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2021 Outlook
Colbert

Chris Schildz:

Welcome to Conversations with Commerce Trust Company. Today, we have Chief Economist Scott Colbert to elaborate on our 2021 Outlook report. Scott, thank you for joining us again.

Scott Colbert:

Sure Chris, happy to do it.

Chris Schildz:

Scott, let's start off with a general overview of the economy. It appears we experienced the V-shaped recovery hoped for as the nation began its battle against the coronavirus in the spring. Can we sustain this comeback of the economy or should we expect some uneven improvement as we go along?

Scott Colbert:

Well, there's no doubt we've had a V-shaped recovery so far. We've had a V-shape from an exceptionally low bottom. The economy fell peak to trough 10% in terms of nominal dollars flowing past on a daily basis. That's about three and a half times to four times deeper than the average recession. So it was an awfully deep recession. It was an awfully quick recession, we began to recover probably literally two months to the bottom, February, March, maybe April and then May and June were better. So it's going to be an awfully quick recovery. Today though, because it was so deep, and even despite the V-shaped recovery that we've had, (the recovery) is driven primarily by two things. All the stimulus that we put in the pipeline, plus frankly, our ability, our ingenuity to essentially work the problem. We're back at about 97% of economic activity that we had going into the crisis.

So there's still another 3% just to get us back to even. And so that's the first thing, even though it's a V-shape recovery, we're still not back to even. And then I think we all know that given the outbreak or the recent outbreak on the third and perhaps the fourth wave of the coronavirus, that we're clearly going to go through a rather thin pipeline before we get to the other side of the tunnel or whatever you'd like to call it, where there is light at the end of the tunnel and that's the vaccine. But you know, we still have several months of very rocky road to cover to get to the vaccine in the March, April, May timeframe. So the V will begin to flatten out considerably and we'll get a lot bouncier as we move forward from here.

Chris Schildz:

As you said in the Outlook report, the cavalry arrived in the form of some effective vaccines just around the corner. The forward looking financial markets are already looking past the virus. When does the economy come out of the pandemic at full speed?

Scott Colbert:

If you just looked at the stock market, you'd say nothing ever went wrong and everything's just hunky dory. We think that's probably a little overly simplistic. The financial markets have been spurred along mightily by the ultra, ultra-low interest rate policy that we have. Plus, all the stimulus that has been thrown at the country, helping 80% of the economy that's doing very, very well, relative to perhaps the 20% that isn't.

But if I had to put it in kind of contextual format right now, they're letting in about a fifth of the people in the select pro football stadiums right now, even with the coronavirus. I think by next fall you'll basically have half attendance. And then we'll take some time towards next year. By next year, I mean the year after this coming year, 2022, to have things totally back to normal. In terms of airline capacity we might be flying around in the 20 or 25% capacity that we're currently flying out today. It might be 75% by the end of the year and then full capacity in 2022. So it's still going to take some time to fully recover in terms of what felt like normal before to get back to normal again.

Chris Schildz:

Now you mentioned some stimulus…the stimulus proposed by Congress has not really materialized at least in the early part of December just yet. Does the economy really need another financial booster shot of monetary and fiscal stimulus?

Scott Colbert:

Well, if there's any good news in not having the stimulus it's that the original stimulus packages were so broad based and deep. Of course, global interest rates have never been lower. And frankly, 10-year interest rates in developed currencies have never been lower. We still have 10-year treasury rates below 1%, and even countries like Portugal are approaching near 0% borrowing rates overseas in Europe, and of course Japan has had zero interest rates for some time.

So the monetary stimulus working with the lag will still be there for years to come, really, although the monetary stimulus we put in (already). The fiscal stimulus, of course is what's wearing out, but this was real money handed off to real businesses and real people that was primarily saved at first and then slowly spent over the second half of the year, which has helped us accelerate into this V-shape recovery. That was essentially $3.3 trillion.

It's hard to understand what $3.3 trillion is, but to put it in terms of percent of the economy, that's about 15% of the economy for almost two month's worth of GDP. So, essentially if the economy fell by 10%, this was throwing 15% at this falling economy just to keep it from falling as low as it was. So that's still working with some lag. Do we need one last little bit of stimulus? I think we do need one last targeted stimulus. Almost all the governmental programs put in place expire at the end of the year. Some have been extended just a little bit, but the key ones, particularly the ones that have to do with unemployment insurance and payments to those unemployed all start to fade basically after the end of the year.

And so I do think it's appropriate that we have a targeted stimulus package. At that, Joe Biden's right about this. The K-shape recovery, 80% of the country is doing just fine and dandy. And in fact, it's doing maybe even better than they were prior to the pandemic. 20% of the country though, those that are attached to the industries that have been the hardest hit... Which are what? Hotels and tourism, entertainment entirely, bars and restaurants and retail, food and beverage, those sectors, which comprise 20% of the economy and about 20% of employment, that's where the targeted stimulus needs to go to let those folks crawl across that bridge while the rest of us are at least walking, if not running across the bridge….these last 20% that have been so wounded crawl across the bridge to get to the other side and the vaccine. That then opens up their venues so they can become reemployed again and attached to society if you will.

So, yeah, I think we should have a targeted package. We have to remember that the stimulus is not free. There are these things called deficits and deficits ultimately matter, basically we're pulling growth forward. It will cause future growth to slow because we're pulling growth into the current situation that wouldn't have been there. I think it's the appropriate medicine for us to take, but it doesn't come free. It comes at the expense of added debt, less flexibility in the future, probably slower growth in the future and perhaps even higher inflation.

Chris Schildz:

Scott, maybe that brings us to the big question, Wall Street at one point seemed to anticipate a gridlocked Congress for the next four years, but there's still much uncertainty in the eventual congressional makeup, depending on the January 5th Georgia runoff. What should investors be thinking?

Scott Colbert:

Yeah, this is a bigger deal. And I think people are largely looking politely past it, almost assuming there has to be one out of those two Republicans elected. The polling and the (political) races, of course, who knows what polling is worth anymore. I think it's been largely discredited over the last two elections and at the state level it even gets tougher. But the latest polling is that these are dead heats between both candidates. Literally 48 and a half percent of people voting for both candidates. And the other 3%, the undecided 3%, could swing either way. These elections, like almost every election, and the reason the polling is off is because they're not exactly sure who turns out to vote. And so the turnout will really determine who wins it.

A coin toss would tell you that there's a 75% chance that one of these two is a Republican, right? It's one out of two and one out of two. The market's betting odds, if you want to look at that, you can bet on just about anything, but the betting odds are about 80%. So it's a one in five shot that the Democrats would take both seats. But I do think there will be some marked reaction in the financial markets if the Democrats take over 50 seats, which of course gives them control because the vice-president has the swing vote on a 50-50 deadlock.

What is the likely reaction? Well it's down, and the reason that it's down is because if Congress has one place to look for additional tax revenues, it's at the corporate tax level. Corporate taxes have not grown in proportion to personal taxes and real estate taxes and all the other taxes. Social security taxes, Medicare taxes, think of any tax you're paying, and essentially almost all those taxes that you're paying as a citizen have essentially doubled since 2000. Corporate taxes though have only grown by about 30%.

So it is true that corporations on a relative basis have benefited at the margin and their tax burden has grown much less than the average households for the average individuals. And so I think that the Democrats would look to raise the corporate tax rate. When the current administration, the Trump administration, lowered the corporate tax rate it ginned up an extra 8% in earnings to the S&P 500. If you take that 8% of earnings away, I think it takes away 8% of the stock market capitalization again. So I think the equity markets get hit. It also probably will increase, there'll be some increase or some potential increase in marginal tax rates. There probably could be an increase in the capital gains tax rate, which might accelerate some selling of securities, putting the downward pressure on the market.

And it probably also spikes the odds for some bigger stimulus package. So if you're a beneficiary of that stimulus package, you like that. But on the other hand, we already have large and rapidly growing... The largest deficits. We have the largest deficit to GDP, federal government deficit to GDP we've ever had, and cumulative debt relative to GDP. About 1.2 times GDP is the largest and highest it's ever been since World War II.

So, we've already done a lot of stimulus. We've already provided a lot of free money and can't continually open this spigot, and I think that the Democrats will be more than likely to do that. And then finally, if all that was to transpire, we'd potentially have higher inflation. Of course higher inflation, going forward given the draconian deficits that we have, we'll start to crowd out the rest of the budget and crowd out the rest of our financial flexibility. I'm pulling for at least one Republican, because I think it will be better for the financial markets and better for the country in the long run to have a split Congress.

It's interesting. If you look back since 1950, the financial markets do the best when Congress is split, and there's both a Republican Senate or House and a Democrat Senate or House. Unified governments, they do pretty well in two, which is what we would have, but they tend to the best when there's a divided Congress, for whatever reason. It's a small number of those statistical samples. There's only been 19 of these opportunities to even look at since 1950, but for whatever reason the divided Congress has provided higher returns on average than any other political situation we've confronted.

Chris Schildz:

All right, Scott, let's take your macro economy hat off and go to fixed income for just a minute. Investors looking for return are having a tough time in this sector with very low bond yields seemingly locked in place. Bonds were a good place to be during 2020. Do they still have a place in a portfolio?

Scott Colbert:

Well, I guess that depends upon your timeframe. I will tell you if you're a really, really, really long-term investor, given that interest rates are the lowest they've ever been, literally in the history of mankind, and I say that without exception, going back all the way to the Medici's (Elite in Italy during Renaissance) and the borrowing back in Italy, nobody lent money to governments for 1% or 0% or negative rates for 10 years ever. And this is the situation that we find ourselves in today. So, it's very difficult for a bond investor to basically build a portfolio that gives them anything near a 2% yield, either pre-tax or even after-tax. So, a 10-year bond ladder or a 20-year bond ladder probably at best provides you a real yield of zero. In other words, just something that probably likely keeps up with inflation in the future.

Now it does offer you an insurance policy for disaster. As we saw when the stock market was tanking and fell 34% basically from late February to March 23rd or so, 39 days is when it took the stock market to fall 34%, treasury bonds rallied like a bandit. And so high quality, low yielding bonds provide that insurance policy. They will still provide that insurance policy going forward, but if you have the wherewithal to work through the recession, and there's a recession on average about once every seven and a half or eight years, and the stock market of course declines about 34% when it does, but you have the ability to look down past that, we think the equity markets are clearly less expensive than the bond market is rich, and we are encouraging people to reduce the amount that they would normally have in fixed income and overweight the amount that they would have in risk assets.

And then specifically on the fixed income side, we try and provide any type of reasonable return in the long run. We've also allocated if you're a municipal bond buyer, about 5% into high yield municipals. And if you're a corporate or a pension fund, or people buying taxable corporate type bonds we're allocating 10% of high yield markets, which have coupons closer to say three and 4% in the municipal space and five plus percent still in the fixed income space. You can do this when you're coming out of recovery. Typically those sectors do pretty well. Those sectors also though behave more like stocks in a downturn. So we tactically allocate to those sectors. Those are not long-term strategic allocations. Those are tactical allocations to take advantage of the recovery right now for people who are following our tactical asset allocation models.

Chris Schildz:

Thanks for that analysis, Scott. Let's wrap up with this: In your role, you probably see as many of our clients as anyone within Commerce Trust Company. What are clients telling you as we head into the end of the year and go into the beginning of 2021?

Scott Colbert:

We certainly touch on a vast number of clients, a vast number of businesses. I will say in general, and this is even more than 80% of our clients, (they) are all surprised at how well they're doing. They all thought that this was going to be a disaster, that it was going to take a long time to recover, that their businesses were going to be grossly impacted and damaged for some time, and in general, it hasn't worked out that way. Now that has probably also because the banking system does not afford a lot of credit to the most cyclical parts of the economy that were hurt the most. If you think about airlines, airlines in general [inaudible 00:16:26]. I hate to say it, but they've gone bankrupt many times before, but yet we still have all of the airlines. Restaurants and bars and hotels are very cyclically sensitive. And these are lower credited opportunities, and the banking system by and large doesn't bank them.

So, our clients in general, most banking clients in general, are pretty well off, and are surprised about how well they're doing. What they are cautious about though, of course, is that they see the coronavirus continue to increase. They know that the vaccine is around the corner, almost holding their breath, and they don't know how much the stimulus has created a facade of a good economy, but perhaps one doesn't quite exist as reasonably well as we think it is because of all the stimulus and low interest rates in the pipeline. But they also remember back to the last great recession and coming out of it how cautious they were, and almost to a person, they typically say, "Commerce Trust, Scott Colbert, Chris Schildz, if you'd just told me we're going to have a 10 year economic recovery and told me to look down the field, I would have invested more in plant capital equipment and got my business together for what amounted to basically a fairly long recovery."

The average economic recovery in this country is seven and a half years, almost 89 months since 1960, so seven and a half plus years. We're only a half a year into this economic recovery. We would encourage people to try and get their businesses right-sized, but what's probably likely to be a fairly steady state long-term economic recovery, like it typically is post ending recession. But at the same time, we understand why customers are still cautious. They're surprised they're doing as well as they are, but they're cautious. And they're still not exactly sticking their necks out because they'd like to see the vaccine work and they'd like to see the country, basically we'd like to see everybody get back to normal.

Chris Schildz:

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Thanks, Scott. That was Scott Colbert, chief economist for Commerce Trust Company. Thank you for those comments. And you can also see those comments in our Outlook report newsletter, on the website or in the electronic version that was emailed to all clients. Thank you so much.

Chris Schildz:

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