Economic Insights: **Roaring into recession**

April 2020 commentary

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The world economy began a pandemic recession in February. It arrived in the United States in March. Equity and credit market pain was intense because the range of credible downside outcomes was so wide.

There were no safe havens.

A temporary equity trough may have been reached on March 18, but market turmoil will persist until the count of new virus cases peaks.

Unprecedented fiscal and monetary measures should keep the virus recession from morphing into an insolvency crisis with prolonged financial upheaval.

Recession likely began in March

It will be impossible to avoid a contraction of world economic output with production and consumption being drastically curtailed

- Growth in China in January and February fell, and savagely, for the first time since records began.
- Industrial production plunged 13.5%.
- Vehicle sales shrank 41.9% and retail sales collapsed 20.5%, all from the prior year period.
- Surveys of purchasing managers plummeted in Europe, Japan, and the U.S., some below the level of the financial crisis.
- Regional Federal Reserve (Fed) surveys of manufacturers in New York, Kansas City, and Philadelphia nose-dived into retrenchment territory.
- High-frequency U.S. data on restaurant visits, airline travel, and box office receipts have fallen 90% or more.
- Initial claims for U.S. jobless compensation surged to 3.28 million more than four times the prior week record from 1982.

The growth hits are staggered, based on the onset of virus infections. China, where the virus originated in December, had its worst shutdown in February. Businesses have since restarted and will be mostly back in production soon. Rush-hour traffic monitors show many Chinese cities fully back to normal. Weekend traffic has been mostly nonexistent until last weekend. Economic activity in Japan and South Korea likely troughed while most of Europe and the U.S. is still closed.

Our U.S. Recession Dashboard tells us recession risk is high, but simple observation suggests it started in March. Our forecasts convey a first quarter contraction of gross domestic product (GDP) near 3%, followed by an historic slump over 10% and a third quarter tumble around 2%.

Growth should revive in the fourth quarter. Here's why.

Recovery

How do we get out of this? Not gonna happen until new cases peak and businesses restart.

China's major outbreak began January 15, new virus cases peaked mid-February, and businesses began to reopen in the following two weeks. By the end of February, new cases had fallen more than 90%. In February, virus problems in Europe appeared first in Italy. Italy's new cases seem to be stabilizing with a peak so far on March 21. The crest may be near in Spain as well. If the U.S. faces a similar cycle, new cases should max out in 1-2 weeks. Perhaps, some light at the end of a very long tunnel.

Further, consider a recession: the period between the peak of an expansion and trough of the downturn. It's a decline in economic activity lasting a few months, impacting real income, wholesale-retail sales, employment, industrial production, and GDP.

Typically, recessions begin from imbalances that build toward the end of an economic expansion. Debt gets too high, defaults surge, bad loans cause banks to fail; the Fed hikes rates markedly; oil prices spike; inflation rages; fast wage gains turn profits into losses; a profit plunge brings layoffs and joblessness; consumers lose confidence and cut spending. None of that has yet happened. This time, recession was a deliberate policy choice to slow the spread of an infectious virus.

This is a far different type of contraction—its origin a shock—so it may unfold in an atypical fashion. It's already triggered massive fiscal and monetary responses by governments and central banks. Nothing in history is remotely comparable: a $2.2 trillion U.S. rescue package on top of more than $100 billion in prior relief, plus trillions of debt purchases by the Fed. The European Central Bank (ECB) authorized €750 billion in new bond purchases with fewer country limits. Official interest rates are near-zero most everywhere. Big relief measures in the United Kingdom, Australia, Japan, New Zealand, Norway, Canada, Switzerland, India, Sweden, Taiwan, and Singapore, to name a few.

With this huge support effort, U.S. households may not suffer the collapse in confidence that comes with a typical recession. Yes, unemployment will surge from business closures. But if the downturn is unrelated to economic imbalances and possibly short, businesses and consumers may look beyond the shutdown shock to a growth revival and come back online more quickly.

At least, that's the hope. Right now, forecasts are only guesses.

An economic future

Second quarter growth outside Asia will be horrific. A decent rebound should be evident in the U.S. sometime in the third quarter; the income supplements will make up for a lot of lost wages. If problems last longer, more money will be sent from Washington; Congress is already talking a Phase 4 bill. The gradual restart to the U.S. economy will prevent any V-shaped surge. Still, the U.S. could revert to trend growth in the fourth quarter and 2021. The rebound will be slower in greater Europe and Japan and start later in the year.

We'd caution against getting too wrapped up with spreading horror forecasts of U.S. growth. Besides, a therapy may soon be available: Warmer weather could hinder the virus' spread and cooped-up families will want to see the sun.

The outbreak of Covid-19 will have long-lasting but unknown consequences. Globalization had been fading anyway, but is this its death-knell? Will this stint of massive working-from-home be the doom of centrally located office space? Will home delivery from online sources crimp retailers and malls even further? What will be the relationship between the U.S. and China as China stresses the advantages of an authoritarian state and builds alliances in Europe? Can schools and universities ever be the same after a few months of forced online classes?
So many questions, so little clarity.

Focus on markets

March was ugly. A few U.S. treasury bond indices did show positive returns; wheat and gold prices rose, but few investors were so positioned. Not one of the 47 world stock indices we follow rose. The equity market collapse was so brutal because the range of credible downside outcomes was so large.

Stock markets in China were leading performers as the country was the first to recover from the virus. The Shanghai Composite Index only fell 4.0% and 9.4% for the quarter. The S&P 500 Index plunged 11.0% and 18.6% for the quarter. Even with a ferocious three-day rally, that index is still down 25.1% from its peak through March 27. It's still one of the better performing world equity indices.

The speed and severity of the month-long waterfall suggest it was driven partly by panic. It was exacerbated by forced selling from quantitative funds that must maintain certain risk levels, i.e., the further markets fall, the more you have to sell. That's akin to the selling generated by "Portfolio Insurance," which accelerated the massive drop on October 19, 1987, Black Monday. Forced selling seems mostly over.

The risk for markets is that this sudden economic downdraft turns into another financial crisis, as it could if the cash crunch for small businesses from widespread closures results in defaults. The equity risk is a full 50% decline in the S&P 500 Index to the 1700 level, another 20% or so down from the March low. While plausible, the colossal relief packages suggest this isn't the most likely outcome.

Investment ideas

In short, it's likely too early yet to buy. The assumption behind our investment strategy is that the virus contagion in the U.S. and Europe will follow a path similar to China. The economic disruption should begin to fade late in the second quarter. This means growth should return through the summer. The net result is that stock markets could recover a good share of their recent losses in the second half of this year.

If growth returns, the plummet has run its course. We expect markets to thrash in a wide range until new cases peak and Europe and the U.S. start back to work. Even so, disaster worries may return and prompt a relapse that retests or exceeds the March low. Since growth should come back later in the year, that retest, perhaps in May or June, would be a good time to move equities to overweight in individual portfolios.

On a six- to nine-month outlook, we prefer cyclical sectors to defensive, i.e., financials, consumer discretionary, materials, and technology rather than recent outperformers such as health care, utilities, or consumer staples. With super-low interest rates and the U.S. dollar likely to weaken further, we'd prefer emerging market stocks to those in developed countries outside the U.S.

Interest rates are likely to stay very low. The Fed and other central banks aren't likely to raise official rates until well into 2021. The revival of growth, though, should put modest upward pressure on long-term interest rates. That would steepen the yield curve and be good for financial stocks. That's already begun. Yields on safe-haven government bonds are so low as to be unattractive for long-term investors. We'd avoid long-maturity safe-haven bonds: U.S. treasuries, German bunds, and Japanese government bonds.

Credit spreads on high-yield bonds have widened dramatically, but it's the bonds of energy companies that have driven the widening given the nose-dive in oil prices. Yields on non-energy bonds may not yet be high enough to offset the risk of further downgrades. We like bonds that the Fed is buying: high-quality investment grade and municipal bonds over high-yield. Still, some high-quality, high-yield bonds may offer a bit more yield. We'd stay with short-to medium-term corporates and municipals. The Fed will be active in these markets, keeping prices from collapsing.

All these suggestions are tactical in nature. Long-term investors should consider whether the virus onset and massive fiscal and monetary relief packages under way will alter the investment climate of the 2020s. We think so; it may be vastly different than what occurred post March 2009. As the underlying financial framework changes, significant market dislocations, i.e., bear markets, usually occur. Those bear downdrafts have often been the line of demarcation between two dissimilar investment environments. We'd guess this bear market is no different.

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