THE LONG AND WINDING ROAD TO RECOVERY - PART 1

Every economic and financial crisis seems to beg for a label that quickly finds its way into the vernacular (e.g., the DOT-Com bubble of 2000-2002, the Great Financial Crisis of 2008-2009). Thanks to the International Monetary Fund, which published its semi-annual World Economic Outlook on April 14, we now have one for the current environment: ***The Great Lockdown***.

The IMF, a leading source of economic statistics and analysis for virtually every country and economy in the world, concluded that the COVID-19 pandemic and related efforts to curtail its spread and impact would cause the world to "experience its worst recession since the Great Depression". It forecasts that overall world economic output will shrink -3.0% in 2020, with the greatest impact being felt in advanced economies including Europe (-6.6%), Japan (-5.2%), and the US (-5.9%).

In consideration of the Great Lockdown's unprecedented economic and societal impacts, we are currently undertaking analyses of its prospective short- and longer-term effects on the US economy and key portions of domestic capital markets (the US stock and bond markets). Economies and markets beyond the US are not unworthy of such detailed scrutiny, but the relatively important world role of the US economy and capital markets – and the US-centric bias of our investment portfolios – suggest a focus will better inform our investment decisions and provide more cogent and concise perspectives to our clients.

As noted in the title above, we anticipate writing several pieces that take into consideration the current state of affairs and possible future directions and outcomes. Beyond this Part I, with its focus on the US economy, we are currently planning to share similar perspectives on the US equity market (Part II) and on inflation, interest rates, and US bond markets (Part III).

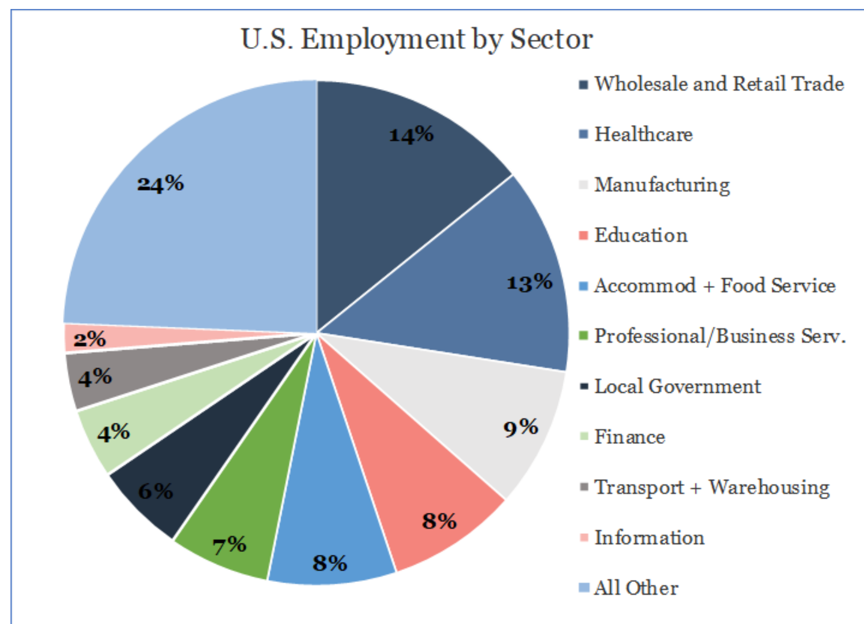
The US Economy in Context

To understand where the US economy may be headed both near-term and across the next few years as it strives to recover from the COVID-19 related shutdown of many private businesses and government entities, it is useful to have a baseline understanding of its pre-crisis size, breadth, and dimensions:

- The aggregate size of the US economy – for which Gross Domestic Product (GDP) is the conventionally used metric – was $21.4 trillion as of December 31, 2019.
- Consumer spending (on goods and services) typically comprises two-thirds of total spending in the US economy. Private investment (in residential real estate, in non-residential structures and equipment) and government spending (national, state, and local governments) each comprise smaller and roughly

equal (17%) shares of the total economy. On balance, some portion of total consumption is imported goods and services; likewise, some portion of total US economic production is exported. US imports have long exceeded its exports.

- A distinguishing strength of the US economy: it is broadly diversified across various sub-sectors. In the private sector (88% of the total economy), economic output from the Financial (21% of GDP), Education (15%), Professional Services (13%), Wholesale and Retail Trade (12%), Manufacturing (11%), and Healthcare (8%) sectors comprise nearly 80% of the $21.4 trillion total economy. Various other sectors (Technology, Construction, Arts, Food Services, Accommodation, Agriculture) are smaller yet still critical sectors for the economy and society more broadly. Likewise, state/local/federal government entities (12% of economic activity) provide a variety of taxpayer and user-funded services in support of the overall economy.



- The US economy employs about 150 million FTEs (full-time and part-time jobs) among the estimated 330 million people living in it. Jobs are likewise spread across many sectors, though not necessarily in direct proportion to their overall economic heft. Finance and Technology jobs, for example, are a proportionally lower share of total jobs; the Retail Trade, Healthcare, Food Service, and Hospitality sectors provide disproportionately greater (and, on balance, less well-paid) total employment than economic value. These sectors – with the exception of Healthcare – have been among the most vulnerable to job losses during the current crisis.

- In aggregate, the preponderance of consumers' gross incomes (61%) comes from wages; other major sources of income (e.g., business profits, interest income and dividends; social security and other government benefits) comprise the balance of what is collectively available to spend (net of taxes) in the broad economy. But not surprisingly, given wage and income disparities and most consumers' lack of *emergency funds*, a sudden and potentially extended period of unemployment can have a huge impact on spending within the economy. During the GFC, for example, the personal consumption portion of the economy shrank by about $450 billion (-3%) in the face of rising unemployment (unemployment claims reaching 6.6 million; unemployment rate peaking at 10%) and declining overall wage income (-4%).

Whither the US Economy: 2020 and Beyond

We wrote recently (Brave New World , April 1, 2020) about economists' collective struggle to calculate the extent to which US and global economic activity will shrink amid COVID-19 related shutdowns. There are no relevant modern precedents upon which to draw. But it seems a virtual certainty that the record surge in unemployment will substantially reduce wage income (CARES program checks notwithstanding) and small business profits. And that "stay at home" polices combined with lower incomes will combine to produce a record-setting decline of personal consumption spending within the economy. Private investment, too, seems likely to fall off sharply amid factory closures and construction halts.

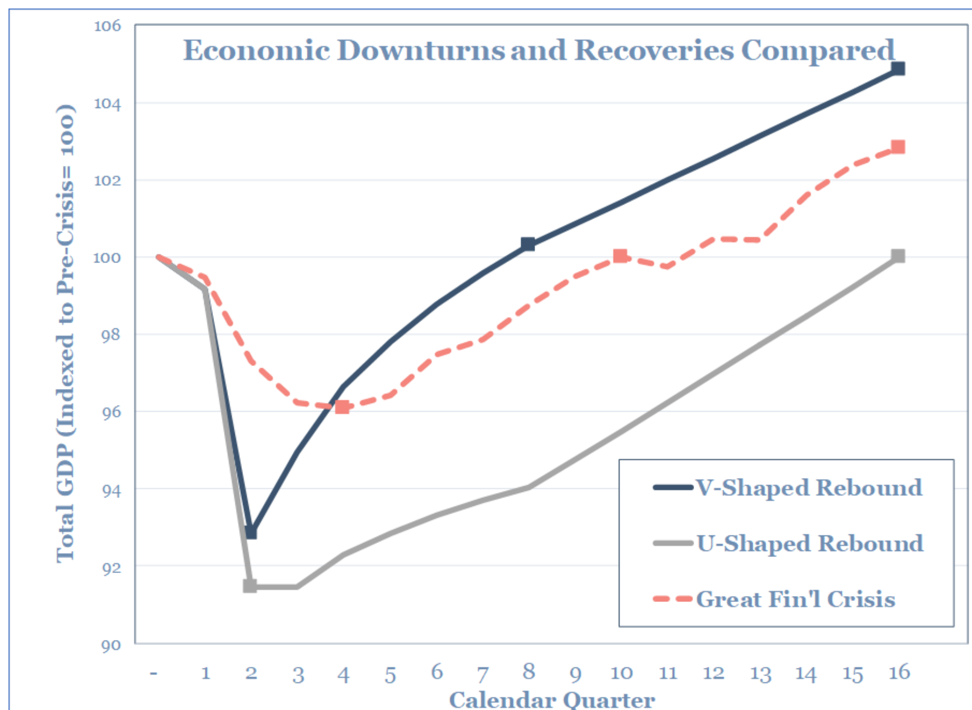
Recent estimates for the just completed first quarter range from year-over-year US GDP growth of +0.8% to a -10.0% shrinkage; the median forecast is for a -3.3% (annualized) downturn. Second quarter estimates are similarly wide but universally more pessimistic, with a median expectation of -23.2%. Thereafter, the current economic consensus is for strong growth across the year's second half (e.g., +9.5% in 3Q and +7.3% in 4Q). [i]

Quarter-to-quarter swings of this magnitude are, to put it mildly, unprecedented in modern US economic history. While we do not doubt the capabilities, models, or intentions of the forecasters, experience shows that the many assumptions that inform such forecasts (e.g., the prospective economic impact of record-high US government spending to support consumers and businesses) makes them imprecise. But directionally, given a months-long shuttering of the economy and already sky-high (over 16 million) unemployment claims, there seems no reason to doubt that the US economy shrank last quarter and that the current quarter will be not only magnitudes weaker but the worst since the Great Depression. [ii]

There is every certainty that the US and global economies will ultimately recover from the Great Lockdown crisis, as they have from other, very different crises of the past. Much of the current debate revolves around the "shape" of the eventual recovery. Will it be V-shaped (a rebound as pronounced in speed and size as the

downturn), U-shaped (a slower rebound), or trace some altogether different pattern across time?

Having neither the prescience nor hubris to make such a call, we instead undertook an analysis to project the US economy's path between 2019-2023 based on a) current consensus forecasts through 2021 and MCCA projections (i.e., our estimates of the sustainable pace of long-term growth) thereafter, and b) adjusted (less optimistic) consensus forecasts through 2021 and MCCA projections thereafter. As shown below, the former path traces a V-shaped recovery and the latter one more closely approximates a U-shaped rebound. Both outcomes are compared to the GFC (for the period June 2008-June 2012):



A *V-Shaped* recovery of the sort mapped out above would produce the following timetable and milestones:

- The US economy would shrink from $21.4 trillion to $19.9 trillion (-7%) by June 30, 2020, roughly identical to its size on December 31, 2017.
- Led by rebounding consumer spending, a strong recovery thereafter would propel the economy forward; it would recover fully by December 2021. The post-GFC crisis full recovery, by way of contrast, took an additional 6 months (2.5 years in total) to playout.

- Barring a resurgent COVID-19 or other crisis, projected long-term growth (MCCA projections: +2.25% annualized) would produce a $22.4 trillion economy by December 2023. Among all (now, 12) post-war recessions it would rank first in depth and the second longest in time to fully recover.

A *U-Shaped* recovery would produce the following timetable and milestones:

- The US economy would shrink more (-30%, annualized) than consensus forecasts, from $21.4 trillion to $19.5 trillion (-9%) by June 30, 2020, roughly identical to its size on September 30, 2017.
- A slower rebound in consumer spending thereafter would more gradually push the economy higher; it would not fully recover until December 2023, four years after the downturn began. Among post-war recessions, it would rank first in both depth and in time to fully recover.

We suspect – without having any way to substantiate our suspicions – that actual economic outcomes may fall somewhere between these two alternatives. It will likely prove more difficult to “reopen” the economy than is projected by a V-shaped recovery. Likewise, once the recovery does get going, an above-average pace of growth across 2021-2022 could accelerate the rebound beyond what is contemplated by the U-shaped recovery detailed above.

Investment Strategy Team
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[i] Source: Bloomberg Finance LP; survey data from 70 private sector economists as of April 10, 2020.

[ii] During the Great Depression, the US economy shrank at an average rate of -17%/year from 1930-1932. Quarterly GDP statistics were not collected by the US government until 1947.

DISCLOSURE

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