Strat/*Views*

Some Notes on the U.S. Economy and the Risk of a Downgrade of U.S. Treasury Debt

January 12, 2021

President Biden's first major initiative has been an aggressive fiscal stimulus package of $1.9 trillion which he has stated will be approved by the Democratic-controlled Congress.[1] The national economy is on track to a moderate recovery with modest improvements in the unemployment rate from its current level; nevertheless, the bulging Federal deficit and the consequent inflationary risk could undermine the positive outlook. This analysis assumes that if the vaccine becomes available to a significant part of the population during the first half of this year, economic activity could continue to recover. We expect the economy will grow by 4.33% this year, after the notable decline of 3.5% in 2020.

The ***risks*** to the U.S. forecast ranked by likelihood of occurrence are:

- ***A spike in the COVID-19 cases without an aggressive vaccine program requiring renewed lockdowns leading to a worsening of the recession***. With the seven-day average of new virus cases/day in the U.S. reaching an all-time high of 248,366 in early January 2021, almost four-times the peak reach in July 2020, another form of lockdown may be unavoidable. More recently, a new more serious strain of the COVID-19 virus has reached the U.S. from other countries. Without an effective vaccine that is readily available to the total population, the economy remains very vulnerable to any surge in cases.

- ***Unsustainable U.S. fiscal deficits and downgrading of U.S. Treasury debt heightens financial market turbulence***. With the huge fiscal deficits in response to the Pandemic, on top of years of chronic deficits, U.S. Treasury debt is likely to reach unsustainable levels. The rating agencies, which for some time have not shown any intention of downgrading U.S. Treasury debt securities, may unavoidably have to lower their ratings, which could in turn contribute to more turbulence in the financial markets as investors weigh the risk of a large structural deficit and its implications for the fixed income market.

- ***The U.S. economy weakens as the global economy continues to struggle with the spread of the virus.*** As more countries enter a second lock-down, the prospects for a global economic recovery will diminish. Since the first reopening in June 2020, many businesses were limited to 50% of capacity. If these constraints continue, it will compromise the sustainability of the recovery.

- ***Medium-term risk to Monetary policy***: The Fed's balance sheet has become an unsustainable monetary bubble along with the outsized roles it is taking on as a lender to the economy. We think

[1] In the Senate there are 50 Republicans, 48 Democrats and 2 Independents who vote with the Democrats, Vice President Harris will be the tiebreaker as has been demonstrated by the expected passage of the $1.9 trillion package. In the House, Democrats hold 51.2% of the votes and the Republicans 48.8%.

the ability of the Fed to respond to a future downturn in the economy is a significant risk in the medium-term.

This Pandemic recession was characterized by a sharp drop during the 2ndQ followed by a strong upturn in the 3rdQ and a slower pace in the 4thQ; however, the rate of recovery, which we define as the increase in real GDP during the 3rd and 4th quarters as a percent of the decline during the 1st and the 2nd quarters, has varied across sectors. The strongest sub-sectors in terms of their recovery rates have been durable goods, especially motor vehicles and household furniture and appliances; in the services sectors, consumer spending on healthcare and financial services.

Business investment in machinery & equipment and in residential construction has recovered nicely, as well as exports and imports of merchandise. The weak spots have been transportation & recreation services, food services and accommodations in the consumer sector, business investment spending in structures, and in the external sector, export and import of services – which include tourism.

The unemployment rate fell from 14.7% in April to 6.7% in December, an exceptionally sharp decline in just a few months compared to previous recessions, although it may not maintain this downward momentum going forward. Nevertheless, many businesses are still operating under limited operating capacity due to the virus, for example, restaurants at 50% for inside dining, and similar caps in many services establishments, so the pickup in employment during the 3rd and 4th quarter may include a significant number of part-time and temporary workers that were full-time workers prior to the Pandemic. Unfortunately, unemployment statistics do not identify those categories of employment.

Another aspect of the unemployment rate is what is called structural unemployment, as businesses adopt new productivity-enhancing technology in production, workers who lose their jobs may not have the skills that vacancies call for.

Fiscal policy and the record Federal deficit due to the Pandemic. The Federal deficit for FY 2020 was estimated by the Congressional Budget Office (CBO) as $3.1 trillion, or 14.9% of GDP. The unsustainable growth of the fiscal deficits since the Great Recession was already a worrisome issue that we had been highlighting in our analysis – as seen in the table below, but with the onslaught of the Pandemic, the deficit has ballooned to even more threatening levels in terms of the required financing.

The CBO 10-year budget projections also imply a downgrading of U.S. Treasury debt, ***yet it is unclear why the rating agencies are not responding to the Federal government's growing chronic deficits which are likely to compromise its ability to effectively manage the budget.*** It appears to be a double-credit standard, as other countries with such high levels of government debt would have already been downgraded substantially.

Strat*info*

Fiscal Year Budget Totals, 2015 to 2020

Billions of Dollars

	2015	2016	2017	2018	2019	2020
Receipts	3,250	3,268	3,316	3,330	3,462	3,420
Outlays	3,692	3,853	3,982	4,109	4,447	6,552
Deficit (–)						
Amount	–442	–585	–665	–779	–984	–3,132
Percent of GDP	–2.4	–3.1	–3.4	–3.8	–4.6	–14.9

Sources: Congressional Budget Office; Department of the Treasury; Office of Management and Budget.

The serious deficit trend, notwithstanding, the bulge in the deficit for FY 2020 was created by the CARES Act which did provide much-needed oxygen to an economy that was seriously threatened by the Pandemic. The rescue package brought immediate relief through significant direct payments to taxpayers and through support of small to large businesses through the Payroll Protection Program and other grants, and tax incentives.

Since September 2020, Democrats and Republicans had been negotiating a second economic and finally reached agreement at the end of December on a new Coronavirus package for $900 billion. The key programs, some of which have yet to be implemented, include direct payments to households ($166 billion), $600 per member which is reduced for individuals with incomes above $75,000; Federal subsidy to unemployed workers of $300-a-week available through March ($122 billion); and more PPP "forgivable loans" ($284 billion). This brings the cumulative Federal expenditures for CARES Act and the two supplements to $3,568 billion. After taking office, President Biden proposed another stimulus package estimated at $1.9 trillion structured along the lines of the CARES Act. It is likely that this legislation with minor modifications will be passed by the Democratic-controlled Congress, thus the cumulative fiscal stimulus during the Pandemic will reach $5.48 trillion, or 26.1% of U.S. GDP in 2020.

Monetary policy: creation of a huge asset bubble, which could trigger inflationary pressures in the medium-term, is currently on stand-by. The Fed has multiple roles which include Central Bank, banking regulator, financier of the Federal budget deficit, commercial bank, and mezzanine finance agency, due to the present unusual circumstances. Given the record low interest rates prior to the Pandemic, monetary policy has been limited in its capacity to stimulate the economy, while at the same time, the size of its balance sheet has compromised its ability to take extraordinary steps to refuel the economy. The Fed's primary activity in the short-term has been to finance the Federal deficit, which limits its ability to provide monetary stimulus to the economy. Some analysts refer to the Fed's actions as supporting the economy by keeping long-term interest rates low; but we differ, at the present time, financing the fiscal deficit is the Fed's priority, which could be crowding out private sector access to financing.

Manuel Lasaga Ph.D., President
StratInfo
January 12, 2021