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Macro

The Great Reboot: Economy and markets in 2020

The U.S. economy is experiencing suspended animation as shelter-in-place orders have powered down a large fraction of activity. How—and when—do we reboot? These are vital questions for 2020. We examine three possible scenarios and their implications for the economy and markets.

KEY TAKEAWAYS

- All three reboot scenarios we examined leave growth for 2020 in negative territory.
- The labor market will likely determine how much traction spending will get as the economy reboots.
- Markets react more to a recession's length than its depth, so a longer slowdown could have downside implications.

Suspended animation: The economy in mid-April 2020

There is little doubt the economy is in a deep contraction. Early economic data for March shows a devastating dislocation in employment and a plunge in consumer confidence. Shelter-at-home orders across the U.S. in response to the COVID-19 pandemic have caused large swaths of the economy to close. Forecasts for Q1 GDP are for a single-digit decline, given that the economy was healthy in January and February. But forecasts for the second quarter are for a historic decline, well beyond anything we have seen in modern data (post-WWII).

Keep in mind that forecasters often quibble over one- or two-tenths of a percent change in GDP. Given the size of our $20 trillion economy, the difference between growth of 1.5% and 2.0% is significant. It is therefore extraordinary that forecasts for the Q2 contraction range from -15% to -50%. Anything in this range would set a record for quarterly contraction.

Adding to the mental gymnastics required to wrap our minds around this catastrophic drop are many forecasts calling for a double-digit rebound in Q3. Would this catapult us back to where we started? Unfortunately, almost surely not. Here it is important to remember that quarterly GDP rates are typically expressed as percentages that have been annualized. In other words, the changing rates may plot as a V-shape, but the underlying level of GDP may not.

2020 may well become known as the Great Reboot. Many aspects of this pandemic are being labeled unprecedented, and a looming challenge that is new to our country is how to safely and effectively reboot our economy after hitting "pause." There are infinite possible scenarios, so to simplify the discussion we have focused on three that have been outlined by The Conference Board, an economic think tank that also produces a leading measure of consumer confidence.

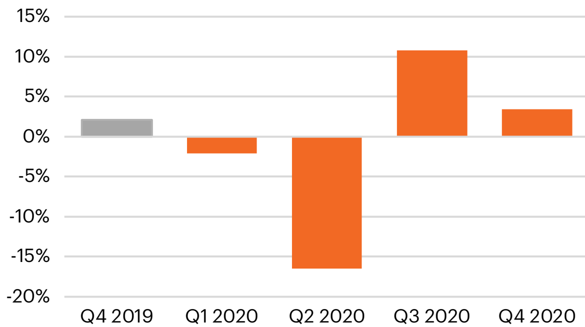
It is critical to note that the overarching variable among these three scenarios is how the pandemic will evolve in 2020.

Scenario 1: May reboot

This is the best-case scenario, which assumes that, beginning in May, we can reopen the economy. This scenario implies the COVID-19 pandemic essentially caused a 6-week-long health crisis that largely resolves. While the -16.5% decline in Q2 would be the worst on record, it would leave 2020 GDP down -1.6%, which is more typical of a normal recession.

MAY REBOOT

Real GDP, % q/q SAAR



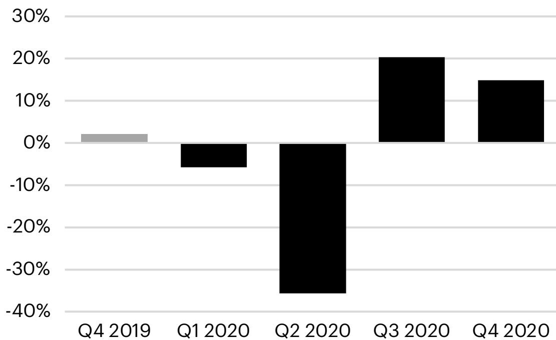
Source: The Conference Board, BEA, as of April 14, 2020.

Scenario 2: Summertime V-shape

This scenario assumes that cases peak at a higher level and peak later into the second quarter. This would mean delaying a reopening until June or even July. This longer broad-based lockdown causes Q2 GDP to decline -35.6%, almost twice as much as the first scenario. It also means a sharper rebound, but it leaves 2020 with a contraction of -5.6%.

SUMMERTIME V-SHAPE

Real GDP, %q/q SAAR



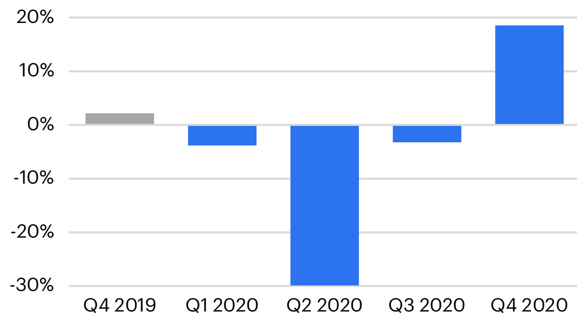
Source: The Conference Board, BEA, as of April 14, 2020.

Scenario 3: Fall recovery

This scenario reflects a more protracted arc to the pandemic. The decline in Q2 is significant, at -29.9%, but in this scenario, as the economy tries to restart mid-Q2, there are setbacks related to a resurgence of COVID-19 cases that causes the shelter-at-home orders to recur. This keeps growth in Q3 weak and, with a third consecutive quarter of contraction, delivers a dismal 2020: a -6.0% contraction in growth, the worst annual showing since 1946.

FALL RECOVERY

Real GDP, % q/q SAAR

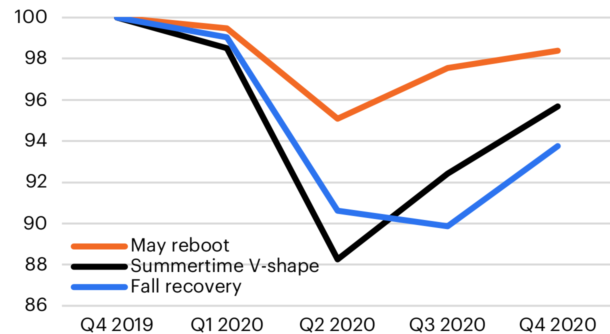


Source: The Conference Board, BEA, as of April 14, 2020.

These scenarios all include an epic decline in Q2, followed by some form of record quarterly gain, causing many to assign a V-shape to the economy. But a look at the comparative levels of output shows one of the most significant repercussions of a recession: permanently lost output. A shallower downturn is better, as is a faster recovery. But at the end of the day, the initial period of recovery for each scenario leaves us at a lower level of activity than our jumping-off point.

3 REBOOT SCENARIOS

Real GDP indexed to Q4 2019 = 100



Source: The Conference Board, BEA, FS Investments, as of April 14, 2020.

In a typical recession, it can take more than a year after the recession ends for the economy to recapture the same pre-downturn level of output. This time around, there are legitimate concerns that the economy will not be able to entirely reopen, with many sectors (think concerts, sporting events, international travel and tourist attractions) still closed or greatly limited. This lingering uncertainty and remaining social-distancing requirements impact particular sectors of the economy and add to the downside risk that this recovery is longer.

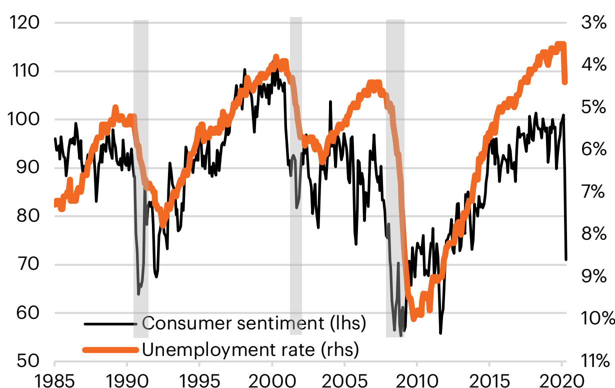
The psychology of the reboot

Many facets of this downturn are unprecedented, emanating from the catalyst of the global pandemic. This makes for a recession that is also smashing the mold. And yet some core similarities may emerge because, at the end of the day, our economy is simply a $20 trillion sum of people and businesses making day-to-day decisions. Psychology, or confidence, ends up driving the timing and strength of economic recovery.

Consider a government order to reboot. Just because businesses can reopen doesn't mean they will. We will see an early test of this in coming weeks as some states allow a limited number of businesses to open. Georgia, South Carolina and Tennessee have already announced the first stage of a reboot to start in the last week of April. But businesses seem far from unanimous that they will open. Employee and customer safety, supply chain disruptions and low demand are concerns that may cause only a fraction of businesses to reopen, and that may be on a more limited basis.

The consumer side of our economy faces even more uncertainty as it reboots. Households make up 70% of our economy[1] and are the ultimate driver of whether our economy is contracting or growing. Yet households have experienced an epic hardship of unemployment, something that will rock consumer confidence. Already, preliminary data shows a cataclysmic drop in sentiment.

CONSUMER SENTIMENT AND JOB LOSSES



Source: University of Michigan, BLS, NBER, as of April 22, 2020. Shaded areas denote NBER-dated recessions.

This means the real question is: "If we reopen, will the consumers show up and shop?" Most recessions show consumer confidence being one of the first indicators to fall. Indeed, the loss of consumer confidence coincides with households cutting back on spending—a demand-driven drop in economic activity that is a hallmark of recessions. This time around, the initial shock has been driven by both supply and demand. However, as we slowly try to bring supply back online (i.e., open businesses), we may be left with a more classic demand-side slump. The key to whether consumers will be ready to spend will likely be the labor market.

The full picture of the drop in employment is only now emerging. So far, 26.5 million people have filed for unemployment insurance in only five weeks. For reference, this is more than the total seen in every recession going back to the 1960s except two. The unemployment rate could spike as high as 20% in April, up from a multidecade low of 3.5% in February. That would be the highest since the Great Depression.

We expect a reboot to proceed in small steps. We may be able to reopen swaths of the economy over the coming weeks or months, but some industries will remain difficult to revive given their very nature. Airlines, hotels, restaurants, retail and sports, to name a few, may be quite difficult to fully reboot simply because the very nature of their business makes accomplishing social distancing difficult.

In our previous article on the economic impact of COVID-19, we framed out a "ground zero" list of industries that are directly impacted by social distancing and employ a total of 33.8 million workers (or 17.8% of U.S. jobs). Should these industries be able to recover 75% of their prior activity, that still implies an unemployment rate of 8%, quite high by historic standards.

The arc of unemployment during this recession has thrown most traditional models into disarray. Typically, the unemployment rate rises throughout a recession—in response to weak demand—and in fact peaks after a recession has ended. Jobs are considered a lagging indicator, and hiring is notoriously slow to recover, even though the economy may be growing again. This time, job losses have been more severe and front-loaded to the downturn.

1 PCE expenditures were 70% of total real GDP in 2019; this is likely to drop in Q1 2020.

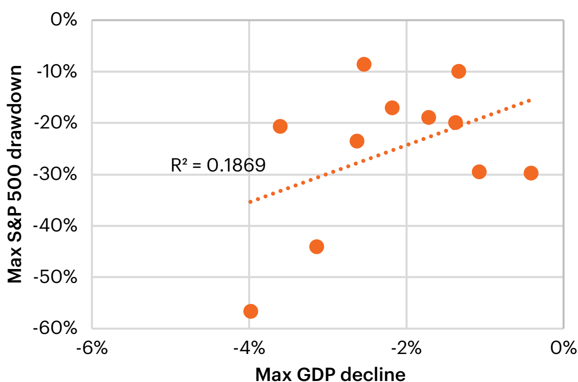
As we consider reboot scenarios and hope for improvements in the pandemic, we may need to prepare for lingering unemployment that could keep consumers cautious and spending constrained.

Connecting the reboot to markets

As the first recession in 11 years is revealed, markets and investors are also dissecting various scenarios of recovery. Indeed, most observers seem to agree and have already priced in the fact that the second quarter will be awful, in terms of both growth and earnings. To that end, as talk has shifted toward the second half of the year and how the economy will reboot, equity markets have taken on a more optimistic tone. The S&P 500 surged 28.5% from its March 23 low in just under four weeks.[2]

We dissected S&P 500 performance over the past 11 recessions dating back to 1947, with some interesting conclusions. While one can calculate an "average" recession, there is in reality wide variance in the depth and length of each economic contraction. Interestingly, for markets, the depth of a recession had very little impact on the severity of the drawdown in equity markets. In other words, whether the total economic contraction was -4.0% or -0.4% had virtually no bearing on the severity of decline in the S&P 500 during the recession.

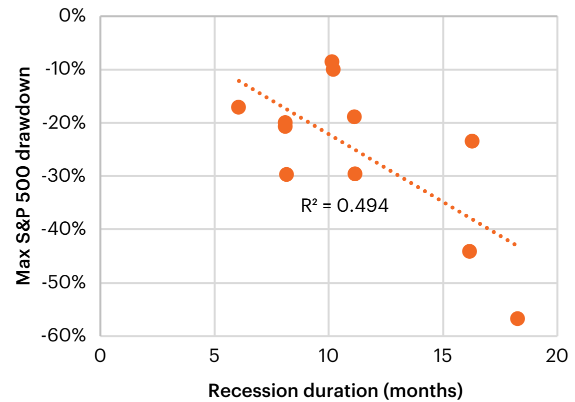
EQUITY DRAWDOWN AND DEPTH



Source: Macrobond, NBER, FS Investments, as of April 14, 2020.

The duration of a recession, however, has had a statistically significant impact. We have experienced recessions as short as only six months, while the 2007–2009 recession was the longest in the post-WWII period at 18 months. In the last six recessions, markets bottomed 3–6 months before the recession ended, which is another way to express the fact that longer recessions lead to deeper equity market

EQUITY DRAWDOWN AND DURATION



Source: Macrobond, NBER, FS Investments, as of April 14, 2020.

contractions. This could have important implications for the market optimism currently emerging. Markets are inherently forward-looking. The fact that markets have regained significant ground indicates that many investors are hoping we have already seen the bottom of equity prices for this cycle. This may reflect expectations that the economic downturn will be short lived and the recession will end soon.

There is an important caveat to this analysis: The Fed has delivered unprecedented (that word again) levels of monetary stimulus. We expect the Fed's balance sheet to balloon by several trillion dollars in the coming quarter. We have seen in the past that significant liquidity inflows can raise valuations, and will certainly support equity markets, all else equal.

The Great Reboot: Hope and uncertainty

The focus on the Great Reboot is sparking hope that our economy, once free of shelter-at-home orders, will nimbly and rapidly rebound. Much of this depends on how the pandemic evolves. Once businesses are allowed to reopen and consumers can shop more freely, a significant amount of activity will return. However, even the best-case scenario shows that 2020 is likely facing lost output and income that will not be recovered for some time.

We expect the economy to reboot in stages, sometimes successfully and sometimes with setbacks. This could impact certain regions, or industries, in ways that are difficult to predict and would cause uncertainty to quickly resurface. Should the Great Reboot take longer than markets are anticipating, investors could yet be in for more downside and significant volatility.

2 The S&P 500 gained 28.5% from March 23 to April 17.

Lara Rhame
Managing Director, Chief U.S. Economist

Lara is Chief U.S. Economist and Managing Director on the Investment Research team at FS Investments, where she analyzes developments in the global and U.S. economies and financial markets. Her fresh take on macroeconomic issues helps to inform and develop the firm's long-term views on the economy, investment trends and issues facing investors. Lara is committed to the Philadelphia community and serves on the boards of the Economy League of Greater Philadelphia, Hyperion Bank and Starr Garden Park.

INVESTMENT RESEARCH
Robert Hoffman, CFA
Managing Director

Lara Rhame
Chief U.S. Economist
Managing Director

Andrew Korz
Associate

Kara O'Halloran, CFA
Associate

Contact
research@fsinvestments.com

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