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Economic Research Note

US: Prediction? Pain

- **In light of developments over the past week we are further reducing our growth outlook**
- **Widespread stay-at-home orders have broadened the scope of impaired economic activity**
- **Federal stimulus should provide only a partial offset to ongoing income losses**
- **Weakened balance sheets suggest a recovery more akin to the one after the GFC than after a weather disaster**

When we revised down our growth outlook last week it was generally received as overly pessimistic. Now it looks somewhat optimistic; such is the pace of events. In light of those events we lower our forecast for real annualized GDP growth in 1Q to -10% (from -4%) and in 2Q to -25% (from -14%). This would leave the level of activity 10% below the pre-virus baseline, apparently similar to what is occurring in areas where the virus is on an earlier path, like Italy. We now expect the unemployment rate to peak near 8.5%. Whereas normally a downward revision to 1H would be expected to result in an upward revision to 2H, we are leaving our second-half forecast unrevised at 6%, incorporating financial headwinds that should dampen the pace of recovery.

Late last week several states—representing a large share of the economy—ordered residents to stay home from all non-essential workplaces. This underscores that the economic effects are broadening from activities that lack social distance in consumption—travel, theaters, etc.—to those that lack social distance in production—a much vaster swath of the economy.

The policy response has also evolved since our last revision. A growing rift between the federal and state approaches to containing or mitigating the spread of the virus suggests the Chinese experience may no longer be an appropriate comparison. At the very least it should further depress sentiment and confidence in the institutions on which the market economy relies. Our forecast continues to embed an assumption that the virus has run its course by June. We are also very close to a roughly $2 trillion federal stimulus effort. This is a useful start and will help. However, much of the federal support will come in the form of loans rather than grants. Loans are better than nothing, but it will add to the debt overhang problem for the business sector.

The debt overhang issue is a useful reminder for economic forecasters that the most important lesson of the Global Financial Crisis (GFC) was the importance of financial factors. Many have made the observation that in the GFC problems in the financial sector transmitted to the real economy whereas now problems in the real economy are transmitting to the financial sector. While the course of the two crises is different, the end point may be the same: weakened balance sheets of households, businesses, financial institutions, and state and local governments. This is exacerbated by the fact that at least for the business sector we entered this crisis with already high debt burdens and pressured profit margins. This makes it more likely that the recovery from the current crisis looks more like the one that followed the GFC, rather than the sharp snapback that usually ensues after natural disasters like hurricanes and earthquakes.

Another take

Economic activity is measured in three separate ways that should be equivalent: the expenditure approach, the value added by industry approach, and the income approach. So far, most of our analysis has relied on the expenditure approach: how much spending for travel, tourism, etc., will decline. The large number of states issuing stay-at-home orders highlights the usefulness of attacking the problem from the value-added approach.

Figure 1: Percentage of total workers who could work at home (%) (2017-18)

Source: B.L.S, J.P.Morgan

The Bureau of Labor Statistics produces data on the ability to work from home (Figure 1). Weighted by industry this would suggest if everyone worked from home value added would be 35% of normal. This could be higher, because in an emergency situation like now more people could find a way to work from home, or lower, because productivity is likely lower when working from home (otherwise it would make economic sense to do it in normal times). In any event, 41% of GDP is in stay-at-home states, 14% in partial stay-at-home states. Assuming that remains the case for the remainder of the month, and assuming the BLS numbers are roughly correct, would imply that these stay-at-home orders take 12.7%-pts off 1Q annualized GDP growth.

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As COVID-19 continues to progress, it also seems more difficult to imagine the stay-at-home orders being lifted soon enough in enough places to produce the May bounce in activity that underlies our current forecast. We thus make a further downward revision to -25% for 2Q growth as well. This would be consistent with these stay-at-home orders remaining in place for the first three weeks of April. Economy-watchers are by now well aware of the massive uncertainty pertaining to projections, but we are quite confident that we will see a historic decline in output in 2Q.

Around the corner

Looking further ahead than 2Q gets much trickier. One might expect a rapid bounceback in activity after a sharp and concentrated shock like the virus, much like we often see after natural disasters. And policymakers are acting quickly to do everything they can to produce an outcome like this. The Federal Reserve has already added a few new tricks to the playbook developed during the GFC, and fiscal policymakers are crafting a package of stimulus checks, bailout loans, assistance to state and local governments, and other programs as we write. There are many details of these programs that will become clearer over time, but we pencil in deficits greater than $2 trillion and 10% of GDP in both fiscal 2020 and 2021 (Table 1).

Table 1: Federal government deficit projections, $ billions

	FY2020	FY2021
Pre-COVID-19 CBO forecast	1,073	1,002
+ Revenue effects of downturn	250	400
+ Automatic spending effects	150	200
+ Fiscal stimulus	900	400
Total	2,373	2,002
JPM deficit forecast	2,400	2,000
As % of GDP	12%	10%

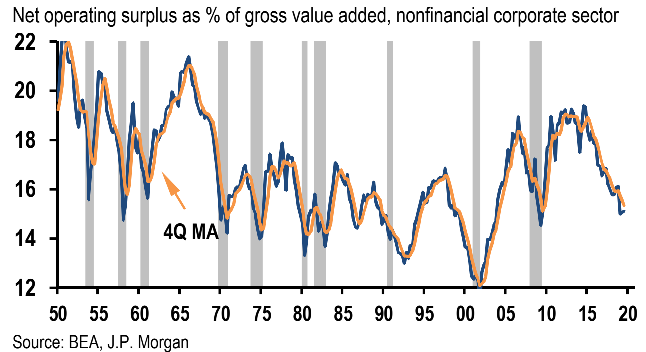
Source: CBO, J.P. Morgan

Still, we think even this Herculean stimulus effort is unlikely to overcome the effects of the COVID-19 shock and its interaction with existing vulnerabilities in the economy. Indeed, well before the virus sprang to life, we characterized vulnerability to recession in the US as "ample, but not glaring." Over the last few years, an unemployment rate near 50-year lows has produced solid wage growth, leaving business margins at their thinnest levels since 2009 (Figure 2). Meanwhile, businesses have borrowed at low interest rates over the last 10 years, leaving the ratio of business debt to GDP at all-time highs (Figure 3). To be fair, general growth in the size of the corporate sector has also led to growth in income and assets, but more carefully constructed corporate leverage metrics are still near the peaks seen around recent recessions (Figure 4).

Even with the credit support promised to various sectors of the economy from the Fed and the Treasury department, we suspect businesses will find themselves constrained by tight financing in the coming months, limiting the rapidity of the bounceback that we can expect in hiring and capital expenditures. The hit to consumer sentiment, labor markets, and net worth is also likely to prove long-lasting in our view.

Figure 2: Nonfinancial corporate business margins

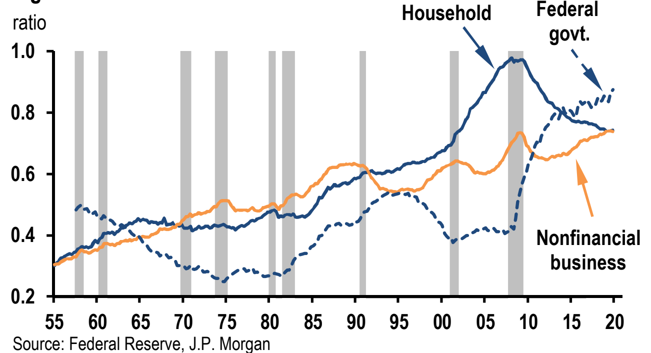
Net operating surplus as % of gross value added, nonfinancial corporate sector



Source: BEA, J.P. Morgan

Figure 3: Debt to GDP ratios

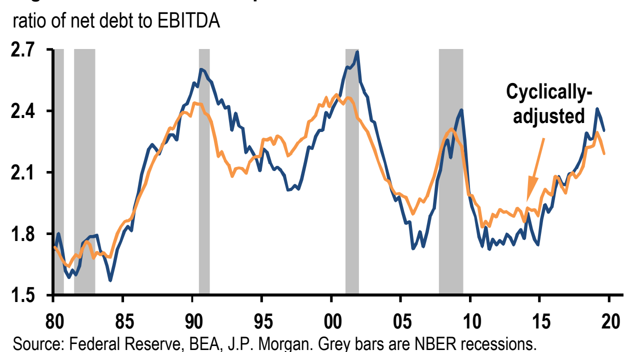
ratio



Source: Federal Reserve, J.P. Morgan

Figure 4: Nonfinancial corporate net-debt-to-income ratio

ratio of net debt to EBITDA



Source: Federal Reserve, BEA, J.P. Morgan. Grey bars are NBER recessions.

Finally, we don't want the income approach to measuring activity to feel neglected. Measuring capital income at a high frequency can be challenging, but jobless claims can provide a weekly snapshot of the state of the jobs market, and hence of the largest component of national income—labor compensation.

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