



ECONOMIC CURRENTS

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Quarantine: How Deep Will the Recession Be?

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Late last week, my colleague made a difficult decision to cancel a trip home to see her grandparents for her birthday. They are in their 90s and she didn't want to risk contagion given the growing body of evidence that young adults can be effective carriers of COVID-19 without showing symptoms. She was later thankful given the crowds that flooded O'Hare airport when travelers abruptly returned home from hot zones in Europe.

Then the cascading events that we have seen play out in countries around the world started to unwind here. Governors declared states of emergency, universities and school districts closed, restaurants and bars closed - even fast food chains shifted to drive-through. Air travel was cancelled. Cities were shut down. San Francisco has a "shelter in place" order but compliance is **spotty**. The mayor of New York said a similar order could be put in place for the country's largest city.

"[Americans] should be prepared that they're going to have to hunker down significantly more than we as a country are doing."

-Dr. Anthony Fauci,
The National Institutes of Health
March 15, 2020, NBC News "Meet the Press."

The Federal Reserve made an aggressive cut in rates to zero and offered up new ways to keep credit markets - the oil of the markets' machinery - from further seizing up. Fed officials knew we were about to enter yet another stage in the quarantine that would deal a devastating blow to the economy. Layoffs have surged across everything from manufacturing to the service sector. What was first and foremost a health crisis has rapidly mutated into a financial crisis. Cash flow for many firms disappeared overnight and because of the sheer magnitude of the losses, layoffs were immediate.

Chart 1

U.S. Outlook: COVID-19 Recession
GDP Percent Change, Annualized Rate



Source: BEA, Grant Thornton LLP

Sadly, financial market participants realized that the rate cuts that supported them for so long were not enough to cure what ails us. We need a mass infusion of what I am now calling stop-gap measures by Congress and the administration to prevent individuals and firms from needlessly slipping into insolvency as the expanding quarantines are bringing much of the economy to a standstill. A recession is inevitable; the only question is whether we can prevent what was first and foremost a health crisis from mutating further into a financial crisis. On March 16, the stock market suffered its worst one-day drop since October 1987. (This isn't my first rodeo.)

My colleague and I sat down - a socially appropriate distance apart, armed with hand sanitizer and disinfectant wipes - to work through scenarios. How many millions of jobs will be lost? Will members of Congress act quickly and aggressively to keep individuals and firms afloat in what are now COVID-19-tainted waters? Could they shelve ideological differences to defeat a common enemy, the devastation wreaked by COVID-19?

This report provides an update on our outlook now that the virus has spread. The global economy slipped into recession in the first quarter. Growth in seven of the ten largest economies is coming in flat to negative. The contraction in China is unprecedented. The U.S. is also slipping into recession. Some losses, such as meals not eaten out, sporting events and shows cancelled cannot be recouped. The only question is whether we can quarantine effectively enough to flatten the curve on outbreaks and avoid the devastation Italy is enduring.

A shortage of protective medical gear is further complicating matters. Tariffs on some \$5 billion in face masks, gloves and high-tech medical equipment from China have curbed those imports since 2018. The president quietly rolled back those tariffs on March 10, but we are now competing with the rest of the world for those supplies. This is at the same time that European countries including France and Germany have stopped all exports of protective medical gear to deal with their own shortages.

The good news is that Washington has finally woken up and realized the severity of the crisis. The president is asking for a \$1 trillion package to blunt the blow to the economy and set the stage for a more robust recovery. Congress passed a \$100 billion package, including paid sick leave, but is still mulling its options on other stimulus.

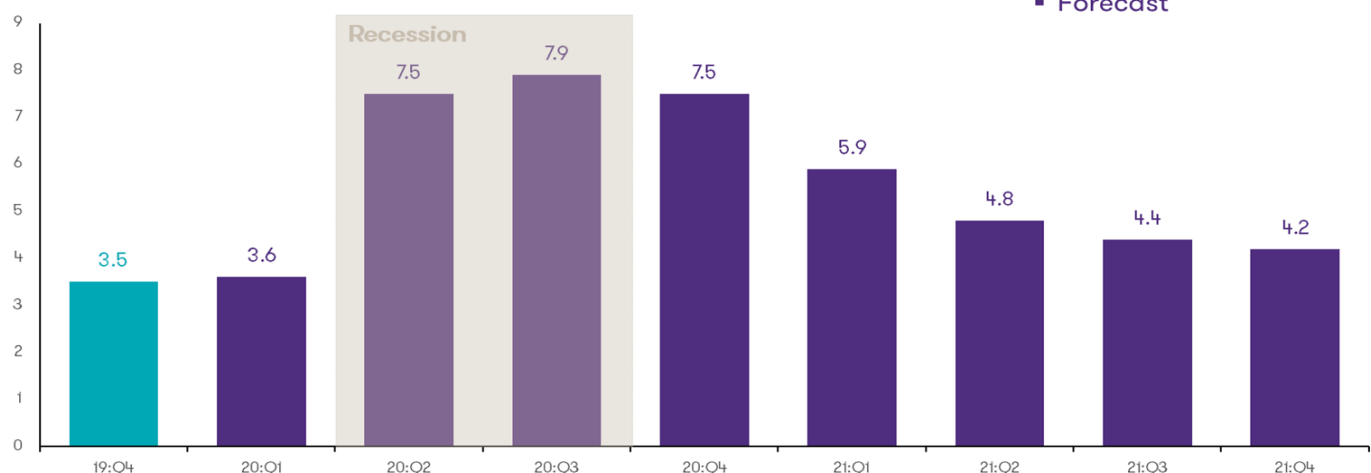
A Viral Recession

Chart 1 shows the outlook for a recession in 2020. Efforts to contain the virus have led to city-wide shutdowns and triggered layoffs in everything from manufacturing to the service sector, with the exception of health care. This recession is abrupt and deep, with the worst of the losses coming in the second quarter. Increased access to testing and the development of antiviral drugs should allow the economy to start to ramp up, despite a second wave of infections in the fourth quarter. South Korea and Singapore have shown that aggressive testing and technology have enabled them to identify hot zones and avoid mass closures.

Chart 2

U.S. Outlook: Unemployment Spikes

Unemployment Rate, %



Source: BLS, Grant Thornton LLP

There also may be a light at the end of the tunnel on treatment. Research in France **suggests** that an existing drug to treat malaria may combat symptoms of COVID-19. A vaccine is expected to take longer, a year or more, to develop and mass produce.

Chart 2 shows the jump in the unemployment rate from a low of 3.5% in January to a high of 7.9% in the third quarter. That marks the highest level for unemployment since the third quarter of 2012, when we were still struggling to emerge out of the Great Recession. Job losses due to this recession are expected to top seven million, just a bit shy of the eight million we lost during the Great Recession.

The magnitude of job losses could be even higher, given the breadth of industries affected. Proposals to provide small businesses with funding to bring workers back to their payrolls, even as they remain laid off, would dampen the drop in reported payroll employment. Another quirk in the data is the participation rate, which could fall precipitously, as workers shut in and locked out of work can't even look for work.

The silver lining is that unemployment could fall sharply as businesses ramp up and workers are called back. That assumes that the government provides the stop-gap measures necessary to keep individuals and businesses afloat during the worst of the crisis. The goal is to have a foundation from which the economy can more easily recover.

Consumer Spending Plummets

Everything from the need for "social distancing" - the Centers for Disease Control and Prevention (CDC) **issued guidelines** to stay six feet away from others in public and limit social gatherings to no more than 10 people - to job losses and the stock market rout will prompt an abrupt drop in consumer spending. As of the writing of this report, several cities were shutting down. The losses will be broad-based and much larger than we saw at the onset of the global financial crisis.

Online spending and home deliveries of food can't begin to compensate. The hoarding of hand sanitizer, sanitizing wipes and toilet paper will borrow from spending later in the month, but pale compared to the drop in spending elsewhere in the economy. Store closings have surged.

The lesson from the SARS epidemic suggests that consumers remain skittish, even after an outbreak has peaked. That further argues for a slow rebound in the fourth quarter and a much stronger rebound at the start of 2021.

Lower oil prices work much like lower interest rates. They can't do much to stimulate demand until consumers can leave their homes and drive to work.

Housing Pauses

The housing market has been on a tear. Sales will drop as major cities shut down and uncertainty about the economy spikes. Job losses are expected to prompt a jump in contract cancellations. The only silver lining is mortgage restructuring; refinancing activity jumped even as the crisis started to unfold. Demand was so strong that mortgage rates spiked while the 10-year Treasury bond dropped to record lows. Interventions by the Federal Reserve in the mortgage-backed securities market are helping to reverse the sharp rise in rates and seed the ground for a much stronger rebound in the housing market down the road. Add tight inventories and the pent-up demand for home ownership by millennials, and the housing market will reclaim its role as a driver of gains out of the recession.

Losses in Business Investment Compound

Business investment appears to have contracted for the fourth quarter in a row during the first quarter. Disruptions to supply chains triggered by the outbreak in China exacerbated those losses in February and early March. The Empire State manufacturing index dropped precipitously to its lowest level since 2009 in March. Add plant closings - the UAW requested that the automakers shut their plants for at least two weeks to prevent the spread of the virus - and the uncertainty surrounding the virus itself. The fate of Boeing's 737 Max is also uncertain, given the turbulence in the airline industry.

The blow from the drop in oil prices to the shale industry will be particularly large. A sharp drop in demand and the price war between Russia and Saudi Arabia have pushed prices well below break-even for the industry. Russia and Saudi Arabia would like to see less shale production in the U.S. High debt levels and a surge in bankruptcies prior to the crisis virtually guarantee it.

Government Spending Explodes

The **administration** is asking for more than \$1 trillion in stimulus to combat the economic effects of the virus. It is asking Congress to approve two \$1000 checks per person (with potential clawbacks for wealthy households), a broadening of unemployment insurance, sick pay, bailouts, tax credits, delays in tax payments, transfers to the states, increased funding for Medicaid and a surge in spending on tests and triage for hospitals. This is in addition to the \$50 billion in funds freed up when the president declared the situation a “national emergency” on March 13. We are assuming Congress will comply with the size, if not the composition of that request.

That surge in spending cannot derail a virus-induced recession. It can blunt the blow to GDP that we will endure in the second and third quarters, and set the stage for a more robust rebound in growth down the road.

Imports and Exports Fall

The trade deficit is initially expected to narrow but for the wrong reason: Imports fall more rapidly than exports, particularly in the first quarter. Imports from China came to a virtual standstill in February and March. A similar phenomenon occurred during the height of the financial crisis when trade flows slowed as commerce between countries ground to a halt. These shifts will exacerbate the slowdown in trade flows triggered by trade wars.

Risks: The recession could be significantly deeper than we are forecasting. The blow to China’s economy was much larger than anyone imagined. Lockdowns in the U.S. are so far much smaller and harder to enforce. But the blow to wages and wealth is real, even with stop-gap measures.

The Fed Intervenes

The Federal Reserve stepped up with a series of actions in recent weeks. It cut rates to zero, eliminated bank reserve requirements and encouraged banks to waive late fees and delay payments for borrowers in the worst affected markets. The Fed provided collateralized loans to banks to keep the overnight credit market from seizing up, extended the length of loans and swap lines for foreign banks scrambling for dollars and launched another \$700 billion round in asset purchases: \$500 billion in Treasuries and \$200 billion in mortgage-backed securities to keep those markets functioning.

“This recession is abrupt and deep, with the worst of the losses coming in the second quarter.”

On St. Patrick’s day, the Fed went a step further and intervened in the commercial paper market. Firms unable to get short-term lending were forced to make massive layoffs during the worst of the global financial crisis in 2008. The Fed was not going to allow that to happen again.

Those interventions helped to counter a marked tightening in credit conditions. However, they can’t do much to stimulate demand until consumers can leave their homes and congregate again. Fed Chairman Jay Powell admitted as much in the **press conference** that followed the Fed’s historic move on rates and asset purchases referred to as quantitative easing.

Former Fed Chairs Ben Bernanke and Janet Yellen **suggested** that the Fed seek approval from Congress to buy corporate bonds, which are seizing up as well, and restart the **Long-Term Asset-Backed Lending** facility. The latter allowed the Fed to expand credit to households and businesses during the height of the financial crisis in 2008-09. Intervening in the corporate bond market is a tool that the European Central Bank (ECB) already has utilized; the Fed should have it as well. Bernanke and Yellen have the benefit of hindsight; they know how much worse this crisis could get if we can’t stabilize financial markets.

The Bond Market Screams for Stimulus

The yield on the 10-year Treasury bond dropped well below 1% in recent weeks. Real (inflation-adjusted) bond yields moved into negative territory. Investors are essentially saying they are willing to pay the federal government to issue debt and bridge COVID-19-tainted waters, rather than risk the economic losses and blow to tax revenues that would occur if it doesn’t.

That message is finally getting through. The administration and Congress need to make good on their promises to be believed. Talk is cheap.

Further complicating matters is the spread of the virus. There are now cases in all 50 states. Those numbers are expected to surge with a rise in the availability of tests. That will further rattle markets. The fear is that we could face a total lockdown in economic activity, not unlike what we are now seeing in other western economies. It is much harder to contain a virus in a world where people have more freedom of choice.

Companies Hemorrhage Losses

Announcements regarding COVID-19 related losses in profits started with the shutdown of China and have compounded since then. One would be hard pressed to find a sector of the economy not affected by the spread of the virus.

The blow to profits in the second quarter is expected to be particularly large. Bailouts and structured loans are needed and could eventually stem those losses but won't cure the problem.

Uncertainty about the size of losses, when the outbreak will crest, and what the economy will look like on the other side of this crisis is fueling the downdraft in stock prices and market volatility. The VIX, a measure of market volatility, crossed 85 on March 16, a new record. We won't get a break in volatility until the veil of uncertainty about how the economy emerges from the crisis is lifted.

Hopes are high for a crest in the outbreak in May or June, but other outbreaks have lasted through the summer. My kids and I came down with the swine flu in July of 2009. This is really hard for everyone, especially those looking at their 401(k)s and worrying about how they will support themselves in retirement.

Bottom Line

Amidst our effort to put this forecast together, I took a break to call the restaurant I had booked for my mother's 80th birthday party. The manager, Kristina, took my call. I said I wanted to delay my mom's party until after the threat of infection abated. She had been taking calls like this all day. The university in town had closed and cancelled graduation. Wait staff had shown up with no place to live after the dorms closed, now homeless and unemployed. They were all in tears, while she scrambled to figure out how to ramp up pickup and deliveries.

This wasn't my first call like this. I had been on the phone all weekend, talking with business owners who were running out of cash and forced to make layoffs. Their business seemed to vanish overnight, through no fault of their own. I looked up and my colleague wiped a tear from her eye. The weight of the numbers we had been staring at all day had become a reality. I felt a pit in my stomach as she processed it all, on a birthday she would soon be celebrating alone.

Isolation is its own toxin. Call your family, your friends, or say hello to the person who walks alone every day. We are in a war to defeat a common enemy - COVID-19. We are stronger in that battle united than alone and divided. Be safe. Stay well.

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	-0.6	2.0	2.1	0.6	-6.8	-2.7	2.1	6.5	2.3	1.9	2.1
Personal Consumption	2.6	-0.7	2.1	1.7	1.0	-8.7	-3.4	2.9	6.0	3.4	2.2	2.2
Business Fixed Investment	2.1	-8.9	0.3	-2.3	-3.5	-23.4	-20.0	-0.7	9.7	8.6	6.2	5.7
Residential Investment	-1.5	3.0	5.1	6.1	11.1	-5.1	-3.1	2.4	5.9	8.5	12.7	13.3
Inventory Investment (bil \$ '12)	67	-48	102	13	-32	-148	-49	39	127	115	92	73
Net Exports (bil \$ '12)	-954	-802	-849	-900	-872	-816	-744	-775	-822	-851	-852	-873
Exports	0.0	-7.9	5.8	2.0	-4.7	-29.9	-8.8	9.7	15.3	12.6	10.1	5.4
Imports	1.0	-10.1	5.8	-8.6	-6.5	-28.3	-14.9	11.6	18.0	13.2	7.6	6.6
Government Expenditures	2.3	5.4	-1.0	2.6	1.9	26.8	-2.1	-5.8	0.0	-4.2	-2.4	-0.3
Federal	3.5	11.8	-4.5	3.8	1.4	79.2	-6.2	-15.7	-2.4	-12.0	-7.7	-2.3
State and Local	1.6	1.6	1.3	1.9	2.2	1.0	1.0	1.7	1.6	1.0	1.0	1.0
Final Sales	2.2	-0.1	1.3	3.1	1.4	-4.8	-4.4	0.4	4.8	2.5	2.4	2.4
Inflation												
GDP Deflator	1.8	1.2	1.5	1.4	1.0	0.3	1.3	1.3	1.3	2.0	1.7	2.0
CPI	1.8	0.7	1.9	2.4	-0.3	-2.3	2.0	2.4	1.7	3.0	1.8	1.7
Core CPI	2.2	1.7	1.4	2.0	2.0	0.9	0.9	1.0	1.5	1.9	1.8	1.9
Special Indicators												
Corporate Profits ²	-1.6	0.6	3.5	-1.6	0.6	-2.5	-2.7	0.6	6.2	4.4	4.6	3.5
Disposable Personal Income	2.9	1.1	1.6	1.7	3.9	0.3	-4.7	0.4	5.2	1.8	3.1	2.4
Housing Starts (mil.)	1.30	1.35	1.56	1.45	1.45	1.26	1.30	1.39	1.42	1.52	1.62	1.70
Civilian Unemployment Rate	3.7	6.6	4.8	3.5	3.6	7.5	7.9	7.5	5.9	4.8	4.4	4.2
Total Nonfarm Payrolls (thous.) ³	1387	-5598	6081	217	319	-6461	-326	870	2584	1914	1011	572
Vehicle Sales												
Automobile Sales (mil.)	4.9	3.2	4.1	4.5	3.9	2.0	2.9	3.9	4.0	4.1	4.0	4.1
Domestic	3.5	2.3	3.0	3.3	2.9	1.5	2.0	2.9	2.9	3.0	2.9	3.0
Imports	1.4	0.9	1.1	1.2	1.0	0.5	0.9	1.0	1.1	1.1	1.1	1.1
Lt. Trucks (mil.)	12.1	9.7	12.6	12.3	11.5	7.5	9.3	10.5	12.3	12.6	12.8	12.8
Domestic	9.7	8.0	10.0	9.7	9.3	6.5	7.5	8.5	9.7	10.0	10.1	10.1
Imports	2.4	1.8	2.7	2.6	2.2	1.0	1.8	2.0	2.6	2.6	2.7	2.7
Combined Auto/Lt.Truck	17.0	12.9	16.7	16.8	15.4	9.5	12.2	14.4	16.3	16.7	16.8	16.9
Heavy Truck Sales	0.5	0.3	0.4	0.6	0.5	0.2	0.2	0.3	0.4	0.4	0.4	0.5
Total Vehicles (mil.)	17.5	13.2	17.1	17.4	15.9	9.7	12.4	14.7	16.7	17.1	17.2	17.4
Interest Rate/Yields												
Federal Funds	2.2	0.4	0.1	1.6	1.3	0.2	0.1	0.1	0.1	0.1	0.1	0.1
10-Year Treasury Note	2.1	0.9	1.2	1.8	1.3	0.6	0.8	1.0	1.0	1.1	1.3	1.4
Corporate Bond BAA	4.4	4.3	3.0	3.9	4.4	5.2	4.0	3.4	2.8	2.8	3.1	3.2
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 \$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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