GLOBAL PANDEMIC: CRITICAL ISSUES

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Summary and Major Conclusions:

My forecast assumes a gradual and uneven reopening of the economy beginning in May. It is highly likely that the restarting process will be staggered and occur in phases, defined by industries, sectors, and geographic regions. In the absence of a major comeback in infections in the fall and winter, the economy should gradually return to near normalcy later this year and throughout 2021. Under this scenario, common stocks should significantly outperform bonds over the next one to two years, albeit with continued high volatility.

- There is growing evidence of a peaking in the coronavirus pandemic, both in the US and in most developed economies. The number of new cases, hospitalizations, intubations, and fatalities is in a declining trend in the US and Europe.

- Although key data trends are improving, public health conditions will likely continue to act as a constraint on the economy for many months. A gradual relaxation of social distancing measures will allow an incremental reopening of the economy, but this imminent trade-off could result in a rise in new infections.

- The future course of the novel coronavirus is impossible to predict until there is widespread availability of an effective vaccine. Many health experts expect a moderation in infections in coming months owing to stringent containment policies in recent weeks.

- Assuming a peak in confirmed cases in April and May, a reopening of the economy in the spring and summer months seems plausible, but at a cautious and measured pace. It is highly likely that the restarting process will be staggered and be administered in phases, defined by industries, sectors, and geographic regions.

- COVID-19 will remain a serious risk and will never totally disappear — although the availability of an effective vaccine will likely be a game changer. The bottom line is that health conditions should be in a gradually improving trend in coming months, but this trend could be disrupted by periodic setbacks as the economy reopens.

- A return to near normalcy awaits the development of an effective vaccine, which appears to be at least one year in the future. Until that time, a vital prerequisite is the increased availability of diagnostic testing devices, in order to optimize the identification and isolation of new infections.

- Another prerequisite to facilitate a smooth reopening of the economy is the discovery of a therapeutic medicine to alleviate the severity and risk of death associated with the illness. The pace of restarting the economy is also contingent upon having sufficient medical equipment and supplies, including ventilators, respirators, masks, and medical protective gear.

- Economic forecasting is currently a daunting task. As a rough approximation, my forecast assumes that US GDP could return to its previous peak from yearend 2019 during the third or fourth quarter of 2021. This timing assumes a peak-to-trough decline in US GDP of 10% this year, by far the steepest since the 1930s.

- Forecasts for company profits are meaningless until the economy is operating at much higher utilization rates. The level of corporate earnings should bottom in the second quarter, but is unlikely to return to its previous all-time peaks until early 2022.

- Inflation is expected to remain depressed throughout 2021. Inflation is a classic lagging economic indicator and tends to trail business conditions by one to two years. Compared with an average of 1.7% over the past two years, core consumer inflation should drift lower, bottoming around 1.0% during the middle of next year.

- Interest rates should also remain historically depressed throughout 2021. A combination of very low inflation, zero policy rates from the Federal Reserve, and strong demand for US Treasury securities will likely act as an anchor on long-term bond yields.

- The Federal Reserve is likely to maintain a zero policy rate for the next two years, at a minimum. I expect the market yield on the benchmark 10-year US Treasury bond to average 1.25% through yearend 2021, fluctuating within a range of 0.75% to 1.75%.

- My forecast assumes a gradual and uneven reopening of the economy beginning in May, staggered across geographic regions. In the absence of a major comeback in infections in the fall and winter, the economy should begin to gradually return to normal later this year and throughout 2021. Under this scenario, common stocks should significantly outperform bonds over a one-year time horizon.

Despite some important developments in recent weeks, the level of uncertainty among investors is unprecedented. This week's *Economic Perspective* answers questions relating to the coronavirus, government policy, economic trends, and the outlook for financial markets.

COULD YOU SUMMARIZE THE CURRENT STATE OF PUBLIC HEALTH CONDITIONS WORLDWIDE?

There is growing evidence of a peaking in the coronavirus pandemic, both in the US and in most developed economies. Prospects are less favorable for the developing economies of Africa, Latin America, and the Middle East. The number of new cases, hospitalizations, intubations, and fatalities has begun to flatten in the US and Europe.

Favorable trends are evident in Italy, France, and Spain, while Germany, Austria, and Switzerland have been most successful at containing the pandemic at much lower rates of infection. There is unambiguous evidence that social distancing has been successful in flattening the curve.

HOW WOULD YOU ASSESS PUBLIC HEALTH TRENDS IN THE US?

Although key data trends are in an improving trend, public health conditions are likely to act as a constraint on the economy for many months. The declining trend of new cases can be attributed to widespread containment and social distancing policies that have been put into effect. An incremental relaxation of social distancing measures will facilitate a gradual reopening of the economy, but the trade-off could be an increased risk of rising infections.

COVID-19 will remain a serious risk for at least the next year and will never totally disappear — although availability of an effective vaccine will likely be a game changer longer term. It is important not to be dogmatic with respect to the outlook for the pandemic. As a general conclusion, health conditions should steadily improve in coming months, although this generally positive trend could be disrupted by periodic setbacks.

WHAT IS THE MOST LIKELY SCENARIO REGARDING THE FUTURE COURSE OF THE PANDEMIC?

The future course of the novel coronavirus is impossible to predict without much greater clarity with respect to the future path of confirmed cases of COVID-19. Some health experts expect a moderation in infections in coming months owing to a combination of stringent containment policies and warmer weather in the Northern Hemisphere. If the coronavirus follows a seasonal pattern — which is far from certain — as assumed by some epidemiologists, we should expect a lull in the summer months, followed by scattered outbreaks in the fall and winter.

WHAT ARE YOUR ASSUMPTIONS REGARDING A RESTARTING OF THE ECONOMY?

Assuming a peak in confirmed cases in April — followed by a gradual declining trend thereafter — a reopening of the economy in the spring and summer months seems plausible, albeit at a cautious and measured pace. It is highly likely that the re-starting process will be staggered and occur in phases, defined by industries, sectors, and geographic regions.

WHAT ARE THE CRITICAL REQUIREMENTS FOR A SUSTAINED REOPENING OF THE ECONOMY?

Of paramount importance is the development of an effective vaccine, which appears to be at least one year in the future. Until that time, there are several prerequisites for a successful and sustained reopening of the economy:

1. Widespread availability of *diagnostic testing devices* to improve the identification and isolation of people with new infections

2. Discovery of a *therapeutic drug* to alleviate both the severity and risk of death associated with the illness

3. Enhanced readiness of the *medical infrastructure* and among healthcare institutions, including an adequate supply of hospital beds and healthcare professionals

4. A *large stockpile* of medical equipment and supplies, including ventilators, respirators, gowns, and gloves

The key point is that a broad and sustained reopening of the economy is not possible until the US health care system is better prepared to respond to the new outbreaks that are likely to occur periodically until there is a vaccine.

HOW RAPIDLY CAN THE ECONOMY RECOVER AND RETURN TO NORMAL?

It is correct to say that the economy is held hostage to the pandemic, meaning that future economic trends are predicated upon a reduction of new COVID-19 infections. Concrete evidence that the pandemic is coming under better control would allow a more rapid return to a normal functioning economy. Conversely, a reversal in the anticipated downtrend in confirmed cases and resurgence of new cases as the economy reopens would be an obvious setback and obstacle to a smooth economic recovery.

The most likely scenario is that confirmed infections will enter a declining trend but remain elevated. The implication is a longer period of partial confinement and social distancing, even as certain sectors and geographic regions are gradually coming back onstream.

Under these more conservative assumptions, the economy is likely to reopen in discrete phases, governed by several variables: (1) Small- and mid-sized cities ahead of large urban centers; (2) Essential industries ahead of discretionary services; and (3) Industries related to manufacturing and construction first. Conversely, transportation, entertainment, leisure, recreation, and consumer services are likely to lag in returning to normal.

WHAT ARE YOUR ASSUMPTIONS REGARDING GDP GROWTH RATES IN COMING QUARTERS?

It does not make sense to think in terms of *quarterly GDP growth rates* because the numbers are meaningless. In particular, the expected unprecedented decline in second quarter GDP provides minimal value for future forecasting purposes because of its artificial and temporary nature.

What really matters is the level of GDP in the final quarter of this year — once the economy has begun to reopen — *and GDP trends during all of 2021 — once the economy has likely been restored to near normalcy*. In terms of general direction, GDP could decline sharply in the first quarter followed by an outright collapse in Q2. Assuming a staggered reopening of the economy in May and June, GDP could increase strongly in both Q3 and Q4.

WHEN WILL THE LEVEL OF GDP BE RESTORED TO PRE-PANDEMIC LEVELS?

As an approximation, US real GDP could return to its previous peak of $19.22 trillion in Q4 of 2019 during the *third or fourth quarter of 2021*. This timing assumes a peak-to-trough decline in US GDP of 10% this year, by far the steepest decline in output since the 1930s. The previous post-World War II record was a 5% decline during the Great Recession of 2008. Real GDP could decline by 5% for all of this year, which would be the worst calendar year since the Great Depression. My forecast assumes a recession of only two quarters, which would be the shortest economic downturn on record.

HOW VULNERABLE ARE US CORPORATE EARNINGS?

Company earnings are vulnerable to severe declines, most notably in the second and third quarters of this year. Year-over-year quarterly declines are likely to persist until the first or second quarter of next year. Company earnings are unlikely to return to their yearend 2019 peaks until 2022. These projected recoveries are comparable to those following similar deep recessions since 1970.

WHAT ARE YOUR ASSUMPTIONS FOR INFLATION AND INTEREST RATES?

Interest rates and inflation should remain depressed throughout 2021. Inflation is a classic lagging economic indicator and tends to trail business conditions by one to two years. Compared with an average of 1.7% over the past two years, core consumer inflation could fall to 1.0% by mid-2021 and average less than 1.5% over the next two years.

Interest rates should also remain historically depressed through the end of 2021. A combination of zero policy rates from the Federal Reserve, low inflation, and strong global demand for US Treasury securities will likely act as an anchor on long-term bond yields. I expect the market yield on the benchmark 10-year US Treasury bond to average 1.25% through yearend 2021, fluctuating within a range of 0.5% to 2.0%.

WHAT ARE YOUR GREATEST FEARS?

The primary risks fall into two broad categories: (1) Developments pertaining to the coronavirus pandemic; and (2) Issues relating to the reopening of the economy.

- Delays in the production and availability of testing equipment
- Ongoing shortages of vital medical supplies and equipment
- A resurgence in new infections resulting from a reopening of the economy
- A reversal in new infections in early-responding countries such as Korea
- Scientific setbacks in the development of a vaccine and antiviral drugs
- Logistics failures in government transfers to consumers and businesses
- Partisan political squabbles that delay appropriation of additional funds

WHAT ARE SOME OF THE KEY POSITIVES IN THE OUTLOOK?

There are some encouraging developments that partially offset the looming challenges faced by businesses, households, governments, and the health care establishment:

- The response of policymakers has been unprecedented in terms of speed, size, scope, and unswerving commitment, and is a major source of optimism regarding the outlook for the economy.

- The private sector has also responded quickly and vigorously — in terms of ramping up production of vital products and supplies. Many companies — including General Motors, Ford, Honeywell, and 3M — have converted their production lines to increase the availability of such items as ventilators, masks, and disinfectant sprays.

- There have been notable advances in medical science — although much remains in the pipeline — in diagnostic testing equipment and therapeutic drugs. A safe and effective vaccine will eventually be approved by the FDA for broad usage, but not likely for another year, at a minimum.

- The public's response to social distancing guidelines has resulted in a flattening in the new infection curve. It has been clearly demonstrated that the pandemic can be contained by a resolute society exercising discipline and restraint.

- Credit market tensions have eased and risk spreads have narrowed. The flow of credit has improved following the unprecedented actions of the Federal Reserve.

- Although its execution and functioning have been far from perfect, the $350 billion government lending facility for small businesses has steadily progressed. Congress should approve another $250 billion for this crucial lending program, as virtually all of the initial funds have been appropriated.

HOW WOULD YOU SUMMARIZE THE OUTLOOK?

The outlook for the economy and financial markets over the next six to nine months is dependent upon progress on the medical front. Of greatest importance are the trajectory in the number of confirmed coronavirus cases, hospitalizations, and fatalities; much greater availability of diagnostic tests; and the introduction of an antiviral therapeutic to mitigate the symptoms and fatalities associated with COVID-19. At stake is the timing and pace of a restarting of economic activity.

The best-case scenario is a steady decline in confirmed cases, along with increased availability of medical supplies and a new medication. The worst-case scenario is a resurgence in infections as the economy reopens, resulting in a reinstatement of containment and social distancing orders. My forecast assumes a gradual and uneven reopening of the economy beginning in May, staggered across geographic regions. In the absence of a ***major*** comeback in infections in the fall and winter, the economy should gradually return to near normalcy later this year and throughout 2021. Under this scenario, common stocks should significantly outperform bonds over the next one to two years.

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CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

MSCI World Ex US Index: Measures the performance of the large and mid-cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

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