

## A Beach Boys summer: Is the U.S. economy like “Sloop John B” or “Don’t Worry Baby”?



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Percentages are funny things, because they aren’t symmetrical; a stock price can drop 50% and then rise 50%, but it won’t be back to its starting point; it will still be down 25%. So too it goes with the U.S. economy as we dig out of the Covid-19 pandemic and its accompanying recession.

On an annualized basis, the U.S. economy shrank by 33% in the June quarter — a “Sloop John B” experience (“This is the worst trip I’ve ever been on,” as the Beach Boys lamented). Yet investors have been looking past that, to what they anticipate will be gaudy percentage gains through the balance of this year and into next year. With visions of sustained double-digit GDP gains twinkling in their eyes, traders have bid up stock prices: “Don’t worry, baby, everything will turn out all right,” as the quintessential optimists also crooned.

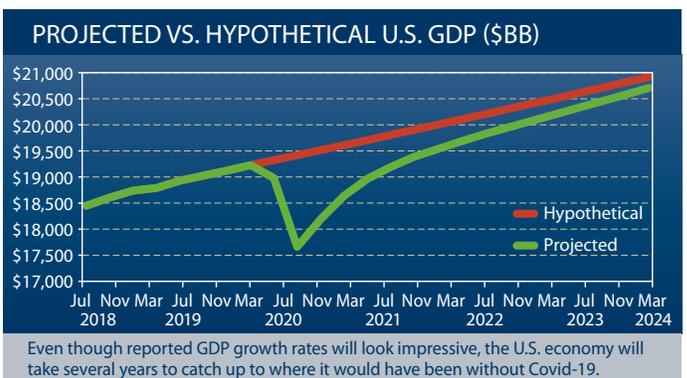
The problem with just looking at lofty percentage gains is that the absolute levels of economic activity are still depressed. Even with a robust recovery, the total output of the U.S. economy isn’t likely to reach its late 2019 peak until next summer; in effect, Covid-19 will have cost us about 18 months of economic activity just to get back to where we were.

Yet absent Covid-19, our economy had been expected to continue growing at about 2% per annum, a trend shown in

red on the chart nearby. Even with a gangbusters recovery as depicted in green, it will likely be well into 2023 or 2024 before we catch up to where we would have been without Covid-19.

That’s the best-case scenario. More likely, our economy will run into snags as it tries to build momentum. Sporadic virus outbreaks will undoubtedly occur; even narrowly-tailored and localized responses will still drag the national economy. Some entire industries — air travel, live entertainment, commercial real estate — may take many years to recover. These and other problems may further delay the U.S. economy’s recovery.

So is this the worst trip we’ve ever been on, or will everything turn out all right? Yes, and yes — but it will take time and resilience before the U.S. economy regains its swagger.



Source: U.S. Commerce Department, Eastern Bank Wealth Management estimates.

### >> PERSPECTIVES ON THE ECONOMY

## Does the economy have the green light again?



**By Timothy Garvey, CFA**  
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Prior to the coronavirus pandemic (for consistency with other articles), the U.S. economy appeared to be on cruise control.

Consumer spending was consistently strong, the job market was tight, and the housing market was showing resiliency. Meanwhile, the Federal Reserve’s monetary policy remained accommodative. A few yellow lights were flashing, like slowing global growth, mounting geopolitical risks, and stubbornly low inflation. But despite these concerns, the economy continued to cruise along on the open road.

Covid-19 was the economy’s red light. The June quarter was the worst period of economic activity since the Great Depression. As stay-at-home orders were promulgated to combat the pandemic, spending nosedived across almost all sectors of

the economy. However, unprecedented relief packages from Congress and liquidity support from the Fed have cushioned the downturn. As the reopening process has taken shape, it seems as though we have passed the bottom. So does the economy have the green light again, or the more cautious yellow flashers?

Most economic data points are signaling a sharp positive bounce, albeit from a very low bottom. The monthly employment reports have shown staggering increases in jobs recently, but the unemployment rate is still over 10%. Consumer confidence and consumer spending have jumped, but both remain significantly below pre-pandemic levels. The same can be said for housing starts and new home sales.

Economic activity has rebounded, but we still have a long way to go. The outlook still hinges on the future course of the epidemic. While the recent data points have sparked optimism, there is still vast uncertainty. For now, flashing yellow appears to be the prudent conclusion.

>> FOCUS ON EQUITIES

## Can the stock market recovery continue?



**By Allen Laine, CFA**  
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Call it the “Rule of 20s”: The S&P 500 index posted its largest quarterly percentage drop on record during the first quarter of 2020, dropping 20%; then it staged a rapid rebound, a 20% gain, representing the best quarter for the market in the past 20 years. The economic impacts of Covid-19 have been massive, but the worst should be behind us. If confidence in this recovery continues to firm, equity markets can still move higher, even eclipsing the record highs set in February and July.

The rebound in the stock market through the first half of 2020 was driven by a small number of larger stocks, while many smaller stocks remained well in the red. Those that have buoyed the market are the beneficiaries of the government-mandated lockdowns and work-from-home policies instituted by many businesses. Technology companies that help support work-from-home functions, like Microsoft and Adobe, have appreciated. Companies that offer home-based activities have also been handsomely rewarded; these stocks include Netflix, Apple, Facebook, and Alphabet, the parent company of Google and YouTube. E-commerce and digital payment stocks have also participated in the rally with PayPal, Amazon, and eBay moving meaningfully higher. Together these companies and their peers make up approximately 20% of the S&P 500 index, and all of them are trading at or near all-time highs.

However, there is a huge dichotomy in performance between the high-fliers and the companies whose businesses were substantially disrupted by Covid-19. Many stocks in the industrial and basic materials sectors have lagged considerably, as have banks and energy companies. These “early cycle” stocks are beginning to look relatively attractive on normalized earnings, and they typically help lead the equity market out of bear market bottoms. That they have lagged the rebound from this year’s bear suggests that the economy is still under severe strain. For these stocks to appreciate, tangible evidence of progress towards economic normalization will be necessary. Initial signs of recovery in the macroeconomic data have emerged and these stocks have begun to reverse their negative course. For the market to advance further, this trend needs to persist, and stocks that are more economically sensitive will need to participate.

>> FOCUS ON FIXED INCOME

## Investors get comfortable with credit risk



**By Tom Bussone**  
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As the U.S. economy began to reopen and the Federal Reserve began providing unprecedented support for corporate debt, investment grade bonds posted their best quarter in eleven years, returning almost 9% through June. Investors were increasingly comfortable taking on credit risk, overlooking the near-term problems brought on by the coronavirus and instead focusing on a rebound that may take place during the second half of the year. Investment-grade companies took advantage of record low yields (the 10-year U.S Treasury yield ended June at 0.66%) and an appetite for debt, issuing more than \$1 trillion through the first six months — surpassing the total for all of last year. This has allowed companies to manage their near-term maturities and help to build a cash reserve to give financial flexibility during severe uncertainty.

Despite the recent rally in credit, we believe that there is still plenty of upside. The spread (the extra yield versus comparable-duration Treasury debt that an investor receives to take on credit risk) remains elevated from the beginning of the year, for both investment grade and high yield paper. We expect spreads will continue to decline, sending corporate bond prices higher; the Federal Reserve has said it will support the credit markets by buying more corporate securities and keeping the federal funds overnight interest rate near zero likely until 2022. Massive inflows of cash coming from overseas aren’t expected to stop, as U.S. debt looks cheap compared with the \$13 trillion of negative-yielding debt globally.



Source: FactSet