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Anatomy of a Double Dip: COVID Surge Threatens Outlook

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Change the course of COVID; change the course of the economy - full stop.

I pinned that to the top of my Twitter feed on July 14 as a resurgence in COVID-19 cases in the Sunbelt was triggering yet another pullback in economic activity. Reservations at restaurants plummeted while credit card usage showed a shift from buying in stores to online and mall traffic dropped in the worst affected areas. A rise in hiring outside of hot spots only partially offset a new round of layoffs and business closures, which caused employment gains to slow in July.

The relationship between COVID cases and the economy's performance is so important that the Federal Reserve added two full lines on it in its **statement** about the economy at the conclusion of the policy meeting on July 29:

> ***The path of the economy will depend significantly on the course of the virus. The ongoing public health crisis will weigh heavily on economic activity, employment, and inflation in the near term, and poses considerable risks to the economic outlook over the medium term.***

The push to reopen college campuses against a backdrop of rising infections is particularly worrisome. Young adults - up to the age of 25 - contract and spread COVID-19 as they engage in riskier behaviors than other demographics. House parties and crowded bars were triggers for the recent surge in infections in the Sunbelt. The timing couldn't be worse as their behavior could spread another surge in infections at the same time we are hit with a second wave in the fall. Historically, the second wave of a pandemic is often worse than the first. Elementary schools pose a lower but still tangible risk. Children as young as 10 can be effective carriers of the virus. Younger children can also become ill.

That would shut schools that had reopened and exacerbate the blow to families and children. Women bear the brunt of childcare responsibilities across income strata and have already been forced to take furloughs, quit or forego reentering the labor market. Low-wage Black and Hispanic households have been especially hard hit by job losses and how far their children are falling behind - they lack the resources to learn online or fill gaps left by the schools in the basics of reading and writing.

Optimism over a vaccine is high but not likely to be available en masse until 2021. Uptake will be another hurdle. A survey in May found that nearly half of adults in the U.S. would not take a COVID-19 vaccine, although that could change with the rising pace of hospitalizations and deaths. Testing, tracking and treatments, which could help us better manage the disease until a vaccine is produced, are lacking. We are chasing a moving target on testing even though it is one of the issues that Congress appears to agree upon funding.

Masks are another cheap and minor shift to dramatically reduce the pace of infections. I feel like a broken record on this front. I will just leave it there.

This edition of ***Economic Currents*** examines the risk that the economy stumbles in the fourth quarter following a rebound in the third quarter. Gridlock over the next aid package and what is sure to be a cut in weekly unemployment benefits could exacerbate losses at a critical juncture. Food insecurity and homelessness may become the worst since the Great Depression.

Anatomy of a Double Dip?

Chart 1 lays out two scenarios for the economy over the next six months. We are down to about a 50/50 chance of the economy slipping again in the fourth quarter. This is despite an expected $1.5 trillion in additional aid from Congress. Another downturn would push out the time it takes to reach the pre-crisis peak in economic performance by six months, relative to our base case.

Consumers Retreat

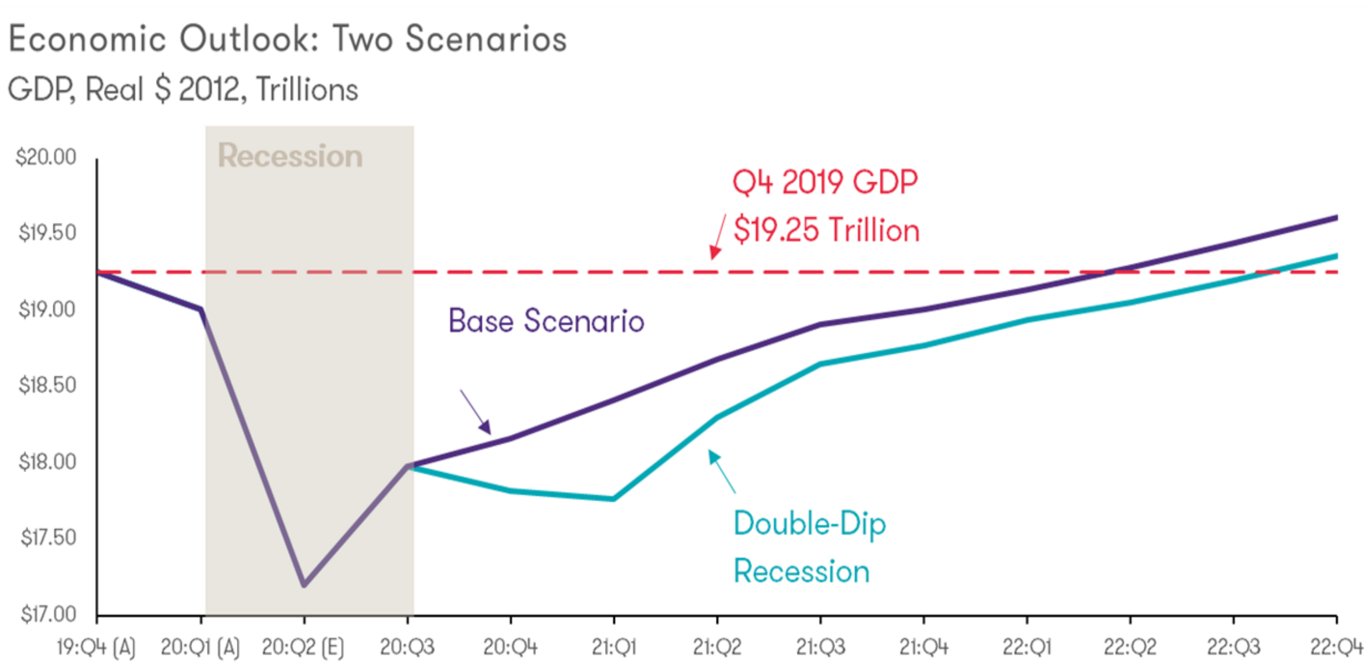
The greatest threat to the outlook is consumers. High frequency data - weekly credit card usage, mall traffic, direction searches on Google Maps, hotel occupancies and air travel - suggest that consumer spending hit a plateau in July after surging in May and June. The good news is that if we could hold at those levels, we would see a large, double-digit gain in spending in the third quarter.

The bad news is what happens after that. Consumer sentiment reversed course in July; expectations about the future cratered as job losses thought to be temporary became permanent. That was at the same time that layoff announcements across large firms jumped, unemployment benefits lapsed and moratoriums on evictions expired. The White House has issued several executive orders intended to partially replace benefits, cut payroll taxes and reinstate moratoriums on evictions, but little appears actionable. The lapse in unemployment benefits alone will take weeks (if not longer) to restore, while evictions have already started.

The level of extra unemployment benefits is expected to be cut from $600 to $400 per week despite an overwhelming amount of evidence that the subsidies have done more to spur spending than deter work during this pandemic. It turns out that people place a greater weight on benefits and the prospect of having a job for the long haul than what they receive in unemployment benefits, even during a pandemic.

A drop in payrolls could come as soon as August when the remainder of the funds tied to the Payroll Protection Program (PPP) loans and grants are set to run out. One recent survey by Cornell University suggests that as many as four in 10 workers supported by those loans are not actually working; they will be the first to be cut.

Chart 1



Source: Bureau of Economic Analysis, Grant Thornton LLP

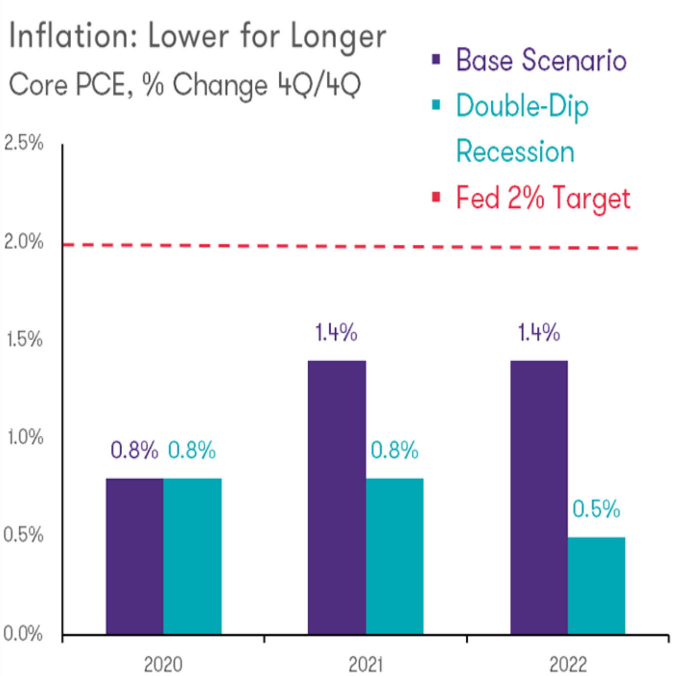
The greatest threat to employment is tied to a resurgence in infections, notably at schools and colleges. Problems linked to early school reopenings have already occurred. Hundreds were quarantined the first weeks when schools reopened in Georgia and Mississippi. Those problems and a high pace of infections have prompted some larger school districts such as Chicago to go back online for the fall semester.

Most colleges are attempting to reopen with a hybrid of in-person and online classes, then close again by Thanksgiving. Halloween could prove challenging. That would prompt businesses and households to scale back even further on celebrations during the height of the holiday season. Employment at bars and restaurants will lose a good portion of the ground regained, while theaters and sports venues remain shuttered.

Housing Reverses Course

Home buying and building played catch-up as the pent-up demand triggered by state lockdowns in March and April was unleashed. Those gains should carry sales and construction activity through the summer. Tighter credit standards and another round of layoffs triggered by the fear associated with large public gatherings could reverse those gains starting in the fourth quarter.

Chart 2



Source: BEA, Grant Thornton LLP

Mortgage and rent deferrals have picked up and could morph into defaults. More than a third of renters surveyed by the Census Bureau's Household Pulse Survey expressed concern about their ability to make rent payments in late July, before enhanced unemployment benefits lapsed. The ripple effects of those losses would be felt from the mortgage to the leasing market and further undermine a rebound in housing, despite tight inventories and pent-up demand.

Businesses Conserve Cash

Businesses are expected to continue to pull back in response to a persistently high rate of infections and sporadic lockdowns abroad. Spending on farm equipment is likely to contract in response to the blow to farm income triggered by the crisis. Many farms were forced to leave crops to rot in the fields as restaurants shut down. Construction equipment will also be hit by the drop in funding for repairs and infrastructure investment at the state and local level.

A burgeoning commercial real estate crisis will exacerbate the decline in heavy equipment and nonresidential structures. The service sector in urban areas has been hit particularly hard as workers who once used those services continue to work from home.

Escalating trade tensions represent another hurdle as we get closer to elections. Hostility toward China has bipartisan support. The problem is the impact on the U.S. economy. A hike in tariffs and threats of a larger trade war with China put a damper on investment in 2019 before the onset of COVID-19.

Government Spending Slows

Government spending is poised to slow to a virtual crawl in the fourth quarter, even if Congress agrees on an additional $1.5 trillion in aid. Distortions created by the hiring needed to complete the 2020 census are the primary reason; the bulk of the spending and hiring for the census occurs during the third quarter and is slated to end in the fourth quarter.

The next federal aid package is expected to include transfers to the states as well. If those funds do not materialize, government spending could contract. Spending on everything from education to first responders will be on the chopping block.

Trade Deficit Narrows

The trade deficit is expected to narrow in the second half of the year as exports pick up faster than imports. This reflects weaker growth at home than abroad. Countries that enter a second wave with a lower pace of infections are expected to weather the storm better. Recent dollar weakness should be a plus for exports in early 2021.

A sharp increase in tariffs and a tit-for-tat trade war would further slow trade flows in both directions. China will bear the brunt of our hostilities leading into the election. Canada is next on the list and has threatened to retaliate before the election. A trade war with Europe over a push to tax U.S. technology giants is another possibility.

Inflation Decelerates

Chart 2 compares the behavior of the core PCE (personal consumption expenditures) index of inflation under the two scenarios. Inflation is expected to remain lower for even longer if the economy contracts again. Higher unemployment, a drop in hours worked and cuts to unemployment benefits are all expected to place a drag on price pressures.

Firms cut wages and asked workers to take unpaid leave to preserve cash at the onset of the crisis. Such a loss in wages is unique to this recession. A repeat of those tactics seems probable if the economy falters. The goal would be to buy time until a vaccine is widely available. More timely testing and tracking with better treatments could support a faster reopening.

Fed Commits to Reflate

The Federal Reserve has at least two more tools that it will deploy to reflate the economy. The first is what is called "forward guidance," which lays out the decision rule on rate hikes. The Fed is widely expected to commit to allowing for an overshoot on its 2% inflation target at the next meeting in September.

What does that mean and why is it important? It means that the Fed learned something from previous mistakes. It no longer believes that it should act to preempt inflation when unemployment plummets. Instead, it is now willing to let unemployment fall until wages accelerate for a prolonged period of time. The goal is to engage and re-employ more of those on the sidelines of the economy.

Overheating is one of the few ways that the Fed can help to level the playing field. That would allow wages to rise as a share of the economy, giving more money and power back to workers. The irony is that a jump in wage share would work to the detriment of Wall Street as it would supress profit margins. Wall Street hasn't realized this yet. The problem is credibility. The Fed has a poor track record of generating inflation. This could take years of low rates to occur but is consequential.

The second tool the Fed has laid out that it will no doubt be forced to use is yield curve controls. This means that the Fed will buy Treasury bonds in an effort to target a specific yield or range of yields on those bonds; it will likely target two- to five-year Treasury bonds.

The goal of such an action is to reduce interest costs and spur credit availability to the broader economy. It has the added benefit of making debt cheaper for the government to service at a critical time, when we need more government spending.

Could the Federal Reserve do even more? I have learned not to underestimate the Fed. But, as Chairman Jay Powell has repeated: the Fed can lend, not spend. The power of the purse rests with Congress. That is where the real power to heal and stimulate the economy rests. The Fed will do all it can to make decisions to support the economy easier for Congress.

Bottom Line

The resurgence in COVID-19 cases and subsequent pullback in activity have already begun. Delays to aid by Congress will exacerbate the slowdown in August. After that, much depends on our ability to ramp up testing, tracking, social distancing and masking to dampen the blow of a second wave. If we don't stop the freight train of infections, the economy will crash again.

The point of doing this analysis is to see how the worst-case scenarios can be avoided. That is the silver lining - full stop.

Economic forecast — August 2020

	2019 (A)	2020	2021	2019:4 (A)	2020:1 (E)	2020:2	2020:3	2020:4	2021:1	2021:2	2021:3	2021:4
National Outlook												
Chain-Weight GDP[1]	2.4	-5.0	3.7	2.4	-5.0	-32.9	20.5	5.7	2.9	8.8	3.7	1.9
Personal Consumption	2.3	-5.6	3.2	1.6	-6.9	-34.6	26.7	2.2	2.0	8.9	2.7	1.8
Business Fixed Investment	3.1	-7.9	-1.2	-0.3	-6.7	-27.0	-5.6	-1.8	0.6	7.3	3.3	0.8
Residential Investment	-0.2	-0.8	1.2	5.8	18.9	-38.7	20.5	2.2	2.5	1.6	3.2	4.0
Inventory Investment (bil $ '12)	45	-198	28	-1	-81	-316	-244	-151	-110	4	83	135
Net Exports (bil $ '12)	-918	-759	-795	-862	-788	-781	-729	-737	-729	-791	-830	-830
Exports	0.5	-13.9	8.2	3.4	-9.4	-64.1	48.9	15.6	16.2	5.8	12.1	11.9
Imports	0.3	-14.8	7.3	-7.5	-15.0	-53.4	24.1	12.6	10.9	13.1	14.2	8.8
Government Expenditures	2.5	2.7	3.7	2.4	1.3	2.7	0.5	13.5	1.6	3.0	2.4	-3.0
Federal	3.7	7.7	7.7	3.9	1.6	17.3	5.6	25.9	2.3	5.4	4.0	-8.8
State and Local	1.8	-0.3	1.1	1.4	1.1	-5.6	-2.7	5.8	1.1	1.3	1.3	1.2
Final Sales	2.4	-3.9	2.6	3.2	-3.6	-29.3	18.5	3.7	2.1	6.4	2.2	0.9
Inflation												
GDP Deflator	1.7	0.9	1.0	1.4	1.4	-1.7	2.0	0.7	1.3	0.7	1.3	1.3
CPI	1.8	1.0	2.1	2.4	1.2	-3.5	3.5	1.2	3.3	2.2	2.3	2.4
Core CPI	2.2	1.4	1.4	2.0	2.1	-1.6	2.1	1.7	1.7	1.5	1.3	1.5
Special Indicators												
Corporate Profits[2]	10.8	-20.0	6.4	10.8	-6.7	-12.6	29.8	-20.0	-7.3	3.0	-29.4	6.4
Disposable Personal Income	2.2	7.1	-6.3	1.9	2.6	44.9	-11.2	2.0	-31.1	6.3	3.8	1.0
Housing Starts (mil.)	1.30	1.25	1.27	1.43	1.48	1.04	1.23	1.23	1.25	1.26	1.28	1.30
Civilian Unemployment Rate	3.7	8.8	8.0	3.5	3.8	13.0	9.7	8.7	8.6	8.2	7.9	7.3
Total Nonfarm Payrolls (thous.)[3]	1388	-8577	2811	221	-1126	-16107	6500	2156	367	657	692	1095
Vehicle Sales												
Automobile Sales (mil.)	4.9	3.3	3.6	4.5	4.0	2.6	3.2	3.4	3.5	3.6	3.6	3.7
Domestic	3.5	2.3	2.5	3.3	2.9	1.8	2.1	2.3	2.4	2.5	2.5	2.6
Imports	1.4	1.0	1.1	1.2	1.1	0.8	1.1	1.1	1.1	1.1	1.1	1.1
Lt. Trucks (mil.)	12.1	9.7	12.3	12.3	11.2	6.8	10.3	10.6	11.7	12.1	12.5	12.8
Domestic	9.7	7.9	9.6	9.7	8.9	6.7	7.8	8.2	9.2	9.5	9.8	10.0
Imports	2.4	2.3	2.7	2.6	2.3	2.1	2.5	2.4	2.5	2.6	2.7	2.8
Combined Auto/Lt.Truck	17.0	13.0	15.9	16.8	15.1	9.4	13.5	14.0	15.2	15.7	16.1	16.5
Heavy Truck Sales	0.5	0.4	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.5	0.5
Total Vehicles (mil.)	17.5	13.4	16.3	17.3	15.5	9.7	13.9	14.4	15.6	16.1	16.6	17.0
Interest Rate/Yields												
Federal Funds	2.2	0.4	0.1	1.6	1.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
10-Year Treasury Note	2.1	0.8	0.6	1.8	1.4	0.7	0.6	0.5	0.5	0.5	0.6	0.6
Corporate Bond BAA	4.4	3.5	3.2	3.9	3.9	3.9	3.1	3.1	3.4	3.2	3.2	3.0
Exchange Rates												
Dollar/Euro	1.12	1.12	1.14	1.11	1.10	1.11	1.13	1.13	1.13	1.14	1.14	1.14
Yen/Dollar	109.0	107.3	106.0	108.7	108.8	107.4	106.7	106.1	106.0	106.0	106.0	106.0

1. In 2019, GDP was $19.1 trillion in chain-weighted 2012 dollars.
2. Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.
3. Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.