Capital Risk

USA ECONOMIC OUTLOOK

Pandemic Policy without a Plan

Photo: Bermix Studio on Unsplash

During a period requiring leaders, the US had politicians. Instead of addressing the problem in front of them, their eyes are fixed on the next election and placating their adoring masses. The long-term effect may be a lost generation. The short-term outcome may be needless hardship for those industries that are primarily hit. The immediate challenge is ensuring that consumer behavior doesn't change permanently. The enduring challenge is to avoid crowding out programs and consumer spending from the required higher debt service and tax rates. A politician once said to never let a crisis go to waste. A leader would say never create waste during a crisis. The difference will determine the future.

"

The Pandemic is testing the fabric of the social safety net in the US and the viability of entire industries.

The US requires a focused and prolonged plan to address the people and industries in need. The Pandemic will pass; however, the policy response will require years. Best start now.

- *Jason Prole*

"

Highlights

- Third quarter GDP will **expand $0.8 trillion** (20% annualized).
- Growth for 2020 is forecast to fall close to **$700 billion or 4%** of GDP.
- The speed of **Healthcare's** rebound will determine the path of consumption.
- **Inventory restocking** will hide investment's slow rebound.
- Export growing faster than imports **improves net exports** and masks the real decline in domestic demand.
- **State & Local government** declines will offset Federal government spending.

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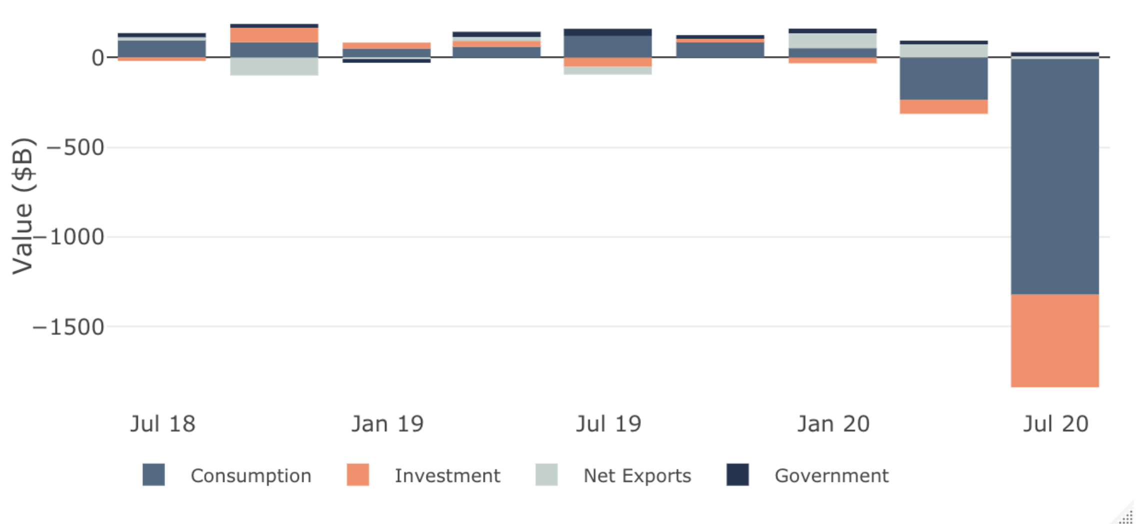
Will consumer behavior change?

As expected, the second quarter was the most significant decline since the 1930s. The critical concern is not what happened; instead, it is where we go from here. The US was virtually alone in keeping most of the economy open during the Pandemic. The growing toll of lives lost shows the cost. That is not the only price that the US will pay. An economic toll will occur that may exceed the initial cost.

Most other developed countries coordinated their national response, and the result is they are tentatively returning to normal. The US now sits as an economic laggard as its citizens remain persona non grata in other nations. At the same time, the US is terra incognito for foreign travel. Unparalleled monetary and fiscal policies helped with the latter totaling *$2 trillion*. Yet, the second quarter saw a decline in consumption of *$1.8 trillion* (exhibit 1). The problem is that a poor Pandemic policy trumps all. As fiscal policies expire, the economic toll will fall upon the economy's sectors experiencing the brunt of the Pandemic: retail, dining and hotels. American exceptionalism, indeed.

Unfocused fiscal policy was not enough.

Exhibit 1. GDP Contribution by Component



Source: Federal Reserve Economic Database, CRM Calculations.

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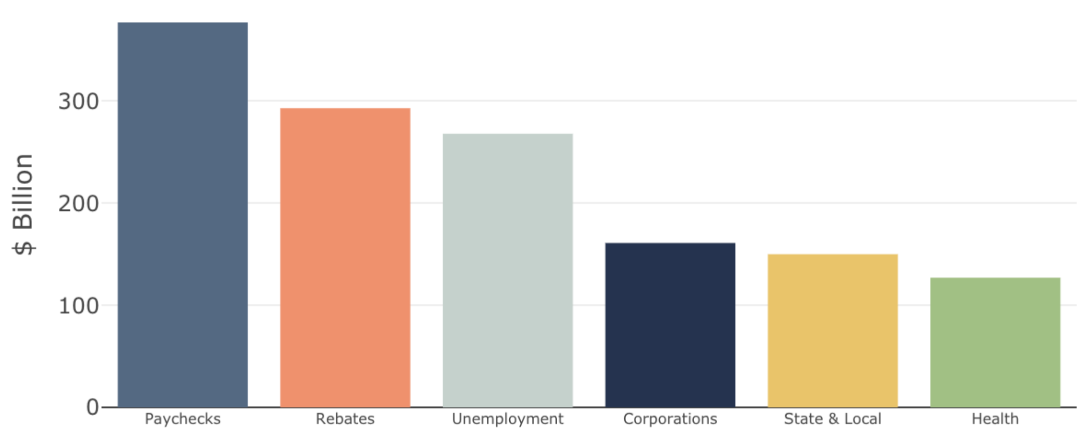
Policy response, particularly fiscal, is critical during times of deficient demand. When faced with a parallel economic tragedy that inspired Keynes's insight, the US decided an alternate path. The second-largest policy response was writing checks to increases demand, irrespective of need (exhibit 2). As a fire can't ignite in a vacuum, spending can't occur when *stores are closed*.

Fiscal policies were large.

Exhibit 2. Major Fiscal Stimulus Programs



Source: Congressional Budget Office, https://www.cbo.gov/system/files/2020-04/hr748.pdf

The problem was they lacked focus.

The stimulus improperly targeted the recipients and industries in need, which resulted in the largest *increase in savings on record*. While the incentive for politicians to write checks in an election year is evident, partially focusing the program would better serve those in need. For example, the rebate program could cover the employment wages for the 27 million employees in the Leisure and Retail sectors over *four months*.

The paycheck program also failed with a lack of focus because it did not target the sectors in need. The damage to employment was severe; however, 80% of people remain employed. Thus, providing support to sectors that are in need does not address the problem. Merely taking half of the paycheck program and focusing it on those sectors in need (e.g., retail and leisure) enables extending their unemployment benefits for *another three months*.

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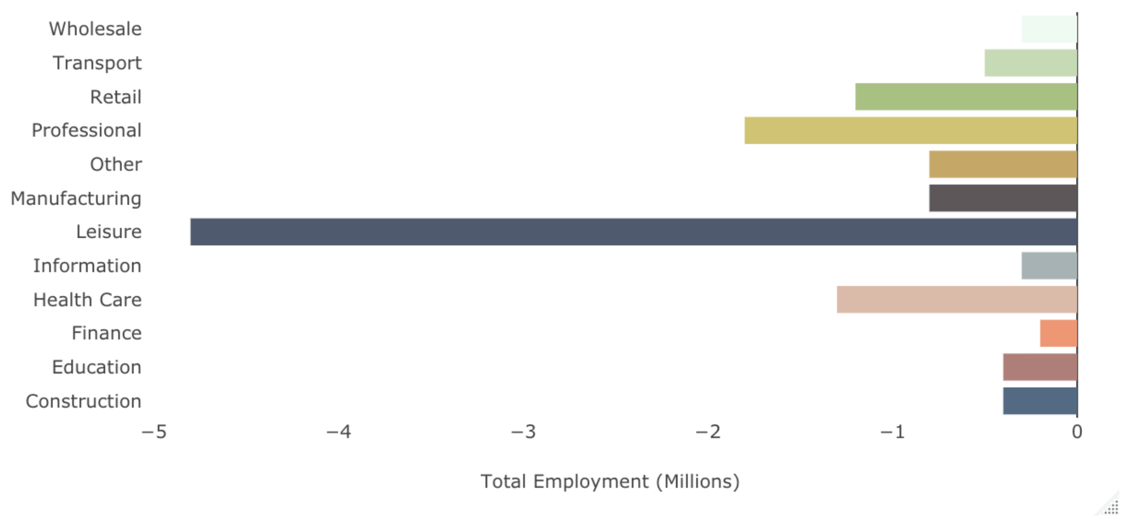
The importance of focus in the programs is evident from the change in employment. Since the end of 2019, the leisure sector lost nearly five million jobs, despite the rebound in June (exhibit 3). Some sectors are experiencing a recession, while others are deeply in depression.[1] By treating the economic response as one-size-fits-all, the outcome is an inefficient allocation of fiscal support that threatens *sustained support for those sectors in need*.

Exhibit 3. Employment Losses by Sector (From Dec 2019 to June 2020)

A one-size policy response does not fit all.



Source: Federal Reserve Economic Database, CRM Calculations.

Healthcare is in critical condition.

An effective response is critical to recovery because of the enduring economic statement: *one person's spending is another's income*. The two next highest sectors facing high levels of job losses include the retail sector and the health sector. While not all workers have employee-linked health insurance, the leisure sector can potentially result in *five million fewer consumers of healthcare.* Some of the job losses are a result of lower demand for elective healthcare during the Pandemic. Indeed, other results from a material drop in demand as people lose their employment-based healthcare. Further, these jobs losses depress

[1] Capital Risk highlighted the economic impact would result in economic epidemics in sectors and regions, while the Pandemic ravages the economy, "Economic Epidemic," **Capital Risk**, April (2020).

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spending across other sectors. If the Leisure sector ran at 50% capacity for a year, it would result in a *one percent decrease* in potential growth.

Faltering export demand imperils growth.

A surprising outcome in the second quarter was the modest improvement in Net Exports. The US enjoys a privileged position in global trade with its exports dominated at the commodity level (i.e., food) and the value-added level (i.e., technology). Both are mostly demand-agnostic. Thus, with a severe retrenchment of imports caused by falling domestic demand, the expectation was for a higher gain. That exports fell at a similar rate to imports is worrisome for a quick recovery. The US *should have enjoyed a greater terms of trade benefit*: it did not. Global supply chains do not return quickly after implementing alternatives and places US global competitiveness at risk.

Exhibit 4. US Treasury Marketable Debt Outstanding

Treasury debt grew *before* the crisis.

Source: Federal Reserve Economic Database, CRM Calculations.

These outcomes are a challenge for the US economy in the context of the national debt. With domestic and external demand expected to return slowly, the US still needs to service an expanding debt load. The current expansion of debt by *$3.5 trillion* is understandable, given the economic peril the US faces (exhibit 4). What is incomprehensible is the nearly *$4 trillion* added between December 2016 and February 2020 that resulted in a GDP growth rate that did

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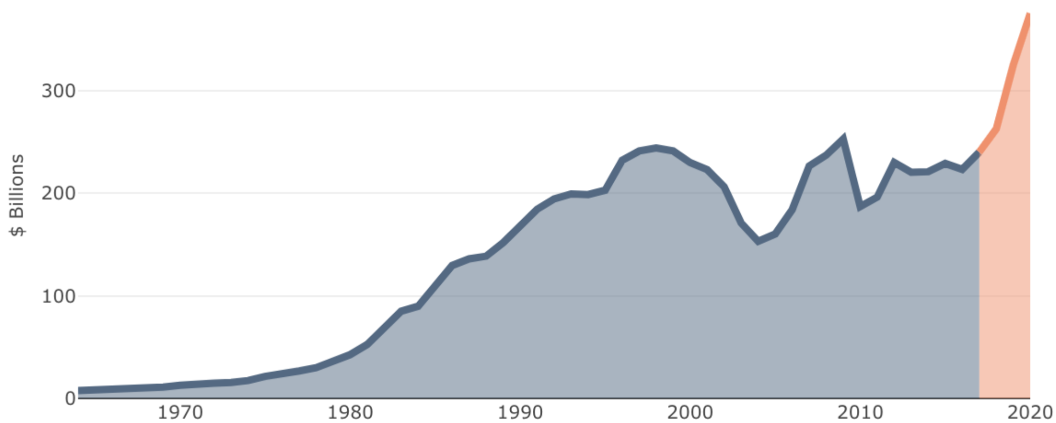
not exceed the *prior six years*. When we spend borrowed money, we should be thoughtful of *how we spend it*.

This egregious spending shows up is in the equity markets as it exceeds prior highs during the *worse contraction in a hundred years*. This outcome is significant because of the debt service that is required. Every dollar spent on paying interest is a dollar less spent on value-enhancing activities such as infrastructure, education, and healthcare. These activities *enable people to work*.

Exhibit 5. US Interest Payments on Treasury Securities

A $4 trillion expansion of debt will increase costs.



Source: Federal Reserve Economic Database, CRM Calculations.

The US can't have constrained demand, both domestic and external, while concurrently servicing a growing debt. The debt service maintained its level for the last two decades as lower interest rates met increasing debt (exhibit 5). The trouble is that debt service expanded by nearly 50% during the previous four years. It does not include the current debt expansion. Higher interest rates account for half of the increase, while the other half is simply a result of $4 trillion more of debt. The current debt expansion of another $4 trillion should add about $40 billion to the debt service, pushing the level over *$400 billion*.

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Prior fiscal largesse will reduce growth.

This level of debt service is roughly equivalent to 75% of non-defense federal spending. Two options exist to mitigate the impact: cut programs or raise taxes. Regardless of the choice, *reduced future demand occurs*. This outcome is the peril that the US faces: slower demand, higher taxes, and less spending. These growth inhibitors may wipe out the benefits of the Millennial generation entering their prime productivity and spending years. The net result is a decline in US competitiveness versus the rest of the world.

These outcomes will delay the recovery of the US. A quick rebound is not probable, given the history of recessions in the US. While the expectation is not for a depression, the prolonged effect of a change in consumer behavior is possible.[2] Consumption growth may slow as savings increases to insure against future calamity. This result would further dampen demand and exacerbate the situation.

A declining workforce magnifies the problem.

The US must avoid these outcomes to ward off a lost generation. The vital importance of this outcome is evident in the workforce size. Poor policy decisions magnified a declining workforce that began for Japan in 1996. Europe's workforce decline began in 2011, China in 2016, and 2020 is the year for the US.[3] Without this beneficial wind pushing growth, the US could experience a *one percent decline* in the growth rate.

Growth focused policy is the only way out. Encumbering the US is tax-cut induced debt that adds nothing to growth. Adding to it is the generational challenge of overcoming a debt-surge from the global pandemic. The demographic dividend that lifted the US after World War II is absent. The GI Bill brought post-secondary education to the masses. The interstate highway system delivered the infrastructure for inter-state trade, and women entered

[2] See "Depressing Recession", US Economic Outlook, **Capital Risk**, First Quarter, 2020, for a discussion on past recessions, their drivers, and the outcomes.
[3] See "Labor's Decline and Filling the Void," **Capital Risk**, September 2017, for a discussion on demographic and workforce trends and the implications for the economy.

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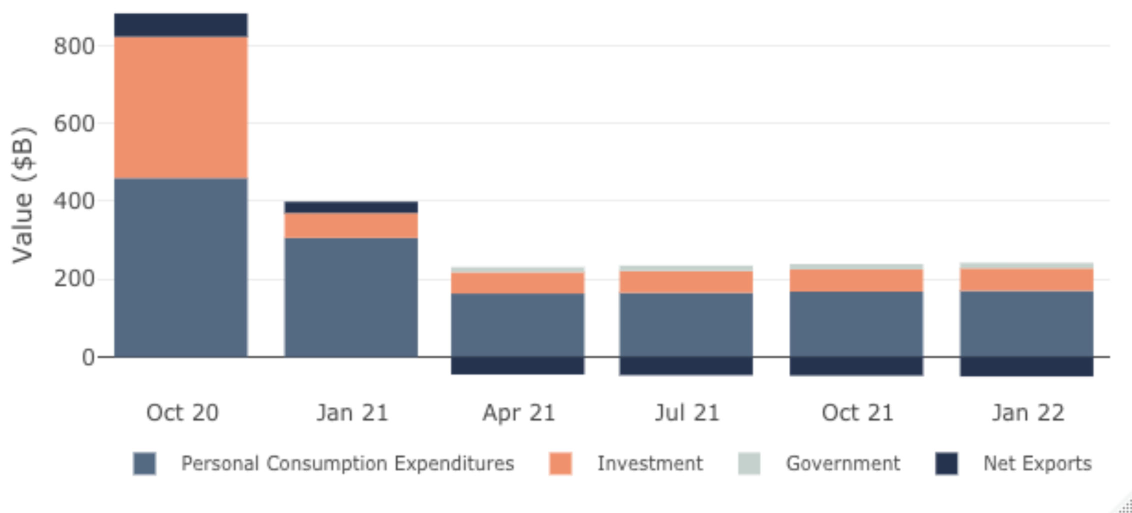
Fiscal program need focus.

the workforce en masse. While the latter is a one-off event, the underutilized people at the bottom of the income spectrum and disadvantaged minorities are a parallel that shows promise. An initiative that begins with aligning education and infrastructure to maximize today's workforce can avoid a lost generation and reboot the US economy. P*olicy must trump politics*.

Exhibit 6. Forecast for US GDP Growth



Source: CRM estimates. Amounts are annualized rates.

A 3.9% decline is forecast for 2020.

The forecast for 2020 remains at a 3.9% decline (exhibit 6). A return to peak output occurs in the first quarter of 2021.[4] This decline is the largest since the 1930s and highlights the economic peril facing the US. There is a material risk to the forecast. An anti-viral/vaccine/testing program is assumed to arrive in the fourth quarter. This outcome permits the dynamism of the US to jump the economy back to normal. Inadequate fiscal policy, poor pandemic management, or political upheaval would place this outcome at risk.

[4] The forecast was adjusted from the first quarter, combining the second and third quarter impacts into the second quarter and moving all other quarterly periods ahead one quarter.

Consumption

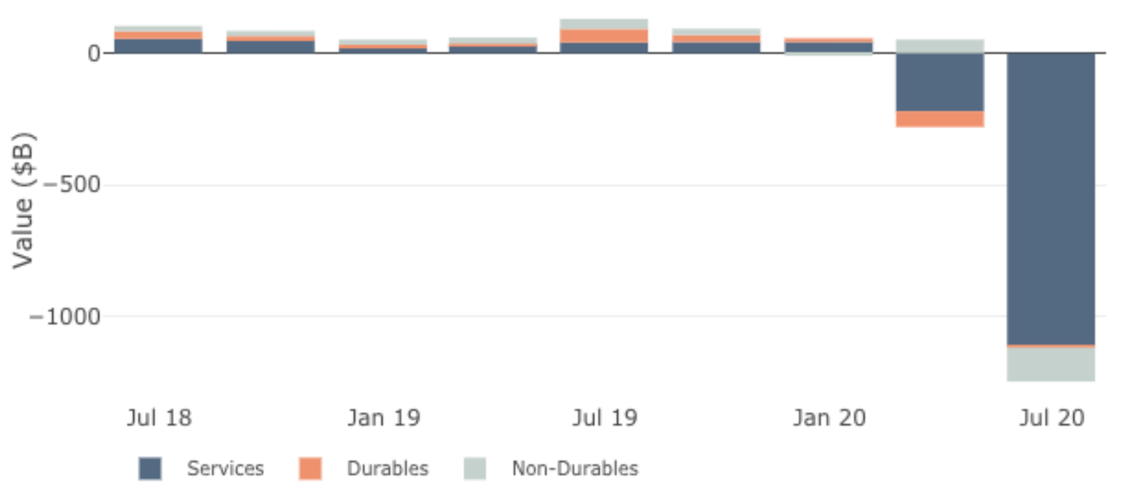
There is no "V" in rebound.

The scale of the collapse of consumption is without a modern parallel. The Great Depression is not even congruent with the current narrative because of the *speed* of the destruction. The current nadir occurred in less than *three weeks*, while the former unrolled over *three years*. The economic cognoscenti argue that government policy induced the economic collapse. Its reversal is simply a matter of policy. This argument ignores the global economy's state before the Pandemic (entering contraction) and the Pandemic's moderating impact on future consumption through consumer behavior. Neither of these characteristics indicates a rapid economic return.

Consumption was supported in the first quarter by hoarding non-durable goods in advance of economic closures (exhibit 7). Of course, the following quarter saw this artifact reverse and decline at a higher magnitude. While a small glimmer of hope rests in durable goods orders, the collapse of services is a cause for alarm, with the contraction reaching over *$1.1 trillion* (a.r.). This decline alone exceeds every quarterly decrease in *total GDP* for the *last 80 years*. The times are indeed different.

A fall of consumption that exceeds all others.

Exhibit 7. Consumption Contribution by Component



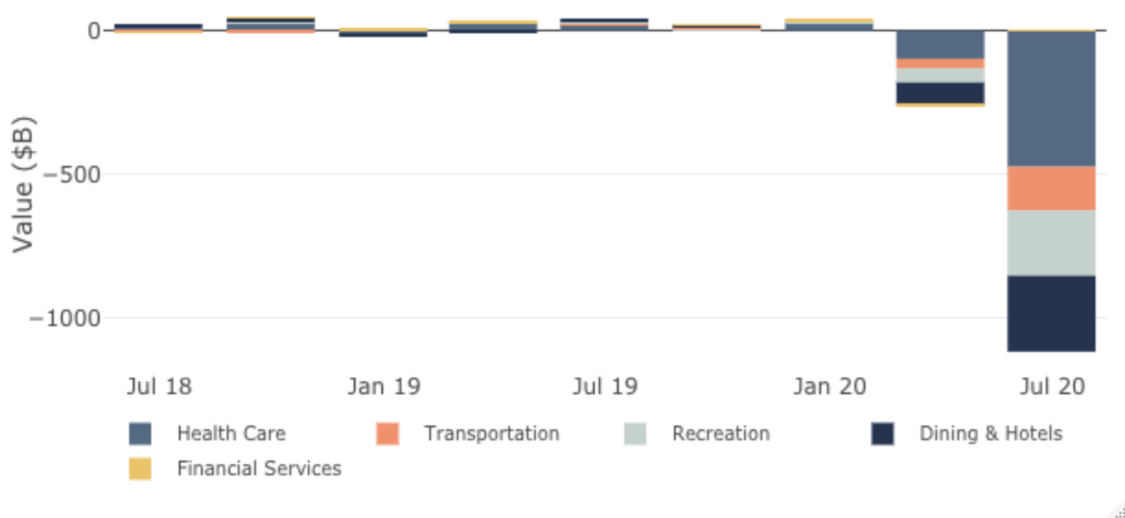
Source: Federal Reserve Economic Database. Values expressed as an annualized rate.

Consumption

Health Care is leading the decline.

The shocking insight for consumption was the decline of healthcare services that almost reached *$500 billion* (exhibit 8). The expectation was that health services would *expand* during the Pandemic.[5] This expectation conflates emergency services and the more extensive preventative healthcare services. Indeed, emergency services increased, but people avoiding hospitals, checkups and preventive care far exceeded it. Further, *the linking of healthcare to employment* magnified the outcome as job losses rose.

Exhibit 8. Service Consumption Contribution by Component



Source: Federal Reserve Economic Database. Values expressed as an annualized rate.

Healthcare's Return will mirror employment.

This outcome highlights one of the critical risks of the Pandemic: an enduring change in consumer behavior. People may find that they do not need to go to the doctor's office as often. Amplification of this decision could occur. The younger Millennial cohort could leverage their relative better health and avoid preventative care. Also, economic necessity may drive this outcome because they are disproportionally hit by unemployment that results in the loss of their employer-sponsored healthcare. The rebound of healthcare services will follow employment: a path that will *take years* to reach the prior peak.

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[5] *Depressing Recession*, US Economic Outlook, **Capital Risk**, First Quarter (2020).

Consumption

The size and high wages make health care material.

The impairment of healthcare services is material due to its size. It is larger than the combination of the three other largest hit services sectors (Transportation, Recreation, and Dining & Hotels). This size makes restoration of the sector paramount in any recovery plan. A muted recovery will unfold unless people start returning to their healthcare services provider. The problem: most US healthcare is employer-provided. Thus, without the return of jobs in the hardest-hit sectors, a complete restoration of healthcare services is not feasible.

Exhibit 9. US Employment, Wages, and Income by Sector

Source: Federal Reserve Economic Database. Size of circle represents total income of the sector.

The ACA may have magnified losses in healthcare!

It is difficult to overstate the significance of the healthcare service sector. While accounting for a quarter of consumption services, its wages and employment number exceeds those of the combined retail and leisure sectors (exhibit 9). The materiality is evident: the healthcare decline was like losing the economic contribution of either of the recreation or retail employment sectors *completely*. Indeed, the policy choice to expand healthcare over the last decade *magnifies the outcome*. A policy choice is addressable. A change in consumer behavior that endures for decade is a different and more severe problem.

Consumption

Recreation leads consumption!

The details of consumption show sectors of concern. Maintaining the level of durables goods orders was achieved with an unprecedented expansion of recreation vehicles. How extreme was it? Recreation vehicle consumption expanded at *ten times* the average rate over the last 20 years. A reversal of this outcome would make durable goods orders a drag in the next quarter.

Clothing and gasoline led the decline of non-durable goods. As people return to commuting and focus travel plans on road-trips rather than air travel, gasoline should return. Clothing may be a challenge as the Millennial generation forgoes the latest clothing fads and keeps their clothing longer, particularly in the face of enduring unemployment. A perplexing sign is the decline of groceries purchases. Certainly, some were a reversal of the prior quarter's hoarding. The combination of the daily necessity of eating and unprecedented fiscal support would make a continued decline ominous.

People are good: non-profits expanded materially.

A bright spot and a positive reflection of people's willingness to help others in need saw an expansion of non-profits by $120 billion. This outcome also highlights a problem: the expansion of private aid organizations speaks to the deficiency of the US's social safety net. A further challenge is that any reversal of this generosity would offset gains in other services categories. Thus, even a glimmer of hope suggests further pain.

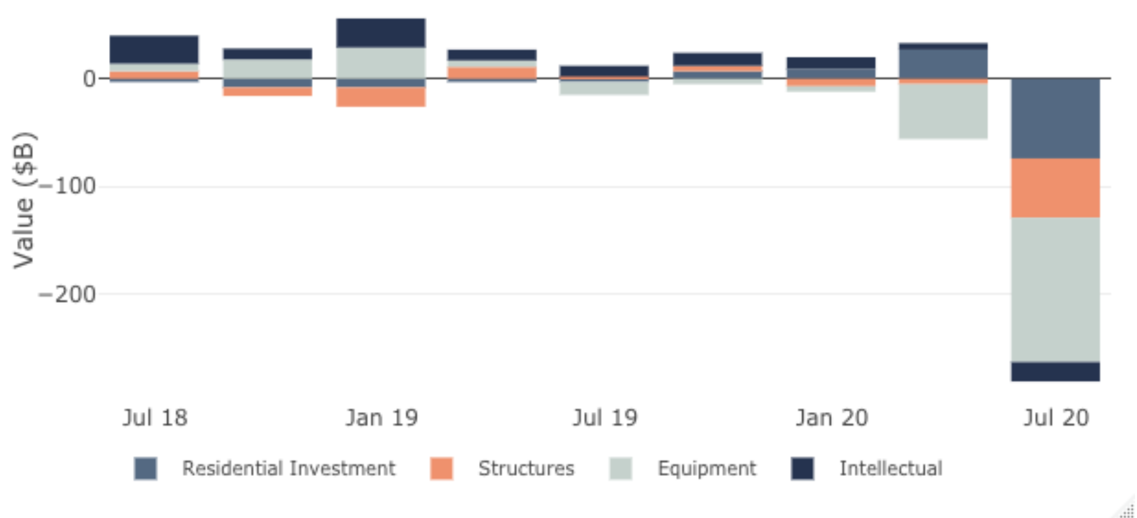
The Pandemic will end. The focus belongs on the long-term effect of changing consumer behavior on consumption. If consumers save more and increase their savings rate one percent, then potential economic growth would *fall roughly 0.5 percent.* Over a decade, this rate would add a further $1.2 trillion to lost production. While this action would increase savings and improve the capital account, it is immaterial in a world of abundant capital and a low cost of capital. Critically, a slower return to normal for the US than its peers' places *future US competitiveness at risk*.

Investment

Investment was contracting *before* the Pandemic.

Investment is the usual harbinger of economic doom. The sector was flashing a warning for the last year with the continued contraction of equipment. Positive signs had emerged as residential housing, and commercial structures rebounded from a multi-year contraction (exhibit 10). Nevertheless, the aggregate investment reality was apparent: a decline occurred in 2019. This artifact of the data suggests that businesses did not see expanding demand in the future. This insight was *before the deterioration* brought on by the Pandemic.

Exhibit 10. Investment Contribution by Component



Source: Federal Reserve Economic Database. Values expressed as an annualized rate.

Restocking inventories may hide Investment's slow return.

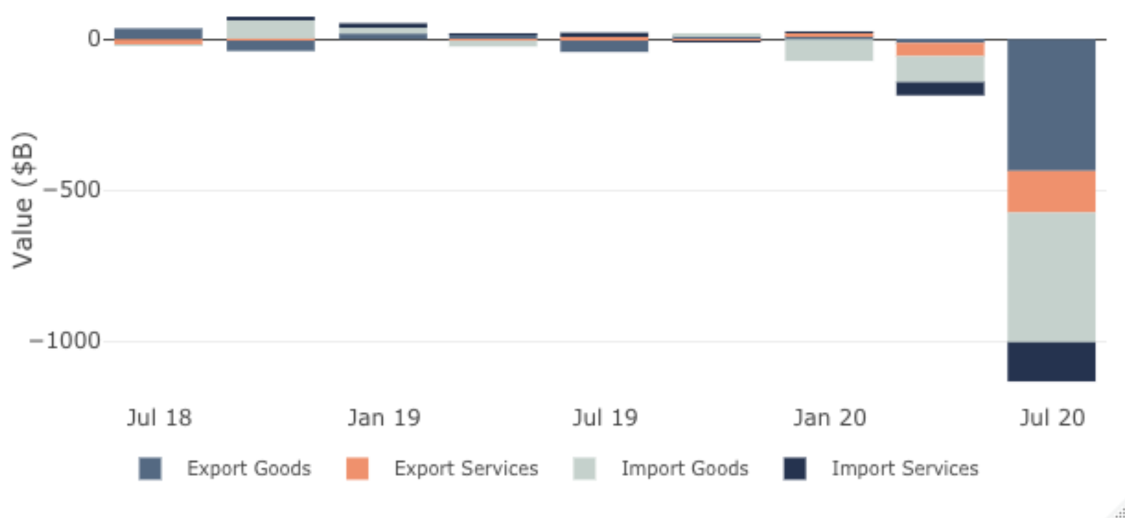
There are few positive insights from the investment data. All the components declined. Even the intellectual property component fell, which is surprising given its long-term nature and ability to produce it remotely. Fortunately, transportation equipment accounted for most of the decline. The bad news is that this component may be slow to return as airplane deliveries slow. Further, a drop of over $300 billion in inventories would suggest restocking in the future. The trouble is determining when that restocking will occur since investment was already slowing *before* a historic decline in demand.

Exports & Imports

The improvement in the trade balance was welcome. Unfortunately, it was not as good as anticipated. The expectation was that imports would decline with the retreat of consumer spending. The unexpected outcome was that export demand matched the declines (exhibit 11). This decline was higher than the fall that occurred during the Great Recession in 2009. This result poses a challenge for a rapid recovery: faltering external demand would inhibit domestic growth.

Exhibit 11. Net Exports

Exports were falling *too much.*



Source: Federal Reserve Economic Database. Values expressed as an annualized rate.

Weakness for the USD is ahead.

The export decline was not purely a function of weakening foreign demand for US goods. The incessant and counterproductive trade wars initiated by the US resulted in zero growth in exports for both goods and services for over *two years*. This outcome is shocking, considering that a necessary commodity (e.g., food) and high-value services (e.g., technology) dominate US exports. There is a significant implication for US competitiveness and the dollar: foreign customers are not engaging with the US and are looking elsewhere for products. Given the lag time with retooling global supply lines, this outcome could endure even with a change in US politics. The implication is that export demand may not return quickly, and the US dollar supremacy *is doubtful*.

Government

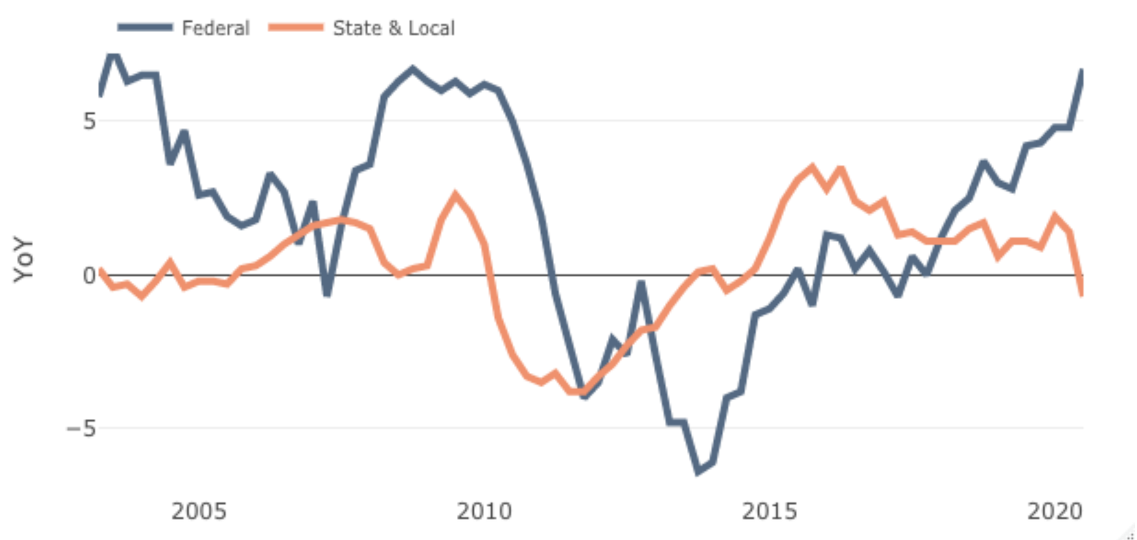
Fiscal support is needed now.

Keynes long ago made the argument for fiscal stimulus during a period of falling consumer demand, which decades of data shows were a prescient insight. The fiscal stimulus enacted by the US is a material step to alleviating widespread destitution. The problem is that it is time-limited and not determined by the situational analysis. While the pols deliberate the amount of support for households and the unemployed, they miss the more significant point of *the timing.*

The fiscal support produced a trillion-dollar expansion of federal government spending, which is welcome during a demand-led contraction. The problem? Balanced budget requirements at the state & local levels mandate cuts. Their tax revenue disappears as business activity stalls, and unemployment dampens tax revenues (exhibit 12). The net result is that total government expenditures only resulted in a *0.5% increase* in spending.

The worry is the State & Local contraction.

Exhibit 12. Federal and State Government



Source: Federal Reserve Economic Database. YoY = year-over-year percent change.

In the face in demand destruction not seen in a century, the fiscal response is insufficiently focused, inadequate, and poorly constructed. How do we know that it is improperly focused? Apple iPhone unit sales hit a record in the second quarter in the US. Expansion of sales of a *premium* product during a

Government

depression and without a new product launch indicates that some people spent their fiscal rebate checks on new phones. The magnitude is significant: the impact was about *six billion* (two percent) of durable goods.

Unfocused rebate checks are wasteful.

Economists argue that this increased spending is helpful during a recession. The problem? Production of Apple's products does not occur in the US, and most of their stores are not open. Deliveries place further pressure on an overtaxed delivery network, while merely bringing forward consumption from future periods. Critically, it does not help those the most in need. Apple is not cutting staff and already enjoys robust profit margins, thus supporting their sales does little for the domestic economy. While this story is antidotal, the goal is merely to illustrate that the thoughtful construction of a fiscal program to aid those in need is paramount.

What is a good policy program? Our suggestion would be to address the people and sectors in need. First, remove all current programs, then:

Focus would yield a better impact at lower cost.

- **Healthcare:** mandate a temporary national health care program for all the unemployed and those that don't have coverage.
- **Retail Sector:** expand unemployment with full compensation of prior wages until the US reaches herd immunity.
- **Leisure Sector:** mandate a national job retraining program for the hotels, bars, and restaurants to ensure that the people are ready for the future, since the expectation is for a prolonged return to normal.
- **Mobility**: ensure the full tax deductibility of moving expenses for relocation to new jobs and a further tax deduction as an incentive.
- **Housing**: provide government-subsidized interest-free loans for housing to those who enter job retraining programs or move for employment.
- **State & Local Government**: remove the balanced budget constraints or provide federal government-backed bonds to prevent further cuts.

Capital Risk

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