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VIEWPOINT

A Stephens Inc. Economic and Financial Commentary

by Thomas Goho, Ph.D.

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Economists have an abysmal record at predicting the onset of recessions. The current recession is positive proof of that fact. But this time, we can give economists a bit of a break; no one saw this recession coming. Policymakers, economists, and the medical community were caught totally unprepared for the chaos caused by Covid-19. Worldwide, the pace of an economic recovery following the Covid-19 ambush will be hard to predict.

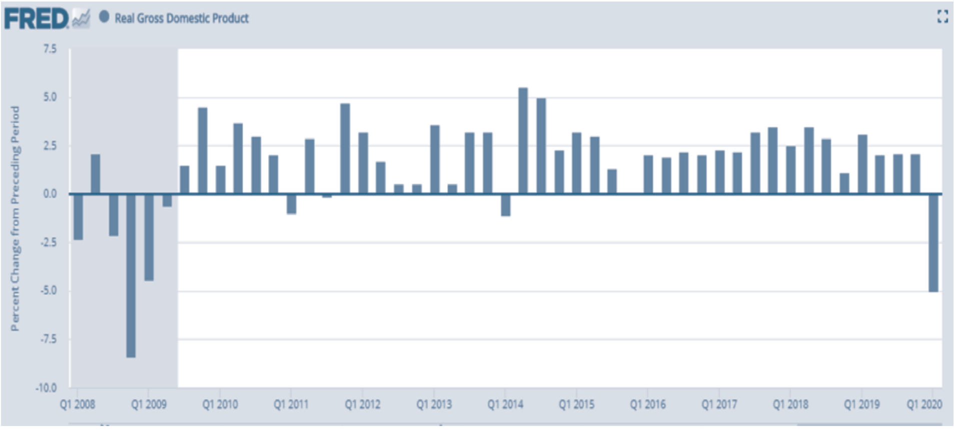
Epidemiologists will play a key role in guiding policymakers through the health issues and subsequent labored opening of the economy. In the meantime, economists must assess the impact of the current catastrophe recognizing that there are no roadmaps or models to guide sound conclusions. Most assessments are and will be rife with guesswork.

We can try to draw some preliminary conclusions on economic conditions such as output, employment, prices, monetary policy, and fiscal policy. Keep in mind much of the data is fragmentary and, in some cases, unreliable information due to problems in data collection.

Economic Growth

The ten-year economic expansion ended in the first quarter of 2020. Economic output, defined as Gross Domestic Product (GDP), contracted 5%. (*See Figure 1.*) This economic contraction is in sharp contrast to the growth of about 2% that persisted, with only a few exceptions, in the past decade.

Figure 1:
Gross Domestic Product From Q1 2008 to Present.



Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database June 9, 2020.

The second quarter of 2020 will be worse than the first quarter negative 4.8%. Real GDP contraction occurred before the full impact of the Covid-19 lockdowns was evident. The second quarter of 2020 will probably contract at an annualized rate of at least 20% to 25%. Keep in mind that the exact course of this recession depends on at least two unknowable factors:

- the pace of government approvals to reopen businesses, schools, and other sectors of the economy
- the projections of viral conditions by epidemiologists' which will impact official decision making

Economists can only make educated guesses in assessing these unknowable factors. Mark Zandi, economist for Moody's Analytics, speculated that "we may shut down again [if there is a second wave of virus], but certainly it will scare people and spook people and weigh on the economy. That would be the fodder for a depression."

Zandi's speculation is probably a worst-case scenario but well within the bounds of possibility. He is likely in the camp of those who predict a **U-shaped recovery**, meaning that the U.S. and global economy will take several years, rather than months, to recover fully to pre-virus levels. This premise is predicated, in part, on the likelihood that we will see new viral outbreaks until a vaccine is widely available. These outbreaks will continue to disrupt any vigorous recovery.

The other prevailing view envisages a **V-shaped recovery** that would be characterized by a rapid return to economic normalcy. Such a recovery would be similar to the one that occurred after the financial crisis of 2008-9. The proponents of this view believe that massive stimuli by governments and central banks will permit households and businesses to rapidly regain their financial footing. Retail sales rebounded almost 18% which lends credence to this scenario. The likelihood and / or timing of additional recovery is currently unknowable.

The American economic recovery will be inextricably linked to international economic/global recovery in 2020. The carnage that has befallen America has been replicated throughout most countries. The International Monetary Fund forecasts that the world economy will contract by 3% in 2020 and then bounce back with growth of 5.8% in 2021. (*See Figure 2*.) The picture for economic growth of advanced economies, including the U.S., is less positive. The IMF predicts that the American economy will contract by 6.1% in 2020 and rebound only to 4.5% in 2021. These figures suggest that the U.S. will not be back to its 2019 level by the end of 2021.

Figure 2:
Global Growth Projections for 2020 and 2021.

(real GDP, annual percent change)	2019	2020	2021
World Output	2.9	-3.0	5.8
Advanced Economies	1.7	-6.1	4.5
United States	2.3	-5.9	4.7
Euro Area	1.2	-7.5	4.7
Germany	0.6	-7.0	5.2
France	1.3	-7.2	4.5
Italy	0.3	-9.1	4.8
Spain	2.0	-8.0	4.3
Japan	0.7	-5.2	3.0
United Kingdom	1.4	-6.5	4.0
Canada	1.6	-6.2	4.2
Other Advanced Economies	1.7	-4.6	4.5
Emerging Markets and Developing Economies	3.7	-1.0	6.6

Source: The International Monetary Fund (IMF). *World Economic Outlook: The Great Lockdown*. April 2020.

The IMF's projections are consistent with many other forecasting groups including the non-partisan U.S. Congressional Budget Office (CBO). Such forecasts reiterate the point that U.S. GDP growth will struggle throughout 2020 and regain some momentum in 2021. Again, these forecasts are packed with caveats tied to the uncertain course of the coronavirus and the prospects for mass distribution of a vaccine in 2021.

Best Guess About Economic Growth

The last two quarters in 2020 and into 2021 will create the patina of a vibrant economic recovery, but many economists suspect that a **sustainable** growth rate of more than 2% per year will not be realized until at least 2022. That growth rate is contingent on the creation and wide distribution of a coronavirus vaccine. There are several reasons for a somewhat pessimistic view:

- Governments have committed massive resources to fighting the financial consequences from the shutdown. The financial condition of federal, state, and local governments, already on shaky ground, could become dire. Lost tax revenues caused by the shutdown will be a drag on future critical governmental spending.
- Businesses that were weak prior to the pandemic will likely go out of business. Firms that were financially strong before this crisis are being weakened or bankrupted by business disruption such as airlines, resorts, cruise lines and many retail chains.

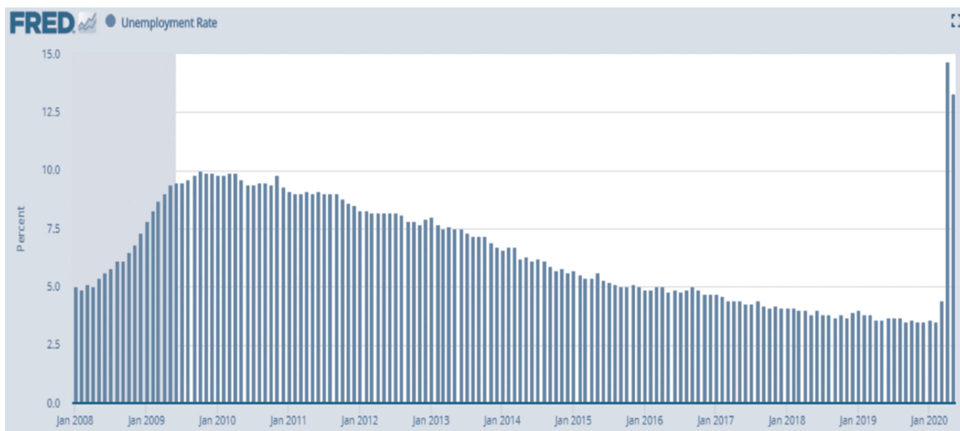
- Potential new small businesses that were on the cusp of existence may have seen their seed capital eroded by this financial hardship. In addition, potential entrepreneurs must now add pandemic impacts to their risk assessment.

Such difficult financial conditions suggest a minimum time frame of about two years for the U.S. economy to achieve a sustainable growth rate of 2%.

Employment and Labor Market Conditions

An obvious consequence of the economic collapse is a large disruption of labor markets. Unemployment has surged from a multi-decade low of less than 4% to the highest rate since the Great Depression. In April 2020 the unemployment rate was 14.9%, decreasing to 13.3% in May. (*See Figure 3.*)

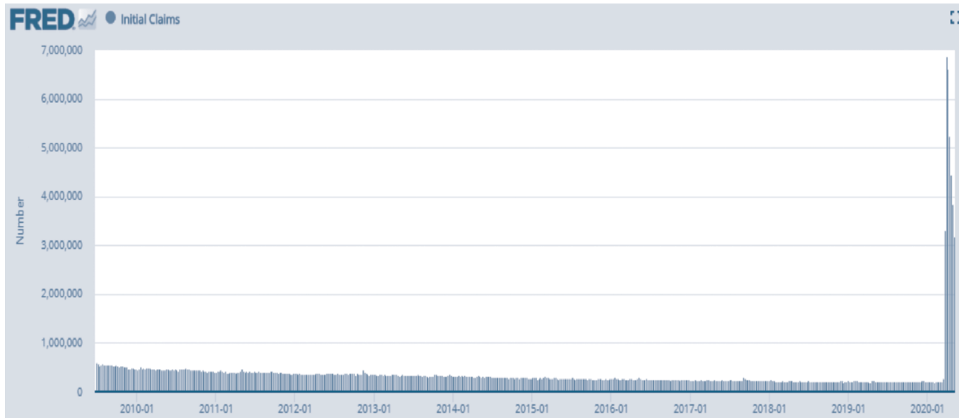
Figure 3:
Monthly U.S. Unemployment Rate From 2008 to Present.



Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database June 10, 2020.

Another manifestation of the labor market dislocation is the significant increase in the number of initial jobless claims. (*See Figure* 4.) Throughout the 10-year economic expansion after the financial crisis of 2008-9, jobless claims averaged slightly more than 300,000 per week. Then the virus occurred. In a period of three months, the number of claims totaled 41 million new jobless claims; a breath-taking number compared to the typical 3-month total of about 3 million in the last few years.

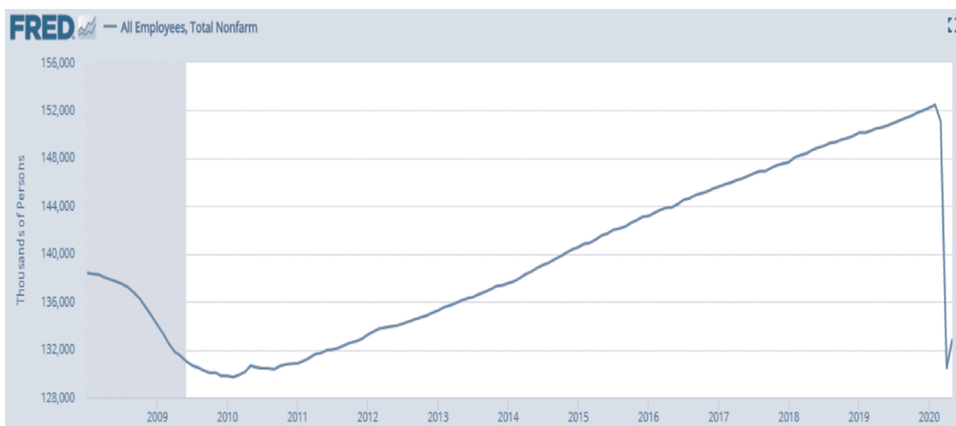
Figure 4:
Initial Jobless Claims From 2009 to Present.



Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database June 10, 2020.

To put this labor problem in context, there are now 7 million fewer workers in the labor force than there were prior to the financial crisis of 2008-9. (*See Figure 5*.) There are 131 million employed workers. In late 2007 there were 138 million employed workers. Just prior to the current economic downturn, the total number of employed workers was 153 million.

Figure 5:
Total Nonfarm Employees, 2007 to Present.



Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database June 10, 2020.

In other words, all the employment gains of the decade-long expansion have been wiped out by the current economic collapse. It would not be surprising if it takes at least three years of employment growth to regain all those lost jobs from the 2020 pandemic.

Best Guess About Employment and Labor Market Conditions

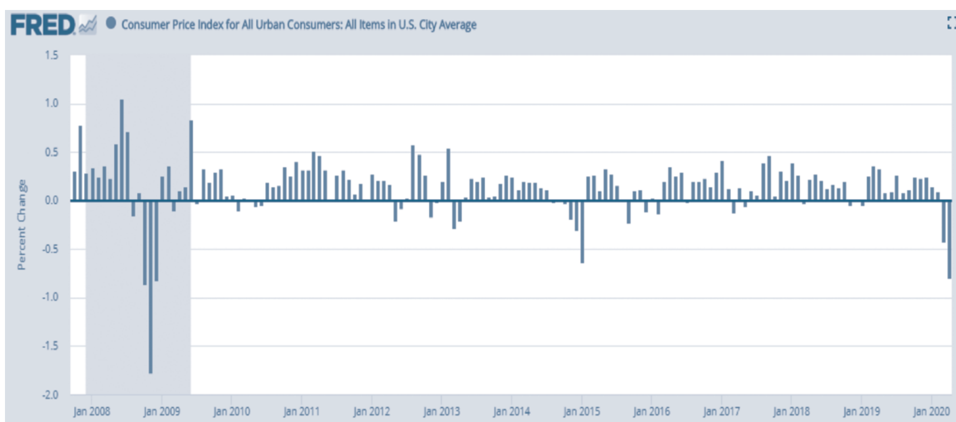
We expect that labor market conditions will remain quite weak at least through the end 2020. The unemployment benefits, especially for low-wage workers, are very generous. These workers are entitled to their normal state unemployment benefits plus an additional $600 per week from the Federal Government. For low-wage unemployed workers this is an attractive alternative to working. We will not get a clear picture of labor market conditions until laid-off workers run out of unemployment benefits and seek re-employment.

After supplemental benefits lapse, we expect an unemployment rate of over 10% for the next 12 to 18 months. After the financial crisis in 2009 the unemployment rate stayed elevated for about two to three years as employers were cautious in their re-hiring decisions. This current crisis will be every bit as difficult for the unemployed and under-employed.

Prices: Inflation and Deflation

Deep recessions, such as the current one, are commonly characterized by persistent falling consumer prices known as deflation. (*See Figure 6.*) Deflation occurred during the financial crisis in 2008-9, and price drops are already appearing in this current downturn.

Figure 6:
Percent Changes in Monthly Seasonally Adjusted Consumer Price Index for All Urban Consumer, 2008 to Present.



Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database June 11, 2020.

Year over year through March 2020 the CPI has increased by just .4%. But that increase was prior to the most recent economic collapse starting in March 2020. In April, prices during the crisis fell by .8% from the previous month. In a word the economy may be entering a period of deflation. Falling prices raise an important and complicated issue. With weak growth and high unemployment, falling prices are likely to become the “new normal” until a Covid-19 solution is achieved.

Price deflation is likely to continue throughout 2020. Low energy prices are one factor that will tilt the price index toward lower prices. A drop in demand for a wide range of products and services such as restaurant meals, auto insurance, and elective medical procedures will put a lid on retail prices.

Best Guess About Inflation and Deflation

Overall, prices are likely to have a downward bias only in the short run. Deflationary factors such as negative growth in GDP and high unemployment will outweigh the impact of higher prices in "bottlenecked" industries such as agricultural and forestry products. The interesting and important question deals with the longer run consequences of the coronavirus on prices. Businesses will likely rethink their supply chains because dependency on foreign suppliers has created problems for seamless production during the crisis. In addition, the government will likely pressure manufacturers to bring some production of critical goods back to the United States producing cost inefficiencies. This deglobalization of production will likely increase prices at the retail level over the longer term.

Fiscal Policy

The coronavirus has forced the U.S. government into taking unprecedented fiscal actions that will have a huge impact on economic growth, the unemployment rate and price levels.

Under current federal legislation, the Committee for a Responsible Federal Budget (CRFB) estimates that the 2020 budget deficit will be four times the size of the massive peacetime deficit of 2019. (*See Figure 7.*) The 2020 federal deficit will be 18.7% of the Gross Domestic Product (GDP), and the cumulative budget deficits will total over $11 trillion for the period 2020 to 2025.

Figure 7:
Projections of the Federal Budget From 2020 to 2025.

	2020	2021	'22 - '25	'20-'25
Pre-Crisis Deficit (CBO)	**$1,073**	**$1,002**	**$4,679**	**$6,754**
Families First Act (CBO)	$134	$57	$1	$192
CARES Act (CRFB)	$2,066	$546	-$466	$2,146
Economic Changes (CRFB)	$570	$469	$802	$1,841
Debt Service (CRFB)	$3	$26	$323	$352
Projected Deficit (CRFB)	**$3,847**	**$2,099**	**$5,338**	**$11,285**
Projected Deficit as Share of GDP	***18.7%***	***9.7%***	***5.6%***	***8.4%***

Source: Committee for a Responsible Federal Budget (CRFB). "Budget Projections: Debt Will Exceed the Size of the Economy This Year." April 13, 2020.

The CFRB noted that these projections almost certainly underestimate the final 2020 deficit because these projections do not consider the additional coronavirus spending that is currently being proposed in Washington. In addition, the CFRB's projections are based on a "rosy scenario" in that the economy will rapidly return to a healthy growth rate. Given the uncertainty surrounding the course of the pandemic, a strong growth rate is far from certain.

Assuming slow growth and a relatively weak economy, the federal debt held by the public will swell from 79% of GDP in 2020 to 117% in 2025. Many economists believe that a country's debt level greater than 90%-100% of GDP creates a drag on government spending and impedes long-term economic growth.

Best Guess About Fiscal Policy

Fiscal policy prior to the pandemic was unsustainable. The Federal Government was running an annual budget deficit of close to $1 trillion per year, and this deficit occurred during a period of full employment, low inflation, low interest rates and moderate growth in GDP. Now the economy is in a recession, and any semblance of a sustainable federal deficit and prudent fiscal policy is gone for the foreseeable future.

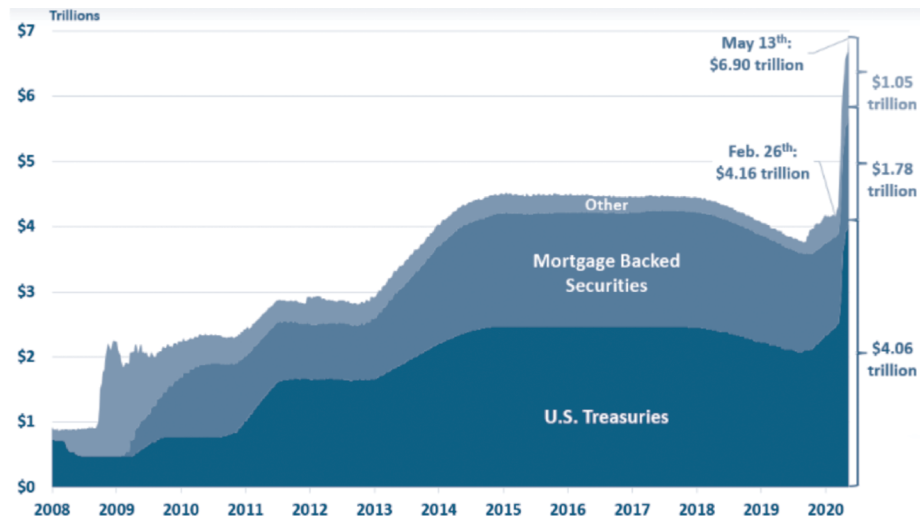
Federal deficit spending must be financed, and that burden will fall on households and businesses. Tax increases on middle- and upper- income families are sure to come. How quickly the increases arrive remains a question mark. A similar increase is likely for almost all profitable businesses. These increases may not come in 2020 or 2021, but they are coming, and the increases will be large.

Monetary Policy

Monetary policy, under the direction of the Federal Reserve and its Federal Open Market Committee (FOMC), is being strained by the impacts of coronavirus. Prior to the financial crisis of 2008-9, the assets of the Federal Reserve totaled $800 billion. The Fed's response to the financial crisis over the following 6-year period caused its balance sheet to balloon to $4.5 trillion. The Fed then slowly began to shrink its balance sheet.

With the onset of the current crisis, the Federal Reserve has committed to buy large amounts of U.S. Treasury debt, mortgages, corporate bonds, loans of varying quality, plus financial assistance to state and local governments. Consequently, the Fed's assets have again mushroomed in size to almost $7 trillion. (*See Figure 8.*) Based on its various commitments, the Fed balance sheet will likely increase by an additional several trillion dollars from the current level.

Figure 8:
Federal Reserve Assets From 2008 to Present



Source: Committee for a Responsible Federal Budget (CRFB). "Covid Money Tracker: Policies Enacted to Date." May 14, 2020.

Best Guess About Monetary Policy

The Federal Reserve undertook a massive expansion in the monetary supply after the financial crisis of 2008-9. The Fed never really completed the unwinding of that expansionary policy. And now again the Federal Reserve has embarked on a new and highly expansionary monetary policy just as it did after the financial crisis. The same outcome will occur. Massive liquidity to avert an economic collapse will continue for several years. However, this time the Federal Reserve will be left holding large amounts of weak assets such as corporate bonds and loans to state and local governments that may default on principal and interest payments.

In addition, the Federal Government will be issuing unprecedented amounts of debt. The Fed will have to absorb these large amounts of the government's debt to keep interest rates unnaturally low. These low interest rates in turn help to minimize the costs of governmental borrowings thus helping to hold down the size of the interest payments on America's massive government debt of $25 trillion to $30 trillion.

Americans were fortunate that the Fed's rapid monetary expansion in the previous decade did not produce high rates of inflation thanks in part to efficiencies generated by new technologies and rapid globalization of production. With pressures mounting to reverse globalization and its attendant global efficiencies, the Fed's current monetary easing could portend much higher inflation. **Investors need to be alert to that possibility.**

Final Thoughts

The U.S. economy will begin a slow recovery in the latter part of 2020. Before that happens, the economy is experiencing and will experience a deep recession in the second and third quarters before a robust recovery begins. (*See Figure 9.*) In May 2020, the Federal Reserve's recession model predicted a 100% probability of a recession.

Figure 9:
Probability of a U.S. Recession, 2008 to Present.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database June 11, 2020.

The National Bureau of Economic Research (NBER), a non-governmental organization, defines a recession as a significant decline in economic indicators such as GDP, employment, industrial production over a significant time of period, usually more than a few months. In an unusual decision by the NBER, it made official that a recession is occurring even without complete data to support such a conclusion, thereby conferring what the Fed model indicated. Of course, it should be obvious to all Americans that we are in the middle of a deep recession.

When the economy does emerge from the recession, we doubt that the economy will be back on the 2% growth trajectory of the last decade. The current horrific situation of at least a 20% negative GDP and unemployment of over 13% will slowly improve. The GDP growth for all of 2020 will likely be a negative 5% to 7% at least according to most governmental forecasts. The unemployment rate will likely end the year at or near 10%.

The U.S. Congress and the Federal Reserve have demonstrated a willingness to take dramatic steps to prevent a prolonged recession or even a depression. Their commitments may achieve their desired stimulation for economy. Having said that, the extent of the economic and financial wreckage in the aftermath of the pandemic will impede a full recovery for several years.

Federal, state and local taxes inevitably are headed dramatically higher to pay for this catastrophe. Higher taxes in turn will slow the long-term growth of economy. Also, the Federal Reserve, at some unknowable endpoint, will have to shrink its balance sheet and normalize interest rates. These monetary and fiscal policy moves will impede dynamic economic growth in the long run.

The economic recovery in the aftermath of the financial crisis in the last decade was a slow but relatively steady slog toward “normal” economic growth helped by large deficit spending and an accommodative Federal Reserve monetary policy. The next recovery is likely to be more of the same, but this time, starting from a much deeper hole. This downturn will mark the worst recession since the Great Depression.

America’s economic conditions are being replicated in 18 of the 20 world’s largest economies. America’s full recovery is unlikely unless other countries act in a concerted way to fix their own economic disasters.

In this economic chaos one should not lose perspective on the possibilities for hope. The great Austrian economist Joseph Schumpeter decades ago recognized that out of periods of economic destruction and chaos, entrepreneurs find new and better ways to organize businesses to make them more enduring and more productive.

As the economy opens back up for normal business, it is reasonable to expect that productive, innovative, and resilient Americans will set to work and help lift us out of this bleak economic period.

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