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ECONOMIC REPORT

Gus Faucher Chief Economist | **Stuart Hoffman** Senior Economic Advisor | **William Adams** Senior Economist | **Kurt Rankin** Economist | **Abbey Omodunbi** Economist

THE PNC FINANCIAL SERVICES GROUP | The Tower at PNC Plaza | 300 Fifth Avenue | Pittsburgh, PA 15222-2401

VACCINE NEWS RAISES HOPES FOR STRONGER RECOVERY; ELECTION RESULTS MIXED FOR STIMULUS

SUMMARY

- Financial markets responded very positively to news of a potential coronavirus vaccine from Pfizer.
- The news could boost near-term growth through higher stock prices and improved consumer and business confidence.
- Quick deployment of a vaccine would be very good for longer-term U.S. economic growth.
- Results from this month's elections are mixed for economic growth. A Republican-controlled Senate could make a big stimulus bill less likely.
- Rapid vaccine distribution could make the Federal Reserve's job trickier.
- The vaccine news and election results will not result in big changes to PNC's economic forecast, which is for solid economic growth over the next few years. Risks to the outlook have moved from the downside to more balanced.

Pharmaceuticals manufacturer Pfizer announced very encouraging early trial results of a potential vaccine for the coronavirus on November 8, raising the possibility that distribution could begin in late 2020 or early 2021. Investors welcomed the news, with the S&P 500 jumping 1.2 percent on the day, even with a stock selloff late in the afternoon; stock prices have been flat in subsequent days. The price of a barrel of West Texas intermediate crude oil jumped from $37 to $41 on November 8 because of expectations that better economic growth will boost demand for energy; oil prices have stayed around that level since then. The yield on the 10-year Treasury rose by a quarter of a percentage point to 0.96 percent on the day, its highest level since before the pandemic, but is back down to 0.88 percent as of November 12.

It is premature to declare the coronavirus pandemic over. Caseloads in the U.S. are at a record high, the vaccine needs to be approved, and there are huge logistical obstacles to distributing it. Even if the vaccine is highly effective, it would take months to make it available throughout the nation.

But the news is encouraging, and is positive for U.S. economic growth in the short run. Higher stock prices increase wealth, especially for upper-income households, encouraging consumer spending. Positive vaccine news is also likely to boost business and consumer confidence. If businesses think the pandemic will end sometime in 2021, they are more likely to invest and hire in the near term, or at least not cut back on investment and headcount. Hope for a vaccine could make consumers more willing to spend, especially on big-ticket items like homes and cars, where sales are already strong.

More importantly, rapid distribution of a vaccine and a faster end to the pandemic would support long-run U.S. economic growth. If hope is on the horizon, businesses are more likely to ride it out until conditions improve. The big fear was that the pandemic would force huge structural changes throughout the economy as some business models became unsustainable, in industries like restaurants, entertainment, and air travel. This type of restructuring is slow and incredibly costly, and also results in big job losses as firms lay off workers. Reemployment for these workers would be difficult as they would need to switch industries; learn new skills, which takes time; and often take pay cuts. This restructuring would also litter the economy with unproductive investments, in equipment, buildings, and technologies, weighing on growth until new investments would arise to take their place. These risks are greatly lessened now.

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While the vaccine news is good for the economy, the implications of the recent election are mixed. President-elect Biden is more likely to push for big economic stimulus than President Trump would have been. But the odds of getting a big stimulus are lower with a Republican-controlled Senate, the most likely outcome. Republicans are likely to push back on the size of stimulus that President-elect Biden wants, both for political reasons (to avoid handing the new president a big win early in his term) and philosophical ones (sincere, albeit misguided, concern about increasing the nation's debt). That being said, Congress is likely to pass a productive stimulus package ahead of two runoff elections for the Senate in Georgia in early January; Senate Majority Leader McConnell would like to show progress to support the campaigns of the two incumbent Republican senators in the state.

The Pfizer announcement does not obviate the need for stimulus. In fact, stimulus could be more effective in the near term, since it could help bridge the gap to a stronger recovery following the distribution of a vaccine. Stimulus should focus on three main areas: aid to small and medium-sized businesses, support for households, and funding for state and local governments. Many small and medium-sized businesses face difficulties; a recent PNC survey found that one-third would go out of business within a year under current economic conditions. To let these businesses founder with the end in sight would be a huge mistake, as it would take time for new businesses to arise and take their place, weighing on the recovery. Households have powered the nascent recovery as stimulus payments have funded consumer spending, but for many households with unemployed workers that aid is running out. A temporary income boost could help support their spending until the labor market rebounds. And without assistance from the federal government state and local governments could be forced to make enormous spending and job cuts to balance their budgets, dragging on growth.

The recent news, especially about the vaccine, makes the Federal Reserve's job a bit trickier. Although an effective vaccine is likely to support a strong recovery, there is still widespread unemployment in the U.S. The unemployment rate dropped from 7.9 percent in September to 6.9 percent in October, and is down from 14.7 percent in April. But the unemployment rate is still far above its pre-pandemic level of 3.5 percent. Job growth has slowed for four straight months, and more and more unemployment is permanent, rather than temporary; it is much harder for a worker who permanently loses her job to find a new position, relative to a temporary layoff. Given the Fed's focus on achieving full employment, the central bank wants strong economic growth to support hiring.

Because of expectations for a stronger recovery long-term interest rates have jumped following the Pfizer announcement, raising borrowing costs for businesses, state and local governments, and households. Ironically, these higher rates could create a drag on the economy. Because of this the Fed is likely to intervene more aggressively by purchasing more long-term Treasurys and mortgage-backed securities to push long-term interest rates back down (a policy known as quantitative easing). Inflation is expected to remain low in the near term, giving the Fed lots of leeway to run expansionary monetary policy. There are wide swathes of excess capacity throughout the economy, limiting firms' ability to raise prices; the high unemployment rate will keep wage growth low; and energy prices, though higher with the vaccine announcement, are still down from early 2020. An effective vaccine does not change PNC's forecast for the fed funds rate, the Fed's key short-term policy rate, to remain near zero at least into 2024.

The Fed could also help bridge the gap to a vaccine with further measures to make credit readily available. Early on in the crisis the central bank stepped in to support the flow of credit to businesses, consumers, and state and local governments, preventing an inability to access funds from crippling the economy. Now, with a vaccine on the horizon, more credit may be needed to help businesses and governments make it through to better times. The central bank started the Main Street Lending Program to provide credit to small and mid-sized businesses, but take-up has been disappointing; the Fed may need to make changes, including taking on more risk, to beef up the MSLP and prevent more business failures ahead of a vaccine.

PNC does not expect to make major changes to its economic forecast following Pfizer's announcement and the election. The baseline forecast still assumes that the pandemic will abate in 2021, and that Congress will provide an additional $1.5 trillion in stimulus in late 2020 or early 2021. PNC currently expects real GDP growth of around 5 percent at an annual rate in the fourth quarter of 2020, with growth of a little above 3 percent for all of 2021. With the vaccine announcement risks to the outlook have become more balanced. There are still substantial downside risks, however, including an inability of Congress to pass additional stimulus funding and potential state restrictions on economic activity, given that daily coronavirus caseloads are now at a record high.

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