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A 50/50 Proposition: Delta Downgrade

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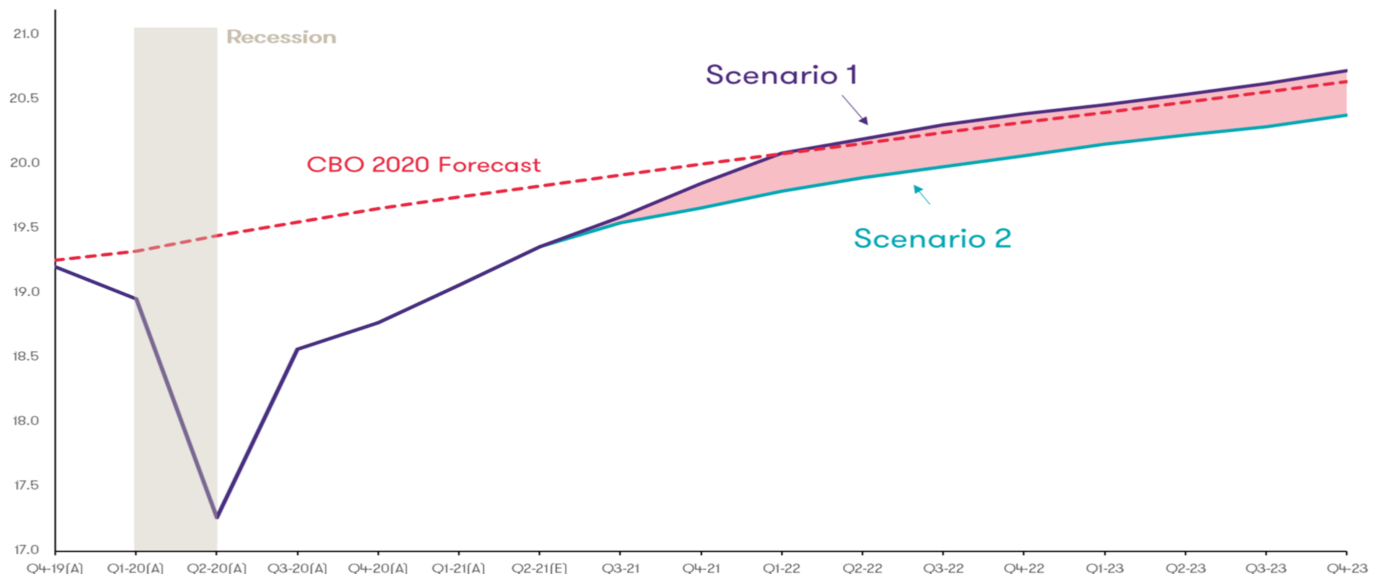
What many once hoped would be a sprint has become a marathon of a pandemic with the finish line a mirage. Soon COVID will transition from pandemic to endemic, something that we learn to live with, much like the flu. Only it is not the flu; it is much worse, with long-term effects that can compromise our ability to work and provide for ourselves and our families.

The Delta variant has brought us to this reality with unusual speed and collective frustration. Fear of contagion has forced developing economies back into lockdown, caused a surge in U.S. cases, brought boosters into focus and triggered another round of disruptions to supply and demand.

We have distilled the downgrade triggered by the Delta variant into two scenarios. Either it continues to disrupt supply chains more than it dampens demand, causing inventories to rebuild more slowly, while inflation persists at higher levels for longer. This would force the Federal Reserve to be more aggressive in tightening to curtail unwanted inflation.

Or, disruption to demand could become greater than the disruption to supply chains. This would prompt firms to rebuild inventories much faster than expected, alleviating the upward pressure on prices and forcing the Federal Reserve back to the sidelines for even longer.

Chart 1



The remainder of this special **mid-month** redo of the forecast lays out the characteristics of these two scenarios. (See Chart.) The first allows the economy to remain slightly above the trend we were on prior to the pandemic. The second shows the economy slipping below its pre-pandemic trend, with the recovery decelerating more rapidly than previously expected.

Both forecasts assume that a bipartisan infrastructure package is passed and that the debt ceiling will be lifted before a default and downgrade to U.S. government debt. These scenarios assume that the administration is forced to cut back on the $3.5 trillion for fiscal 2022 and beyond for social programs. There is no additional stimulus or emergency aid, but one never knows in an election year.

Scenario 1

Regional outbreaks persist, both at home and abroad. Vaccinations, boosters, better treatments and savings amassed during the crisis keep demand from cratering, while bottlenecks continue to build, including in the supply of labor:

- Inventories rebuild more slowly than previously expected, which means the surge in prices related to supply shocks persists.
- Long-haul COVID, especially among younger workers, the need to care for children sent home from schools and forced to quarantine, delays to training and education triggered by the move online and a rise in retirements keep more workers on the sidelines.
- Immigration, which was the primary driver of labor force growth prior to 2017, remains suppressed.
- Labor shortages intensify despite a shortfall in employment from the crisis.
- Employment surpasses the peak hit in February 2020 in mid-2022, much more rapidly than we saw emerging from the global financial crisis of 2008-09.
- Wages continue to move up, albeit slower than during the initial rush to reopen.
- Inflation cools from the highs at reopening but lingers at a warmer level than we have seen in decades.

Inflation settles into a 2.5% to 3% range in 2022 and remains well above the Fed's 2% average target.

The Fed Tightens

The Fed is forced to aggressively hit the brakes. The first step is to taper the $120 billion a month in Treasury bond and mortgage-backed securities purchases.

Fed Chairman Jay Powell will likely lay out the road map for tapering of asset purchases next week. As soon as the September meeting, the Federal Open Market Committee (FOMC) could make an announcement about how and when it intends to start tapering. Asset purchases are likely to end by mid-2022. Powell will include contingencies related to the Delta variant, but the consensus within the Fed to wind down is building.

We expect the Fed to start lifting rates by year-end 2022. Rate hikes thereafter could be faster than many expect, given the fact that the Fed is now chasing instead of preempting inflation; it has not had to do that for decades. This could come as a shock for financial markets and take a toll on asset prices. The risk of a policy misstep and a premature end to this business cycle is rising.

Financial Market Volatility Intensifies

Risk of a broader market correction increases as volatility picks up in both the bond and equity markets. Equity market gains become even more concentrated in the technology and life sciences sectors; other sectors struggle to deal with the consequences of the margin squeeze triggered by inflation and higher rates.

The silver lining is that private sector debt loads remain low. The housing market bubble is not underwritten by debt as it was in the early 2000s. Speculators are snapping up properties with cash and crowding out first-time buyers. They will lose when home prices fall but that should not cause the spillover effects we saw during the subprime crisis. I have learned to remain humble, however, when home prices are surging on a global scale.

Scenario 2

A fifth wave hits with the threat of even more dangerous and vaccine-resistant mutations. Disruptions to demand are greater than disruptions to supply:

- Inventories rebuild more rapidly than many expect. Some sectors are suddenly awash in unwanted inventories, which precipitates price cuts. Commodity prices are most at risk.

- Employment is much slower to reach the precrisis peak, which will leave more workers on the sidelines of the labor market for longer; labor shortages abate for low-wage jobs.
- Wage gains slow after surging in the first half of 2021. The blow to wage growth for low-wage earners is acute.
- Inflation cools rapidly and dips below the Fed's 2% target in 2022 and stays there in 2023.

Inflation slows to close to 1.5% in 2022 and 2023.

Fed Forced to the Sidelines

The Fed has to delay or pause its plans to taper and continue to grow its balance sheet through 2022 and 2023. Rate hikes could be delayed to 2024 or longer.

Many worry that we will see an uptick in zombie firms much as Japan did in the 1990s. Recent research by the Federal Reserve rebuts that idea, asserting that zombie firms (unprofitable and highly indebted) are few in number, small in size and concentrated in manufacturing and retail.

Financial Markets Remain Deceptively Calm

Financial markets have grown accustomed to low rates. The wall of liquidity that central banks have provided has insulated markets from sluggish demand and kept valuations unusually high. That said, we can't rule out a larger correction and more volatility when reality sinks in.

Bottom Line

The pandemic is morphing into an endemic with seasonal surges, which could be much more severe than the flu. We can either manage it, or it will manage us. We need much more widespread distribution and uptake of vaccines, both at home and abroad.

A pandemic anywhere is a pandemic everywhere. We will need vaccines that are capable of fighting variants as they emerge, in addition to widespread masking, testing and treatments to deal with outbreaks as they occur.

The backlash over the virus and masking is nothing new. History records a similar reaction to masks and expert advice during the 1918-19 flu pandemic, which was more severe. Backlash to quarantines and misinformation was widespread when the Black Death hit Europe in the 14th century.

That doesn't mean we are doomed to repeat all of the mistakes of the past, but it does mean we need to incentivize a different set of behaviors if we want to break the vicious cycle we are in. Financial incentives have proven effective in boosting vaccinations in some states. We need to embrace whatever works and collaborate across disciplines - health professionals, economists, historians, etc. - to get us all to heal and get the economy up and running on all cylinders.