ALTERNATIVE ECONOMIC SCENARIOS

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Summary and Major Conclusions:

The shape and speed of the economic recovery is dependent upon several critical variables, most of which are associated with the COVID-19 epidemic, including daily infections, hospitalizations, and fatalities. Other critical variables include the size and composition of the next fiscal policy program passed by Congress; credit availability; the magnitude of business failures; and private sector confidence. Business confidence will dictate hiring and firing decisions while consumer confidence will heavily influence the recovery in household spending.

- Although I have not changed my economic outlook for a U-shaped recovery, I have lowered the probability of this outcome and increased the odds of alternative scenarios less favorable to financial markets.

- The reason for this shift is straightforward: The recent resurgence of coronavirus infections and hospitalizations — accompanied by both pauses and reversals in reopenings of many states in the south and west — is threatening to undermine the sustainability of the tentative and fragile economic expansion.

- I have developed four economic scenarios that could play out over the next one to two years. Each of these scenarios makes the common assumption that the worst of the recession is in the past and that an economic recovery of an unprecedented nature lies ahead. They differ in the economic strength/weakness that lies ahead.

- The most likely scenario is a moderate but steady economic recovery through yearend, although the odds of this outcome are now far less than 50%. The concept underlying this scenario is that the COVID-19 epidemic remains under reasonable control, and that a nationwide lockdown is avoided.

- Under this scenario, the US economy is allowed to return to high levels of resource utilization during 2021, with real GDP returning to its previous 2019 peak in the fourth quarter of next year. Common stocks would significantly outperform bonds. The probability of this scenario is 40%.

- The second economic scenario is a W-shaped recovery that would emerge from a pattern of regularly recurring outbreaks of the coronavirus into the winter months, resulting in more widespread, semi-permanent lockdowns.

- The concept underlying this second scenario is a pattern of alternating periods of accelerating and stabilizing infections and hospitalizations, resulting in periodic regional shutdowns and a loss of upward economic momentum. This saw-toothed pattern in infections would be evident in a stop-start economy.

- Under this scenario, US real GDP would move in a sideways pattern and not return to its previous peak until Q3 of 2022. The equity market and bond yields would also move in a sideways pattern until yearend. The probability of this scenario is 25%.

- The third scenario would involve a renewed period of economic contraction beginning in Q4 of this year. The concept underlying this scenario is straightforward: A second wave of the COVID-19 epidemic more severe than the first would culminate in another nationwide lockdown. However, the brief decline in GDP would be far less severe than that of March and April.

- Under this scenario GDP would not return to its previous peak until the fourth quarter of 2022. The domestic equity market would be vulnerable to a decline of 10% to 20% prior to yearend. The probability of this scenario is also 25%.

- The fourth economic scenario is a robust V-shaped economic recovery. This economic outcome is becoming less likely as relaxations of social distancing guidelines are systematically being met by rising coronavirus infections, causing states to renew partial lockdown regimes.

- A V-shaped recovery would occur only in response to a sooner-than-expected availability of a vaccine in mass quantities. Under this scenario, real GDP would return to its previous peak in Q2 of 2021. Both the equity market and bond yields would rise sharply through yearend. The probability of this scenario is less than 10%.

- Under my base-case U-shaped recovery, stock prices and bond yields move in a primarily sideways fashion in coming months, although an equity market setback of 10% or more cannot be ruled out as the outbreak worsens in the fall.

- The long-term outlook for stock investing is favorable. Steadily improving prospects for corporate earnings in an environment of low interest rates and inflation would overwhelmingly favor common stocks over the fixed-income market in both 2021 and 2022.

Although I have not changed my economic outlook for a U-shaped recovery, I have lowered the probability of this outcome and increased the odds of two alternative economic scenarios that are less favorable for financial markets. The reason for my change in thinking is straightforward: The recent resurgence of coronavirus infections — accompanied by both pauses and reversals in reopenings of many states in the south and west — is threatening to undermine the sustainability of the current tentative and fragile expansion.

Data since the onset of the pandemic leave no doubt regarding the tight relationship between social distancing guidelines and restrictions and both mobility and economic activity. In other words, ***a strong economy and large-scale lockdowns are very much mutually exclusive***. Considering the uncertainties, this week's *Economic Perspective* explores the most likely scenarios for the US economy over the next year.

FOUR ECONOMIC SCENARIOS

I have developed four economic scenarios that could play out over the next one to two years. Each of these scenarios makes the common assumption that the worst of the recession is in the past and that an economic recovery of an unprecedented nature lies ahead. These four scenarios differ in terms of the contour of the recovery and the speed at which it unfolds.

SCENARIO I: MODERATE U-SHAPED RECOVERY

The most likely scenario is a moderate but steady economic recovery. *The concept underlying this scenario is that the COVID-19 epidemic remains under reasonable control, and that a nationwide lockdown is avoided*. This scenario assumes that new infections, hospitalizations, and deaths reach a plateau within the next month or two. However, unlike most European and Asian countries — which have managed to effectively flatten the curve — new cases in the US form an extended plateau. This is followed by another rise in cases as the widely expected second wave of the COVID-19 epidemic begins in the fall and persists through the winter months.

The ramifications of these public health assumptions are that the trajectory of the recovery will be slower than previously anticipated, but that the expansion will be sustained. *A critical assumption is that the public health system is much better prepared to counter the rising spread of infections, such that a nationwide lockdown is not necessary*. Favorable news regarding an imminent vaccine for emergency use — along with a broader array of therapeutics to treat infected patients — would also bolster confidence.

In terms of critical economic variables, this scenario assumes continued effective functioning of credit markets; continued moderate growth in consumer spending; solid growth in residential construction; and a gradually declining trend in unemployment. In combination with additional fiscal policy measures, these economic trends suggest that business failures and debt defaults are likely to fall short of current dire expectations. I would expect the following to occur under this scenario:

- US real GDP would return to its previous 2019 peak in the fourth quarter of 2021
- Stock prices and government bond yields would trend modestly higher
- Common stocks would significantly outperform bonds

The probability of this scenario is 40%.

SCENARIO II: CHOPPY W-SHAPED RECOVERY

A less sanguine W-shaped recovery would materialize in an environment of persistent and regularly recurring outbreaks of the coronavirus into the winter months, resulting in more widespread and semi-permanent lockdowns. *The concept underlying this scenario is a pattern of alternating periods of accelerating and stabilizing infections and hospitalizations, which would result in periodic regional shutdowns and a loss of economic momentum*.

This ***saw-toothed pattern*** in coronavirus infections would be evident in a ***stop-start economy*** — with alternating month-to-month ups and downs in aggregate output and spending — that would be ended only by widespread availability of a vaccine. Monthly data on employment, retail sales, and industrial production would be highly volatile, oscillating between brief periods of growth and contraction. I would expect the following to occur under this scenario:

- US real GDP would not return to its previous 2019 peak until the third quarter of 2022
- The equity market and bond yields would move in a sideways pattern until yearend
- The equity market would be vulnerable to a 10% correction

The probability of this scenario is 25%.

SCENARIO III: DOUBLE-DIP RECESSION

This scenario is the most negative for financial markets and would involve a further period of economic contraction beginning in the fourth quarter of this year. *The concept underlying this scenario is straightforward: The second wave of the COVID-19 epidemic is more severe than the first wave, prompting another nationwide lockdown*. Following a rebound in GDP in the third quarter, the US economy would suffer a mild decline in Q4, and possibly the first quarter of next year, before responding favorably to mass inoculation of a vaccine for COVID-19 during the first half of next year.

This scenario has risen in probability over the past two months as a result of the sudden resurgence in new COVID-19 cases and sharp rise in hospitalizations that began in mid-June. More than 25 states have either reversed or paused reopenings in the past month, accompanied by a return to more stringent social distancing practices. Under this scenario, a nationwide lockdown would undermine the fragile recovery, leading to a contraction in spending, output, and employment. I would expect the following to occur under this scenario:

- US GDP would not return to its previous 2019 peak until the fourth quarter of 2022
- A second contraction in GDP later this year would be far less severe than that in March and April
- The equity market could decline by 10% to 20% prior to yearend
- Government bond yields would decline to all-time lows

The probability of this scenario is 25%.

SCENARIO IV: SHARP V-SHAPED RECOVERY

The odds of a robust V-shaped economic recovery are low and declining. This scenario would occur only in response to a sooner-than-expected availability of one or more vaccines in mass quantities. *The concept underlying this scenario is that the economy returns to full capacity much sooner than expected because the distribution of a vaccine occurs much sooner than expected*.

Availability of an effective antiviral therapeutic in very large quantities could also ignite a sharp economic rebound. *Medical breakthroughs of this nature would allow for a more immediate reopening of the economy*, a surge in business and consumer confidence, and a sharp rebound in employment and consumer spending.

While a vaccine could be available for emergency use later this year, full FDA approval of a vaccine for the general population is unlikely until the first half of next year. A ramp-up to production of hundreds of millions of doses would also require several months. In the absence of an imminent vaccine, a sharp economic recovery appears highly unlikely. A strong rebound in hiring needed for a robust recovery would not occur. I would expect the following to occur under this scenario:

- US real GDP would return to its previous 2019 peak in the second quarter of 2021
- Both the equity market and bond yields would rise sharply through yearend
- The equity market could rise by 25% over the next year

The probability of this scenario is low and less than 10%.

INDEPENDENT VARIABLES

The shape and speed of the economic recovery is dependent upon several critical variables, many of which are associated with the COVID-19 epidemic. These include the size and specific composition of the next fiscal relief package passed by Congress; credit availability; the magnitude and scope of business failures; and private sector confidence. Business confidence will dictate company hiring and firing decisions while consumer confidence will heavily influence the recovery in household spending.

- **The Coronavirus Epidemic**: The most critical variable in the outlook is the future path of new cases, hospitalizations, and deaths associated with the coronavirus, which is impossible to predict.

- **Medical Breakthroughs**: The ultimate game changer will be availability of vaccines in mass quantities, the timing of which is unknown.

- **Fiscal Policy Measures**: With the approach of the dreaded fiscal cliff in August, the economy is in desperate need of another multi-trillion-dollar package of spending initiatives to avoid a double-dip recession.

- **Credit Flows**: Continued availability of credit for businesses and households is a prerequisite for sustained economic growth.

- **Business Failures**: Bankruptcies are increasing at a rapid pace, especially among small firms; the future trend of business failures and credit losses will determine the strength of employment and consumer spending.

- **Job Creation**: Labor market trends are heavily dependent upon business confidence, which in turn is predicated upon developments in the public health arena, credit conditions, business solvency, and sustained growth in final demand.

- **Consumer Confidence**: The economic recovery is heavily dependent upon the household sector, which in turn is predicated upon consumer sentiment, which in turn is dependent upon job security.

INVESTMENT CONCLUSIONS

The economic outlook will remain murky in coming months because of the extremely unpredictable path of the US COVID-19 epidemic, and hence lack of clarity regarding the timing and pace of fully reopening the economy. **The most likely economic scenario incorporates the following critical assumptions**:

- Daily infections and hospitalizations in regional hotspots (Texas, Florida, Arizona, southern California) peak during the next month, but plateau at high levels

- New outbreaks elsewhere lead to partial lockdowns in those new states, offsetting improving trends in current regional hotspots

- Broadly, the US experiences a pattern of rolling increases in infections across regions, implying a continued high level of new cases nationally

- Unlike Europe and Asia, outbreaks in the US persist at dangerously high levels, acting as an impediment to a more rapid economic reopening, as has occurred in other advanced economies

- A second wave of the epidemic in the fall and winter pushes daily cases to new highs, accentuating the effects of the seasonal influenza

- The enormous improvement since March in the capacity of the public health system in treating patients acts as a powerful offset, resulting in a sharp decline in morbidity and fatalities

- Nonetheless, increased social distancing guidelines lead to a flattening in the business recovery, although a broad contraction in GDP is avoided

- Production and distribution of hundreds of millions of doses of vaccines in the first half of next year proves to be the catalyst sparking a nationwide economic reopening and sustained increase in business activity as 2021 unfolds

- GDP growth rapidly accelerates during the second half of next year and during 2022, supporting a strong rebound in company earnings

Under this economic scenario, stock prices and bond yields move in a primarily sideways fashion in coming months, although equity investors should be prepared for the possibility of a 10% correction as both the economic and public health news continues to deteriorate. Thereafter, steadily improving prospects for corporate earnings in an environment of low interest rates and inflation and hyper-accommodative monetary policy would favor common stocks over the fixed-income market in both 2021 and 2022.

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