ALTERNATIVE ECONOMIC SCENARIOS: DETERMINING THE SHAPE OF THE RECOVERY

by **Robert F. DeLucia, CFA**
Consulting Economist

The shape and speed of the economic recovery is dependent upon several critical variables, most of which pertain to the coronavirus pandemic. Included in this category are the path of new infections of COVID-19; the speed at which testing, therapeutics, and ultimately a vaccine become available; the skill and effectiveness of state governments in reopening their economies, at the same time limiting new outbreaks of the virus; and the future path and effectiveness of fiscal policy stimulus.

Summary and Major Conclusions:

- There is no doubt that an economic rebound will follow the massive contraction in second quarter real GDP, company profits, and employment. The critical issue for financial markets involves the timing, speed, and shape of the ultimate business cycle recovery.
- The shape and speed of the economic recovery is dependent upon several critical variables, most of which pertain to the coronavirus pandemic. The most critical variable in the outlook is the future short-term path of new cases, hospitalizations, and deaths associated with the coronavirus.
- The other critical variable is the effectiveness of government officials in reopening the economy on a state-by-state and industry-by-industry basis, while limiting the acceleration in new cases of COVID-19.
- Ample availability of antiviral medicines will be crucial when the number of cases begins to climb, most likely in the fall and winter months. Therapeutics will be extremely helpful in mitigating symptoms of the virus and reducing the number of fatalities.
- The ultimate game changer will be the availability of a vaccine in unlimited quantities. The pharmaceutical industry is on an accelerated path toward development of one or more vaccines that can be produced in billions of doses, but this development is not expected until 2021.
- Taking into consideration the varying direction of these key independent variables, I envision four economic scenarios that could play out over the next one to two years. Each of these assumes that the recession will end in the second quarter, and be followed by an economic recovery of differing characteristics.
- The odds of a robust V-shaped economic recovery are relatively low and would hypothetically take place in response to a sooner-than-expected availability of a vaccine in mass quantities. The probability of a V-shaped recovery is less than 20%.
- The most likely outcome is a U-shaped recovery — a moderate but steady revival of economic growth, beginning in the third quarter, with a probability of 45%. Under this scenario, the expected resurgence of the COVID-19 pandemic would occur in the fall, but the public health system would be fully equipped to counter the rising spread of infections.

- The most negative scenario for common stocks would be an L-shaped recovery — an extended plateau following an economic bottom in Q2 of this year. This scenario is the least likely of my four possible scenarios, with an estimated probability of only 10%. US real GDP would not return to its previous peak until 2022 or 2023.

- A so-called W-shaped recovery would be consistent with an environment of regularly recurring outbreaks of the virus in the indefinite future. This start-stop scenario envisions a pattern of rolling outbreaks, followed by renewed social distancing, resulting in a saw-toothed economic recovery. The probability of this scenario is estimated at 25%.

- By definition, the unprecedented nature of this recession means that econometric models used to forecast business trends are not available. In short, history provides very few insights. My forecast assumes that the most likely scenario for the US economy is a U-shaped recovery.

- This implies a gradual revival of growth during the second half of this year and first half of 2021, followed by more rapid GDP growth beginning in the middle of next year and continuing throughout 2022.

- I also believe that the odds of a prolonged economic downturn and financial crisis similar to 2008 are low. Moreover, a protracted multiyear deleveraging cycle — as occurred during the decade following the financial crisis — is unlikely, thereby removing a major headwind to growth in 2022 and beyond.

- My base case economic forecast of moderate but sustained economic growth is consistent with rising stock prices over the next one to two years. Equities are likely to move in a sideways pattern over the next several months until investors receive more favorable economic news and become more confident in assessing the likely risks in reopening the economy.

- Historically low rates of inflation — and a rising fear of deflation — will compel the Federal Reserve to maintain zero interest rates for an extended period, supporting all income-producing financial assets through historically depressed discount rates.

- In the end, the direction of the economy and financial markets will be predicated upon breakthroughs in the medical arena. The next positive catalyst for stock investing will be FDA approval of one or more therapeutics for widespread use in the fall.

The US recession that began in late February is unprecedented on numerous fronts and has created widespread uncertainty and fear for investors. As opposed to all previous recessions in American history, the current economic downturn was induced by government policy in an effort to save lives, rather than by profound underlying weakness in the economy and financial system. This recession is unique in other respects:

- The speed and magnitude of the contraction in economic activity is unlike any other recession in modern history.

- The surge in job losses has been the most severe on record.

- The speed and magnitude of government policy stimulus has been unprecedented.

There is no doubt that an economic rebound will follow the massive contraction in second quarter real GDP, company profits, and employment. However, the critical issue for financial markets involves ***the shape of the ultimate business cycle recovery***. This week's *Economic Perspective* explores several possible economic scenarios that could unfold over the next two years as the economy struggles to return to normal.

INDEPENDENT VARIABLES

The shape and speed of the economic recovery is dependent upon several critical variables, most of which pertain to the coronavirus pandemic. Included in this category are the path of new infections of COVID-19; the speed at which testing, therapeutics, and ultimately a vaccine become available; the skill and effectiveness of state and local governments in reopening their economies; and the future path of fiscal policy stimulus.

- **The Coronavirus Pandemic**: The most critical variable in the outlook is the future path of new cases, hospitalizations, and deaths associated with the coronavirus. The most likely scenario is a temporary respite in the summer followed by an escalation of unknown magnitude in the fall and winter. *The ultimate trend in these metrics is the primary wild card in the outlook*.

- **Reopening the Economy**: The other critical variable is the effectiveness and success of government officials in reopening the economy on a state-by-state and industry-by-industry basis, without a large escalation in new cases of COVID-19. State and local government officials have an enormous responsibility to exercise caution and good judgement when relaxing social distancing guidelines.

- **Availability of Testing**: The notably slow progress in ramping up diagnostic testing in the US over the past four months has significantly slowed progress in containing the coronavirus pandemic. There has been some encouraging news regarding recent FDA approval of several new testing platforms. The timing in reaching sufficient critical mass in testing is a critical variable in the outlook.

- **Availability of Therapeutics**: Ample availability of antiviral medicines will be crucial when the number of cases begins to climb in the fall and winter months. Therapeutics such as Gilead's Remdesivir are extremely helpful in mitigating symptoms of the coronavirus and reducing the number of fatalities. Additional therapeutic medications are expected prior to the fall.

- **FDA Approval of Vaccines**: The ultimate game changer will be availability of a vaccine in unlimited quantities. The pharmaceutical industry is on an accelerated path in the development of one or more vaccines that can be produced in billions of doses.

- **Fiscal Policy Measures**: There are two unknown variables pertaining to fiscal policy: (1) The *logistical efficiency* of the $3 trillion in relief spending already authorized; and (2) *Nonpartisan congressional agreement* on ***phase two*** of fiscal stimulus, targeting small businesses, state governments, and the unemployed. Progress in each of these two areas is crucial.

FOUR ECONOMIC SCENARIOS

Taking into consideration the possible direction of these six independent variables, I envision four economic scenarios that could play out over the next one to two years. Each of these assumes that the recession will end in the second quarter, and be followed by an economic recovery of varied characteristics.

SHARP V-SHAPED RECOVERY

The odds of a robust V-shaped economic recovery are relatively low and would most likely take place in response to a sooner-than-expected availability of one or more vaccines in mass quantities. An effective antiviral therapeutic in very large quantities could also produce a sharp economic rebound. While a vaccine could be available for emergency use later this year, full FDA approval of a vaccine in large quantities is unlikely until the middle of next year. In the absence of an imminent vaccine, a sharp economic rebound later this year and in early 2021 appears highly unlikely. *Under this recovery scenario, US real GDP would return to its previous peak in the first quarter of 2021* [**20%** probability].

MODERATE U-SHAPED RECOVERY

A moderate but steady economic recovery beginning in the third quarter is the most likely outcome. Under this scenario, the widely expected resurgence of the COVID-19 pandemic would occur in the fall, but the public health system would be fully prepared to counter the rising spread of infections. Specifically, availability of a large supply of testing equipment along with one or more therapeutics would help to mitigate any outbreaks that might occur and allow a steady economic recovery to proceed. Prospects for an imminent vaccine for emergency use would also bolster confidence. *US real GDP would return to its previous peak in the fourth quarter of 2021* [**45%** probability].

STAGNANT L-SHAPED RECOVERY

The scenario most negative for financial markets would be an extended plateau following an expected economic bottom in Q2 of this year. The catalysts for this scenario include the following: (1) Persistently elevated numbers of new COVID-19 cases, hospitalizations, and fatalities that prevent a sustained restarting of the economy; (2) A delay in the availability of antiviral therapeutics; and (3) Protracted delays in the availability of vaccines in very large quantities. This scenario is the least likely of my four possible scenarios. *US real GDP would not return to its previous peak until 2022 or 2023* [probability **10%**].

CHOPPY W-SHAPED RECOVERY

A so-called W-shaped recovery would materialize in an environment of regularly recurring outbreaks of the virus in the indefinite future. Under this scenario, *a recurring pattern of COVID-19 rolling regional outbreaks persists, prompting renewed lockdowns*, followed by alternating periods of moderating infections and accompanying reopenings. This saw-toothed pattern would consist of a sustained ***stop-start economy*** with ups and downs in aggregate output and spending that would be ended only by widespread availability of a vaccine. *Under this scenario, US real GDP would not return to its previous peak until the fourth quarter of 2022* [probability **25%**].

ECONOMIC SUMMARY

By definition, the unprecedented nature of this recession means that econometric models used to forecast business trends are not available. Nonetheless, my forecast assumes that the most likely scenario for the US economy is a U-shaped recovery. This implies a slow and gradual revival of growth during the second half of this year and first half of 2021.

Economic momentum should build over the course of 2021. My forecast assumes a rapid acceleration in GDP growth beginning in the middle of next year and continuing throughout 2022. I continue to believe that the domestic economy reached rock bottom in April, and that it should exhibit some preliminary signs of recovery in May and June. A sustained recovery should become evident during the second half of this year.

I also believe that the odds of a prolonged economic downturn and financial crisis similar to 2008 are low. Similarly, a *protracted multiyear deleveraging cycle* — as occurred during the decade following the financial crisis — is unlikely, thereby removing a major headwind to growth. The major assumptions of my economic forecast are as follows:

- The coronavirus will become a normal fixture of American life but will weaken in strength in 2021 and 2022.

- One or more localized waves of COVID-19 outbreaks are likely to begin this fall and winter, and will pose a risk to the sustainability of the reopening process.

- A major offset to the lockdown will be continuation of massive government support. Another fiscal spending program is likely, targeting state and local governments and small businesses. ***And the expected decline in inflation over the next year or two strongly suggests that monetary stimulus will remain at maximum levels over the next several years***.

- Technological innovation and medical breakthroughs will eventually conquer the disease through antiviral medications before yearend and ultimately mass distribution of one or more vaccines during 2021.

- ***The next three to six months could be the period of greatest risk:*** There is a high likelihood of a second wave of infections. At the same time, confidence could suffer as businesses and consumers grow impatient until one or more vaccines are available in mass quantities.

- Most major obstacles to economic growth will be greatly alleviated upon mass production of a vaccine, expected during the second half of next year.

This forecast is consistent with a 6% decline in real GDP this year followed by a 5% rebound in 2021 and 4% growth in 2022, resulting in ***a compound annual growth rate in real GDP of 1.5% over the three years ending in 2022***. As a lagging indicator, consumer inflation could decline to 1% or less over the next 12 months, while the unemployment rate would remain well above its long-term average of 6% until 2023.

INVESTMENT SUMMARY

My base case economic forecast of moderate but sustained economic growth is consistent with a rising trend in both stock prices and government bond yields over the next one to two years. Highly positive liquidity trends should be supportive of financial asset prices. <u>*Historically low rates of inflation — and a rising fear of deflation — will compel the Federal Reserve to maintain its policy of zero interest rates for an extended period*</u>.

In the short term, common stocks are likely to move in a sideways pattern, fluctuating within a range of 2700 to 3100 on the S&P 500, currently 2950, as investors gauge the likely success in reopening the economy on a state-by-state basis. ***In the end, the direction of the economy and the financial markets will be determined by science***. <u>*The next positive catalyst for stock investing will be the FDA approval of one or more therapeutics for widespread use in the fall*</u>. <u>*The ultimate positive catalyst will be FDA approval of one or more vaccines for experimental use later this year and mass distribution in 2021*</u>.

It should be emphasized that forward-looking financial markets will not wait for large-scale production to begin. As was evident on Monday, the mere ***announcement*** of favorable news with respect to vaccine developments should be a sufficient signal to investors that the economy can be reopened at a more rapid pace, even though mass shipments of a vaccine are unlikely to begin until 2021. Market yields in the fixed-income market should move gradually higher along with stock prices over the next year, implying significant excess returns for common stocks over bonds.

Robert F. DeLucia, CFA, was formerly Senior Economist and Portfolio Manager for Prudential Retirement. Prior to that role, he spent 25 years at CIGNA Investment Management, most recently serving as Chief Economist and Senior Portfolio Manager. He currently serves as the Consulting Economist for Prudential Retirement. Bob has 45 years of investment experience.

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