The Recovery is Losing Momentum

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The recovery has progressed more quickly than generally expected.... Even so, overall activity remains well below its level before the pandemic and the path ahead remains highly uncertain.... The economic downturn has not fallen equally on all Americans, and those least able to shoulder the burden have been hardest hit.... The outlook for the economy is extraordinarily uncertain and will depend in large part on our success in keeping the virus in check.¹

- Jerome Powell, Federal Reserve Chair  
September 16, 2020

Following a 31.7% annualized decline in real GDP during the April-June time period (9.1% non-annualized), we are now forecasting annualized growth of 28.3% for the July-September time period (6.4% non-annualized). The decline in the second quarter has been less severe than we expected, and the recovery, from such a low base, has been significantly faster than we expected (see Exhibit 1). But don’t be fooled by these seemingly similar numbers. The 31.7% decline is from a much higher base than the 28.3% recovery. After the projected third quarter increase in GDP, it still remains 4.5% below the fourth quarter of 2019. This compares to a 4.0% peak-to-trough decline during the Great Recession.

There are several reasons for this better-than-expected outcome: the economy reopened more quickly than we anticipated; further restrictions have been limited despite a surge in cases in several states over the summer; some consumers and businesses adapted quickly to a virtual and socially-distanced world; the Federal Reserve has provided and has committed to continue providing unprecedented monetary support; and the fiscal stimulus approved earlier in the pandemic continues to work its way through the economy.

Our forecast assumes either widespread availability and usage of an effective vaccine in early 2021 or that the pandemic’s impact on economic activity abates and is relatively mild in 2021 and 2022. It also assumes another, more limited round of fiscal stimulus before the end the year. None of these assumptions are assured, and if they do not come to pass, our forecast, presented here, is too optimistic. Importantly, we have assumed the stimulus package imbedded in our forecast does not contain transfers to state and local governments to offset falling revenues.

This first part of the recovery is the comparatively easy part. After such a steep, depression-like decline because of the shutdowns in the second quarter, the bounce back once the economy reopened was going to be big. The magnitude of the bounce, at a forecasted 28.3% annualized rate in the third quarter, has pulled forward much of the recovery we had been anticipating for later quarters. Consequently, the current forecast is for stronger 2020 growth and weaker 2021 growth.

We are now forecasting 1.2% annualized growth (0.3% non-annualized) in the fourth quarter. On a fourth-quarter-to-fourth-quarter basis, we are forecasting a 4.2% decline in real GDP for 2020, which, to put into perspective, is 50% greater than the decline of 2.8% from the Great Recession in 2008. Because of the earlier opening of parts of the economy than we anticipated, our current forecast is substantially less severe than the 8.6% decline we were forecasting back in mid-June. For 2021 and 2022, we are forecasting growth of 3.5% and 4.0%, respectively (see Exhibit 2).

Even as the economy recovers, the sticking point is unemployment. Following the peak of 14.7% in April, unemployment declined to 13.3% in May, 11.1% in June, 10.2% in July, and 8.4% in August. We forecast that we’ll end the year with 7.8% unemployment, and unemployment will continue to decline to 6.3% by the end of 2021 and 4.7% by the end of 2022, but will not reach pre-pandemic rates until at least late 2024 (see Exhibit 3). The employment recovery has initially been fast, as workers have been recalled back to their jobs from temporary layoffs with the reopening, but continued recovery will be much more arduous as more bankruptcies unfold and slack demand for sectors with high human contact continues. Rising permanent layoffs in these high human contact sectors result in more lengthy job searches (see the article by Professor Ed Leamer in this book). Employment in these sectors won’t fully recover until consumers and businesses return to old habits, which won’t be for some time, if ever.
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Exhibit 2  Fourth-quarter-to-fourth-quarter growth, 2000 - 2022

Source: U.S. Department of Commerce and UCLA Anderson Forecast

Exhibit 3  Unemployment rate, quarterly average, seasonally adjusted

1. Goodbye Inflation-Targeting, Hello "Labor Market Conditions"

To support the economic recovery, the Federal Reserve announced a policy shift in late August committing to near zero percent interest rates until labor market conditions recover. On September 16, 2020, Federal Reserve Chair Jerome Powell provided the following forward guidance:

*We will keep the policy where it is now, keep the rate policy where it is now until unemployment reaches the Committee’s assessments or levels that are going to – sorry, not unemployment – labor market conditions reach levels that are consistent with the Committee’s assessments of maximum unemployment, until inflation reaches 2%, and until it’s on track to go above 2% moderately for some time.*

There are some key takeaways from this statement. First, unlike the recovery from the Great Recession, the Fed is now committing to not increase rates in anticipation of inflation reaching 2%. Now, the Fed will wait until after inflation reaches 2% and until it’s on track to go above 2% “moderately for some time” before it considers increasing rates.

In the recovery following the Great Recession, the Fed was criticized for increasing rates too soon and slowing the economic recovery. In hindsight, we know that allowing the unemployment rate to decline to 3.5%, beyond the estimated natural rate of unemployment of 4.4%, did not cause sustained inflation above the Fed’s 2% inflation target (see Exhibit 7).

Second, the Federal Reserve is focusing not on a specific unemployment number, but on “labor market conditions.” This is an important distinction. The Fed has committed to addressing labor market inequality by focusing on the labor market conditions of specific groups of workers, not just the overall unemployment rate. Indeed, even as the unemployment rate has recovered over the past several months, it has done so more for whites and males than for blacks and females (see Exhibit 4). Lower education workers were also hit much harder by the shutdowns. While there has been some improvement in the unemployment rate for these workers, the unemployment gap between lower and higher education workers is considerably larger now than before the pandemic (see Exhibit 5).

The Federal Reserve’s commitment to keep the Federal Funds Rate near zero until labor market conditions recover

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**Exhibit 4**

Unemployment rate, monthly, by white/black and male/female

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Source: U.S. Bureau of Labor Statistics
Notes: Unemployment rate, monthly, 20 years and over; seasonally adjusted.

3. The natural rate of unemployment is the unemployment rate below which economists assume inflation will begin accelerating. In other words, if unemployment is at the natural rate of unemployment, economists assume that inflation will remain constant. See https://fred.stlouisfed.org/series/NROU for the natural rate of unemployment.
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Exhibit 5  Unemployment rate, monthly, by education level

Source: U.S. Bureau of Labor Statistics
Notes: Unemployment rate, monthly, 25 years and over, seasonally adjusted.

Exhibit 6  Fed Funds Rate, Mortgage Rates, Corporate Bond Rates, and Yields on 30-Year T-Bond and 10-Year T-Note

Source: Federal Reserve Board, Freddie Mac, Moody’s, and UCLA Anderson Forecast
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means borrowing rates will remain low for some time. Borrowing rates are at historic lows, below the levels reached during the Great Recession (see Exhibit 6). These low rates are a boon to corporate and mortgage borrowers and are currently fueling equity and housing markets. However, these low rates make it more difficult for the Fed to rein in liquidity when labor market conditions improve and more difficult for the Fed to respond to future fluctuations in economic activity.

Despite the near-zero Federal Funds Rate and multiple rounds of Quantitative Easing following the Great Recession, the Fed was not able to achieve its stated goal of sustained inflation rates of 2%. We forecast that the change in the consumer price index (CPI) will be 1.2%, 2.4%, and 2.2% in 2020, 2021, and 2022, respectively, and core inflation, excluding food and energy, will be 1.7%, 2.0%, and 1.9% in 2020, 2021, and 2022, respectively (see Exhibit 7). Our inflation forecast is higher than the Fed’s, which projects the same 1.2% CPI inflation we do for 2020, but lower inflation of 1.7% in 2021 and 2.0% in 2022. If firms adjust their supply chains for resiliency rather than efficiency and bring back offshore production to the U.S., we believe their costs will increase, and they’ll pass on at least some of these costs to consumers. This would lead to inflation exceeding the Fed’s projections for 2021 and 2022. Though our forecast is for moderately higher inflation, it is not high enough to trigger rate increases over the forecast horizon.

2. Is the Housing Boom Sustainable?

With the combination of record low mortgage rates, working-from-home causing some households to rethink their housing choices, and the closure of urban amenities decreasing the cost to Millennials with family plans of moving to the suburbs earlier than anticipated, home sales have quickly recovered from a springtime dip. As of this writing, home sales exceed last year’s sales (see Exhibit 8). Consequently, home builders are the most optimistic they have been over the last 35 years about the return to developing new properties.4

The question is whether this boom represents a short-term adjustment or a long-term trend. On the one hand, consumers who were planning to move to suburbs or to larger homes anyway, for demographic and family reasons, may have accelerated their decision to do so because of the pandemic. This would simply pull forward home purchases and housing starts that would have occurred in the coming quarters, and therefore lead to a temporary boom that will fade away. On the other hand, the post-pandemic work-from-home world may represent a structural shift in preferences, where households prefer more space in the suburbs. This would lead to a longer-term trend of higher rates of home purchases and home building in suburban areas. Although both forces are at play, our forecast leans more on the view that the recent boom reflects a pulling forward of home purchases and

Exhibit 8  Sales of new and existing single-family homes (in millions), quarterly data SAAR

Source: U.S. Census, National Association of Realtors, and UCLA Anderson Forecast

Exhibit 9  Housing starts (in millions), quarterly data SAAR

Source: U.S. Census Bureau and UCLA Anderson Forecast
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Housing starts than a longer-term structural shift in consumer preferences. We forecast that housing starts will be 1.33 million in 2020 and 1.29 million in each of 2021 and 2022 (see Exhibit 9). We believe this forecast is conservative, with potential upside risk.

3. The Lack of Additional Fiscal Stimulus Will Impair the Recovery

We have optimistically assumed additional fiscal stimulus of $1.0 trillion before the end of the year. While this may be unlikely in the current political environment, we have kept it in our forecast and note that there are downside risks if this stimulus does not occur. Even without additional stimulus, the economy is still benefiting from the CARES Act as consumers spend the portion of the stimulus transfers they saved earlier in the year. We assume another jump in real personal income associated with additional transfers in the fourth quarter of 2020, and forecast a decline thereafter to below pre-pandemic levels. Real personal income only returns to pre-pandemic levels in the latter half of 2021. Real personal consumption similarly does not reach pre-pandemic levels until the end of 2021. Note that this is a return to fourth quarter 2019 levels and not a return to the normal growth trend. We forecast that consumers initially save a substantial portion of their additional stimulus income and then gradually spend it down over time (see Exhibit 10).

4. Technology is Enabling the Recovery

The host of NPR’s Marketplace, Kai Ryssdal, has a famous tagline: “the stock market is not the economy.” Indeed, despite the highest unemployment rates and steepest decline in output since the Great Depression, U.S. stock indices have not only recovered, but have surpassed previous all-time highs. Stock markets are in theory forward-looking, and their recovery would seem to suggest that investors are optimistic about the future of the economy. But a disaggregation of the stock market shows a different story, one of an economy that is led by a concentrated number of large, capital-intensive technology titans, and one where many labor-intensive sectors that provide the goods and services for human interaction lag behind. The future that the stock market portends is one where we work virtually, socialize

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Exhibit 10  Personal income, consumption, and saving

Source: U.S. Department of Commerce Bureau of Economic Analysis and UCLA Anderson Forecast
virtually, shop virtually, exercise virtually, dress casually, and invest in our homes, where we spend more time, more so than we did in the past.

In Exhibit 11, we show some of the leaders and laggards of this new economy. The leaders are companies that facilitate screen time and remote working (Zoom, Apple, Microsoft, Netflix, Nintendo), shopping from home (Amazon, Wayfair), exercising from home (Peloton), having goods shipped to our homes (UPS), having meals delivered to our homes (Grubhub), dressing casually (Lululemon), and improving our homes (Home Depot). The laggards are companies that involve travel, especially business and international travel (American Airlines, Boeing, Marriott), entertainment with crowds (Carnival Cruises, Live Nation, Six Flags Parks, Dave & Buster’s, AMC Theatres), eating in restaurants (Darden Restaurants), exercising in gyms (Planet Fitness), working in office buildings (Vornado Realty), shopping in malls (Simon Properties), and dressing up (Nordstrom).

The leaders of this new economy tend to be less labor-intensive firms, and the workers they employ tend to have more education. This will make the employment recovery more difficult, especially for the low education workers that have been disproportionately affected during this recession.

However, to the extent these firms also have larger scale, efficiency, and purchasing power over suppliers, they can offer lower prices for the products and services they replace. For example, Amazon may be able to offer lower prices than mom-and-pop retailers, Netflix can deliver family entertainment more cheaply than AMC Theatres, Zoom can facilitate meetings at a lower cost compared to travel for in-person meetings, Peloton can deliver daily cycling classes at a lower cost than in-person cycling studios, Nintendo can provide a less expensive alternative to Six Flags theme parks and Dave & Buster’s. This new, technology-driven economy may be both less labor-intensive but also less expensive.

5. Conclusion

We are more optimistic than in prior forecasts about the economic recovery in the near term. The economy’s reopening came earlier than we anticipated, there have not been renewed shutdowns despite a summer surge in cases in several states, many consumers and businesses adapted quickly to new technologies and remote-working, and the Fed has committed to providing continued monetary policy support for a sustained period of time. All of these factors have contributed to better-than-expected output and employment recovery during the third quarter.
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However, the economic recovery still has a long way to go before we get back to pre-pandemic levels of output and employment, and there are significant headwinds to getting back to these levels. First is the course of the pandemic during the rest of 2020 and early 2021. Will there be a resurgence of cases necessitating renewed shutdowns? When will there be a viable vaccine that can be widely distributed and that the public will accept? Second is the political environment. With Washington focused on the Supreme Court, can additional fiscal stimulus still be passed this year? Third is global instability. How will conflicts with China over trade and technology affect supply chains, exports, and investments? Will there be economic repercussions from a troubled Brexit? Fourth is election uncertainty. If the election is not decided on November 3rd, will consumer sentiment and business investment suffer? While our forecast is optimistic, we are in a period of considerable uncertainty and downside risks. And, with our fourth quarter 2020 forecast for GDP at only 1.2% annualized growth (0.3% non-annualized), it is important for business and government decisions to keep the downside risks in mind.