CIO | VIEW

U.S. Economic Outlook

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Marketing Material

A NEW ECONOMIC ERA HAS BEGUN: A FIRST ECONOMIC ASSESSMENT

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IN A NUTSHELL

_ Measures to contain the pandemic are unprecedented in U.S. economic history.
_ How long labor markets will take to recover ultimately depends on the progress of the pandemic.
_ For now we remain calm but vigilant. However, we do not subscribe to narratives of a quick, V-shaped economic recovery.

The coronavirus pandemic has hit the United States with its full force. At the time of writing, the daily statistics paint a devastating picture, making the United States the world's number one Covid-19 hotspot.[1] As the human tragedy unfolds, the economic consequences are becoming clearer. Public-health measures to contain the pandemic are without any parallel in U.S. economic history. Growth forecasts of a drop of the gross domestic product (GDP) by around 30% quarter-on-quarter annualized in the second quarter seem fairly realistic to us.

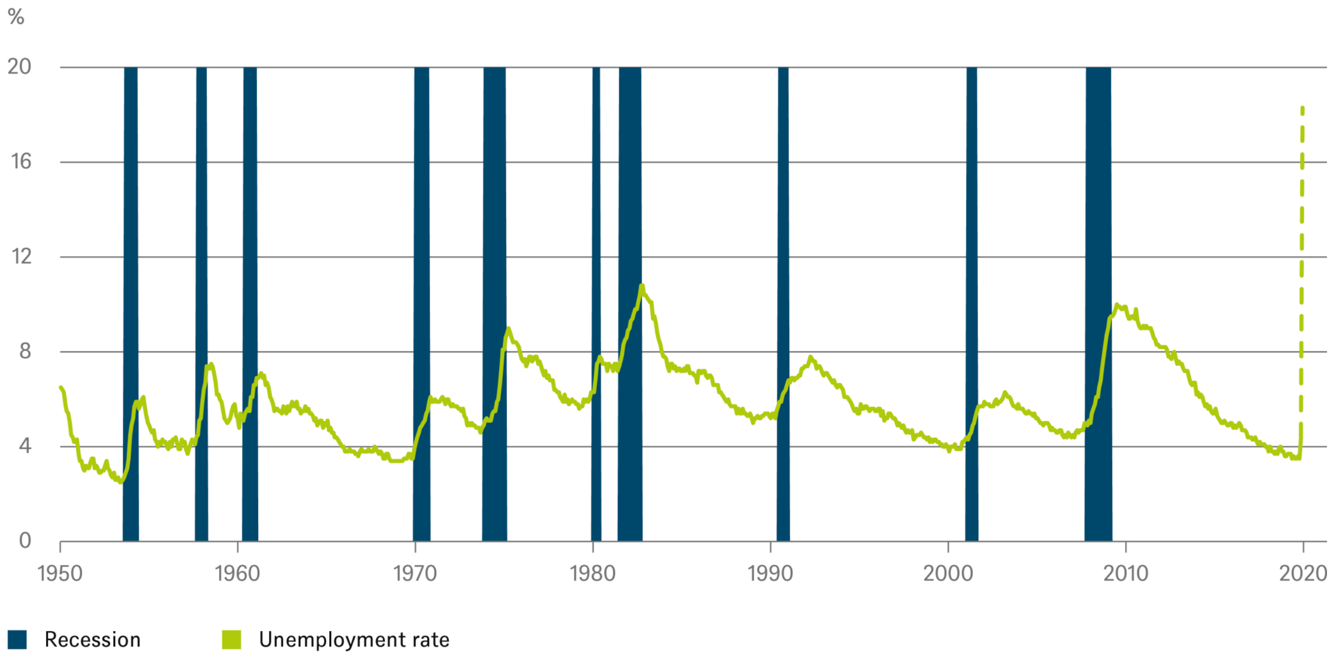
THIS TIME IT MIGHT BE DIFFERENT

During previous recessions, we typically observed a fast but step-by-step slowdown. Often, that was rooted in imbalances that had built up over time beginning to unwind. During the last downturn, for example, stalling and eventually falling U.S. home prices hurt construction activity, before the pain began to spread to other areas of the economy. By contrast, the current crisis has seen a sudden, simultaneous stop of large parts of the economy. To illustrate this, it is worth taking a look at the unemployment rate (chart below) on a longer time scale. It seems like each post-war recession basically ended once the unemployment topped out. The typical mechanisms are fairly straightforward: some companies get into trouble, say because of unsustainable business models or systematic imbalances like unaffordable debt loads. As a consequence, they are forced to fire employees or go out of business altogether. Gradually shrinking household income causes demand to shrink. More firms are forced to lay-off workers or go bust, causing a vicious cycle. Once the process of creative destruction is complete, people get hired again by surviving or new businesses and the recovery begins.

The current crisis looks like the same sort of pattern, only in reverse order. To illustrate this, we utilize a back of the envelope calculation to estimate what we call the hidden unemployment rate. It's important to keep in mind that the most recent labor-market report only contains information up to the second week of March.[2] The hidden unemployment rate attempts to overcome this blind spot by incorporating the weekly initial unemployment benefit claims reported since then.[3] In addition, we add another 1.3 million to the official figure of 7.1 million counted as unemployed in March as the report admits some measurement errors because of the unique situation.[4] Demographic factors aside, the result is quite shocking: the unemployment rate could be already as high as 18% – the high-

[1] As of April 20, https://gisanddata.maps.arcgis.com/apps/opsdashboard/index.html#/bda7594740fd40299423467b48e9ecf6
[2] "In the household survey, the reference period is generally the calendar week that contains the 12th day of the month. In the establishment survey, the reference period is the pay period including the 12th, which may or may not correspond directly to the calendar week." https://www.bls.gov/news.release/empsit.tn.htm
[3] As of April 20, claims that have been reported leading up to April 10
[4] https://www.bls.gov/news.release/empsit.nr0.htm

HIDDEN UNEMPLOYMENT RATE OF AT LEAST 18%[5]



Sources: Bureau of Labor Statistics, National Bureau of Economic Research as of 4/20/20

est value in the post-World War 2 period. One needs to look back far in history to get numbers topping this: 1933 at around 25% – at the height of the Great Depression.

Despite the limited usefulness of the official 4.4% unemployment rate, the March report does contain some useful information on which sectors have been hit hardest. As we expected, the initial shock was unleashed in the service sector. Our hidden unemployment-rate estimates, also show a steep decline of 659,000 service jobs, concentrated in leisure and hospitality businesses.

Certainly high-contact-intensive jobs, like those in restaurants and shops, will not be the only ones affected in this crisis. A recent study by the Federal Reserve Bank of St. Louis illustrates our thesis of a crisis in reverse. It shows a clear link between high-contact-intensive (HCI) industries and less-contact-intensive (LCI) industries via the so called input-output relationship.[6] While around 85% of the output of HCI industries serves final demand, i.e. direct consumption, only roughly 39% of LCI industries does so. As, the study elaborates, 16% of the LCI output goes to HCI industries as an intermediate input, resulting in another significant exposure to the shock. The key takeaway is, that the initial shock might spill over into other areas. Being able to work remotely from home is of little help, if there are no clients.

Without revenues business owners and furloughed employees alike are likely to cut back on their spending. The initial shock translates backward into the rest of the economy, resulting in failures of a variety of businesses, mainly those that cannot adapt quickly to the new LCI situation. Therefore, we expect the unemployment rate to top out at rather high values and, unlike during previous recessions, to remain there for a while. How long labor markets will take to recover ultimately depends on the progress of the pandemic, or at the very least on how fast we learn to adjust to the current situation in economically less damaging ways.

A SHORT UPDATE ON THE PANDEMIC

There are still many open questions. How many U.S. residents might have been exposed to the virus, beyond the official statistics? Will those previously infected remain immune and if so, for how long? Will immunity also protect those with mild or no symptoms? What effects will seasonal temperature and weather changes have on transmission rates, not just during the spring and summer, but particularly during the next fall?

[5] Forecast (see dotted line in the chart)
[6] https://www.stlouisfed.org/on-the-economy/2020/april/impact-social-distancing-ripples-economy?utm_source=Federal+Reserve+Bank+of+St.+Louis+Publications&utm_campaign=dbe6f1f73b-BlogAlert_2020-04-07&utm_medium=email&utm_term=0_c572dedae2-dbe6f1f73b-60877229

What we do know from overseas examples in Asia and Europe is that the earlier governments react, the better. Social distancing can indeed slow the transmission. Unfortunately, recent studies also suggest that transmission frequently occurs before the onset of symptoms.[7] This implies that once the virus prevalence has reached a certain threshold within a population, it becomes almost impossible to contain by solely isolating symptomatic individuals. Beyond hopes of wide-scale tests for antibodies, an important alternative to lockdowns could be specialized mobile apps. In theory, such an app, if widely used, could allow health authorities to rapidly notify and isolate those previously in contact with a newly confirmed carrier, before they can spread the virus further.

However, such a solution cannot be rolled out overnight. Development efforts are not negligible and the implementation of any kind of surveillance measure is viewed with some level of mistrust.

Likewise, anti-body tests and eventually vaccines will also raise a whole host of ethical, legal and constitutional issues.

Having spread globally, this highly transmissible virus is probably here to stay. At best, there will probably be better treatments in the coming months, sufficiently widely available to keep most patients out of intensive care, and eventually, a vaccine. However, all of these potentially good medical news remain far from certain.

THE WAY OUT OF THE MESS

From a solely economic perspective, a quick reopening of the U.S. economy would solve many of the problems. Doing so too soon could result in people living in the constant, and well-founded, fear of another pandemic wave. Citizens and forecasters, alike are probably better off trying to get used to the current situation, or at least some aspects of it.

Some of the harsher measures like staying at home for weeks will eventually be lifted. But softer social-distancing routines like wearing masks, washing hands, restricted access to shops and eating at home might be the new trends for the months to come. People and businesses are already starting to adjust to the new situation. The recent news flow on mass hiring from certain online-shopping companies suggests the potential scope for supply-side adjustments. Yet these are very early green shoots. Not every new business venture conceived at the height of the pandemic will necessarily flourish. Supply-side adjustments to new demand patterns could prove uneven, painful and sluggish – depending, in part, on government policies.

BUILDING BRIDGES: FISCAL POLICY

As we argued in our last U.S. economic outlook, smart policy measures to cope with the situation are key. And truly we have not been short on policy announcements of epic proportions.

The Coronavirus Aid, Relief, and Economic Security (CARES) Act contains measures worth around 2.3 trillion dollars, or almost 10% of GDP. But is the stimulus the big deal? Well, only about half of the package can be interpreted as fiscal spending. The other half serves as loans and guarantees or as financing for Federal-Reserve (Fed) buying programs. While such loans and guarantees are essential lifelines in times of distress, they are unlikely to have a significant multiplying effect (e.g. the effect fiscal spending has on change of GDP growth).

The other 50% of the package consists of very reasonable and targeted measures. These include tax provisions for businesses and households, as well as direct payments to the latter. Crucially, Congress has also increased unemployment benefits and other safety-net provisions. Such measures can support GDP growth to some extent. But keep in mind that they are only designed to partially make up for the loss of income workers would have otherwise received. Given the uncertainty households face, we could well see their savings rate increasing in coming months.

All in all, the CARES Act looks like a well calibrated package, also including provisions for health care and infrastructure spending. However for a fast recovery we would like to see further measures, with high fiscal multipliers, such as additional infrastructure spending. And with all its measures, the government will also need to ensure that it does not end up supporting businesses that will ultimately not be viable.

ANOTHER FINANCIAL CRISIS: MONETARY POLICY

As markets realized in mid-March that this pandemic was indeed a big issue, causing turbulence not seen since 2008. Equity markets dropped aggressively, credit spreads widened and even the most liquid as-

[7] Quantifying SARS-CoV-2 transmission suggests epidemic control with digital contact tracing, by Luca Ferretti, Chris Wymant, Michelle Kendall, Lele Zhao, Anel Nurtay, Lucie Abeler-Dörner, Michael Parker, David Bonsall, Christophe Fraser; Published Online31 Mar 2020; DOI: 10.1126/science.abb6936

set classes like U.S. Treasuries got under stress. The latter is remarkable. As the (Bank for International Settlements (BIS) commented in the aftermath that "… government bond markets experienced uncharacteristic turbulence, sometimes selling off sharply in risk-off episodes when they would normally attract safe haven flow."[8] Fortunately, the Fed managed to get ahead of the curve.

Starting by mid-March, the U.S. central bank quickly lowered interest rates to zero and increased short term-liquidity provision through various channels. We now have no less than ten different programs and facilities that support markets and the real economy alike. Highlights of this monetary-policy clavier include basically unlimited buying of U.S. Treasury securities, and extensive credit-buying facilities. The Fed even intends to buy below investment-grade-rated bonds – colloquially known as junk - as long as such "fallen angels" have been rated as investment grade on March 22. Last but not least, there is a so called Main-Street-Lending facility that supports small and medium-sized businesses. As far as we know, the whole set of measures well could have a volume of another 4 trillion dollars – depending on how the math is done. For now it seems like the pure amount of liquidity pumped into markets has prevented the worst. However, keep in mind that number crunchers usually need some time to figure out how extensive the damage to their business was. Also a recent blog post from the Fed New York suggests that withholding bank specific information in times of crisis could be helpful.[9]

For now we remain calm but vigilant. However, we do not subscribe to a V-shaped narrative. Based on the nature of the shock, we expect this to take somewhat longer. Nevertheless, we remain optimistic that the coronavirus crisis could also pave the way for innovative new concepts for our daily life – especially if government actions do not stop the process of creative destruction[10] altogether.

GLOSSARY

The Bank for International Settlements (BIS) is the international organization of central banks.

A central bank manages a state's currency, money supply and interest rates.

The Great Depression was the deepest and longest-lasting economic downturn in the history of the Western industrialized world.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Investment grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

Junk bond is a colloquial term for a high-yield or non-investment-grade bond.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The spread is the difference between the quoted rates of return on two different investments, usually of different credit quality.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

The U.S. Federal Reserve, often referred to as "the Fed", is the central bank of the United States.

The United States Congress is the legislature of the federal government. It is comprised of the Senate and the House of Representatives, consisting of 435 Representatives and 100 Senators.

[8] https://www.bis.org/publ/bisbull02.htm
[9] https://libertystreeteconomics.newyorkfed.org/2020/04/the-value-of-opacity-in-a-banking-crisis.html
[10] "Process of industrial mutation that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one." (Capitalism, Socialism, and Democracy, 1942 by Joseph Schumpeter)

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