IdahoTrustBank

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WealthManagement

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Market Insights

A periodic newsletter from Idaho Trust Bank

The U.S. economy suffered its worst period of economic growth ever last quarter. Economic output fell at its fastest pace on record as the coronavirus pandemic forced businesses across the United States to close their doors and kept millions of Americans shut in their homes for weeks. The collapse was unprecedented in its speed and severity.

Economic Activity

After a sharp rebound in the economy in May and June, the economic recovery has slowed as consumers, workers and businesses remain extremely cautious. This suggests that the economy will likely remain sluggish for the remainder of the year. The labor market has a long way to go before it will be considered fully recovered. The latest jobs data marks a sharp moderation from the initially strong recovery experienced as many areas begun to reopen from the coronavirus induced shutdowns. Early estimates are that the Gross Domestic Product (GDP) will rise by approximately 5% next year. The unemployment rate is expected to remain around 10% at the end of this year, as any additional jobs recovery will likely only happen once there is a vaccine for the coronavirus.

The next six to 12 months will likely still see the impact from the prolonged dislocation in the labor market. The latest data show that most of the job gains

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since April have come in the heavily impacted sectors, such as food services, hotel accommodation and retail. Growth in manufacturing jobs stalled in July with the exception of the automotive sector. The labor-force participation rate dipped in July after gains in May and June. The retail sector continues to struggle and bankruptcies are looming in many sectors of the economy. The biggest headwind in the next few months will be a large drop in personal income, due to the expiration of massive federal relief. Even if Congress does agree to another round of extended employment benefits or direct payments, it won't replace all the income support that was used to prevent widespread economic disruptions this spring.

The decline in U.S. economic output in the second quarter was the sharpest on record. Economists expected sever economic repercussions due to the shutdown to combat Covid-19 to persist. The economic road to recovery is shaky at best for the next several quarters as the country continues to struggle with managing coronavirus. Unfortunately, the timeline for a proven vaccine remains elusive and creates a higher level of uncertainty going forward.

The Federal Reserve Bank

The Federal Reserve Bank (Fed) held its annual Jackson Hole meeting last month. This event is notable because the Fed has historically used this gathering to announce important policy changes. The theme this year was "Navigating the Decade Ahead: Implications for Monetary Policy." Chairperson Jerome Powell gave a speech titled "New Economic Challenges and the Fed's Monetary Policy Review." In his remarks, Powell said that the Fed will shift its emphasis when deciding to adjust interest rates. This marks a notable shift in policy and thinking for the Fed. Previously, the Fed stressed the need to raise interest rates proactively in order to ward off possible inflation. This belief was a result of the challenge in halting inflation once it started. Consequently, there has been a concerted effort to stop it before it became too strong.

The new policy seems to suggest that Chairman Powell thinks that the battle against inflation is over, at least for the next few years. The recent threats to the U.S. economy have been a pandemic and a financial crisis. Inflation has not been an issue in recent memory. The Fed is no longer using an "inflation target" of 2% as a guiding philosophy. As a reminder, in 2012, the Federal Reserve adopted a policy of targeting inflation at 2%. Many central banks around the world adopted similar policies. The benefit of targeting inflation is that it gave the public a clear view of what the Fed was trying to do, which has improved the transparency of monetary policy.

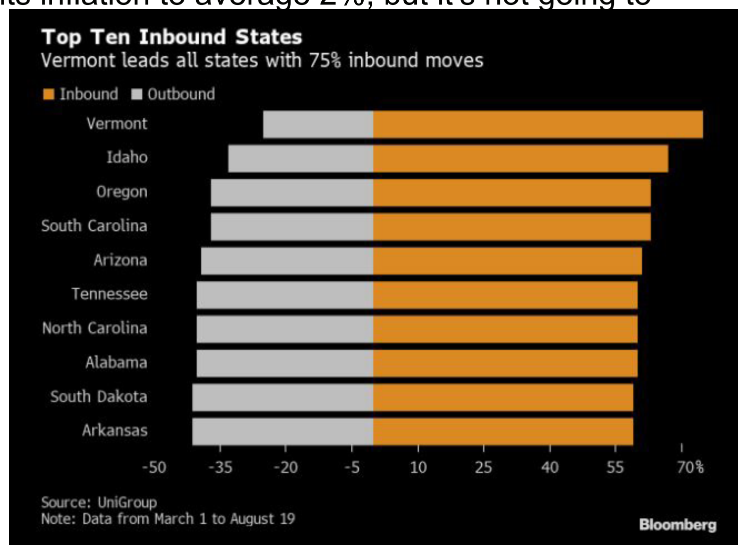
Since the Great Financial Crisis, inflation has remained well below the 2% level with any movement above that level temporary and regarded as transient. The Fed has undershot 2% inflation for a very long time. Powell cited four major changes in the Fed's understanding of the economy. One is that 'normal' economic growth is now assumed to be much less than what it had been. During latter third of the 20th century, the U.S. economy routinely

grew by 3% per year in real terms. Now the economy has struggled to stay around the 2% growth rate.

The Fed also assumes that interest rates now need to be much lower than they have been. Under the old playbook, during an expansion, the Fed would raise interest rates to 2% or 3% above inflation. During a recession, it would cut rates to about the level of inflation. That hasn't been the case in over 10 years. Powell also noted that before Covid-19, the labor market was on strong footing. The unemployment rate dropped to a 50-year low. Even when the labor-force participation rate started to rise, there was no signs of wide-spread inflation. One problem with lower inflation is that the Fed has had less room to boost the economy with rate cuts. That explains why the Fed has embarked on some non-traditional policies.

The Fed likely believes that some inflation is necessary at this point in the economic cycle. Mr. Powell stated that "Our new statement indicates that we will seek to achieve inflation that averages 2 percent over time. Therefore, following periods when inflation has been running below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time."

To be clear, the Fed wants inflation to average 2%, but it's not going to worry if it rises above 2%. It's also good to keep interest rates low. Generally speaking, stocks have performed well under modest inflation and aggressive rate hikes have negatively impacted the stock market.



Moving

Since the coronavirus emerged, many America's have begun to move to new locations. The shift is interesting as far more people moved to Vermont, Idaho, Oregon and South Carolina than left during the pandemic (see the chart). On the other hand, the reverse was true for New York and New Jersey, which saw a high percentage of outbound traffic.

Conclusion

The economic contraction experienced in the U.S. has been profound affecting many segments of the population. Many are hopeful that it will be short-lived and economies around the world will be back on a positive track in 2021. However, at this point, there remain many unknowns surrounding coronavirus, which is likely to keep volatility levels elevated over the next few months at a minimum.

S&P 500 Index

3 Month	15.48%
Year-to-Date	9.74%
1 Year	21.92%
3 Year	14.49%
5 Year	14.43%

MSCI EAFE Net Index

3 Month	11.26%
Year-to-Date	-4.61%
1 Year	6.13%
3 Year	2.34%
5 Year	4.72%

Barclays Aggregate Bond Index

3 Month	1.31%
Year-to-Date	6.85%
1 Year	6.47%
3 Year	5.09%
5 Year	4.32%

As of 8.31.2020

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