ANOTHER NEW NORMAL

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Divergences between industries and workers are likely to become more pronounced in coming years. Information technology, factory automation, healthcare, communication services, and industrial equipment could be the primary beneficiaries of the new normal, while consumer staples, travel-related industries, materials, and real estate could decline as a share of GDP. Many industries could become inversely correlated: A reduction in spending on air travel could result in increased spending on single-family housing and household durables.

Summary and Major Conclusions:

- Although the current world health crisis is vastly different from the 2008 world financial crisis, there is one major similarity: The world economy will be entering a "new normal" that could persist for many years, comparable to the years following the 2008 crisis.

- Investors should expect massive changes in behavior by businesses, households, financial institutions, investors, and governments. In some cases, structural trends already in place will be accentuated by the pandemic. Structural change in some sectors of the economy could be permanent.

- The trauma experienced by millions of households and small businesses is likely to have a long-lasting effect on the way that Americans behave. Economic hardships emanating from the global pandemic are likely to usher in a protracted period of fiscal conservatism for households and businesses.

- For consumers, this suggests a higher savings rate and a reduced tendency to take debt. For the nonfinancial business sector, balance sheet management will become a much higher strategic priority. Companies are likely to hold more cash and reduce debt-to-equity ratios.

- The broad economic implications include a slower trendline growth in GDP over the medium term, as spending is restrained. Slower growth in spending and credit would also imply a combination of lower interest rates and inflation.

- In stark contrast to the private sector, the federal government will increase its debt levels at the fastest pace since World War II. The economic repercussions will become more evident over time, in the form of higher interest rates.

- US industry could witness another wave of consolidation over the next several years as a result of large-scale business failures and bankruptcies among small- and mid-sized firms. The expected large number of business failures could be augmented by a wave of mergers and acquisitions, also adding to industry concentration.

- Although many employees currently working remotely will return to offices, factories, and stores, many more could continue to work from their homes indefinitely. Many firms will likely reorganize their workforces by encouraging an increasing share of employees to work remotely, with negative implications for office leasing.

- Similarly, an increasing share of retail sales will likely take place via the internet, as consumers become more accustomed to online shopping. The result would be an acceleration in retail store closings as e-commerce comprises an increased share of total retail sales.

- Inflation and interest rates are likely to remain at historically low levels for at least several years, as demand for goods and services trails supply over the next several years. Low inflation and near zero policy rates should keep long-term bond yields at depressed levels.

- Globalization peaked in 2016 with the election of Donald Trump, and its decline could be accelerated by the global pandemic. Many nations have already responded to the COVID-19 pandemic by placing a greater emphasis on self-sufficiency and secure access to necessary materials, especially with respect to vital medical supplies.

- China is likely to experience a progressive degradation with respect to its role and importance in the world. Whether or not it is warranted, the image of China during the global pandemic has been tarnished because of its secrecy and blatant withholding of information regarding the virus outbreak in Wuhan.

- Many countries are becoming fearful of their reliance on China as a supplier of vital components and end products — especially on the medical and national security fronts. The result could be a marked shift in production from China to domestic factories.

- The aftermath of the COVID-19 pandemic could witness an explosion in the role of technology in the US economy, providing new solutions and innovations for a wide range of applications.

- History is very clear how national emergencies — such as wars, profound geopolitical threats, natural disasters, and pandemics — spur large-scale entrepreneurship and significant technological innovation. Technology spending and investment could rise as a share of GDP, providing a strong boost to productivity.

- Divergences between industries and workers are likely to become more pronounced in coming years. Information technology, factory automation, healthcare, and industrial equipment could be the primary beneficiaries, while consumer staples, travel-related industries, and real estate could decline as a share of GDP.

Although the current world health crisis is vastly different than the 2008 world financial crisis, there is one major similarity: The world will be entering a “new normal” that could persist for many years, comparable to the new normal following the 2008 crisis. Structural change in some sectors of the economy could be permanent.

Investors should expect massive changes in behavior by businesses, households, financial institutions, investors, and governments. Many of the most significant behavioral changes will become apparent only with the passage of time. This week’s *Economic Perspective* attempts to identify some of the most important structural changes that might have a major impact on financial markets.

FINANCIAL CONSERVATISM

The trauma experienced by millions of households and small businesses is likely to have a long-lasting effect on the way Americans behave. Economic and financial hardships emanating from the global pandemic are likely to usher in a protracted period of fiscal conservatism, similar to that following the 2008 world financial crisis. It seems reasonable to assume that all private sectors of the US economy will develop an increased tendency toward risk aversion, especially with respect to financial matters.

For consumers, this suggests a higher savings rate and a reduced tendency to take on debt. *For the nonfinancial business sector, balance sheet management will become a much higher strategic priority*. Companies are likely to hold more cash and reduce debt-to-equity ratios. It also implies higher capital and liquidity ratios for banks and a tendency toward more conservative lending and funding.

The broad economic implications include slower trendline growth in GDP over the medium term, as spending is restrained. As an offset, a possible silver lining would be reduced risk within the financial system. Slower growth in spending and credit would also imply a combination of lower interest rates and inflation. Ultimately, FDA approval of a vaccine will accelerate a return to normal, which could result in a gradual return of risk-taking, but slowly over the course of many years.

FEDERAL GOVERNMENT DEBT

In stark contrast to the private sector, the federal government will increase its debt at the fastest pace since World War II, the result of two factors: (1) The surge in federal government expenditures and transfers to households, businesses, and banks to support the economy during its temporary shutdown phase; and (2) A collapse in tax revenues resulting from the steep decline in economic activity.

Compared with a roughly $1 trillion deficit last year, the federal budget deficit could surge to $2 trillion this year and to $2.5 trillion in 2021. After stabilizing at 78% of GDP, US Treasury debt held by the public could approach 100% within the next several years.

The economic and financial repercussions will become more evident over time. For the next year or two, inflationary pressures are likely to remain dormant, as a result of an excess supply of goods, services, and labor. Similarly, financing the deficit will not become a burden for the US Treasury, for two reasons: (1) Borrowing costs for the US Treasury are extraordinarily low; and (2) There is an insatiable demand worldwide for US government debt. In short, the risks are likely to be manifested in the long term, rather than the short term.

ECONOMIC GROWTH: INITIAL HEADWINDS

My forecast assumes that the US economy will stabilize in the third quarter of this year, following a steep contraction in the second quarter. Beyond that, GDP growth could accelerate off a very depressed bottom over the next several quarters, but this sharp rebound is unlikely to prove sustainable. US economic growth will be constrained until the discovery of an effective vaccine for COVID-19, expected in 2021, which would pave the way for faster growth in 2022 and 2023.

Several other factors could weigh on growth over the next one to two years. In addition to lingering fears of infection, global supply chains will need to be repaired and rebuilt. As already discussed, households and business firms are likely to exhibit a higher level of risk aversion in spending and savings decisions, along with a reduced propensity to take on debt.

There are three countervailing forces that would suggest a more robust growth scenario beyond the next year: (1) Massive pent-up demand that accrued during the lockdown; (2) Unprecedented fiscal and monetary stimulus provided to bridge the economy during its period of maximum coronavirus risk; and (3) The likelihood of a vaccine for COVID-19 within the next 12 to 18 months.

INDUSTRY CONSOLIDATION

The US economy will likely witness another wave of consolidation over the next several years as a result of large-scale business failures and bankruptcies among small- and mid-sized firms. The implication is that the big will get bigger: The three or four largest survivors in many industries should gain significant market share at the expense of the weaker firms.

The expected large number of business failures could be augmented by a wave of mergers and acquisitions, which would accelerate industry consolidation. This trend will be apparent in many industries, including retail stores, restaurant chains, oil and gas companies, banks, real estate developers, a wide range of business services, homebuilders, auto dealers, hotels, and entertainment and travel-related industries.

REMOTE WORKERS AND E-COMMERCE

Although many employees currently working remotely will return to offices, factories, and stores, many more could continue to work from their homes indefinitely. Realizing the cost and efficiency benefits derived from telecommuting, many firms will likely reorganize their workforces by encouraging an increasing share of employees to work remotely.

This trend would most likely be apparent in knowledge-based occupations in information processing industries, including financial services, real estate services, communications, and technology. The obvious result would be a structural decline in the demand for office space.

Similarly, an increasing share of retail sales could take place via the internet, as consumers become more accustomed to online shopping. The result could be an acceleration in retail store closings, as e-commerce comprises an increased share of total retail sales. In short, *commercial real estate developers will likely face a challenging adjustment period in coming years, with negative implications for real estate stocks*.

INFLATION AND INTEREST RATES

Inflation and interest rates are likely to remain at historically low levels for at least several years in the aftermath of the 2020 recession. Growth in demand for goods and services is likely to fall short of the expected rise in supply over the next several years, resulting in a large Keynesian ***output gap***. Low inflation and near zero policy rates should keep long-term bond yields at depressed levels.

Capacity utilization in most industries will likely remain at depressed levels, while labor markets are unlikely to return to full employment until 2023, at the earliest. The likely result will be downward pressure on prices and wages throughout 2021, and possibly longer. The rate of inflation and wage growth could average only 1.5% and 2.5%, respectively, over the next several years.

RESILIENCY VERSUS EFFICIENCY

Following the current economic and health crises, businesses are likely to place a greater emphasis on resiliency and flexibility versus efficiency. This means that instead of just-in-time inventory management, companies are likely to hold somewhat larger inventories for *precautionary reasons* at both the intermediate- and final-goods stages of production.

It also implies that rather than locating production facilities in the lowest-cost regions of the world, firms might opt to build manufacturing plants closer to their customers, in an effort to make supply chains more secure. This could be especially true with respect to China. The result could be a trade-off of lower profit margins in exchange for resiliency and redundancy.

NATIONALISM AND DE-GLOBALIZATION

Globalization is defined as the integration of the world economy through trade, immigration, travel, capital flows, and foreign direct investment. It is not an exaggeration to conclude that the spread of globalization since 1975 was the most important force raising living standards throughout the world, especially within the developing economies of Asia, Latin America, Africa, and Eastern Europe.

Globalization peaked in 2016 with the election of Donald Trump. *Both immigration and free trade were dealt a harsh blow by policies of the Trump administration*. Beginning in 2017, the number of legal immigrants to the US began to decline. Beginning in early 2018, the Trump administration increased protective tariffs on Canada, Mexico, and Europe. By the middle of that year, an outright tariff war with China was underway, which intensified during most of 2019. Following an extended period during which the *average US tariff rate* averaged 1.66%, the rate has risen to nearly 5%, a multi-decade high.

TRADE PROTECTIONISM

Regrettably, the shift away from globalization that began with the Trump administration is likely to intensify in future years, for two reasons. First, increased trade restrictions are consistent with an increased trend toward populism and nationalism. Second, many countries have responded to the COVID-19 pandemic by emphasizing internal self-sufficiency and secure access to necessary materials and finished goods, especially with respect to vital medical supplies.

The implications could be profound. *There is only one principle on which all economists agree — that everyone in society benefits from free trade*. Spreading trade protectionism would almost certainly be manifested in slower growth in world GDP, income, wealth, and living standards. Because of their heavy reliance on exports, *emerging market economies would be the biggest casualties to spreading protectionism*, although all countries would suffer.

CHINA AND THE WORLD

For a variety of reasons, China could be the single biggest casualty of de-globalization and isolationism. China is likely to experience a progressive degradation with respect to its role and importance in the world. Whether or not it is warranted, the image of China has been tarnished during the global pandemic — for the country's secrecy and blatant withholding of information in the early days and weeks of the outbreak. There is growing evidence that the Communist Party's coronavirus deception is turning Western opinion against China.

The image of China's leaders as irresponsible and unwilling to play by the rules will likely become more widely held throughout the world. Following years of flagrant violations of fair-trade practices, widespread violations of human rights, government brutality, income inequality, and disregard for the environment, China is likely to become more of an outcast within the global community. In short, in the absence of structural reforms, animosity toward China could intensify in coming years.

On a more tangible level, *many countries are becoming fearful of their reliance on China as a supplier of vital components and end products* — especially on the medical and national security fronts. The result could be a marked shift in production from China to domestic factories. Many countries are also likely to hold China accountable for years of cheating in trade policy. The result could be a shift in trade flows away from China.

Finally, the symbiotic commercial relationship between China and the US — commonly dubbed ***Chimerica*** — that developed over many years could be at considerable risk. Growing animosity and mistrust between the two super powers could result in a decoupling of US-China relations, manifested in diminishing trade relations and growing geopolitical tensions. *Because more than 20% of Chinese exports are directed to the US, a breakdown in trade relations could harm China significantly*.

THE ROLE OF TECHNOLOGY

The one thing that sets the US apart from all other countries is its entrepreneurial culture and unique capacity for innovation, creativity, and ingenuity. History clearly reveals how entrepreneurs have time and again responded to national crises through remarkable innovations (please see my report *The Wealth of Nations* dated March 9, 2020). The aftermath of the COVID-19 pandemic will likely witness an explosion in the role of technology in the US economy, providing new solutions and innovations for a wide range of applications.

History is very clear how national emergencies — such as wars, profound geopolitical threats, natural disasters, and pandemics — spur large-scale entrepreneurship, and technological innovation. Consistent with this pattern, it would not be surprising to see a steadily rising increase in technology spending and investment as a share of GDP.

Similarly, technology-related workers are likely to comprise an increasing share of the workforce. Demand for workers in the science and technology sectors — including software engineers, data scientists, programmers, and product designers — is expected to surge over the next three years. *The result could be a sharp increase in trendline growth in productivity*, as innovations become absorbed within the economy and society in general.

A BIFURCATED ECONOMY

Divergences between industries and workers are likely to become more pronounced in coming years. Information technology, factory automation, healthcare, and industrial equipment could be the primary beneficiaries of the new normal, while consumer staples, travel-related industries, materials, and real estate could decline as a share of GDP. Many industries could become inversely correlated: A reduction in spending on air travel could result in increased spending on single-family housing and household durables.

Regrettably, income inequality could become even more pronounced in the new normal. In an increasingly technological economy — in which robotics and various digital platforms become ubiquitous — demand for highly skilled workers with college degrees is likely to increase rapidly, at the expense of lower-skilled workers and occupations. Finally, as discussed previously, large businesses are likely to prosper at the expense of smaller firms.

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Bloomberg Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index: Measures the performance of rules based, market value-weighted inflation protected securities issued by the U.S. Treasury. It is a subset of the Global Inflation-Linked Index (Series-L).

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.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.