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A Fork in the Road:

Fear, False Narratives and Fiscal Fatigue

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The U.S. economy is at a proverbial fork in the road. Either we tame the COVID-19 virus and provide more support for households and firms ravaged by the humanitarian and economic effects, or we will suffer a deeper and longer recession. The push to reopen states before the pace of infections has crested, combined with the pushback to more stimulus from our elected officials, suggests we have chosen but it is not too late to course correct.

There are no "Field of Dreams" scenarios where if we build it, or reopen, consumers will come. The idea that we can trade health for economic policy is a false narrative; shutdowns allow stronger and more sustained recoveries. We learned this from the 1918 pandemic and are only reinforcing those lessons as countries emerge from lockdown ahead of us. A recent paper by the researchers at the Federal Reserve Bank of New York also suggests that a shortfall in funding for municipalities with the greatest deaths following the 1918 flu pandemic in Germany fueled the rise in voter support for Nazis.

Fear of infection and trust in the government matter. This was laid bare by what happened in China as it reopened. Consumers are still reluctant to return to public spaces more than a month after Wuhan reopened. The China Beige Book offers insights into the hurdles we face. More than 90% of businesses surveyed were reopened by late April, most with workers on site, but they were still operating at less than 50% of capacity. Global demand remains weak, which is further complicating their efforts to ramp up. More than 80% of executives worry about a resurgence of the virus and more than two-thirds think that business will hold at April lows for some time to come.

U.S. Joins Global Recession

Real GDP growth fell at a 4.8% pace in the first quarter, ending the expansion of the 2010s. Consumer spending and investment plummeted in advance of school and state closures as uncertainty surrounding the COVID-19 pandemic intensified. The World Health Organization did not declare the outbreak a pandemic until March 11. Government spending slowed at the federal, state and local levels while inventories were drained. The only offset was the trade deficit, which narrowed as imports fell more rapidly than exports.

Prospects for the second quarter look much worse. Real GDP in the U.S. will plummet by nearly 36% on an annualized basis because much of the global economy came to a standstill in April. States began lifting restrictions in May, before new COVID-19 cases actually fell. Consumer spending and a shart drop in inventories will drive those losses. Business investment is also collapsing. A surge in federal spending on checks to individuals, enhanced and expanded unemployment insurance, small business PPP loans, tests, ventilators and funding for hospitals offset the weakness in state and local spending. (Remember: Schools and courts were closed.)

The rebound in the second half of the year is expected to be muted. Growth in the third and fourth quarters is now expected to average 5.5%. Real GDP for the year is forecast to fall 7.2%, the worst performance since 1946 when millions of soldiers returned home from WW-II.

States that reopened before the virus crested are seeing a similar response. Malls and restaurants in Georgia are still almost empty even after the state lifted its shelter-at-home mandate. Many businesses remain shuttered as the benefits of reopening against the backdrop of social distancing don't justify the costs of staff and electricity. It is hard for a restaurant that relies on heavy crowds Thursday through Saturday to cover overhead, let alone waitstaff, when it is only allowed to be 25% full.

This should not be surprising. Consumers and companies pulled back aggressively in the weeks leading up to state-wide shutdowns for fear of infection. The survey for the March employment report, which was taken before schools closed and states shuttered, revealed a sharp drop in employment. Losses in the leisure and hospitality industry led the pack. Even health care, which rarely falters, suffered the worst losses in history as elective surgeries, doctors' appointments and dental visits were cancelled for fear of infection.

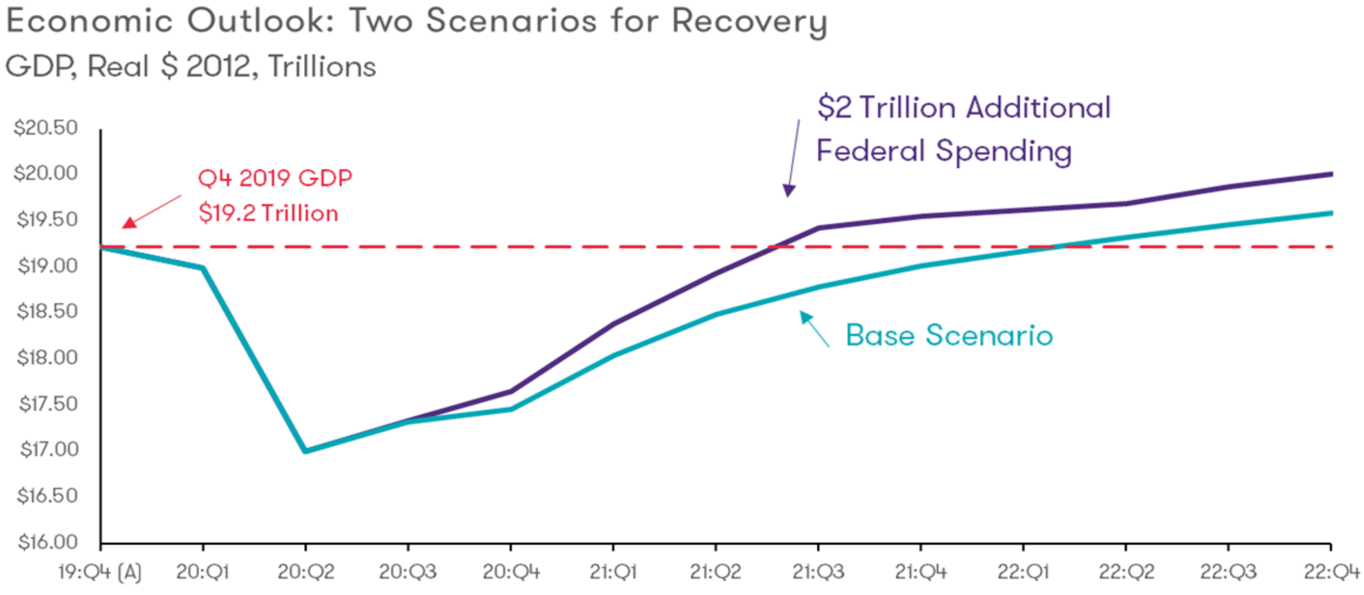
COVID-19 is first and foremost a health crisis. The shutdowns were designed to bend the curve on infections so that we could avoid overwhelming the health care system. The idea was that we would buy time - our most precious commodity in a pandemic - to limit contagion and ramp up efforts to combat the disease with treatments and, ultimately, a vaccine.

Hurdles to ramping up abroad prompted the International Monetary Fund (IMF) to further downgrade its forecast in April. The IMF is now forecasting a 3% contraction in the global economy in 2020, the biggest decline since the Great Depression. Even that forecast is too optimistic. Larger than expected losses in Europe, the UK, Japan, China and India suggest global growth could fall between 4% and 5% this year.

This edition of *Economic Currents* takes a closer look at the U.S. recession and how long it will last. The forecast is now for a deeper and longer recession than we had expected just a month ago. It doesn't have to be that way. Efforts to reopen are occurring before we have bent the curve on infections, which means higher levels of contagion, uncertainty and repeated outbreaks. Fiscal fatigue in Washington is a big factor.

Another phase of aid and stimulus is bogged down by political battles over who has liability for COVID-related infections and deaths. (Corporate and malpractice lawyers will be the only true winners here.) This is at the same time that the administration is hitting the brakes on additional aid and stimulus. White House Economic Adviser Kevin Hassett mused recently that "there may not be much need for another bill."

Chart 1



Source: BEA, Grant Thornton LLP

An unusually high level of COVID-19 cases over the summer, the risk of regional outbreaks and cuts to state and local government budgets will have an impact. This is a service sector recession, the first of its kind. The blow to discretionary services has been particularly hard and cannot easily be cured just by reopening. People need to feel confident that they can return to public areas safely before they show up. Health and economic policies are not competitive in a pandemic; they are complementary.

Special attention will be paid here to which industries can more easily open than others and how the shifts are likely to reshape the economy. The crisis will act as an accelerant on a broad array of trends from online retail, grocery delivery and telemedicine to online education. Sadly, the crisis is also expected to worsen inequality, increase consolidation across a spectrum of industries and intensify the backlash to globalization.

Deep Recession, Slow Recovery

Chart 1 compares two scenarios for the recession and eventual recovery. Our base case assumes another $500 billion in funding for unemployment insurance, paid sick leave, testing and transfers to the states. Scenario 2 lays out a more optimistic outlook with nearly $2 trillion in additional funding, including more money for the states, unemployment insurance and a multiyear infrastructure package to fuel growth on the other side of the crisis.

Both scenarios assume there will be a second wave of infections in the Fall with the onset of the flu season, which has the potential to overwhelm the health system given our inability to lower the pace of infections without further lockdowns. A second wave is assumed and feared by retailers who are bracing for a sparse holiday season. A vaccine is expected to be available next Spring but much depends upon who produces a vaccine and where. A global consortium to fund testing, treatments and vaccines has been formed by G-20 countries; the U.S. and Russia are the two countries conspicuously absent. There is some hope of a vaccine in the Fall, but the uncertainty regarding needed supply is extremely high.

Trade tensions with China are heating up; the U.S. and its trading partners are angry over how China handled the outbreak. Neither of our scenarios includes a sharp escalation of tariffs on China because of what that would mean to profits across the board but stranger things have happened.

Additional stimulus today would fuel a stronger and faster recovery. The baseline forecast now shows it will take well into 2022 to get back to the peak in economic activity we saw in the fourth quarter of 2019. Scenario 2 shows us reaching that peak in 2021, nearly a year sooner.

Consumers Remain Skittish

Consumer spending is expected to come back in fits and starts while fear of returning to public spaces remains elevated. Outdoor venues will be more popular than indoor venues as it is believed that the virus does not survive as long on surfaces in sunny, hot and humid climates. The problem is the host. The virus lives in us no matter the climate, which means that social distancing will be with us through at least the summer. That will put a damper on everything including the level of activity we see returning to restaurants, bars, retail, arts and entertainment venues.

> "The bright spot is investment in technology, which is expected to accelerate as more businesses move online and embrace working remotely."

Health care and education are also viewed as risky propositions. The pullback in visits to doctors and dentists as fear of COVID-19 infections spread is stunning. My own dentist has refused to reopen despite a loosening of the rules in Illinois because of how risky it would be for his workers and clients, and how low on the totem pole dental offices rank in getting access to critical personal protective equipment (PPE).

Education is a wild card. Many college freshmen are likely to defer starting in the Fall. They don't want to risk infection as a second wave arrives. They are also not keen on paying full tuition for hastily assembled online courses. Primary education is an even tougher nut to crack. Children are even harder to keep apart in overcrowded classrooms than adults but many parents need schools to reopen to return to work. It is unclear what role, if any, children play in the transmission of the disease. More research is needed ASAP.

The results will leave employment and wage gains suppressed with the exception of a spurt tied to the Paycheck Protection Plan (PPP) loans. In order for the government loans to become grants, businesses have to rehire workers up to February levels. When those loans expire in eight weeks, businesses that are still struggling will have to make another round of layoffs. This is at the same time that the fiscal year for many state and local governments is slated to begin, on July 1. Expect to see cuts to everything from education to first responders.

The demographics have turned against us. Baby boomers, who once drove spending with high levels of debt, are now near or in retirement. They actually banked what they saved when they refinanced their mortgages before this crisis. There is no reason to believe they will loosen their purse strings while we are still in a crisis.

Housing - Poised for a Comeback?

Home buying and building were on a tear prior to the COVID-19 crisis. After hitting the pause button, housing should be the sector to drive us out of the recession.

The problem is the credit market, which has tightened in recent weeks. Mortgage servicers are caught between homeowners, who can now defer their payments for six months to a year under the CARES Act, and their obligations to the banks who expect those payments to be made. Fannie Mae and Freddie Mac could use their reserves at the Treasury, which top $240 billion, to cover those costs but so far the administration has not allowed that to occur.

Federal Reserve Chairman Jay Powell has taken notice and will intervene if necessary. Those actions would take time and could mute the rebound in growth tied to the housing market; the demand from millennials, who had to defer home buying in the wake of the Great Recession, remains particularly strong.

Business Investment - An Albatross

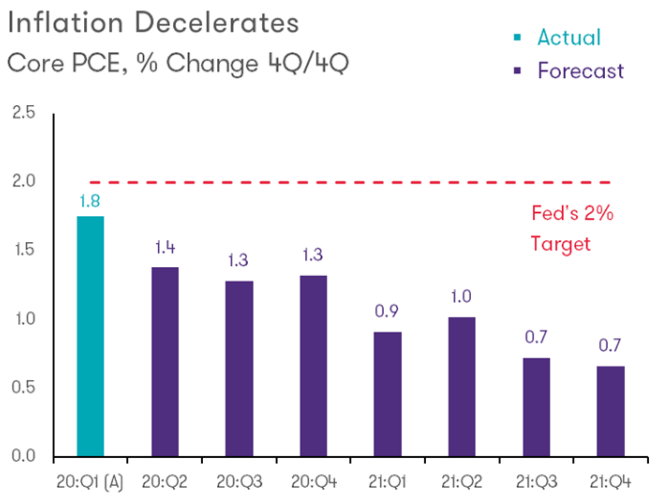
Business investment has been contracting for a year and is not expected to rebound anytime soon. Escalating uncertainty tied to COVID-19 has prompted many firms to cancel capital spending plans. Everyone from retailers to delivery companies has put capital spending on hold for 2020. Plummeting oil prices are acting as a sledgehammer on investment in the shale industry.

The bright spot is investment in technology, which is expected to accelerate as more businesses move online and embrace working remotely. The push to expand telemedicine has been rapid and is expected to intensify given the ongoing threat of infection in doctors' offices. The problem is broadband with uneven internet access for poorer and more rural communities. This is an area where infrastructure investment by the federal government could help mitigate inequality. Are you listening, Washington?

Separately, inventories will eventually have to be rebuilt, which should trigger a recovery in the manufacturing sector. Large, multinational manufacturers are particularly well positioned as they have already adopted effective protocols to sanitize premises, stagger shifts and check symptoms in hot spots abroad. Plants in Wuhan, China were among the first industries there to reopen. The costs to smaller and midsize manufacturers here will be more difficult to absorb. Meat and poultry processing plants are in a category all their own. The pace of contagion is so high that plant closings threaten our meat supply this Spring.

The greatest hurdles to reopening most plants are weak global demand and supply chain disruptions. The U.S. and Canada have plans to open borders at the same time but Mexico is a laggard because of a later outbreak. Parts literally cross the U.S. and Mexican border several times before they become a finished good. The vehicle industry is particularly vulnerable to delays coming in from Mexico.

Chart 2



Source: BEA, Grant Thornton LLP

Government Spending - Not Enough

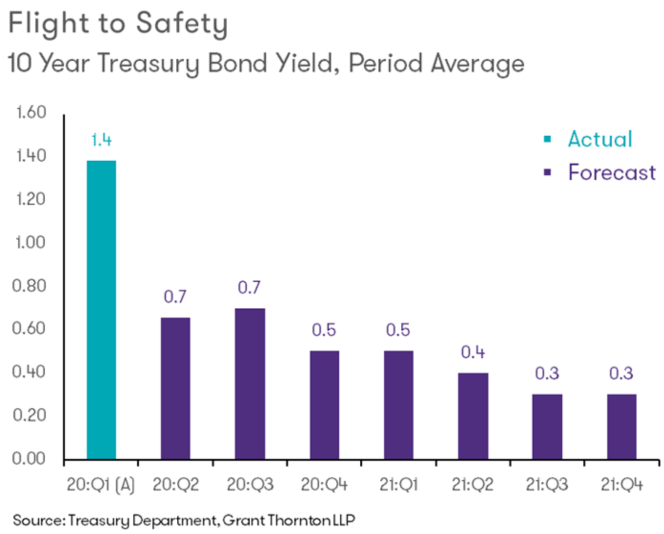
The federal government has approved nearly $3 trillion in aid, loans and grants for paid sick leave, expanded unemployment benefits, testing, research, hospitals, PPE and reimbursements for direct COVID costs for the states. It still isn't enough.

The country's leading epidemiologists are calling for billions of dollars for testing, tracing and research. We need to have multiple plants ready to start producing, regardless of whether their vaccines are the winners, once viable vaccines are discovered. Even then, we may not be able to ramp up fast enough to manufacture the millions of doses of vaccine that will be needed; the glass vials used to transport vaccines are in short supply.

The gaps in funding for state and local governments are particularly large. No state has escaped the blow to revenues triggered by COVID-19. The shortfall was exacerbated by expanding unemployment benefits to furloughed, gig and contract workers. Estimates of the shortfall range from $500 billion to $1 trillion over two years. The tourism bust in Florida and shale industry implosion in Texas are of particular concern.

Many in Washington are reluctant to "bail out" states that were mismanaged prior to the crisis. Knowing what I do about the role that state and local governments play in the speed of recovery and the unique nature of this shock, I am befuddled.

Chart 3



Source: Treasury Department, Grant Thornton LLP

State and local governments employed one in eight workers in the U.S. prior to the crisis. Shortfalls in their budgets in the wake of the Great Recession are the main reason the rebound in employment was not more robust. Cuts to education were deep in the wake of the Great Recession because real estate tax revenues dried up with the housing market bust.

The Federal Reserve will be buying municipal bonds, which will help bridge some short-term funding gaps for state and local governments, but debt alone can't cure what ails the states. State and local governments are much more tied to what they bring in terms of revenues to fund their spending. This time, cuts will come more quickly than in the wake of the Great Recession. The shortfall in retail sales revenues will show up in the new fiscal year budgets, many of which start July 1. We assume Congress will come up with a compromise to fund transfers to the states but not enough to fill the sinkholes.

Trade - A Perverse Plus

Both exports and imports imploded as economies around the world went into what the IMF termed the "Great Lockdown." The initial drop in imports outpaced the drop in exports as the U.S. was one of the last to actually close down. Those shifts will help to narrow the trade deficit and blunt the blow to the economy in the first half of the year.

The outlook for the second half of the year is more dicey. We expect imports to pick up faster than exports as the economy slowly reopens. Overall global trade flows will remain suppressed for some time to come. Escalating trade tensions and moves to tighten border restrictions are expected to exacerbate those trends and result in a slower global recovery in 2021 and 2022.

Deflation Becomes a Threat

Chart 2 shows the forecast for the core (excluding food and energy) PCE deflator, the Federal Reserve's preferred inflation measure. Inflation is expected to fall further below the Fed's 2% target in the months to come and could dip dangerously close to zero. The blow to demand triggered by the COVID-19 crisis is highly deflationary. Hence, the Fed's willingness to do all that it can to blunt that weakness and keep credit markets functioning. Deflation is much harder to deal with than inflation, which can be curbed with rate hikes.

That said, we can't rule out a secondary supply shock with widespread consolidation and production cuts resulting in shortages down the road. Fear of that has flared in the food supply chain as farmers who once serviced restaurants now let their crops rot in the fields. We see meat and poultry producing plants sidelined by a surge in COVID-19 infections that threaten our meat supplies. For the moment, those threats remain significantly smaller than deflation, especially in light of the downward pressure we expect to see in wages as the economy struggles to heal.

The Fed to the Rescue

Chairman Powell is one of the few policy makers in Washington to acknowledge that the humanitarian and economic crisis triggered by COVID-19 is unique. Businesses, states, nonprofits and households are suffering extraordinary losses through "no fault of their own." In response, the Federal Reserve has put together a large array of credit market backstops, bond buying programs, including municipal and junk bonds, direct lending programs for Main Street and unlimited purchases of mortgage-backed securities and Treasuries.

Moreover, the Fed has pledged to do more. Powell has acknowledged his concern about the market for mortgage servicers and is actively considering yield curve control, which could bring down long-term bond yields even lower than we have seen in recent months. For the moment, the Fed has sidelined using negative interest rates to stimulate the economy over concern that the costs of such a move could outweigh the benefits. Bank balance sheets and money market accounts, which provide much of the short-term lending for companies, would be especially hard hit. And, it still isn't enough.

That said, the Fed is limited in what it can do: It can lend but not spend. The latter is the purview of Congress. In a rare break from tradition, Powell was blunt in his plea for more spending by Congress in his press conference following the last Federal Open Market Committee meeting on April 29, "This is the time to use the great fiscal power of the United States to do what we can to support the economy and try to get through this with as little damage to the longer run productive capacity of the economy as possible."

> "Additional stimulus today would fuel a stronger and faster recovery."

Powell directly addressed concerns about the deficit, which he had worked to reign in earlier in his career. "The time will come… where we can think about a long-term way to get our fiscal house in order… But this is not the time…to let that get in the way of us winning this battle."

Treasury Yields Fall

Chart 3 shows the forecast for the yield on the 10-year Treasury bond. A global flight to the perceived safety of the U.S. bond market, unlimited buying by the Federal Reserve and efforts to control the yield curve are expected to push long-term bond yields closer to zero. After adjusting for inflation, bond yields are expected to move into negative territory, which means investors will be begging the U.S. government to do more to blunt the blow of recession and stimulate on the other side.

Bottom Line

The expansion following the Great Recession came to an abrupt and brutal end in the first quarter of 2020. Economic conditions grew markedly worse as states locked down to stem the spread of this deadly virus. We are not alone as much of the world shut down as well. The economy will come back in fits and starts as individual states try to reopen. The recession is now expected to be deeper and the recovery slower than we initially hoped.

The reality of living with a higher level of infections in the U.S. will leave us more vulnerable to regional outbreaks and further seed uncertainty about the future. The gaps left by state and local government spending will be larger. It doesn't have to be this way. We will never look back and say we did too much. We could look back with regret and grief, wondering: Why didn't we do more when we had the chance?

Economic forecast — May 2020

	2019 (A)	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	-7.2	5.0	2.1	-4.8	-35.7	7.6	3.4	14.0	10.1	6.7	4.9
Personal Consumption	2.6	-8.2	6.0	1.8	-7.6	-42.0	18.2	6.9	11.1	10.8	8.1	6.9
Business Fixed Investment	2.1	-12.7	-1.0	-2.4	-8.6	-33.9	-20.7	-1.3	9.9	8.1	6.2	5.4
Residential Investment	-1.5	-11.9	13.1	6.5	21.0	-59.3	-25.3	13.0	36.1	44.8	35.0	22.9
Inventory Investment (bil $ '12)	67	-202	12	13	-16	-114	-299	-378	-131	-5	72	111
Net Exports (bil $ '12)	-954	-602	-754	-901	-817	-648	-461	-480	-558	-689	-825	-943
Exports	0.0	-10.5	8.3	2.1	-8.7	-41.7	-2.3	21.6	18.7	11.7	9.6	9.2
Imports	1.0	-17.8	11.8	-8.4	-15.3	-46.9	-25.4	20.9	28.3	30.1	27.0	22.6
Government Expenditures	2.3	2.0	1.3	2.5	0.7	2.6	2.5	1.2	1.4	1.1	0.6	-0.3
Federal	3.5	4.6	2.1	3.3	1.7	8.7	6.8	3.2	1.0	-0.8	0.3	0.2
State and Local	1.6	0.4	0.8	2.0	0.1	-1.0	-0.1	-0.1	1.6	2.3	0.8	-0.7
Final Sales	2.2	-6.0	4.0	3.1	-4.3	-34.3	11.5	4.9	8.7	7.5	5.2	4.2
Inflation												
GDP Deflator	1.8	1.1	0.8	1.4	1.4	-1.0	2.4	1.3	0.3	0.7	0.7	1.0
CPI	1.8	1.1	1.8	2.4	1.2	-3.2	3.0	3.1	1.7	2.0	1.2	1.7
Core CPI	2.2	2.1	1.2	2.0	2.1	1.2	2.9	1.6	0.3	1.0	0.7	1.5
Special Indicators												
Corporate Profits[2]	2.2	-18.9	20.3	2.2	-6.6	-23.9	-19.0	-18.9	5.0	27.2	23.0	20.3
Disposable Personal Income	2.9	3.5	0.8	1.6	0.5	11.5	11.4	-11.8	1.9	2.3	2.4	-1.0
Housing Starts (mil.)	1.30	1.12	1.48	1.44	1.47	0.83	0.99	1.21	1.28	1.50	1.51	1.64
Civilian Unemployment Rate	3.7	12.5	10.5	3.5	3.8	17.0	15.3	13.9	13.6	10.9	9.7	7.8
Total Nonfarm Payrolls (thous.)[3]	1383	-20751	17428	216	279	-25382	1165	3187	3527	5858	3427	4616
Vehicle Sales												
Automobile Sales (mil.)	4.9	3.4	4.0	4.5	4.0	2.4	3.4	3.7	4.2	4.0	4.0	3.9
Domestic	3.5	2.5	2.9	3.3	2.9	1.8	2.5	2.7	2.9	2.9	2.9	2.8
Imports	1.4	0.9	1.2	1.2	1.1	0.6	0.9	1.0	1.3	1.1	1.1	1.1
Lt. Trucks (mil.)	12.1	9.3	12.6	12.3	11.2	7.3	8.5	10.2	11.5	13.0	13.0	12.9
Domestic	9.7	7.3	9.9	9.7	8.9	5.7	6.5	8.0	9.0	10.3	10.2	10.0
Imports	2.4	2.0	2.7	2.6	2.3	1.6	2.0	2.2	2.5	2.7	2.8	2.9
Combined Auto/Lt.Truck	17.0	12.7	16.6	16.8	15.1	9.7	11.9	13.9	15.7	17.0	17.0	16.8
Heavy Truck Sales	0.5	0.3	0.4	0.6	0.4	0.2	0.2	0.3	0.4	0.4	0.4	0.5
Total Vehicles (mil.)	17.5	12.9	17.1	17.4	15.5	9.9	12.1	14.2	16.1	17.4	17.4	17.3
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	0.4	1.8	1.4	0.7	0.7	0.5	0.5	0.4	0.3	0.3
Corporate Bond BAA	4.4	3.4	3.2	3.9	3.9	4.4	2.6	2.8	3.9	2.8	3.2	2.7
Exchange Rates												
Dollar/Euro	1.12	1.10	1.09	1.11	1.11	1.10	1.09	1.08	1.08	1.08	1.09	1.10
Yen/Dollar	109.0	106.9	106.0	108.7	108.8	106.8	106.3	106.0	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.

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