worst case.

The FOMC unanimously voted for its new long-run guidance, which argues for letting the economy run until the economy is at maximum employment and inflation exceeds 2%. Chair Powell has explained this in terms of not just a low unemployment rate, but also low minority unemployment, faster wage growth, and narrowing income inequality.

This week, Boston Fed President Eric Rosengren read a speech, "Financial Stability Factors and the Severity of the Current Recession," in which, among other things, he argues, "Instead of pushing the unemployment rate below its natural rate, the focus should be on avoiding the subsequent large spikes of unemployment and slow recovery that occur when the downturn is made worse by a lead-up that involves excessive risk-taking and the associated imbalances, both real and financial."

Elsewhere, Rosengren says he supports the Fed's long-run policy goals, but here he is clearly opposed to the means by which the Fed might achieve these goals. That's not even the first thing wrong with this sentence, because the Fed does not "push" the unemployment rate below the natural rate, it allows the unemployment rate to fall below the natural rate. And, for that matter, the natural rate is an uncertain, artificial construct to begin with. But for now, even assuming these logical lapses were not problematic, the core idea of fighting the means by which the Fed would achieve its long-run policy goals is.

Normally, opposition from one regional bank President is no big deal. There are always a few working against the core FOMC. **If the President replaces the Chair, however, a lack of unity of purpose among the Presidents could be a very big deal, as a new Chair is usually greeted by a wave of resignations from the FOMC, typically resulting in a whole new core group learning the ropes at once. Under these circumstances, an experienced old-hand at a regional Fed gains considerable influence.**

For now, then, we can assume the Fed will continue to act consistently, but we should be open to the possibility the FOMC's commitment to a less hawkish approach could crumble under a new administration, meaning quicker tightening, but lower inflation, lower yields, and a flatter curve as a result in the long run.

– Chris Low, Chief Economist

The Week Ahead

This Week's Numbers

			CONSENSUS			
		PRIOR	HIGH	LOW	MEDIAN	FHNF
Monday, November 16	Empire Manufacturing - Nov	10.5	16.0	9.9	13.9	**14.0**
Tuesday, November 17	Retail Sales Advance MoM - Oct	1.9%	0.8%	-0.7%	0.5%	**0.7%**
	Retail Sales Ex Auto MoM - Oct	1.5%	1.0%	-0.8%	0.6%	**0.8%**
	Retail Sales Ex Auto and Gas - Oct	1.5%	0.8%	-0.7%	0.6%	**1.0%**
	Retail Sales Control Group - Oct	1.4%	0.9%	-0.3%	0.5%	**0.5%**
	Import Price Index MoM - Oct	0.3%	1.0%	-0.2%	0.2%	**0.2%**
	Import Price Index ex Petroleum MoM - Oct	0.7%	0.4%	0.1%	0.4%	**0.3%**
	Export Price Index MoM - Oct	0.6%	0.3%	-0.6%	0.3%	**0.2%**
	Industrial Production MoM - Oct	-0.6%	1.7%	-0.2%	1.0%	**1.0%**
	Capacity Utilization - Oct	71.5%	72.8%	71.4%	72.3%	**72.3%**
	Manufacturing (SIC) Production - Oct	-0.3%	1.3%	0.5%	1.0%	**1.0%**
	Business Inventories - Sep	0.3%	0.7%	0.2%	0.5%	**0.6%**
	NAHB Housing Market Index - Nov	85.0	85.0	80.0	85.0	**86.0**
Wednesday, November 18	Building Permits - Oct	1,553k	1,645k	1,400k	1,568k	**1,600k**
	Building Permits MoM - Oct	5.2%	6.5%	-9.4%	1.5%	**3.0%**
	Housing Starts - Oct	1,415k	1,530k	1,375k	1,450k	**1,457k**
	Housing Starts MoM - Oct	1.9%	8.1%	-2.8%	2.5%	**3.0%**
Thursday, November 19	Initial Jobless Claims - Nov 14	709k	725k	700k	720k	**690k**
	Continuing Claims - Nov 7	6,786k	--	--	--	**6,500k**
	Existing Home Sales - Oct	6,540k	6,650k	6,330k	6,440k	**6,500k**
	Existing Home Sales MoM - Oct	9.4%	1.7%	-3.2%	-1.6%	**-0.6%**
	Philadelphia Fed Business Outlook - Nov	32.3	29.4	10.0	22.0	**24.0**

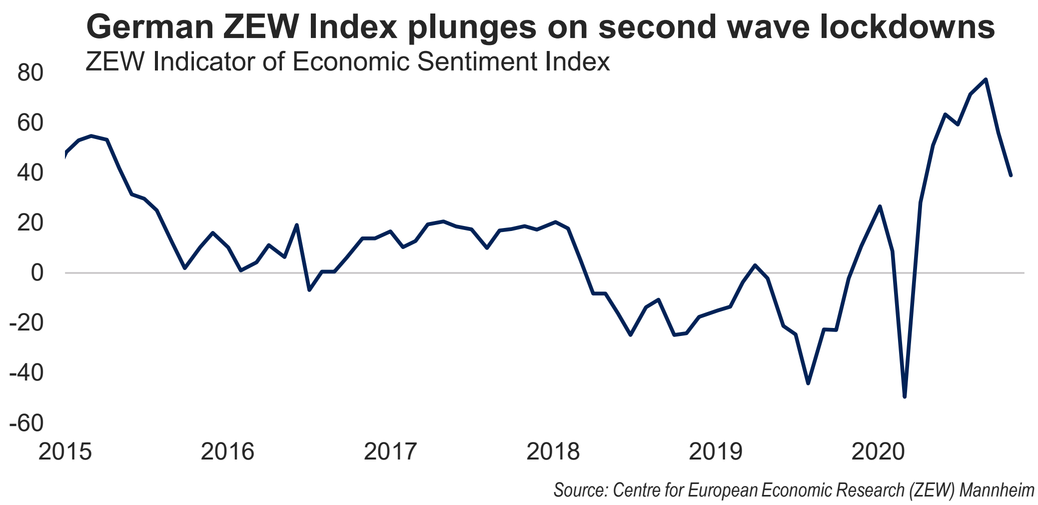
Review

This week, the ZEW Survey, a leading indicator for the German economy, dropped sharply, reflecting the return of a national lockdown. ECB President Lagarde and BOE Governor Bailey spoke about regulating financial reporting of climate change risks. Chair Powell joined the two in a panel discussion later in the week to discuss the uneven recovery and uncertain outlook.

- **Monday, at the World Economic Forum's Green Horizon Summit, ECB President Lagarde and BOE Governor Bailey spoke** about regulating climate change disclosures. Lagarde called for a wholesale transformation of the economy and reporting frameworks. "Harmonization efforts are crucial," she said. "We need common technical reporting standards and increased data collecting to enable a consistent way to classify green activities and a taxonomy of carbon intensive activities."

  Governor Bailey gave a speech titled, "The time to push ahead on tackling climate change." He said, "Our goal is to build a UK financial system resilient to the risks from climate change and supportive of the transition to a net-zero economy." Presumably he meant net-zero emissions, not net-zero growth. He added, "Progress has to focus on data and disclosure," and pointed to the UK's Taskforce for Climate-related Financial Disclosures (TCFD) to lead the way. "What we cannot measure, we cannot manage, so it is important that financial firms and their clients use the TCFD framework."

- **November's ZEW survey plunged** 17.1 points to 39.0 in October, missing consensus of 44.3. Financial experts worry about the economic impact of a new lockdown and what it will entail. Brexit uncertainty and the US Presidential election did not impact their current assessment. The index has fallen 38.4 points since September's 20-year high.



- **Thursday, Chair Powell** joined Bailey and Lagarde at the ECB Central Banking Forum. The three were positive about vaccine development and economic recoveries but noted the recovery is mixed and incomplete. Powell said the pandemic accelerated some preexisting technological trends, such as automation, and has made the economic outlook less certain. Technological changes will increase productivity over the long-term, but in the short-term, it means some service-sector jobs will disappear. "We're recovering, but not to the same economy. We're recovering to a different economy," Powell explained.

  Lagarde said the second wave poses no less danger then the first because businesses that have made it this far may decide trying to survive another lockdown is no longer worth the effort and give up. She added the impairments of some assets must be acknowledged, particularly as fiscal policy has provided a moratorium to "attenuate the hardship of the crisis" and has been a great shield but that shield will eventually be lifted. "I hope that happens gradually," she said. Governor Bailey said the recovery is uneven, with services unsurprisingly more impacted. "The more rapid the sustained recovery from this, the less the longer term scarring will be because more firms will be able to come through." He added, "Scarring I'm afraid will be a feature of the economy, but it won't necessary be as large as some forecasters think." He pointed to the sustained high unemployment of the '70s, '80s, and parts of the '90s from the structural move out of heavy industry, manufacturing, and coal mining and into services.

  Powell resisted pressure from the moderator to comment on the US Presidential election other than to say, "This is a great time to take a step back and let the institutions of our democracy continue to do our jobs." He did comment on climate change, however, and pointed to the Fed's Financial Stability

> Report published this week. It highlights climate change risks to financial assets. He agreed with Lagarde's response to those calling on central banks to stick to their mandates and not venture into areas outside their control.
>
> They both said recurring natural disasters impact prices and inflation targets and thereby touch on central bank mandates. Powell said, "We do think that central banks and we the Fed have contributions to make here. We also think that climate change is clearly an issue that requires a broader, societal, across government, across the private sector response, and so we are just part of that. We will make sure the financial system is resilient across all sorts of major risks, including climate change."

The Atlanta Fed did not update its GDPNow forecast this week. The NY Fed's Weekly Economic Index was unchanged at 2.86%.

Preview

Note: ★ = High Impact Event
All times Eastern

Next week's economic releases are retail sales Tuesday, housing starts Wednesday, and existing home sales Friday. Retails sales are expected to rise again after five straight months of gains, despite sales already well-above pre-COVID levels. Housing starts are also expected to rise, to an annualized pace of 1440k units from September's 1415k. Existing home sales are projected to slip after four months of increases. The boom in existing home sales has taken the sales pace to its highest since 2006.

Next week's most notable Fed speaker is Fed Vice Chair Richard Clarida. Monday, he discusses the economy and monetary policy at the Brookings Institution.

Overseas, China reports retail sales and Japan releases preliminary third quarter GDP Sunday. Thursday, Japan publishes preliminary November PMI and EU leaders hold a videoconference to discuss coronavirus containment measures. Should they decide to close more economies, the Eurozone economy will be set up for double-dip recession and worse.

Saturday, November 14

- US: Secretary of State Michael Pompeo is on a 10-day trip to France, Turkey, Georgia, and the Mideast, including Saudi Arabia, in what could be his last foreign travel in this role.

Sunday, November 15

- 6:50pm – Japan:
  - GDP Annualized - 3Q P (Last: -28.1% q/q; Con: 18.9% q/q)
  - GDP Deflator – 3Q P (Last: 1.3% y/y; Con: 1.0% y/y)
- 8:30pm – China: New Home Prices – Oct (Last: 0.34% m/m)
- 9:00pm – China:

- Industrial Production – Oct (Last: 6.9% m/m; Con: 6.7% m/m)
- Retail Sales – Oct (Last: 3.3% m/m; Con: 5.0% m/m)
- Fixed Assets Ex Rural – Oct (Last: 0.8% YTD y/y; Con: 1.6% YTD y/y)

- 11:30pm – Japan: Industrial Production – Sep F (Sep P: 4.0% m/m)

Monday, November 16

- Brussels: Brexit crunch. Negotiations are planned to continue as the U.K. and EU approach the latest deadline. There have been signs of compromise, but neither side expects an easy week.
- 8:30am – US: Empire State Manufacturing PMI – Nov (Last: 10.5; Con: 13.9)
- ★ 2:00pm – US: Fed Vice Chair Richard Clarida will discuss the economy and monetary policy in an online conversation hosted by the Brookings Institution.

Tuesday, November 17

- ★ Vienna: OPEC+ Joint Ministerial Monitoring Committee meets to discuss delaying its planned output increase as countries impose second wave lockdowns.
- 3:30am – Hong Kong: Unemployment Rate SA – Oct (Last: 6.4%; Con: 6.6%)
- 8:15am – Canada: Housing Starts – Oct
- ★ 8:30am – US:
  - Retail Sales Advance – Oct (Last: 1.9% m/m; Con: 0.5% m/m)
  - Retail Sales Ex Auto – Oct (Last: 1.5%m/m; Con: 0.6% m/m)
  - Retail Sales Ex Auto and Gas – Oct (Last: 1.5% m/m; Con: 0.6% m/m)
  - Retail Sales Control Group – Oct (Last: 1.4% m/m; Con: 0.5% m/m)
  - Import Price Index – Oct (Last: 0.3% m/m; Con: 0.2% m/m)
  - Import Price Index ex Petroleum – Oct (Last: 0.7% m/m; Con: 0.4% m/m)
  - Import Price Index YoY - Oct (Last: -1.1% m/m)
  - Export Price Index – Oct (Last: 0.6% m/m; Con: 0.3% m/m)
  - Export Price Index YoY – Oct (Last: -1.8% m/m)
- 9:00am – UK: BOE Governor Andrew Bailey speaks.
- 9:15am – US:
  - Industrial Production – Oct (Last: -0.6% m/m; Con: 1.0% m/m)
  - Capacity Utilization – Oct (Last: 71.5% m/m; Con: 72.3% m/m)
  - Manufacturing (SIC) Production – Oct (Last: -0.3% m/m; Con: 1.0% m/m)
- 10:00am – US:
  - Business Inventories – Sep (Last: 0.3% m/m; Con: 0.5% m/m)
  - NAHB Housing Market Index – Nov (Last: 85; Con: 85)
  - The CEOs of Facebook and Twitter have volunteered to testify before the Senate Judiciary Committee about their decision to restrict an article about the son of President-elect Joe Biden.
- 3:00pm – US: Atlanta Fed President Raphael Bostic, San Francisco Fed President Mary Daly, Boston Fed President Eric Rosenren, and Minneapolis Fed President Neel Kashkari discuss racism and the economy. (Kashkari votes on the FOMC this year.)
- 4:00pm – US:
  - Net Long-term TIC Flows – Sep (Last: $27.8b)
  - Total Net TIC Flows – Sep (Last: $86.3b)

- 6:50pm – Japan:
  - Imports – Oct (Last: -17.2% y/y; Con: -8.6% y/y)
  - Exports – Oct (Last: -4.9% y/y; Con: -4.5% y/y)
  - Trade Balance – Oct (Last: ¥675.0b; Con: ¥308.9b)

Wednesday, November 18

- 5:00am – EU: CPI – Oct F (Oct P: -0.3% y/y)
- 5:30am – UK: BOE Chief Economist Andy Haldane speaks.
- 7:00am – US: MBA Mortgage Applications – Nov 13
- 8:30am – Canada: CPI – Oct (Last: 0.5% y/y)
- ★ 8:30am – US:
  - Building Permits – Oct (Last: 1553k; Con: 1568k)
  - Building Permits – Oct (Last: 5.2% m/m; Con: 1.5% m/m)
  - Housing Starts – Oct (Last: 1415k; Con: 1450k)
  - Housing Starts – Oct (Last: 1.9% m/m; Con: 2.5% m/m)
- 12:15pm – US: New York Fed President John Williams takes part in a webinar discussion hosted by the Society for Advancing Business Editing and Writing. (FOMC voter)
- ★ 1:20pm – US: Saint Louis Fed President James Bullard discusses his economic outlook at the Rotary Club of Hot Springs National Park. (FOMC voter in 2022)
- 6:00pm – US: Dallas Fed President Robert Kaplan Moderates Panel Discussion. (FOMC voter)
- 7:00pm – US: Atlanta Fed President Raphael Bostic takes part in Fed Education Event. (FOMC voter in 2021)

Thursday, November 19

- ★ EU: European Union leaders hold a summit by videoconference to discuss the bloc's latest efforts to contain the coronavirus.
- 8:30am – US:
  - Initial Jobless Claims – Nov 14 (Last: 709k; Con: 720k)
  - Continuing Claims – Nov 7 (Last: 6,786k)
  - Philadelphia Fed Business Outlook – Nov (Last: 32.3; Con: 22)
- ★ 10:00am – US:
  - Existing Home Sales – Oct (Last: 6540k; Con: 6440k)
  - Existing Home Sales – Oct (Last: 9.4% m/m; Con: -1.6% m/m)
  - Leading Index – Oct (Last: 0.7% m/m; Con: 0.7% m/m)
- 11:00am – US: Kansas City Fed Manufacturing Activity – Nov (Last: 13)
- 7:01pm – UK: GfK Consumer Confidence – Nov (Last: -31; Con: -34)
- 7:30pm – Japan:
  - Jibun Bank Japan PMI Manufacturing – Nov P (Last: 48.7)
  - Jibun Bank Japan PMI Services – Nov P (Last: 47.7)
  - Jibun Bank Japan PMI Composite – Nov P (Last: 48.0)

Friday, November 20

- US: U.S. and Taiwan hold economic talks in Washington. Undersecretary of State Keith Krach heads the U.S. delegation. Taiwanese Vice Economic Minister Chen Chern-chyi will lead his country's contingent.
- 2:00am – UK: Retail Sales – Oct (Last: 1.5% m/m; Con: -0.4% m/m)
- 2:00am – Germany: PPI – Oct (Last: -1.0% y/y; Con: -0.9% y/y)
- 4:00am – Italy: Industrial Orders – Sep (Last: 15.1% m/m)
- 8:30am – Canada: Retail Sales – Sep (Last: 0.4% m/m)
- 10:00am – EU: Consumer Confidence – Nov A (Last: -15.5; Con: -17.9)
- 1:30pm – US: Kansas City Fed President Esther George and Dallas Fed President Robert Kaplan discuss energy and the economy at a conference co-hosted by the Kansas City and Dallas Feds. (Kaplan votes on the FOMC this year.)

– Rebecca Kooshak, Economic Analyst