The Road To Recovery

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Every summer when I was growing up, we would spend a week or two on holiday in the West of Ireland. These trips would always start in discomfort, as I was one of a large number of children squished into the back of a small car. It was a four or five hour journey, depending on whether we were headed to Galway or Kerry, but before we had even left the outskirts of Dublin, amidst the kicking, elbowing and shouting, someone would yell out “are we there yet?” Over time, though, we adjusted to the long road ahead of us, and, elbowing each other less, we would gaze out at the changing scenery, dream of the sunny beaches of the West and play games like “I Spy” and “20 Questions.” Instinctively we realized we were stuck for a while and had better make the best of it.

The same could be said of our virus nightmare today. The uncomfortable truth is that right now we are stuck in no-man’s land. It is too late to crush the disease through intensive testing and too early to be rescued by better treatment or a vaccine. We appear to lack the collective discipline to maintain the kind of lockdown necessary to eradicate it. We also, however, are not so reckless or heartless as to abandon all caution and accept the potentially awful toll from a quick march to herd immunity.

More could be said on all of these points. However, for investors, it is probably best just to accept that both our lives and the economy will remain constrained by the pandemic into 2021 and look forward to better times thereafter. The sooner we accept that we are stuck on a long and unfamiliar road, the sooner we can consider what this new landscape means for investment choices.

Last week, the CDC outlined three phases for a return to normality. However, for the economy and markets, the road to recovery could perhaps be best described in a five-phase framework:

- The Strict Lockdown Phase
- The Adjusted Lockdown Phase
- The School Reopening/Better Treatment Phase
- The Vaccine Distribution Phase
- The Post COVID-19 Phase

The Strict Lockdown Phase

The strict lockdown phase started in mid-March in many states and its full brunt will be seen in second-quarter economic data. At this point, we expect real GDP to fall roughly 5% annualized in the first quarter followed by a roughly 25% annualized decline in the second. While a huge drop in consumer spending would be the single biggest contributor to this decline, falling investment spending and falling inventory levels could also contribute to the weakness, only partly offset by a lower trade deficit.

Such a collapse in output in the second quarter would make this the biggest recession since the Great Depression, with a cumulative decline in real GDP of 7.8%, compared to 4.0% during the Financial Crisis. Recent weekly unemployment claims also suggest a historic collapse in the labor market, with the unemployment rate potentially rising to close to 15% in April, well above its previous post-WWII peak of 10.8%. Profits will also be down sharply in the quarter, reflecting the general slump in business activity. Meanwhile, we expect CPI inflation to fall to roughly 0.7% year-over-year in April, largely due to the collapse in oil prices.

The anticipation of these dismal numbers has triggered an aggressive policy response from both the Federal Reserve and the Federal Government, with substantial aid for both households and businesses in the CARES Act, signed into law on March

27th. However, with the emergency small business loan program already out of money and bonus unemployment benefits set to expire on July 31st, Congress appears set to pass further measures. We expect that a number of supplemental packages will be passed between now and the middle of 2021 to try to tide both households and businesses over until a more robust economic recovery can take hold.

The Adjusted Lockdown Phase

The adjusted lockdown phase could begin over the next few weeks in many states where there are at least some signs of falling cases and deaths from the virus. However, it should be noted that the degree of opening depends at least as much on the behavior of consumers and businesses as on government edict. According to PCSU, a nationwide credit union servicing organization, in the eight states that did not have a full lockdown in early April, credit and debit card spending was down almost as much as in the states that did.

That being said, in an adjusted lockdown phase, the emphasis will be on what we can safely do without making the pandemic worse. More outdoor activities will make sense, provided social distancing is observed, and some businesses could reopen, even if they are not essential, provided they don't seem to pose too great a medical risk. Buying a new car or new house, for example, should be possible without violating social distancing and both vehicle sales and home sales could rise in the third quarter. More restaurants may reopen on a take-out-only basis and most factories should be able to operate, again with a heightened focus on hygiene.

For the economy, this could allow real GDP to see modest growth in the third quarter, particularly if inventories fell by less or were replenished. Payroll employment might drift down further. However, the unemployment rate could also peak and begin to come down, as a collapse in immigration and people giving up on job searches caused the labor force to fall. Corporate profits would likely remain very weak. However, inflation could well stop falling as supply-side constraints increased the cost of many of the goods and services bought by consumers.

The School Reopening/Better Treatment Phase
September will mark a crucial turning point for the social distancing recession as states will have to decide on reopening schools, even with a still-rising total death toll. While this decision may, unfortunately, get politicized, it is a genuinely tough call. As a new school year approaches, we will have to weigh the risk of greater contagion, particularly for the old, against the long-term damage that social distancing and ineffective schooling could inflict upon the young.

If, by then, we have more widespread testing, better treatment protocols, and more effective drugs to treat the disease, then the mortality rate should be lower. If it is, then schools will likely reopen, albeit trying to maintain as much social distancing as possible. If this occurs, some offices that have been shut could also reopen, as parents no longer have to look after house-bound children. Careful arrangements will also likely be made for early voting in the November election, along with spaced-out arrangements to vote in person, with plenty of masks, gloves and hand-sanitizer.

However, all of these steps will likely still be tentative in the absence of a vaccine, and it will likely not include any significant resurgence in restaurant meals, hotel stays, airline travel, spectator sports or even shopping at the mall. Any gains in employment, output and profits will likely be small in the fourth quarter of 2020 and early 2021 as we all await a vaccine.

The Vaccine Distribution Phase
Hopefully, by sometime in early 2021, a safe and effective vaccine will have been found and manufactured. However, distributing this vaccine will require an army of health-care workers together with supplies and facilities in which social distancing can be maintained. Even if this is organized well, it could take months to fully accomplish, with vaccine days perhaps being first reserved for front-line medical workers and then allocated randomly based on birthdays. It would also necessitate some card or app to allow people prove that they were immune either due to the vaccine or because they already had the virus.

A vaccine would be a game changer. If businesses require that all employees prove that they are COVID-19 immune and check the same thing for customers as they enter the business, they should be able slowly to get back to normal. Airports should gradually fill up again with COVID-free cards or apps being checked at security, and restaurants, hotels, sporting events and group activities should begin to reopen.

Some of these businesses will, unfortunately, open up under new management if government efforts to sustain existing firms through the recession fall short. However, it should be relatively straightforward to open these businesses and real GDP growth should begin to surge, as the population gets vaccinated, with corresponding increases in employment and profits. Inflation may also begin to rise as businesses face increased costs from medical precautions, some shortages due to remaining supply constraint and the pent-up demand of a public willing to pay above the usual price for something resembling normality.

The Post COVID Phase
Assuming a successful vaccine that is distributed over a number of months, there should come a day when the government will declare that the pandemic is over, with 95% of the American public now vaccinated. At that point, the country will try to get back to normal with a rush. However, we will all have been changed. Masks at airports will be a more common sight than before and strangers will always think twice before shaking hands. Some online businesses will have gained a new foothold in people's lives, while many traditional retail outlets will likely find it hard to reopen.

Pent up demand for all goods and services should cause the economy to grow very rapidly, potentially at a double-digit annual rate in the second half of 2021. The unemployment rate should fall rapidly, although it should still be high enough to prevent a sharp increase in wage rates. Corporate profits should surge as companies see revenues rise faster than costs and inflation could also begin to rise. Long-term interest rates could also move higher. Finally, with the economy quickly recovering and inflation and long-term rates rising, the Federal Reserve could begin to taper quantitative easing and raise the federal funds rate in the fourth quarter of 2021.

For investors, this would ultimately lead to some losses in high-quality fixed income over the next two years. For equities, a return to relatively normal earnings by 2022 could help justify the resilience of the stock market in recent weeks. However, with another 3.0% gain in the S&P500 last week, the argument for strong returns going forward is gradually being eroded.

All of this, of course, depends critically on assumptions about the course of the pandemic, medical treatments to deal with it, and the implementation of appropriate government policies. It may well be that other countries, particularly in East Asia, do a better job in controlling the virus. Moreover, the highly service-sector-dependent U.S. economy may suffer more damage than other nations. This could allow the dollar to fall and international equities to outpace their U.S. counterparts.

Finally, however, investors should reflect on the unpredictability of it all. Just a few months ago, prospects for the global economy and financial markets looked completely different from today and we are always vulnerable to shocks. For this reason, it is important, while staying calm, to also stay well diversified on this long road to a much-deserved better place.

David Kelly is chief global strategist at JPMorgan Funds.
