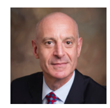
Recession 2020—Deep but Short

Tracking the COVID-19 shock.

March 2020



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KEY INSIGHTS

- I'm anticipating a contraction in economic activity over the first two quarters of 2020 that roughly matches the longer decline over the financial crisis.
- When shuttered industries and shut-in workers can start the transition back to normal life—probably sometime in May—growth should resume.
- Solid pre-virus underpinnings in the business and household sectors and the unprecedented policy response should help short-circuit a prolonged recession.

Severe restrictions have been imposed on roughly half of the country, and government-enforced social distancing measures, including stay-at-home orders, are likely to proliferate in the near term. I currently anticipate that the breadth of measures in place—and their drag on economic activity—will reach maximum intensity during the first half of April.

From that point, output should have nowhere to go but up, at least as far as the coronavirus's impact is concerned. From this perspective, recovery will begin once virus mitigation has progressed to a point that social distancing restrictions can be moderated. I'm assuming that this gradual return to work will begin sometime in May.

Unprecedented Quarterly Declines, but Concentrated in March and April

The impact of this sudden halt in economic activity on second-quarter growth is likely to be unprecedented. The consensus forecast[1] of a 10.8% decline in real GDP growth (at a seasonally adjusted annual rate) would be the sharpest one-quarter decline in the 72-year history of the series.

I would stress that the uncharted territory in which we find ourselves means that any outlook is exceptionally uncertain. With that caveat, I see downside risk to the consensus forecast, arriving at a 15% second-quarter contraction based on the following assumptions:

- I would expect activity to contract by about half from February to April in transportation and warehousing, education, arts, entertainment, and accommodation and food services.

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[1] The median of 9 forecasts issued since March 16 in a Bloomberg survey.

Recovery would then start with 10% monthly increases in activity in these sectors in May and June.

- Other sectors should fare better. Manufacturing activity might shrink around 20% in the second quarter, while health care services activity will probably expand by 30% in March and hold that level through June. Government spending should increase 10% in March and also hold that level through June.

If these ballpark assumptions hold true, the cumulative result would be a 4% first-half contraction, roughly on par with the 2008–2009 recession, which stretched over six quarters.

Longer-Term Recession Drivers Appear Absent

Recessions typically entail the correction of imbalances, often associated with excessive demand—whether in fixed investment or consumer spending, or both—that has undermined private sector finances. In contrast, as is well understood by now, the current downturn is being driven substantially by an enforced pullback in activity in the name of social distancing and virus mitigation. The unique nature of this downturn suggests it will be more dramatic but shorter than usual.

Business Capital Spending: No Obvious Overhang

The unfolding reduction in output will surely be echoed in falling business capital expenditures (capex), at least in the very near term. But the pullback is not coming from a high level, in large measure because of last year's manufacturing recession, which was ending when the coronavirus emerged. Net investment fell sharply over the course of last year and likely slipped in the current quarter. This adjustment appears to have slowed annualized growth in the business capital stock last year to the low end of its recent range, or about 1.8%, as in 2016–2017. Even before the impact of the coronavirus, the capital stock was poised to grow by little more than 1.5% in 2020—the slowest pace since 2011.

The relatively slow recent growth in the capital stock argues against the notion that business capex has run ahead of the economy's underlying needs. Neither has capex gotten ahead of the business sector's financial capacity. Approaching the previous two recessions, the business sector's financial balance—undistributed profits less capital spending—was deteriorating and becoming increasingly negative. In contrast, the financial balance was close to zero as of late 2019, not indicative of a need to slash capex.

To be sure, capex in sectors taking the most direct hit from the pandemic—including education, arts and entertainment, recreation, accommodation, and food services—may grind toward a halt in April. Yet we should also recognize the possible offset from increased capex in chemical manufacturing, which includes the pharmaceutical industry, and health care services. The former set of industries account for 10.1% of total business capex, while the latter account for 10.4%.

Housing: Nothing to Cut

Housing starts and sales maintained their recent upward trend through February, but sharp recent declines in indexes of mortgage applications signal a near-term drag on housing activity as a result of enforced social distancing. Still, there is relatively little fuel for downside momentum if the labor market correction subsides once the coronavirus is contained. The recent expansion remains exceptional in the absence of housing supply (new home starts) outpacing demand (household formations).

Interrupting the Typical Recession Dynamic

Despite sturdy initial conditions in private investment sectors, a more typical recession dynamic could be propagated from near-term layoffs and subsequent

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consumer spending cutbacks. A record 3,283,000 Americans filed jobless claims in the week ended March 21, and many more are claims are undoubtedly coming as more restaurants and other consumer services businesses shut down.

The newly unemployed buy less of everything, including products of industries not at all directly affected by the virus. Those industries, facing less demand, reduce capacity, including through headcount. Nevertheless, I anticipate that this secondary drag on growth will be handily offset by the primary contribution from the post-virus containment return to work.

Unprecedented Monetary and Fiscal Response

Monetary and fiscal policy have both responded promptly and forcefully to cushion the blow from mandated reductions in economic activity. The Fed has gone beyond its 2008–2009 playbook, with open-ended purchases of Treasury, residential and commercial mortgage-backed securities, liquidity support for the investment grade corporate bond market, and plans for a Main Street Business Lending Program. A USD 1.5 trillion package of tax relief and government spending is larger than the 2009 stimulus (7.1% of GDP vs. 5.5%), and funds should begin to flow by the third week in April.

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