
CONSENSUS BEGINS TO EMERGE ON ECONOMIC OUTLOOK

5-6% decline in U.S. output implied by NY Fed's weekly indicator, unemployment claims and weak domestic demand in China

April 16, 2020

On April 14, 2020 the CFA Society of Detroit hosted Chris Low, Chief Economist at FHN Financial. Low anticipates real U.S. GDP to decline 5 per cent in 2020. This is based upon 13-15 per cent unemployment in April, and the NY Fed's new weekly economic indicator which suggests real-time GDP decline of 11 per cent. The NY Fed's indicator includes same-store retail sales, initial unemployment claims and raw steel production amongst 10 variables. The IMF is slightly less optimistic, predicting U.S. real GDP decline of 6 per cent in 2020, followed by recovery of 5 per cent in 2021; and unemployment of 10 per cent in 2020 and 9 per cent in 2021. Low also expressed a view that the share market has not incorporated the full magnitude of small businesses losing 3-4 months of revenue, and weak domestic demand in China. The S&P 500 is down 18 per cent from its high of February 19, 2020.

I make two comments. First, the recession has, again, demonstrated there is no "economic cycle." Retail investors believe that the longer a period of expansion, the closer we are to the next recession. But the virus which caused the recession could have arrived at any time in the last decade. In January the IMF forecast 2.0 per cent real GDP growth for the U.S. Second, prudent investors leave market-timing decisions to the handful of skilled investors who analyze data in real-time (and who are hard to identify in advance). The S&P 500 fell by 34 per cent from its peak over 33 days, and has recovered to be down just 18 per cent after 56 days. A small market timing mis-step can leave plenty of money on the table. Research on successful active investors shows that most investors who achieve above-benchmark performance do so on the basis of individual security selection, not asset allocation.

Introduction

On April 14, 2020 the CFA Society of Detroit hosted a webinar on the economic outlook. The presenter was Chris Low, Chief Economist at FHN Financial.¹ Chris addressed the key question of magnitude and duration of the recession. He also expressed a view that the share market had not incorporated the full magnitude of the negative economic impact.

Magnitude and duration of recession

- Chris Low
 - U.S. Real GDP decline of 5 per cent in 2020.
 - U.S. unemployment rate of 13-15 per cent in April 2020.
 - New weekly economic indicator from Federal Reserve Bank of New York (NY Fed) suggests real-time GDP growth of -11 per cent.
- International Monetary Fund (IMF)
 - U.S. Real GDP decline of 5.9 per cent in 2020, followed by recovery of 4.7 per cent in 2021.
 - U.S. unemployment rate of 10.4 per cent in 2020 and 9.1 per cent in 2021.

In terms of U.S. real GDP, Low anticipates a 2020 annual decline of 5 per cent. This average result includes a 33 per cent fall in 2nd quarter output and a 19 per cent recovery in the 3rd quarter. The IMF is slightly less optimistic.² In its biannual economic outlook, the IMF projects a 5.9 per cent fall in real GDP in 2020 and a 4.7 per cent recovery in 2021. It was only in January 2020 that the IMF had expectations of real GDP growth of 2.0 per cent in 2020 and 1.7 per cent in 2021. So in aggregate, economic output over two years is likely to be 5 per cent lower than anticipated just three months ago.

Two key measures Low referred to are employment and a new weekly economic index produced by the NY Fed.

Employment. New unemployment claims have been 22 million in the four weeks ending April 11.³ Low anticipates a total drop in employment of 20-25 million and an April 2020 unemployment rate of 13-15 per cent. The IMF projects U.S. unemployment across the whole of 2020 at 10.4 per cent, falling to 9.1 per cent in 2021.

NY Fed Weekly Economic Index. The NY Fed has developed a new, timely measure of economic activity based upon 10 weekly indicators, including same-store retail sales, initial unemployment claims and raw steel production.⁴ For the week ending April 11, 2020 the index was -11.0 per cent. This means that, if economic conditions persist for a year, real U.S. GDP would fall by 11.0 per cent. The previous low point of -4.0 per cent was observed on February 28, 2009.

¹ <https://www.cfasociety.org/detroit/Pages/Speaker.aspx>

² <https://www.imf.org/en/Publications/WEO/Issues/2020/04/14/weo-april-2020>

³ <https://oui.doleta.gov/press/2020/041620.pdf>

⁴ <https://libertystreeteconomics.newyorkfed.org/2020/03/monitoring-real-activity-in-real-time-the-weekly-economic-index.html>; and https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr920.pdf?mod=article_inline

Share market view

- Low's view is that the 18 per cent fall in the S&P 500 has not incorporated the full impact of the recession.
 - Stimulus effect dampened by consumer tendency to save in recession and constraints on the services consumers can buy.
 - Domestic demand in China is weak.

Low expressed a view that the share market had not incorporated the full economic impact of the recession. At April 15, 2020 the S&P 500 is down 17.8 per cent from its peak of February 19, 2020. Low believes that the market has under-estimated the extent of the economic damage when small businesses lose 3-4 months of revenue.

Low's thesis is that we have economic stimulus in terms of unemployment benefits (boosted by an additional \$600 per week) and government programs for business (or example, the Paycheck Protection Program). But while we will see spending on staples be maintained, consumers have a tendency to save in a recession, which mitigates the benefits of direct cash payments.⁵ For example, the savings rate was 5.1 per cent during the post-tech bubble recession (March 2001 to November 2001), declined to 4.6 per cent during the subsequent expansion (December 2001 to November 2007) and increased to 5.4 per cent during the most recent recession (December 2007 to June 2009). However, during the subsequent decade of expansion, U.S. households have increased their savings rate to average 7.0 per cent (July 2009 to February 2020).

This means that, while households have cash available to spend even – a decade of savings and the current government support – this does not mean they will. After all, discretionary services simply are not available for consumers to spend money on, aside from those which can be delivered remotely (the Blue Apron stock price is up 219 per cent from February 19, 2020 and Peloton has risen by 31 per cent).

Low's view on the share market is also motivated by weakness in domestic demand in China. He is concerned about Chinese government purchases of personal protective equipment, and anecdotal reports from journalists within China that the country does not have the handle on the virus that China claims.

Comment

I leave share market predictions to those analyzing market movements in real time. But the recession has highlighted two important points for investors.

First, there is no such thing as an economic cycle, a term which suggests a natural period of expansion and contraction like waves rolling into a beach. Retail investors believe that the longer a period of expansion, the closer we are to the next recession. The reality is that expansions and recessions have an indeterminate timeframe. In January the IMF predicted 2.0 per cent U.S. real GDP growth, a forecast which has been revised downwards by 7.9 per cent. The U.S. had 10 years of expansion, and there was no structural reason that a recession became more likely today, three years ago or five years ago. The virus could have arrived at any time.

Second, some portfolio managers have skill in timing their entry and exit to asset classes (shares vs bonds, for example). But this portfolio formation approach is best left to investors analyzing prices and economic data in

⁵

real-time. And it is hard to identify those skilled managers in advance. The S&P 500 fell by 34 per cent from its peak in just 33 days, and has since recovered by 24 per cent in just 23 days. This makes the overall decline 18 per cent over 56 days. Research on the individual securities held by active investors shows that, of the active investors who are able to earn above-benchmark returns, most do so by individual security selection rather than clever asset allocation. For the underlying investor providing capital to a portfolio manager, ask for detail about your portfolio manager's strategy. Determine whether this strategy is repeatable month after month, and in volatile and benign markets. The objective is to ensure portfolio risk is appropriate for the investor, and that returns are not left on the table by a panicked sale after a market fall, or attempting to ride a trend when prices rise.