US recovery getting underway...

Recent data confirm the US economy’s sharp contraction only extended through April. After a surprising 2.7 million jobs were added in May, payroll employment increased by a further 4.8 million in June (in total retracing about 1/3 of the jobs lost in the prior two months). Consumers have been a key driver of the early rebound—retail sales surged by 18% in May, and core sales were actually higher than in February. That likely reflects the release of some pent up demand as retailers were allowed to re-open and Americans had more opportunities to spend some of the government handouts (including cash payments in April and a generous top up to state unemployment insurance) that have supported household incomes during the pandemic.

That said, consumer confidence remains subdued and big ticket purchases like autos were well below pre-pandemic levels in June. And some activities continue to be restricted by physical distancing. Sales at food service and drinking establishments were still 40% below pre-pandemic levels in May and restaurant reservations were less than half of last year’s levels as of late June.

…but fresh outbreaks pose a threat

The resurgence in coronavirus cases is putting this early recovery at risk. Average daily case growth over the past week is now in excess of 50,000, well above the 32,000 daily peak in early-April. While renewed outbreaks in large states like Florida, Texas and California are drawing attention, fully 3/4 of US states were seeing an acceleration in weekly case growth as of early-July and nearly 40% saw an uptick in deaths. Having re-opened before the virus was under control, some states are beginning to re-impose restrictions on economic activity. That’s likely to reduce re-hiring momentum, and will create challenges for businesses that have already run through much of their Paycheck Protection Program loans (generally worth about 2.5 months’ payroll).

High-frequency tracking of employment at small service sector businesses already suggests the rebound in jobs and hours worked started to stall in late-June. Weekly initial jobless claims remain stubbornly high at more than 1.3 million, indicating businesses continue to cut jobs even as others are re-hiring. The federal top up for UI benefits is set to expire at the end of July, which will mean an income hit for the millions of Americans that remain unemployed. Congress is working toward another stimulus package in the $1 trillion range that will likely provide some further support to those out of work. Nonetheless, we think challenging labour market conditions over the second half of the year will make for a slow recovery. And while we’re penciling in a 20% annualized rebound in Q3 GDP (after an expected 35% drop in Q2), risks are skewed to the downside if more states need to re-impose restrictions.

Monetary policy to remain accommodative for years

The Fed held its policy rate just above zero in June, and according to the committee’s dot plot, it’s likely to remain there for years to come. 15 of 17 FOMC members don’t expect to raise interest rates through the end of 2022. That reflects a concern that ongoing economic slack—the Fed’s median forecast doesn’t see GDP reaching end of 2019 levels until 2022—will keep core PCE inflation below the Fed’s 2% objective, a mark it had difficulty achieving even in good economic times.

Other stimulus measures aren’t going away anytime soon. With financial conditions having improved, some of the Fed’s lending programs have seen less uptake. But other liquidity facilities are just getting underway and could be worth hundreds of billions of dollars. While the Fed has slowed the pace of asset purchases since the height of the crisis, it will continue buying roughly $80 billion of Treasuries and $40 billion of agency mortgage-backed securities per month. For reference, the Fed’s monthly Treasury purchases were $45 billion at the height of its ‘QE3’ program in 2013. The Fed didn’t provide specific guidance on how long QE will continue, though minutes of the June meeting suggest some form of outcome-based forward guidance (a commitment to keep policies in place until specified unemployment or inflation objectives are achieved) might eventually be used to provide additional clarity on the likely path for fed funds and asset purchases. Yield curve targeting (currently being used by central banks in Japan and Australia) was discussed but most of the committee appeared skeptical.