ECONOMY & MARKETS

# What is the real impact on the economy—and what can provide relief?

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Insights into what we may have to face and how governments are responding

The magnitude of the coming first-half slowdown is going to be severe—and, to be clear, this slowdown is a necessary consequence of halting activity to prevent the spread of the COVID-19 virus. But how negatively the virus affects the economy, markets and investors greatly depends on how governments respond.

How dark are the clouds on the horizon?

- Recession—For the first half of the year (H1), we now expect a global and U.S. recession. Many regions can expect to see the sharpest quarterly GDP contraction on record. Our outlook for full-year 2020 is a GDP contraction for the United States and the Eurozone of around -1.2%, and at the global level, meager growth between 0% and 0.5%, the slowest since the global financial crisis.
- U.S. unemployment—Unemployment could spike in the coming weeks, as more than 20% of U.S. employment is vulnerable to reduced hours and layoffs. Sufficient fiscal policy responses that replace lost income and keep businesses afloat will be needed to avoid sustained high unemployment.

Our sense is that economic analysts have not appreciated the potential severity of the social distancing–induced slowdown we are going to see reflected by the economic data in the coming months. Data released from China for the month of February are consistent with GDP growth of -20% year-over-year (YoY) and suggest how ugly it may get in the West. For this reason, in the United States, policies set by the federal and state governments are extremely important. Their responses will determine how long unemployment lasts and how badly this slowdown hurts. For it to be sufficient, the fiscal response in the United States should come quickly and be in the trillions.

What this scary economic data and uncertainty surrounding the fiscal response mean for markets is less clear. As of March 20, markets were pricing in global GDP growth of around 1%, which is greater than we project. However, markets were pricing in close to 4% before the selloff date, which means the vast majority of market declines are likely behind us. In other words, markets shot first, and economists are shooting second with their downward growth revisions.

Nobody really knows how restrictive social distancing will be, or how long the virus will be with us. Given such uncertainty, we think it's more fruitful to provide a range of possible outcomes for U.S. GDP growth in the first half of this year, and some sense of the fiscal stimulus that may be needed to offset these projections.

The tables below provide "choose your own adventure" scenarios. To construct them, we isolate those sectors in the GDP accounts that are most at risk from social distancing: air travel, movies, sporting events, etc. Then, assuming a spillover multiplier to other sectors, the output becomes a function of time and the utilization rate.

## How low can GDP go?

To give you a sense of the magnitude of the potential GDP decline, if social distancing were in place for three months and the relevant sectors ran at just 20% utilization (extreme but not completely unrealistic assumptions), the result would be a -23.7% annualized drop in GDP in the first half of the year. In this scenario, we'd experience most of the pain in Q2 and witness the sharpest post-war quarterly decline in GDP: roughly -20%. That would be essentially double what is currently the worst quarterly drop on record: -10% in Q1 1958.

Economists in our Investment Bank currently expect a Q2 annualized decline of -14%. Our outlook for full-year 2020 is a GDP contraction for the United States and the Eurozone of around -1.2%. At the global level, we see meager growth of between 0% and 0.5%.

Embedded in our view is an expectation that the West will experience a level of social distancing broadly similar to what unfolded in China, and that it will last through the end of May. Fiscal stimulus may help, and we will adjust our estimates as details of that response become concrete.

## How much could the virus response drag down first-half 2020 GDP growth?

| Reduction in activity vs. normal | Weeks of required "social distancing": 4 | 6 | 8 | 12 | 16 |
|---|---|---|---|---|---|
| -10% | -1.1% | -1.6% | -2.2% | -3.2% | -4.3% |
| -20% | -2.2% | -3.2% | -4.3% | -6.4% | -8.4% |
| -33% | -3.5% | -5.3% | -7.0% | -10.3% | -13.6% |
| -50% | -5.3% | -7.9% | -10.4% | -15.4% | -20.1% |
| -67% | -7.1% | -10.5% | -13.8% | -20.1% | -26.1% |
| -80% | -8.4% | -12.4% | -16.3% | -23.7% | -30.5% |
| -90% | -9.4% | -13.9% | -18.2% | -26.3% | -33.8% |
| -95% | -9.9% | -14.6% | -19.1% | -27.6% | -35.4% |

Source: BEA as of February 29, 2020.

### Fiscal policy to the rescue?

There is an economic principle called Okun's Law that relates GDP declines to rises in the unemployment rate. Policymakers are attempting to break Okun's Law by simultaneously:

- Triggering a deep GDP recession with measures intended to stop the spread of the virus.
- Using supportive fiscal and monetary tools to stave off a self-reinforcing labor market recession.

The sectors most affected by social distancing are disproportionately labor-intensive and collectively account for 22% of U.S. employment (e.g., retail, leisure & hospitality, and air transportation.) Therefore, if there is no fiscal response, we expect the unemployment rate rise would be more extreme than implied by Okun's Law.

How can we get some sense of the size of the fiscal package needed? Congress is debating a package totaling close to $2 trillion, which, as you can see in the table below, would provide a meaningful offset to many scenarios—though not the most extreme.

## Sufficient fiscal stimulus to offset the slowdown

USD billions

| Reduction in activity vs. normal | Weeks of required "social distancing": 4 | 6 | 8 | 12 | 16 |
|---|---|---|---|---|---|
| -10% | 105 | 157 | 209 | 314 | 418 |
| -20% | 209 | 314 | 418 | 628 | 837 |
| -33% | 345 | 518 | 690 | 1,036 | 1,381 |
| -50% | 523 | 785 | 1,046 | 1,569 | 2,092 |
| -67% | 701 | 1,051 | 1,402 | 2,103 | 2,803 |
| -80% | 837 | 1,255 | 1,674 | 2,511 | 3,347 |
| -90% | 941 | 1,412 | 1,883 | 2,824 | 3,766 |
| -95% | 994 | 1,491 | 1,988 | 2,981 | 3,975 |

Source: BEA as of February 29, 2020.

Table shows potential amount of fiscal stimulus the economy will need to offset a range of economic slowdowns based on a scale of weeks of required social distancing (4 to 16) and reduction in activity (-10% to -95%). In the scenario of 16 weeks of social distancing and a -95% reduction in activity, the economy would potentially require $3,975 billion in fiscal stimulus to offset the economic slowdown.

Also extremely important are stimulus quality and speed (how quickly money can get into the hands of consumers and businesses). The longer we go without a meaningful stimulus, the more likely unemployment will persistently rise. In fact, workers are already feeling the effects of the virus's impact on our economy. A survey conducted last week found that 18% of workers (and 25% of workers in households making less than $50,000) were either laid off or had their hours reduced because of COVID-19. This trend is especially worrisome, considering some surveys show only 40% of U.S. citizens can pay an unexpected bill of $1,000 from their savings.

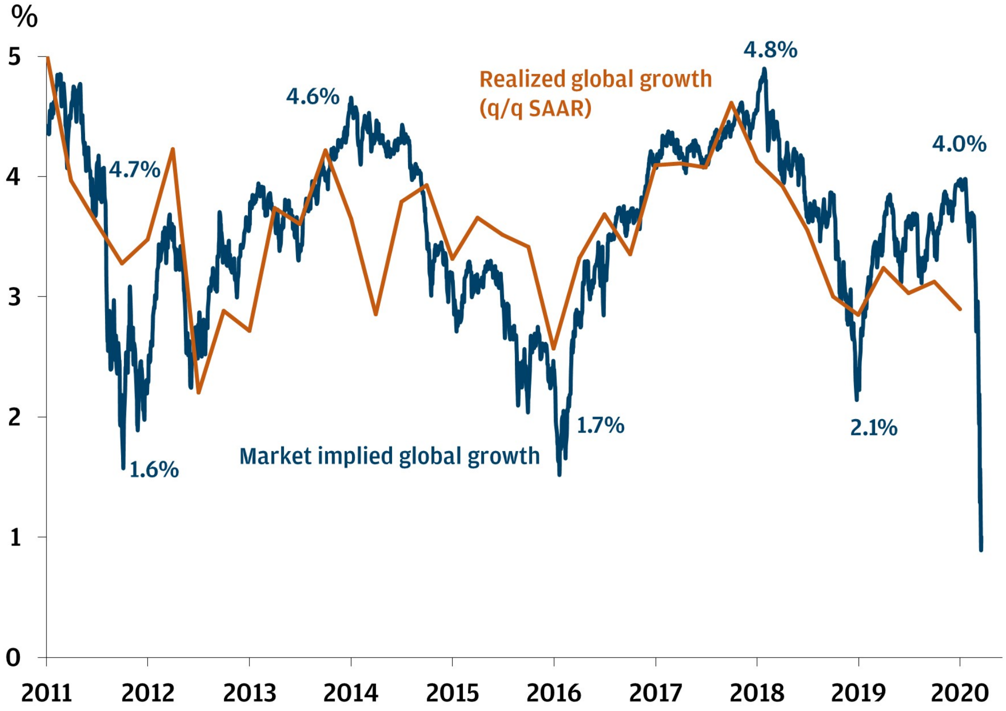
The initial rounds of proposed fiscal relief are more targeted on the virus, but subsequent phases must first provide support for affected industries and workers, and then broader-based stimulus to the economy.

## Investors' road ahead

For investors, the biggest risk is that the current proposal doesn't make its way through Congress. Flashback to 2008: When the initial TARP proposal failed to gain enough support in Congress, the stock market responded by sliding an additional 7% the next day. Looking further ahead: If the global shutdown extends into June or later, or if the economic and financial spillovers are greater than we anticipate, markets could continue to slide.

In the near term, markets are likely to remain volatile, with all eyes on the details of fiscal packages. Still, for long-term investors, this is an opportune time to discuss emerging value with their advisors. The recent selloff has been extreme (see chart below). While markets are still pricing in economic growth greater than we forecast, the gap has been reduced significantly, which means the vast majority of market declines are likely behind us.

## The recent sell-off has been extreme




Source: UBS as of March 17, 2020.

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