Grant Thornton

MARCH 03, 2020

An Economic Pandemic:
COVID-19 Recession 2020

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There was a lot of optimism that the novel coronavirus, now called COVID-19, would be a transitory economic event. Upfront disruptions due to quarantines in China were expected to be short-lived and easily recouped. That optimism was based on three key assumptions:

1. China would be able to contain the spread of the virus.
2. Underutilized capacity in China would allow plants idled by the virus to ramp up quickly.
3. The spread of the virus would crest relatively quickly.

Two of those assumptions are no longer valid; the third is up for debate. Japan has closed schools for the month of March to counter contagion. Some schools in China will be closed until May. Japan hopes to proceed with the Olympics in July but there is no guarantee.

My daughter contracted H1N1, or the "swine flu," in Germany in 2009 and spread it to my son and myself before we detected it. I still think about how many people were exposed on our flight home when we had no idea. We believe that she was infected by another child who had not been officially diagnosed.

The World Health Organization (WHO) has yet to declare the outbreak a health pandemic but it is what we are terming an "economic pandemic." It is global in scope and will disrupt activity for some time to come. The line between panic and prudence is thin. Efforts to contain the virus are triggering massive economic disruptions even if they don't actually work to contain the virus. Quarantines and school, store, plant and border closures are becoming the norm when a new outbreak is discovered.

A Viral Slowdown

Real GDP growth is expected to grow at a 0.6% pace in the first half of the year as disruptions associated with COVID-19 migrate from abroad. That level of growth is too weak to keep the unemployment rate from rising. Layoffs and furloughs are already happening in the travel and tourism industries. Factories are also scrambling to get much needed parts out of China.

Our forecast currently calls for a rebound in the second half when the fear and cloud of uncertainty surrounding COVID-19 lifts. The greater threats to the outlook are the solvency of highly indebted firms and the risk that the blow to profits could turn into a vicious cycle of layoffs and lost demand.

The Federal Reserve and Congress are expected to act to stimulate the economy but such tools are poorly designed to deal with the unique disruptions triggered by an epidemic. Rate cuts and tax cuts can't do much to reopen idled factories or bring nesting consumers back into stores. Policies designed to keep firms afloat through the crisis and stimulate demand after it has passed would work better.

Why not just let the virus take its course and avoid the disruptions to the economy? Because an uncontained outbreak without the promise of a vaccine could trigger even larger disruptions to the labor market and business down the road. Containing the virus is painful but ultimately better than letting it spread.

The practice has become so common that the International Monetary Fund (IMF) and WHO have warned against such extremes. The concern is that the disruptions to the global economy could be as bad or worse for people's well-being than the virus. A study on the economic impact of a severe outbreak by the World Bank revealed that shifts in behavior alone were responsible "for as much as 80 - 90 percent of the total economic impact [GDP losses] of the epidemics."

Some countries have already moved to stimulate to blunt fallout from the virus, but it is unclear how much those efforts will help. Monetary and fiscal stimuli are not designed to offset the kind of disruptions triggered by a pandemic. Tax cuts cannot restart factories idled to contain the virus or boost spending by quarantined consumers. That hasn't stopped investors from believing in miracles; the stock market rallied on March 2, hoping a rate cut would rescue the economy.

A better tactic would be to follow China's approach, which is focused on keeping highly indebted companies solvent. It is ordering banks to lower rates and defer payments; it is even issuing crisis bonds. The hope is to prevent current economic losses from mutating into a financial crisis.

This edition of ***Economic Currents*** provides an update to the rapidly shifting global and U.S. outlook. We will revisit the forecast by sector as the ground has shifted dramatically over the last month. A global recession now looks increasingly probable. The U.S. is not an island; weakness abroad will impact us at the same time that businesses are pulling back in anticipation of an outbreak here. I have lost count of the number of U.S. conferences that have been cancelled in the last week alone.

The Fed cut short-term interest rates to shore up confidence and try to stem the panic that has hit Wall Street. The Fed will also likely direct banks to ease up on loan servicing requirements via the Community Reinvestment Act. There is a clause that allows them to ease up on regulatory requirements, waive late fees, etc. in case of a natural disaster. That will alleviate debt burdens for some firms but fall short of offsetting the blow dealt to business by supply chain disruptions and suppressed consumer demand.

We are also likely to see efforts to stimulate via fiscal stimulus. The administration has been pushing for another round of tax cuts, although it is unclear what tax cuts can do to right a ship capsized by a pandemic. Fear trumps economics when a pandemic becomes reality. The best course of action is to contain the spread of the virus for the public, then to contain the fallout for cash-strapped firms to avert a vicious cycle of falling profits and layoffs.

Chart 1

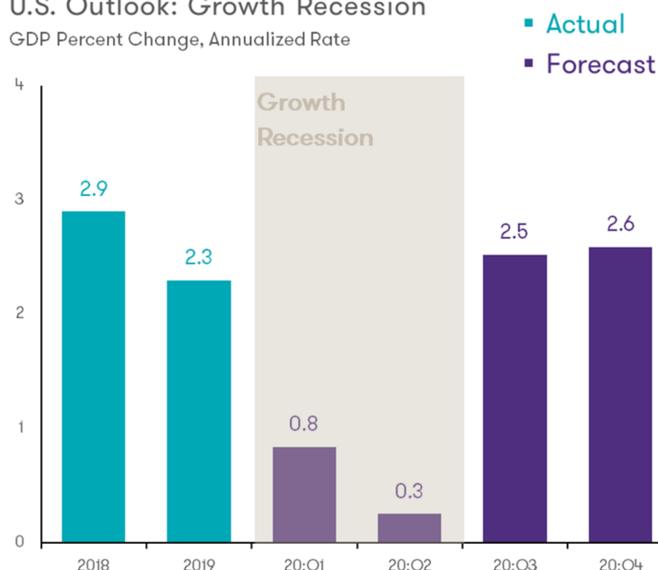
Election year politics could further complicate the outlook. Trade hawks in the administration have been pushing the president to double down on his nationalist stance, which includes curbs on immigration, more tariffs and quotas, and a push for another round of subsidies for favored industries.

We have already seen a prelude to this. The French finance minister recently warned of the need to abandon global supply chains for more regional supply chains at the Group of 20 meetings in Saudi Arabia, while the president has threatened to close the border with Mexico in response to the crisis.

A Global Recession

We are now expecting a global recession as the effects of the epidemic disrupt economic activity across both developing and developed economies. One of the unique aspects of the current crisis is its impact on China, which helped by being more resistant to the global financial crisis back in 2009. (See Chart 1.) Losses in the first half of the year are expected to be only partially offset by efforts to recoup production and consumer spending in the second half. China is expected to endure its first quarterly contraction in 30 years during the first quarter but may not report the loss in the government's official data.

Chart 2



Source: BEA, Grant Thornton LLP

Growth is likely to be flat to negative in seven of the ten largest economies in the first quarter. These include: China, Japan, Germany, the UK, France, Italy and Canada. Brazil is now at more risk as it depends heavily on exports to China and is now dealing with its own exposure to the virus. Global growth is expected to slow to 1.8% in 2020, well below the 2% threshold that indicates a global recession.

The State Department placed COVID-19-related travel restrictions on 13 countries, starting February 2. Those restrictions, cancellations by consumers and businesses have prompted the airlines to cut back on flights to Asia, Italy and the Middle East. Saudi Arabia has suspended visas for Muslims seeking to make pilgrimages to Mecca and Medina in an effort to prevent contagion.

Epidemiologists are most concerned about the humanitarian crisis that could develop as the virus spreads to lesser developed countries and refugee camps in the Middle East, Turkey and parts of Africa. Countries that had closed their doors to refugees are not likely to open them to refugees who may be sick.

A Growth Recession in the U.S.

Chart 2 shows the forecast for a "growth recession" in the U.S. That occurs when growth is too weak to keep unemployment from rising. Growth for the year is 1.5%, one half percent weaker than it was just a month ago.

A recession cannot be ruled out. An epidemic in the U.S. would be even more disruptive to production and demand than it is abroad, given the sheer size of the economy and the risks to highly populated areas. We now have a 50% probability of a recession occurring in the U.S. this year.

Consumer Spending Slows

The most obvious effects of COVID-19 were initially expected to show up as reduced tourism and a loss in paychecks, predominantly in manufacturing states. Wealthy Chinese tourists have played a disproportionate role in supporting high-end shopping and tourist destinations, while disruptions to supply chains will add insult to injury in the manufacturing sector.

Now, fear of contagion has prompted a more dramatic pullback in business travel and conferences across the U.S. Consumers have also opted to cancel vacations, which will further crimp both payrolls and spending as we move into March.

The recent stock market rout is another issue, particularly for baby boomers. Those who are in or close to retirement accounted for almost all of the pullback in spending that occurred during the height of the stock market correction in December 2018. More recently, boomers have opted to consolidate debt and save cash generated by mortgage refinancing, instead of using it to supplement consumption. The saving rate jumped to the highest level in nine months in January.

Shortages will likely constrain spending. Imports from China have plummeted, which has brought ports in California to a standstill. Brace yourselves for empty shelves as we move into March.

A full-fledged pandemic would trigger a toxic mix of demand and supply shocks. Other countries have seen schools, amusement parks and sports arenas closed. The result could be a vicious cycle of lost profits and layoffs.

We learned from the SARS outbreak in 2003 that it took a while for consumers to return to stores and other public spaces once the epidemic abated. It could easily take until Summer before we return to a sense of normalcy.

Housing Pauses

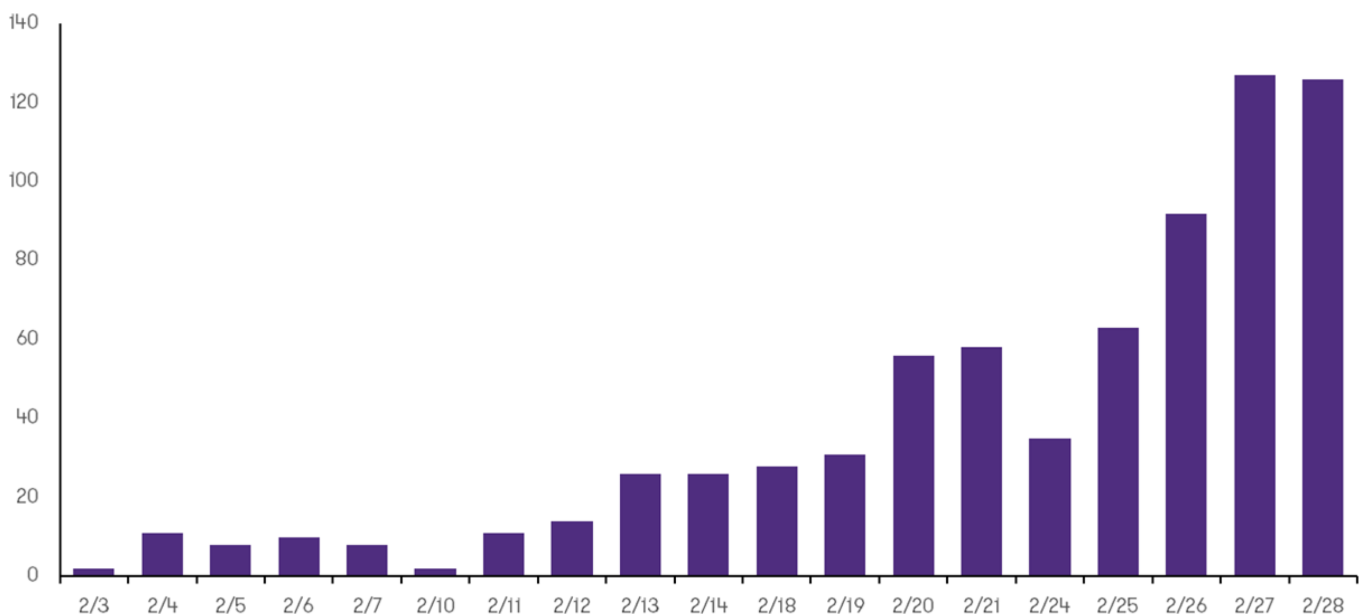
Housing has been on a tear. Fear associated with the outbreak and a shortage of imported materials are expected to temporarily sideline construction and sales. Some sales will be cancelled. Wealthy Chinese buyers have been pulling back in the coastal markets for some time; those losses will compound rapidly in the wake of the devastation triggered by COVID-19 in China.

The silver lining is that millennials are back in the game and eager to buy. Housing is expected to return as a driver of gains when the crisis abates. This is one place where lower rates finally matter again.

Business Investment Contracts

Business investment is expected to be hit the hardest by COVID-19. A full year contraction is possible given supply chain disruptions and the uncertainty associated with the virus. Firms now need to hedge against pandemics.

Chart 3



Profit warnings due to disruptions triggered by the coronavirus have surged since the outbreak became public. (See Chart 3.) Some 35% (620 of 1773 filings) have mentioned COVID-19, most of them citing downside risks to the outlook. Some 4,300 firms have yet to report to the Securities and Exchange Commission (SEC) this quarter. Brace for more warnings.

Losses span nearly every sector in the economy, from manufacturing to tech, finance and retail. Transportation, cruise lines and energy have been hit particularly hard. The majority of our pharmaceuticals are produced in Wuhan, China.

A sharp drop in oil prices will exacerbate the contraction in investment. The oil sector had been the primary driver of investment earlier in the cycle. Consolidation in the oil industry is expected to accelerate as bankruptcies rise; large firms are now dominating.

Closing the border with Mexico would be particularly costly. Parts cross the border multiple times before they become finished products. Hopes for a resurgence in manufacturing have disappeared.

"Efforts to stimulate economic activity are likely but will not have the desired effects."

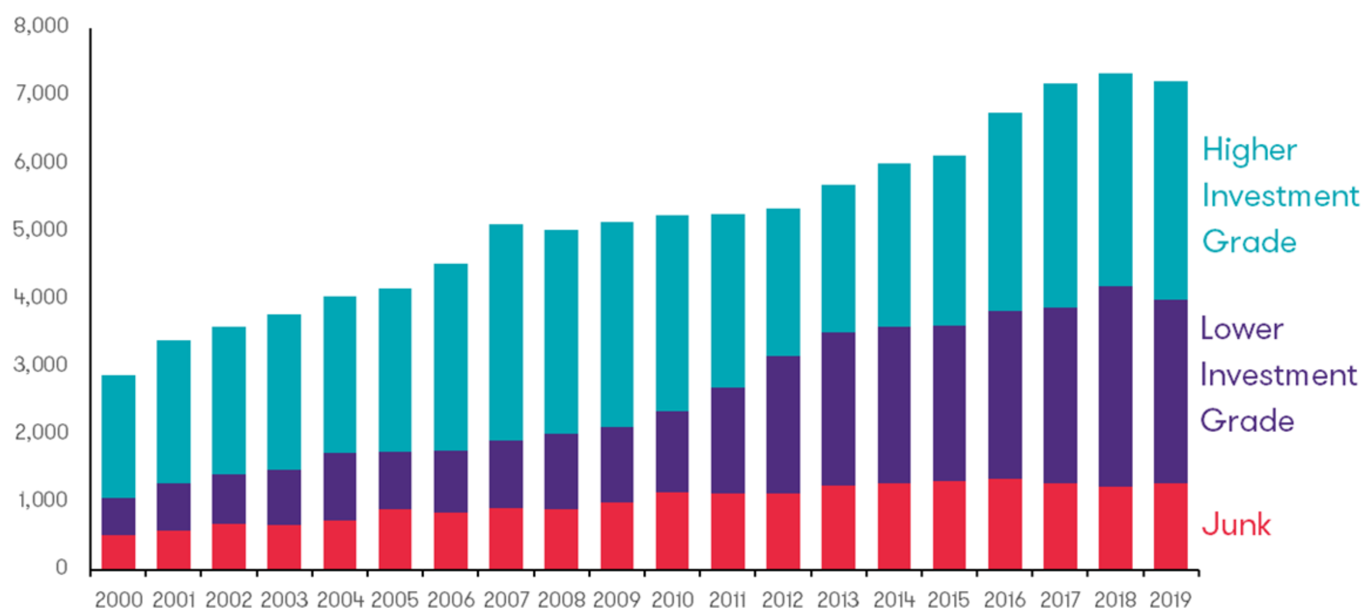
All of those losses would compound if we were to see a major outbreak in the U.S. Plants would be shuttered as debt-laden firms would be forced to preserve cash.

Pandemics are now reality instead of just a scary movie plot. They will force senior managers to allocate more time toward hedging supply chain disruptions instead of long-term strategy. We expect to see firms accelerate moves out of China into other developing economies. Vietnam and Mexico are considered the long-term winners in these scenarios, barring a border closure.

Inventories Plummet

Disruptions to trade and production are expected to push inventories to the lowest levels since the Great Recession during the first half of the year. The hope is that prospects for a vaccine and better treatments for those who suffer the most from the virus will allow a rebound in production to replenish a portion of inventories in the second half.

Chart 4



Source: Moody's Analytics, Grant Thornton LLP

> “Firms and countries hoping to hedge themselves against future outbreaks will pull back on global supply chains and erect more hurdles to clear at borders.“

Government Spending Rises

Costs associated with containing the crisis at the federal, state and local levels will further strain government coffers. Efforts to stimulate economic activity are likely but will not have the desired effects, given the unique nature of the disruptions we are experiencing. They will do more to provide a lift for economic activity after the crisis has abated.

A better tactic would be to prevent overly indebted firms from going under. The U.S. is not immune to another financial crisis, this time emanating from a large overhang of questionable corporate debt. Well over half of corporate bonds outstanding are just above the threshold for investment grade or below it. (See Chart 4.)

The risk is that the tranche of debt just above the investment grade threshold could fall to junk bond status. The current situation is particularly precarious given the easing in grading standards in recent years. The junk bond market actually seized up during the last week of February. (We never learn.)

Trade Improves Initially

The downdraft in imports is expected to exceed the drop in exports, at least initially; this will be one of the few offsets to the weakness. Delays to parts and finished products will cause most of the damage. The Port of Long Beach, California, the destination of much of China’s imports, is a ghost town. There are reports that as many as fifty percent of the longshoremen have been laid off.

The volume of trade across countries is expected to further slow, following the blow from the trade wars. Firms and countries hoping to hedge themselves against future outbreaks will pull back on global supply chains and erect more hurdles to clear at borders.

Disinflation Returns

Inflation is expected to slow after a minor improvement at the start of the year. A sharp drop in oil prices, weaker global growth and lost wages in the U.S. are expected to more than offset any temporary surge in prices related to shortages.

The challenge for central banks will be to counter the slowdown in inflation and what could be a more insidious drop in expectations surrounding inflation. The goal is to avoid a Japanese-style trap of low growth and falling inflation expectations.

The Fed Stimulates

Federal Reserve Chairman Jay Powell has already acknowledged the crisis and the Fed’s willingness to cut rates. We now have two 50 basis-point cuts for the first half of the year, starting in March with today’s cut. We will return to zero in the event of a full-blown recession.

The Fed is also expected to leverage the might of its balance sheet. Ideally, it would inject liquidity into markets that seize up, much as it did during the financial crisis. The Fed alone restarted the mortgage market with a large expansion of its balance sheet during the height of the global financial crisis in 2009.

The Catch-22 is that the Fed lacks the tools to right the ship if it capsizes, no matter the reason; it is even more limited to offset the disruptions associated with COVID-19, regardless if it is declared an official pandemic or not. Lower interest rates alone cannot stem the cancellation of travel by firms or restart idled factories. The best we can hope for is that they alleviate fears or instill a sense of calm amidst the chaos, reduce the cost of servicing debt and set the stage for a larger rebound later.

Financial Markets Overshoot

Eventually, the panic that has seized financial markets will abate. Information is key. Investors need to get a sense of when the global outbreak might crest to start assessing the real instead of the perceived (panicked) blow to profits and economic activity. Progress on treatment and a vaccine will help. The enemy of financial markets is uncertainty.

Central banks and governments have roles to play in that they can inject a sense of calm and clear messaging. Even Chinese President Xi Jinping admitted his government could have stemmed the fallout by being more transparent about what was happening at the outset of the crisis. Head-in-the-sand policies seed the very panic that we would like to avoid. Xi also underscored that it was a mistake to treat the outbreak like the flu at the onset; necessary data on how the disease was spread and information for a vaccine were delayed.

Our government could also roll back tariffs and quotas to reduce the blow to profits associated with trade and the outbreak. I wouldn't hold my breath.

Bottom Line

COVID-19 represents an economic pandemic because it is suppressing growth on a global scale. The U.S. is not immune. U.S. growth is poised to slow to a near standstill in the first half as the global economy tanks. The long-term effects could be even greater if it further undermines globalization. Cutting back on trade shrinks the overall size of the economic pie.

One can only hope that we can contain the spread of the virus. Thankfully, the data gathered thus far has paved the way for a vaccine. That will still take time but the stars are aligning. My daughter landed from Japan last week, worried that she could once again be a carrier. So far, so good but we are not taking chances this time around. My house is filled with the smell of bleach and my hands are becoming raw from washing. These are seemingly small sacrifices, given what so many have already had to endure.

Economic forecast — March 2020

	2019 (E)	2020	2021	2019:4 (A)	2020:1	2020:2	2020:3	2020:4	2021:1	2021:2	2021:3	2021:4
National Outlook												
Chain-Weight GDP[1]	2.3	1.5	1.9	2.1	0.8	0.3	2.5	2.6	2.2	1.5	1.6	1.5
Personal Consumption	2.6	1.8	1.9	1.7	1.3	0.8	1.9	1.7	2.0	2.0	2.0	1.9
Business Fixed Investment	2.1	-1.1	3.4	-2.3	-2.0	-1.6	2.8	3.2	4.7	3.8	3.5	3.4
Residential Investment	-1.5	3.6	0.1	6.1	10.3	-2.7	0.4	1.7	0.1	-0.7	-0.4	1.2
Inventory Investment (bil $ '12)	67	10	49	13	2	0	3	35	43	46	54	52
Net Exports (bil $ '12)	-954	-913	-950	-900	-910	-940	-907	-894	-903	-937	-967	-994
Exports	0.0	0.8	5.4	2.0	-1.6	-2.5	8.7	7.6	6.6	3.9	3.8	3.7
Imports	1.0	-0.6	5.1	-8.6	0.1	1.7	2.3	4.0	6.0	6.8	6.2	5.8
Government Expenditures	2.3	2.1	0.8	2.6	1.5	3.3	0.7	0.5	0.8	0.7	0.5	0.4
Federal	3.5	3.5	0.3	3.8	1.4	7.2	1.5	-0.4	-0.2	-0.4	-0.4	-0.4
State and Local	1.6	1.3	1.1	1.9	1.6	1.0	0.2	1.0	1.3	1.4	1.1	0.9
Final Sales	2.2	1.8	1.8	3.1	1.0	0.3	2.5	2.0	2.0	1.5	1.4	1.5
Inflation												
GDP Deflator	1.8	1.6	2.1	1.4	1.4	1.7	1.7	2.0	2.3	2.0	2.3	2.3
CPI	1.8	1.9	1.9	2.4	1.7	0.8	3.0	2.3	1.5	1.4	2.1	2.7
Core CPI	2.2	2.2	2.1	2.0	2.4	2.3	1.8	1.9	2.2	2.2	2.1	2.2
Special Indicators												
Corporate Profits[2]	-1.6	2.5	3.8	-1.6	0.9	-5.0	-1.4	2.5	5.4	8.6	5.7	3.8
Disposable Personal Income	2.9	1.9	1.9	1.7	2.8	1.8	0.9	1.5	2.6	2.4	2.0	1.6
Housing Starts (mil.)	1.30	1.40	1.41	1.45	1.44	1.36	1.39	1.41	1.41	1.41	1.40	1.42
Civilian Unemployment Rate	3.7	3.7	3.7	3.5	3.6	3.7	3.7	3.7	3.7	3.7	3.7	3.8
Total Nonfarm Payrolls (thous.)[3]	1387	475	870	217	318	-82	17	222	286	245	197	142
Vehicle Sales												
Automobile Sales (mil.)	4.9	4.3	4.1	4.5	4.4	4.2	4.2	4.2	4.2	4.1	4.1	4.1
Domestic	3.5	3.1	3.0	3.3	3.2	3.1	3.1	3.1	3.1	3.0	3.0	3.0
Imports	1.4	1.1	1.1	1.2	1.2	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Lt. Trucks (mil.)	12.1	12.3	12.1	12.3	12.4	12.1	12.3	12.3	12.2	12.2	12.1	12.0
Domestic	9.7	9.8	9.7	9.7	9.8	9.7	9.8	9.8	9.7	9.7	9.7	9.6
Imports	2.4	2.5	2.5	2.6	2.6	2.4	2.5	2.5	2.5	2.5	2.4	2.4
Combined Auto/Lt.Truck	17.0	16.5	16.3	16.8	16.8	16.3	16.5	16.5	16.4	16.3	16.2	16.1
Heavy Truck Sales	0.5	0.4	0.5	0.6	0.5	0.4	0.4	0.4	0.4	0.5	0.5	0.4
Total Vehicles (mil.)	17.5	17.0	16.7	17.4	17.3	16.7	16.9	16.9	16.8	16.8	16.7	16.5
Interest Rate/Yields												
Federal Funds	2.2	1.0	1.3	1.6	1.6	1.0	0.6	0.6	0.8	1.2	1.5	1.6
10-Year Treasury Note	2.1	1.4	2.3	1.8	1.5	1.1	1.3	1.7	2.0	2.2	2.4	2.6
Corporate Bond BAA	4.4	3.6	4.1	3.9	3.8	3.5	3.4	3.7	3.9	4.0	4.2	4.3
Exchange Rates												
Dollar/Euro	1.12	1.10	1.11	1.11	1.11	1.09	1.09	1.09	1.09	1.10	1.11	1.12
Yen/Dollar	109.0	107.0	106.0	108.7	108.5	107.3	106.3	106.0	106.0	106.0	106.0	106.0

1. In 2019, GDP was $1907.2 billion 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.

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