US ECONOMIC OUTLOOK

Road to recovery will be long and bumpy

- **Overview** – The easing of the lockdowns has generated a bigger rebound in spending in May and June than we were originally anticipating but, given the resurgence in coronavirus infections, the pace of recovery is likely to be slower in the second half of the year. Accordingly, while we now expect GDP to contract by a more modest 4.6% in 2020, we also expect the recovery to be more muted, with GDP growth of 4.5% in 2021 and 4.0% in 2022. (Pages 3 & 4.)

- **Consumer Spending** – Although the initial bounce back in consumption has been impressive, new virus outbreaks, the ongoing need for physical distancing measures and waning fiscal support mean the recovery further ahead will be slower. We expect consumption to contract by 4.9% in 2020 and rise by 5.8% in 2021, with consumption remaining below its pre-virus trend. (Pages 5 & 6.)

- **Investment** – The relatively modest initial hit to business investment, together with the sharp rebound in housing demand and the bounce back in energy prices, means we now expect private fixed investment to contract by 3.2% this year, before rebounding by 3.3% in 2021. (Pages 7 & 8.)

- **External Demand** – While both exports and imports will rebound, as production recovers and global supply chains resume, the trade deficit is unlikely to shrink all the way back to its pre-pandemic level. We expect a renewed escalation in trade tensions with China before November, though depending on the outcome of the election, they could either intensify or dissipate over the coming years. (Pages 9 & 10.)

- **Labour** – The post-lockdown rebound in employment is likely to continue at a more rapid pace than during normal recoveries, as temporarily furloughed workers return to their previous jobs. But the lasting hit to activity in industries like tourism, retail and leisure means that the unemployment rate is unlikely to return to its pre-pandemic low for years. (Pages 11 & 12.)

- **Inflation** – We expect headline CPI inflation to rebound as energy prices recover, rising from near zero to an average of 1.8% in 2021 and 1.9% in 2022. (See Chart 41.) But the lasting hit to demand suggests that the rebound in core inflation will be more gradual. We expect core CPI to come in at 1.4% this year, 1.5% next year and 1.8% in 2022. (Pages 13 & 14.)

- **Monetary & Fiscal Policy** – Policymakers have been unusually aggressive in response to the pandemic and there is no reason to believe that they will change tack during the second half of this year. If demand for the Fed’s new emergency lending facilities remains muted, then we would expect it to pivot to increase the pace of its Treasury securities purchases again. Even in an election year, there is an opportunity for Congress to agree on another bipartisan fiscal stimulus. (Pages 15 & 16.)

- **Long-term Outlook** – The pandemic could change the long-term economic outlook in a number of ways, but the most obvious shift is that the higher public debt burden will necessitate even lower interest rates than we previously anticipated. (Pages 17 & 18.)
## Key Forecasts Table

### Table 1: Key US Forecasts

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<th>% q/q annualised (unless otherwise stated)</th>
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<th>2021</th>
<th>2022</th>
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<tr>
<td><strong>Other</strong></td>
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<tr>
<td>Current Account (% of GDP)</td>
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<td>-2.8</td>
<td>-2.6</td>
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<tr>
<td>Federal Gov't Bal. (% of GDP)</td>
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<td>-</td>
<td>-</td>
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Sources: Refinitiv, Capital Economics
Overview

Road to recovery will be long and bumpy

- The easing of the lockdowns has generated a bigger rebound in spending in May and June than we were originally anticipating but, given the resurgence in coronavirus infections, the pace of recovery is likely to be slower in the second half of the year. Accordingly, while we now expect GDP to contract by a more modest 4.6% in 2020, we also expect the recovery to be more muted, with GDP growth of 4.5% in 2021 and 4.0% in 2022.

- After falling by a cumulative 18% between February and April, as lockdowns were imposed in most states, real consumption rebounded by 8% in May. (See Chart 1.) The high frequency activity data point to a further solid rebound in June. But the resurgence in infections, which has forced some states in the South and West to impose new restrictions on activity, will weigh on spending in July and beyond. (See Chart 2.)

- We don’t expect states to re-instate the types of draconian lockdowns enacted in mid-March, but rising infection numbers will lead to the closure of bars and restaurants. Moreover, regardless of what measures the authorities take, people will be fearful and more likely to stay at home.

- Nevertheless, even if the recovery in July and beyond tails off, the rebound in May and the expectation of a further recovery in June already guarantee a decent rebound in third-quarter consumption and GDP. After an estimated 35% annualised fall in second-quarter consumption we expect a 30% rebound in the third quarter.

- Similarly, following a 30% annualised decline in second-quarter GDP, we expect a 23% rebound in the third quarter. (See Chart 3.) But that would still leave GDP well below its pre-pandemic level. (See Chart 4.) The need for ongoing physical distancing restrictions means that – barring a vaccine – GDP is likely to remain below its pre-pandemic growth path for several years.

- After peaking at close to 15% in April, the unemployment rate had fallen back to 11% in May and, as more furloughed workers gradually return to their jobs, we expect that rate to fall to 8% by the end of this year. (See Chart 5.) Nevertheless, even by the end of 2022, we expect the unemployment rate to be 5%, well above its pre-pandemic level.

- Inflation fell sharply in the early stages of the pandemic, but that was mainly due to some big declines in prices of the most affected services and the slump in energy prices. We expect inflation to rebound over the second half of this year. (See Chart 6.)

- Congress has already enacted stimulus worth close to $3tn, which will push the budget deficit up to 18% of GDP this year, and our expectation is that there will be some further bipartisan action to extend the enhanced unemployment benefits, which are due to expire at end-July. (See Chart 7.)

- Joe Biden now leads Donald Trump in the race to win November’s presidential election. (See Chart 8.) A Biden victory might weigh on equities if the Democrats win the Senate too. But even if taxes were raised – which is far from guaranteed since the Democrats wouldn’t have a filibuster-proof majority in the Senate – that would only happen as part of a fiscally neutral, or even positive, package that included big increases in spending too. The upshot is that we don’t see the election outcome as having a material impact on the outlook for GDP growth in 2021 and beyond.
Overview Charts

**Chart 1: Monthly Real Consumption ($ Trillion)**

**Chart 2: COVID-19 Infections & Patients**

- Currently Hospitalised (RHS)
- Daily New Infections (7d Ave, LHS)

**Chart 3: Real GDP**

**Chart 4: Real GDP ($ Trillion)**

- Pre-virus Forecast
- CE Forecast

**Chart 5: Unemployment Rate (%)**

**Chart 6: CPI Inflation (%)**

- Headline
- Core
- CE Forecasts

**Chart 7: Federal Budget Balance (As % of GDP)**

**Chart 8: Betting Odds For Presidential Election (%)**

- Biden
- Trump

Sources: Refinitiv, CE, PredictIt
Consumer Spending

Impressive initial rebound will give way to slower recovery

• While the initial bounce back in consumption has been impressive, new virus outbreaks, the ongoing need for physical distancing measures and waning fiscal support mean the recovery further ahead will be slower. We expect consumption to contract by 4.9% in 2020 and rise by 5.8% in 2021, with consumption remaining below its pre-virus trend for the next few years. (See Chart 9.)

• After falling by close to 20% over March and April, consumption staged a remarkable rebound in May as lockdowns were eased, with consumption now just 11.2% below pre-pandemic levels. The high-frequency indicators all point to another big recovery in June, as the densely populated Northeast eased restrictions. (See Chart 10.) Even allowing for a sharp slowdown from July onwards, consumption is on track to rise by close to 30% annualised in the third quarter. (See Chart 11.)

• We expect the recovery over the rest of the year to be much less impressive. As the renewed surge in virus cases across the South and the West highlights, there will be a continued risk of flare-ups, which require states to pause reopening or reimpose restrictions. If outbreaks continue spiralling out of control, there is a downside risk of a return to widespread lockdowns. For now, with healthcare systems better prepared and testing more widespread, we expect activity in affected states to fall back, but not collapse as it did in March. At the national level, that means we expect the recovery to be bumpy, rather than be thrown into reverse.

• The need for ongoing physical distancing means some activities will not return to normal for years to come. Most of the recovery so far has reflected the resumption of less risky activities, such as purchasing autos and big box store sales. (See Chart 12.) Continued restrictions and lingering fears mean the recovery in other forms of spending will take much longer. (See Chart 13.)

• The strong initial rebound also reflects the extraordinary fiscal support, which has meant personal incomes have risen through the pandemic. (See Chart 14.) We expect that some of the additional unemployment benefits will be allowed to lapse later this summer, however, while the boost from the one-off $1,200 stimulus cheques will fade.

• Consumption will also be held back by a higher precautionary saving, but we expect this effect to be limited. Consumer confidence never fell that sharply during the pandemic and has already begun rebounding. Moreover, consumer fundamentals heading into the crisis were solid. As a share of disposable income, household debt is at a near 20-year low, debt servicing costs are at a record low. Unlike past cycles, the saving rate had been rising modestly over the past few years. All that suggests there is no need for households to deleverage in the wake of the current crisis. (See Chart 15.)

• The virus has accelerated some long-term trends, such as online shopping as well as towards more flexible work patterns. But history suggests many behaviours will return to normal once the virus has been contained. Air travel remained depressed for many years post 9/11, but eventually made a full recovery. (See Chart 16.) We still expect consumption will return to its pre-virus trend over the longer term.
Consumer Spending Charts

Chart 9: Real Consumption

Chart 10: Daily Activity Indicators (%y/y)

Chart 11: Real Consumption

Chart 12: Consumption (% Change Feb. to May)

Chart 13: Large/Moderate Risk to Own Health (% Respondents)

Chart 14: Personal Incomes ($ trn)

Chart 15: Household Debt & Servicing Costs (% Disposable Income)

Chart 16: US Flight Passenger Numbers (Indexed)

Sources: Refinitiv, BTS, STR, Axios/Ipsos, OpenTable, TSA, CE
Investment

Uncertainty a persistent drag

- The relatively modest initial hit to business investment, together with the sharp rebound in housing demand and the bounce back in energy prices, means we now expect private fixed investment to contract by 3.2% this year, before rebounding by 3.3% in 2021.

- The incoming monthly data are consistent with a near 20% annualised contraction in private fixed investment in the second quarter. That would be smaller than the decline in GDP we anticipate, which is highly unusual given that investment tends to be far more volatile over the cycle. (See Chart 17.)

- Investment looks set for a mixed recovery over the coming quarters. (See Chart 18.) Residential investment, which was already in the early stages of an upturn before the pandemic hit, looks set to rebound sharply, fuelled by a low-interest rate driven surge in home demand. (See Chart 19.)

- By contrast, business structures investment will be held back by depressed activity in the mining sector. The collapse in the rig count points to a 100% annualised decline in mining investment in the second quarter, with the rebound in crude oil prices pointing to only a partial recovery in the second half of the year. (See Chart 20.)

- The prospects for equipment investment lie somewhere in between. Capex intentions and survey measures of new orders have rebounded sharply, suggesting that, after declining by far less than they did in the 2008/09 financial crisis, durable goods orders will rebound in the second half of the year. (See Chart 21.)

- That quick rebound has been supported by the Fed’s actions, which have ensured relatively loose financial conditions, with firms able to issue record amounts of corporate bonds in recent months. (See Chart 22.)

- That said, we suspect investment will be held back by continued uncertainty over the possibility of future waves of the virus and a sustained period of subdued demand. Capacity utilisation is running well below normal levels and nearly 40% of small manufacturing businesses think it will be at least six months before their business returns to normal levels of output.

- Firms may also be more cautious about expanding investment with an overhang of debt. This is the first downturn in which firms have increased their leverage. Non-financial corporate debt had already surged to a record high as a share of GDP at the end of the first quarter. (See Chart 23.)

- High leverage suggests firms will also be sensitive to a rise in interest rates but, with the Fed keeping rates on hold and backstopping the corporate bond market, the near-term risks appear low. In contrast to 2008/09 the Fed’s latest stress tests underline that banks are well capitalised to deal with losses, helping to maintain the flow of credit.

- More generally, business equipment and residential investment are both well below their long-run averages as a share of GDP. (See Chart 24.) That indicates there are few signs of obvious excesses that have built up over the past decade that would need to be worked through.
## Investment Charts

### Chart 17: Private Fixed Investment & GDP (%y/y)

- **Private Fixed Investment**
- **CE Forecasts**
- **GDP**

### Chart 18: Investment (% y/y)

- **Structures**
- **Equipment**
- **Residential**

### Chart 19: Homebuilder Confidence & Housing Starts

- **NAHB Homebuilder Confidence Index (LHS)**
- **Housing Starts (000s, Ann., RHS)**

### Chart 20: Oil Prices & Mining Investment

- **WTI Oil Price ($pb, Adv. 3m, LHS)**
- **Oil Rig Count (RHS)**

### Chart 21: Regional Surveys & Durable Goods Orders

- **Average New Orders Index of Regional Surveys**
- **Core Durables Orders (%3m/3m Ann., RHS)**

### Chart 22: Monthly Corporate Bond Issuance ($bn)

### Chart 23: Non-Financial Corporate Debt Ratios (%)

- **Debt-to-GDP (LHS)**
- **Debt-to-Internal Funds (RHS)**

### Chart 24: Investment As % of GDP & Long-Run Average

- **Residential Investment**
- **Business Equipment Investment**

Sources: Refinitiv, Capital Economics
External Demand

Election could prove a turning point for trade tensions

- While both exports and imports will rebound as production recovers and global supply chains resume, the trade deficit is unlikely to shrink all the way back to its pre-pandemic level. We now expect a renewed escalation in trade tensions with China before November, though depending on the outcome of the election, they could either intensify or dissipate over the coming years.

- Mirroring the decline in output, both exports and imports appear to have fallen by close to 20%. (See Chart 25.) Much of that contraction reflects the closure of cross-border supply chains, especially in the auto sector. (See Chart 26.) The latest survey measures of export demand also point to a V-shaped recovery in goods trade. (See Chart 27.) That in turn reflects how the pandemic has affected consumer demand. While the need for ongoing social distancing means demand for many services will remain subdued for years to come, demand for many goods has rebounded rapidly.

- The trade deficit would usually be expected to narrow in a downturn, but it could instead widen a little over the coming years as US exports may struggle to make a full recovery. Many key export industries were hit particularly hard. First, the shale oil sector has rapidly adjusted to lower oil prices, hitting production and oil exports. (See Chart 28.) While we expect some rebound in drilling activity in the second half of the year, the US is likely to flip back to being a net oil importer as gasoline demand rebounds.

- Aircraft exports were already sluggish before the pandemic hit thanks to the ongoing worldwide grounding of the Boeing 737 Max. But the collapse in air travel demand has prompted a wave of aircraft order cancellations and a cutback in production, which will limit the rebound in commercial aircraft exports. (See Chart 29.)

- Services trade will remain depressed for many years. The US enjoys a surplus in travel services, but with embassies and consulates closed and a range of travel bans in effect, tourism will remain close to zero this year and recover only slowly in future years. (See Chart 30.) With many colleges resuming classes in the fall online and travel restrictions likely to remain in place, the number of foreign students studying in the US could decline significantly.

-Offsetting those negative trends, most of the surge in the dollar has been unwound in recent months, as risk appetite has returned. We expect a further gradual depreciation over the coming year or two, meaning a stronger dollar will not be as big a headwind for exports as it has been in some recent years. (See Chart 31.)

-Prompted by tensions over coronavirus and the new security law in Hong Kong, we expect the Phase One trade deal with China to be scrapped before November. That will have little immediate impact, given China had no chance of hitting the ambitious purchase targets agreed to. (See Chart 32.) But it does add to the sense that the election could prove a tipping point for trade relations. If Donald Trump is re-elected, we would expect a continued escalation of tensions. It is unclear whether Joe Biden would reverse those tariffs, particularly given that some congressional Democrats are increasingly protectionist. But we suspect Biden is still at heart a supporter of rules-based free trade.
External Demand Charts

Chart 25: Exports & Imports (%y/y)

Chart 26: Monthly Auto Exports & Imports ($bn)

Chart 27: US Exports & ISM Export Orders

Chart 28: US Oil Output & Trade (Mn Barrels)

Chart 29: Monthly Commercial Aircraft Exports ($bn)

Chart 30: Trade in Travel Services ($bn Annualised)

Chart 31: Real Trade W'td Dollar (Mar. '73 = 100)

Chart 32: Exports to China Under Phase One Deal ($bn)

Sources: Census Bureau, Refinitiv, Capital Economics
Labour

Full recovery will take years

- The post-lockdown rebound in employment is likely to continue at a more rapid pace than during normal recoveries, as temporarily furloughed workers return to their previous jobs. But the lasting hit to activity in industries like tourism, retail and leisure means that the unemployment rate is unlikely to return to its pre-pandemic low for years. (See Chart 33.)

- After plunging by more than 22 million in March and April as much of the country shut down, the 7.5 million rebound in employment in May and June indicates that workers are now being recalled to their jobs as lockdowns have eased. (See Chart 34.)

- There is clearly still a long way to go, but there are good reasons to expect employment to continue to rebound rapidly over the coming months. 60% of unemployed workers were still reporting in June that they were on temporary layoff, rather than permanent job losers, suggesting they could eventually be recalled to their jobs. (See Chart 35.)

- Nevertheless, some of those temporary job layoffs will eventually develop into permanent separations. Jumps in temporary unemployment have historically tended to be followed by permanent layoffs, and the latter has also now started to pick up.

- The still high number of jobless claims is another reason for caution, with the insured unemployment rate more elevated. (See Chart 36.) But that appears to be partly the result of the increased generosity of unemployment benefits, which has significantly increased the incentive to claim, and the struggles many states are still facing in processing backlogs of applications.

- Even as employment continues to rebound, the drop back in the unemployment rate over the next few months may not be quite as fast. Millions of workers temporarily left the labour force in March and April, causing the participation rate to plunge. (See Chart 37.) As the lockdowns are eased, more of those people will resume looking for work.

- The pandemic is likely to inflict longer lasting damage on the labour market. The sectors most affected by ongoing social distancing requirements like leisure, food services and retail account for a disproportionate share of employment and are unlikely to fully recover for years. (See Chart 38.) Those sectors will also be most exposed to the renewed restrictions on activity in response to the big upturn in infections across the South and the West. The upshot is that we expect the unemployment rate to still be 8% by year-end and to remain above 5% through the end of 2022, well above the 50-year low of 3.5% seen in February.

- Elevated slack is likely to put wage growth under downward pressure over the coming months. Average hourly earnings growth initially surged when lockdowns began, but only because job losses were concentrated amongst the lowest-paid workers. (See Chart 39.) Alternative mix-adjusted measures, like the Atlanta Fed’s median wage tracker or the employment cost index, provide a better guide to the underlying trend. The early survey evidence points to annual wage growth dropping down to 2.0%. (See Chart 40.)
Labour

Chart 33: Unemployment Rate (%)

Chart 34: Non-Farm Payroll Employment (Millions)

Chart 35: Unemployment Rate by Reason (%)

Chart 36: Insured & Official Unemployment Rates (%)

Chart 37: Labour Force Participation Rates (%)

Chart 38: Change in Employment (Feb-Jun, 000s)

Chart 39: Wages & Earnings (%y/y)

Chart 40: NFIB Compensation Plans & ECI

Sources: Refinitiv, Capital Economics
Inflation

Core inflation likely to rebound only gradually

- We expect headline CPI inflation to rebound as energy prices recover, rising from near zero to an average of 1.8% in 2021 and 1.9% in 2022. (See Chart 41.) But the lasting hit to demand suggests that the rebound in core inflation will be more gradual. We expect core CPI to come in at 1.4% this year, 1.5% next year and 1.8% in 2022.

- The plunge in gasoline prices pushed headline CPI inflation down to a five-year low of 0.1% but, with prices stabilising more recently, that drag will fade. (See Chart 42.) Gasoline prices should gradually rebound over the next couple of years as recovering global demand lifts crude oil prices, driving headline inflation back up.

- Headline inflation will also be supported by the surge in food prices. Although restaurant prices have so far been fairly stable, inflation for food at home has jumped to an 8-year high (See Chart 43.) That party reflects supply chain problems, particularly in the meatpacking industry, which should fade, but also the shift in demand towards grocery shopping, which won’t fully unwind for some time.

- Core inflation has fallen at an unprecedented pace over the past few months, with the core CPI rate dropping to a nine-year low of 1.2%. Rather than reflecting a widespread deflationary collapse, however, that has mainly been driven by big falls in a few travel-sensitive categories. (See Chart 44.) With activity gradually rebounding, hotel room rates and airfares probably won’t fall much further, but the decline already seen will keep core inflation subdued over the next 12 months.

- Admittedly, core inflation hasn’t yet fallen as far as it did after the Global Financial Crisis, and the far bigger hit to demand this time suggests we should expect the drop in inflation to be much larger. But the weakness in core inflation back then was largely driven by the unwinding of the housing bubble, with shelter costs accounting for 40% of the core CPI. The rapid recovery in housing demand and lower valuations suggests house prices may not fall at all this time around. More generally, changes in the output gap have had only a modest impact on core inflation over the past 30 years. (See Chart 45.)

- The stability of inflation expectations also suggests a plunge into deflation remains unlikely. (See Chart 46.)

- Base effects will probably push core CPI inflation a little lower over the coming months, but the upshot is that we think the big falls have already happened. The Fed’s preferred core PCE gauge will run even lower and, as it has for most of the past decade, is likely to remain well below the 2% target. (See Chart 47.)

- The impact of the pandemic on inflation further ahead is still uncertain. We aren’t too concerned that the explosion of the Federal budget deficit and huge expansion of the Fed’s balance sheet will result in a surge in inflation, which has little direct relationship with broad money growth. (See Chart 48.) But there is a risk that supply constraints could start to push up prices in some sectors, with restaurants and airlines potentially having to permanently reduce capacity, while offices and manufacturing plants face additional costs from investment in larger spaces and protective equipment.
Inflation Charts

Chart 41: CPI Inflation (%)

Chart 42: Gasoline Prices & Contrib’n to CPI Inflation

Chart 43: CPI Food (%y/y)

Chart 44: Core CPI Inflation (%)

Chart 45: Output Gap & Core CPI

Chart 46: Household Inflation Expectations (%)

Chart 47: Core Inflation (%)

Chart 48: Broad Money & Core Inflation

Sources: Refinitiv, CE, CBO
Monetary & Fiscal Policy

Policymakers will provide more stimulus as needed

- Policymakers have been unusually aggressive in response to the pandemic and there is no reason to believe that they will change tack during the second half of this year. If demand for the Fed’s new emergency lending facilities remains muted, then we would expect it to pivot to increase the pace of its Treasury securities purchases again. Even in an election year, there is an opportunity for Congress to agree on another bipartisan fiscal stimulus, which would include an extension of the temporary enhanced unemployment benefits.

- The pandemic spurred the Fed into an unprecedented monetary stimulus – with interest rates being slashed to near-zero and the balance sheet almost doubling in size from $4trn to $7trn. But most of that expansion of the balance sheet occurred in the early stages of the crisis, when the Fed was aggressively buying Treasury securities and agency bonds to prevent liquidity drying up in those markets. (See Charts 49 and 50.)

- The Fed is now focused on expanding its balance sheet further by building up demand for its new 13(3) emergency facilities, which focus on channelling credit directly to non-financial firms, households and the public sector. The Fed has been buying corporate bonds in the secondary market, but the take-up for its other facilities has been disappointingly low. (See Chart 51.)

- The Fed is partly a victim of its own success, with firms and households able to borrow at competitive rates in private markets. Nevertheless, if demand for those facilities remains underwhelming, we wouldn’t be surprised to see the Fed switch focus again, and pivot back to buying more Treasury securities or corporate bonds.

- Officials also appear to favour targeting specific parts of the yield curve. But, with yields already close to zero on bonds maturing over the next seven years, those limits would be used to prevent an unwanted rise in long-term rates in the future, rather than to drive rates even closer to zero now. (See Chart 52.)

- The Federal budget deficit is expected to hit close to $4trn in the current fiscal year, equivalent to nearly 18% of GDP. (See Chart 53.) Congress has already passed stimulus worth close to $3trn and there is a possibility of a further bipartisan stimulus worth $1tn to $2trn later this year. The biggest issue is that the enhanced unemployment benefits included in the original stimulus are due to expire at the end of July. Those benefits are unprecedented in size, boosting incomes by $100bn per month, equivalent to more than 5% of GDP. (See Chart 54.)

- The Federal debt burden is on track to exceed 100% of GDP this year and could hit 120% within another few years. Nevertheless, with borrowing costs unusually low, there is no immediate danger of a crisis. (See Chart 55.)

- Finally, because of requirements to balance budgets, the slump in state and local government revenues will trigger an equally severe contraction in spending. The pandemic has already led to an unprecedented drop in employment, albeit partly because of school closures. (See Chart 56.) The Federal government will need to provide a lot more fiscal support to lower levels of government in the coming years. Without it, the broader public sector could be an even bigger drag on the economy than it was coming out of the financial crisis.
Long-term Outlook

Higher public debt burden complicates the long-term outlook

- The pandemic could change the long-term economic outlook in a number of ways, but the most obvious shift is that the higher public debt burden will necessitate even lower interest rates than we previously anticipated.

- Although the pandemic has triggered an unprecedented slump in GDP this year, which will probably be followed by an almost equally unprecedented rebound in 2021, it could have surprisingly little impact on the long-run outlook for potential economic growth. (See Chart 57.)

- Renewed waves of infections could occur over the next year or two but, even if a vaccine isn’t developed or the population doesn’t reach herd immunity, the lesson from historical episodes is that new viruses eventually become less deadly as the population builds up its immunity. That suggests the threat will eventually recede and economic life will return to normal, even if it takes several years to reach that point.

- Admittedly, the rapid spread of the virus around the world could lead to a permanent reduction in trade flows and migration. A simplification of global supply chains would boost US productivity levels, but at the risk of a marked increase in labour costs and, consequently, the final selling price of goods that are currently imported from developing countries. Permanently lower immigration would also put upward pressure on domestic labour costs and the resulting hit to labour force growth would lower the economy's potential growth rate.

- At the same time, the pandemic has accelerated some structural changes linked to technology that were already taking place – including the shift to online sales and the demise of traditional office working culture. The shift to working from home could have knock-on impacts on the value of commercial real estate, particularly in the most densely populated cities, and lead to a permanent shift toward eating at home and away from restaurant dining.

- Overall, it is too soon to tell how all these factors will play out so, for now, we still expect GDP growth to average between 2.0% and 2.5% over the long-term.

- We do, however, already know that the Federal debt burden will hit 100% of GDP this year, which is much sooner than we previously expected. Given the ongoing impact from the aging of the population, we expect that debt-to-GDP ratio to continue trending higher over the next couple of decades. (See Chart 58.) As long as interest rates remain unusually low, however, there is no reason to expect a debt crisis.

- With the Fed enthusiastically going even further beyond the norms of monetary policy during the pandemic – and seemingly in favour of yield curve control – there is little reason to expect any significant increase in interest rates for many years to come. (See Chart 59.)

- The big question is whether the mix of high debt and very accommodative monetary policy will eventually trigger a renewed surge in inflation, as it did coming out of previous similar episodes? (See Chart 60.) In the near-term, the pandemic increases the chances of a slide into a Japan-style deflation. But, if that can be avoided, we think the bigger risk is a return over the longer-term to much higher inflation.
Long-term Outlook Charts

Chart 57: Real GDP (%y/y)

Chart 58: Federal Debt (As a % of GDP)

Chart 59: Interest Rates (%)

Chart 60: CPI Inflation (%)

Key Forecasts (% y/y Averages, unless otherwise stated)

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Sources: Refinitiv, CE
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