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A Return to Normal?

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Over the past year, I have often wondered what the tale of Rip Van Winkle would look like if it were set in the year 2020. When Washington Irving wrote the story, he had Rip asleep for 20 years and recounted how much the world had changed during that time. However, in my version there would be a twist. Similar to the initial rendition, I imagine Rip falling asleep at the beginning of the year. But instead of him waking up at a specific time, he would wake up at different points in the pandemic. Depending on when Rip woke up and tried to make sense of the world around him, his reaction would vary greatly. Surprisingly, the longer Rip slept, the less extreme his reaction would be when he woke up.

A familiar sight before the COVID-19 pandemic: the famous Katz's Delicatessen in New York City, where customers struggled to find an open table.

Similar to the original version, my rendition of "Rip Van Winkle" would use his daily routine to symbolize the changes that have occurred in the economy, while avoiding the often dry economic data that they represent! Certainly, if Rip woke up in April 2020, he would have been quite unsettled by how abnormal the world had become, seeing empty restaurants and malls, and the shortage of consumer products. However, as time has passed, many of the changes that occurred in the economy at the outset of the pandemic are reverting back to how they were beforehand: people are shopping, returning to school and work, and dining out. The later Rip wakes up, the fewer differences he would notice. All of this could make subsequent versions seem mundane. If it were only that simple.

At the outset of the pandemic, the unemployment rate skyrocketed from 3.5% in February 2020 to 14.8% in April 2020. As of March of 2021, the unemployment rate has fallen to 6.0%. According to the minutes from the March 17th Federal Reserve meeting, the unemployment rate is expected to fall to 4.5% by the end of this year, which would be close to pre-pandemic levels.

Economic output as measured by the Gross Domestic Product (GDP) was another factor severely affected by the pandemic. With many businesses being closed during the second

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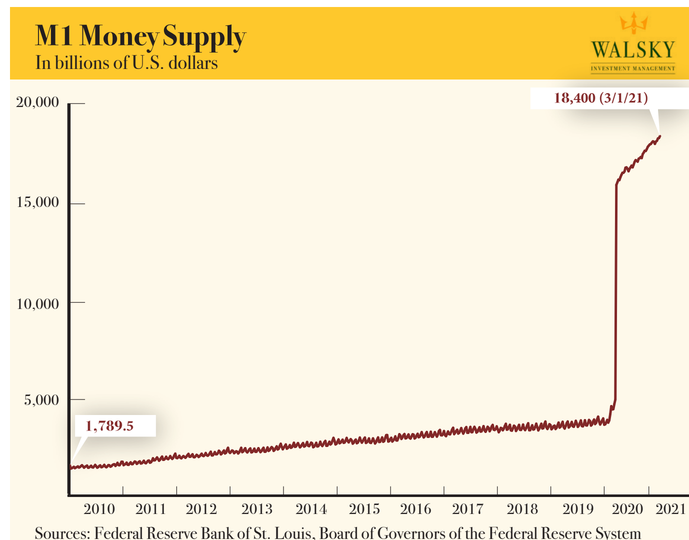
quarter of 2020, the nation's GDP fell 8.3% from the previous year. As businesses have reopened, the outlook for the GDP has improved. In fact, the Fed expects it to increase 6.5% in 2021, before cooling off to a 4% growth rate for the next two years. Similar to the unemployment rate, economic growth is expected to return to the same (albeit slow) rate that has persisted in the U.S. for the past decade.

As consumer spending was greatly reduced at the onset of the pandemic only to pick up later in the year, the rate of inflation experienced a similar pattern, with a declining rate in 2020 followed by a sharp uptick in 2021. Many economists are expecting consumers to flood back to restaurants and stores as the pandemic ebbs, leading them to conclude that the economy should be booming in the second half of 2021. The possibility of a resurgent economy has caused some investors to be concerned that inflation will be a problem in the future; however, the Federal Reserve discounts this belief. In their most recent meeting minutes, they indicated that they expect to keep interest rates unchanged through 2023, as there will be little need to curb inflation rates.

As economic data has rebounded, so has the stock market. After dropping around 20% in the first quarter of 2020, stocks regained their losses and much more. From March 31, 2020 to March 31, 2021, the S&P 500 grew over 53%, as investor confidence went from glum to giddy based on expectations that the U.S. economy will be at full steam by the end of this year.

With so much positive economic news, one might conclude that by the end of the year, things may be so "normal" that someone lucky enough to have fallen asleep in early 2020 could wake up at the end of 2021 without noticing too many differences. While that may be the case, this reversion back to "normal" will have been enabled by a significant change in economic policy, resulting in consequences that will be with us for decades.

In our Winter 2021 report, we questioned whether the U.S. government was going to embrace modern monetary theory by funding various government programs through expanding the money supply. While neither the Trump nor Biden administrations have used this term, it is obvious that to address the economic hardship caused by the COVID-19 crisis, the government has greatly increased its money supply and corresponding national debt over the past 12 months. This was accomplished by having the U.S. Treasury issue bonds and the Federal Reserve buy many of them, thus giving the government more money to distribute into the economy. In 2021 alone, the Federal Reserve has purchased $2.3 trillion of U.S. Treasury bonds. The result was a massive increase not only in the national debt, but in the overall amount of money in the economy, as measured by the M1 money stock (M1). M1 is the total supply of currency and coin and deposits in accounts, and is considered the basic supply of money in the economy.



While the increase in the money supply and its potential impact on inflation is of concern, the corresponding increase in the nation's debt presents its own challenges. Another way of looking at the increase in the national debt is to realize that as of the second quarter of 2020, the amount of U.S. government debt represented 135% of the nation's entire GDP. In other words, we owe more than we make.

In the past, the rise in government borrowing would lead critics to conclude that the additional debt could curtail future economic growth. However, since interest rates fell in March 2020, the U.S. government has been able to significantly increase its borrowing without the interest owed on this debt increasing as much. Much like a homeowner who refinances a mortgage at a lower rate to decrease the monthly payments, the U.S. government has been able to "refinance" its debt and increase its borrowing while keeping the payments low. Even with the sharp increase in the national debt, the amount the government pays for the interest on this debt is only 1.6% of the GDP, which is below the 50-year historical average of 1.98%. In 1992, the interest paid as a percentage of the GDP was 3.2%, twice what it is today.

In many ways, the future of the U.S. economy is looking remarkably like it did in the past... at least in the short-term. If this continues, my modern rendition of "Rip Van Winkle" would end the year 2021 with the economy similar to how it was before the pandemic hit. Only time will tell if this will be the case, or if the sharp rise in the nation's money supply will change the story's ending.