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Monthly Economic Outlook -- The Pandemic So Far...

COVID-19 has affected the data collection process for the major economic reports, including employment, consumer prices, retail sales, and industrial production. However, the incoming economic figures imply a stunningly swift, sharp decline in economic activity. This is especially clear in the two best real-time indicators, weekly jobless claims, and the UM Consumer Sentiment survey. We have not seen the economy bottom out, and forecasting the recovery is difficult. As Fed Chair Powell noted in mid-March, "the economic outlook depends critically on the spread of the virus, the measures taken to contain it and how long that goes on, and all that's really not something that's knowable."

Parallels?

When considering the economic aspects of the pandemic, it's important to ask if there are any parallels, any examples of previous shocks and their impacts on the economy. The 2007-09 financial crisis reflected the collapse of a housing bubble, but was also an unwinding of massive leverage within the financial sector. While financial strains are part of the current weakness, they are not the primary cause. The Great Depression was also caused by a financial crisis, but the reasons it was so severe and lasted so long was that policymakers made all the wrong moves – the Fed raised interest rates to defend the currency (because we were on the gold standard), the government raised taxes in the middle of the depression because lawmakers were worried about the budget deficit, and the government let thousands of banks fail, taking people's life savings with them. The current situation is somewhat like World War II, in that we are we are going through a period self-sacrifice, but World War II also coincided with a redirection of capital into defense goods, which isn't really going on right now. Hence, this is really an unprecedented event in economic history. Looking at past recessions for guidance is unlikely to be useful.

The key aspects of the coronavirus are its asymptomatic transmission (the fact that one can show no symptoms and still spread it) and its relatively long incubation period. That makes it difficult to contain. The death rate varies by age and the initial health of the individual. It's more deadly if you're older or have health issues, such as respiratory problems, diabetes, or heart disease. While many of the infected exhibit mild symptoms, about 20% of the cases are serious and require hospitalization. As with any virus, the spread appears to start slow, but builds exponentially, doubling every few days until it either runs out of potential hosts or is met by mitigation (efforts to contain it). This is where social distancing comes in. Social distancing (staying at home and avoiding crowds) slows the spread of the virus, helping to insure that hospitals won't be overrun with infected patients, and buys time for the development of palliatives (treatments or a vaccine). States and countries that adopted social distancing earlier have had better results in containing the virus. Testing is improving, but has long been inadequate. As a consequence, we haven't had a good handle on how many people have had the virus and it has been much more difficult to track the spread. In a best case scenario, it will take 12-18 months to develop a vaccine, although that process has already begun. To date, we don't have an effective treatment, which will be a key factor in re-opening the economy.

Ending social distancing too soon risks generating a wider outbreak of the virus and a more significant impact on the economy (as self-imposed social distancing would last a lot longer). The key is whether we can test enough people, and be able to detect and isolate infected individuals and those with whom they have come into contact. Coming up with an effective treatment will help to ease public fears and having a vaccine would be ideal.

There's a lot of uncertainty now about how to loosen the social distancing and what the new normal is going to look like. Eventually, the pandemic will be behind us. However, the severity of the economic decline implies that this won't be a V-shaped recovery.

The Economic Impact

When we started to look at the economic impact of COVID-19, it initially looked like there was going to be a large, temporary effect in China, which would disrupt supply chains for U.S. manufacturers and reduce sales for U.S. firms into China. As the virus quickly spread to other countries, the implication was that we would see significantly slower global growth, further supply chain problems, and a substantial reduction in global trade. As the virus has spread throughout the U.S., social distancing soon became the main mitigating effort. There was an immediate effect on restaurants, air travel, hotels, cruise lines, sporting and spectator events, and retail shopping. We now worry about second-round effects. As people lose jobs, the lost income reduces spending, which is someone else's income. Credit problems will cascade. State and local government revenue shortfalls show up quickly. Economic weakness will tend to snowball. Policymakers have reacted rapidly to counter this.

While the near-term picture of the economy remains muddled, the incoming data have provided some clarity. The base-case outlook is that economic activity contracted in 1Q20. The advance estimate of GDP growth will be reported on April 29, and is likely to be around a -4% annual rate). A huge decline is anticipated for 2Q20 (advance estimate to be reported in late July). Bear in mind that GDP is a quarterly figure, but it's reported at an annual rate. So, an 8% decline in a single quarter would be reported as a -30% annual rate (as if that 8% decline were compounded over four quarters). At this point, with limited data, it looks as if second quarter GDP growth may be between -25% and -35%. We probably get a rebound in the second half of the year, leaving 4Q20 GDP 5%, or 10%, maybe even 20%, below the level of 4Q19.

Economic data are generally backward-looking and noisy. There's a lot of statistical uncertainty and seasonal adjustment difficulties even in the best of times. Prior to seasonal adjustment, March through June is a strong period for the U.S economy. We normally see more business creation and big gains in jobs, retail sales, and housing activity. Hence, the virus has hit at a very bad time. COVID-19 has had an effect on the collection of economic data, including many of the key figures (employment, consumer and producer prices, retail sales, and industrial production). So one should take the reported numbers with a grain of salt. However, the direction is pretty clear and the magnitude is large. Retail sales were reported to have fallen 8.7% in March. That reflected weakness in restaurants, department stores, clothing stores, gas stations, and auto dealerships. The March weakness was enough to push the retail sales for the first quarter to a -9.2% annual rate (relative to 4Q19). Prior to seasonal adjustment, retail sales edged up 0.2%, but rose 16.5% in March 2019 – that's a big shortfall relative to the usual seasonal pattern. Manufacturing output was reported down 6.3%, with sharp weakness in motor vehicle production, leaving a -7.1% annual rate in 1Q20. These are indicative of a sharp recession. Single-family housing starts are normally choppy, but fell 17.5% in March, down at a 3.5% annual rate in 1Q20.

We have two good real-time indicators for the economy, weekly jobless claims and the University of Michigan's Consumer Sentiment Index. The claims figures have been horrific, totaling more than 26 million over the last five weeks. That is inflated somewhat by the seasonal adjustment (unadjusted claims typically run low during this time of year). Prior to seasonal adjustment, 24.4 million have filed claims in the last five weeks – representing about 15% of the labor force (that's one out of seven workers). However, the claims data understate the weakness in the job market, many laid-off individuals (such as part-time workers or the self-employed) haven't been able to file (and some states have had problems processing claims). The CARES Act expands eligibility, so the claims numbers are going to remain elevated and in the near term.

The UM Consumer Sentiment Index and other confidence measures are widely followed by financial market participants, but consumers don't spend sentiment. Income is the key driver of consumer spending, along with wealth and the ability to borrow. Consumer sentiment doesn't add much to the spending outlook. However, sentiment figures are indicative of the fundamentals and arrive earlier than data on jobs and income. So when you see a big drop in consumer sentiment, that decline reflects a deterioration in the household sector fundamentals. The drop in April was the largest on record.

Policy Support

In early March, we started to see dislocations in the credit markets, including the Treasury market (the most liquid market in the world). While there is limited evidence so far, we can expect to see issues with missed debt payments. Delinquencies are expected to build in the near term. There are mitigating efforts through the CARES Act, but these problems are still going to be there. Longer-term, insolvency and bankruptcy will be an issue for at a lot of companies. These are all very serious concerns.

In response to liquidity and credit concerns, the Federal Reserve has taken aggressive action. In two intermeeting cuts, the Fed lowered the target range for the fed funds rate to 0-0.25% and issued forward guidance (the Fed indicated that it expects to maintain these low levels of short-term rates until it's confident that economy has weathered recent events and is on track to achieve its goals maximum appointment and priced stability). The Fed also restarted large scale asset purchase (what most people call quantitative easing) and then made that unlimited. The Fed will expand its balance sheet, buying as much as needed to provide liquidity it to the markets. The Fed has restarted a number of emergency credit and lending facilities that it had employed in response to the financial crisis and added a number of new ones. It's important to note that the Fed cannot give grants or take credit risk, but the Treasury can through the Fed. Some of the features of the CARES Act, such as the paycheck protection program are Treasury efforts done through the Fed (and the Fed can lever those up to some extent).

We've now had four phases of fiscal support from lawmakers in Washington, totaling about $4 trillion or about 18% of GDP. These efforts include public health expenditures, an expansion of unemployment benefits, lending to small businesses, $1200 "recovery rebate" checks to individuals, and additional funding for state and local governments. There have been some issues in implementation, especially in lending to small business, but that's not unusual. These things are rarely smooth. However, support has come rapidly.

One of the key concerns in the recovery process will be budget strains at the state and local government level. This was a problem in the recovery from the financial crisis. In the $837 billion American Recovery and Reinvestment Act of 2009 (ARRA), a third of that was aid to the states. State and local governments have balanced budget requirements. In a downturn, spending increases and revenues decline. Even with federal support, strains on state and local government budget led to a huge amount of public-sector job losses in the early stages of the recovery. That was unusual. Normally, government jobs and spending provide some cushion in an economic downturn. Instead, government subtracted from GDP growth, weakening the pace of recovery. From late 2009, we lost about 700,000 state and local government jobs. These included police, firefighters, and teachers. It was only within the last year that we saw the level of state and local government payrolls recover. Legislators have provided support for state and local governments, but we know that a lot more will be needed.

In FY09, amid the worst of the financial crisis, the federal budget deficit hit $1.4 trillion, or about 10% of GDP. Ahead of COVID-19, with the economy operating near full employment, the budget deficit had been running at a little more than $1 trillion per year, or about 4.7% of GDP. Fiscal support measures to counter the effects of the virus will add another $3 trillion, bring the deficit to around $4 trillion or about 18% of GDP – and we will need more support in the weeks ahead.

Many investors are concerned about the expansion in the Fed's balance sheet and the increase in government borrowing. Will the Fed's actions lead to higher inflation? Will the surge in government borrowing create problems later on and how are we going to pay off the debt? These questions had also come up in the aftermath of the financial crisis and the answers are the same as they were then. Currently, deflation is more of a concern than inflation. Over the last several years, the Fed has struggled to achieve its 2% inflation goal (as measured by the PCE Price Index). In the near term, with demand weak, there should be little upward pressure on prices. There may be some concern that productive capacity will be diminished and supply chains disrupted enough to lead to shortages once demand picks up, but that doesn't seem likely. The Federal Reserve and other central banks have not abandoned their commitments to keep inflation under control over the long term. Amid strong demand for safe assets, the government has no problem borrowing. Interest rates are low. We, our kids, and our grandkids do not have to pay off the debt. We never paid off the debt from WWII. All we have to do is be able to roll over the debt and meet the interest payments – and that should not be a problem.

The Rest of the World

While the focus of investors has been on the domestic economy, developments in the rest of the world will have significant implications on the U.S. economy and firms doing business abroad. In the April update to its World Economic Outlook, the IMF lowered its estimate for global growth in 2020 from +3% (in January) to -3% and stressed that the risks are weighted to the downside. China reported negative GDP growth for the first quarter. Its recovery will depend a lot on what happens in Europe and the U.S., as they are the country's key export markets. China has some fiscal and monetary space to support its economy. Europe's economy is undergoing a major contraction. There are limited prospects for fiscal coordination across Europe. Germany still favors tight budgets, while the southern economies will experience severe budget strains. This will seem familiar to Spain, Italy, and Greece, and we are likely to see a renewed euro crisis (which, if you recall, was a big deal for U.S. financial markets in the early part of our recovery). Emerging economies are unprepared. They have limited capacity in their healthcare systems to deal with the pandemic, and limited fiscal space to counter the economic impact. The outlook for the rest of the world implies a substantial hit to U.S. exports in the near term and probably lower export growth once the virus has passed. In addition, with the virus circulating around the world, there is a possibility it could return to the U.S., especially if we were to drop our vigilance. By definition, a pandemic is a worldwide phenomenon. To fight it, we need global coordination and cooperation.

Opening up the Economy

Unwinding social distancing should be coordinated, gradual, in phases, with widespread testing, continued elevated hygiene, plenty of personal protective equipment, and contact tracing. The key to slowing a pandemic is to identify and isolate those infected. We need more testing. We need to identify those infected, trace who they have come into contact with, and isolate those individuals. The process should be dynamic, so that if the virus appears to be spreading more rapidly in one area, we can resume social distancing to tap that down. However, we could find that the opening up is uncoordinated, haphazard, and self-defeating. If we move too quickly, the virus will spread a lot more and social distancing, largely self-imposed, will last longer and the economic impact will be a lot larger.

Make no mistake, there is a trade-off between the economy and lives. That may sound cold, but as a society, we make these kind of choices all the time. In food and product safety, for example, there's always a trade-off between doing more to prevent unnecessary deaths and the cost of doing so. We could save tens of thousands of lives per year by setting the speed limit at 20 miles an hour, but we don't. We could prevent thousands of deaths from the flu by adopting social distancing every year, but we don't. Social distancing has helped to flatten the curve, slow the spread of the virus, and prevent our hospitals from being overrun. Without a widely available vaccine, we will make a trade-off. However, we clearly want to reduce that possibility of additional deaths as much as possible.

Forecasting the economy has been especially difficult over the last several weeks. The worst-case scenario one week becomes the base-case scenario the next week. Figures on jobless claims have been horrific in recent weeks, leading to a very rapid deterioration in the near-term economic outlook. COVID-19 has affected data collection for most GDP components, adding to the usual noise and uncertainty in the headline growth figure. However, the March figures appear weak enough to push 1Q20 GDP growth below zero. Second quarter GDP will be much more severe.

There is a wider dispersion in expectations for the economy in the third and fourth quarter of this year and beyond. Clearly, the recovery is going to depend on how we end social distancing and how rapidly that occurs. Going into social distancing was uneven across states. Without central coordination, re-opening the economy will also be uneven. Some may go too soon, leading to a wider outbreak of the virus and greater economic damage in the long run.

In summary, there is still a lot of uncertainty about the virus and the economic impact. The economic data will be distorted in the near term, but we do know that this is going to be a very large sharp hit to GDP growth in 2Q20. The U.S. economy should rebound, but gradually – and there are downside risks in getting the re-opening wrong. Credit conditions are worrisome in the near term. There are a lot of questions about missed debt payments and so on, but we should see strains helped somewhat by the Fed’s liquidity injections. Fiscal support is large. It won’t prevent the economy from weakening, but it should help to lessen the damage and should aid in the recovery. Anecdotally, there is severe hardship for those at the lower rungs of the economy. The Fed’s survey of consumer finances had noted that half of all households did not have the means to deal with an unexpected bill of $400. Food banks around the country have been overwhelmed, although we should see some improvement as food distribution networks are re-worked.

There will be some significant long-term changes to the U.S. economy once the pandemic has passed. Individuals may be less likely to travel, to go out to restaurants, or to go to theaters and sporting events. Households may increase their savings (spending less out of income). We will definitely see some changes in global trade, not just in supply chain issues, but in the amount of the global trade.

This ought to be a stock pickers market. Investors should focus on companies with strong balance sheets, adequate cash flows, and good prospects for survival. The market focus is long-term and investors remain generally optimistic, but there is likely to be a lot of volatility in the near term as the outlook shifts.

Pandemics have often changed the course of history. (M20-3058940)

Notes on the forecast: The table represents a crude forecast of GDP growth. Obviously, there is a lot of uncertainty about the re-opening of the economy and there are downside risks of moving too rapidly. However, this is not going to be a V-shaped recovery. The level of economic activity at the end of the year will be lower than before the pandemic.

GDP (%)	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20	1Q21	2Q21
q/q	+2.1	+2.1	**-3.8**	**-32.0**	**+5.0**	**+7.5**	**+6.5**	**+6**
y/y	*+2.1*	*+2.3*	***+0.6***	***-9.1***	***-8.5***	***-7.3***	***-4.9***	***+6.2***

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The **Dow Jones Industrial Average (DJIA)** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

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The **MSCI World All Cap Index** captures large, mid, small and micro-cap representation across 23 Developed Markets (DM) countries. With 11,732 constituents, the index is comprehensive, covering approximately 99% of the free float-adjusted market capitalization in each country.

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