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## Forget About The Shape, Define “Recovery”...

We devoted most of last month’s edition to discussing why we find it hard to have much, if any, confidence in economic forecasts – ours included – being made in the current environment. While at any given point in time issues pertaining to the timing and quality of the economic data inject some degree of uncertainty into any forecast, those issues are greatly amplified in the midst of the abrupt and unprecedented shutdown of wide swaths of the U.S. economy. One consequence is that any forecast being made in this environment is even more reliant on the assumptions made by the forecaster than is normally the case.

As we’ve seen more of the economic data over the past few weeks, we’ve gotten a better sense of how data collection issues in this environment are impacting what is being reported. As we see even more data releases over the coming weeks, that sense will become even more refined, and we’ll be increasingly comfortable with, though perhaps not a lot more confident in, our economic forecasts and those of others. That said, as we write this in early May, we are only now beginning to see the economic data for the month of April, which is bound to be amongst the worst, if not the worst, batch of economic data on record.

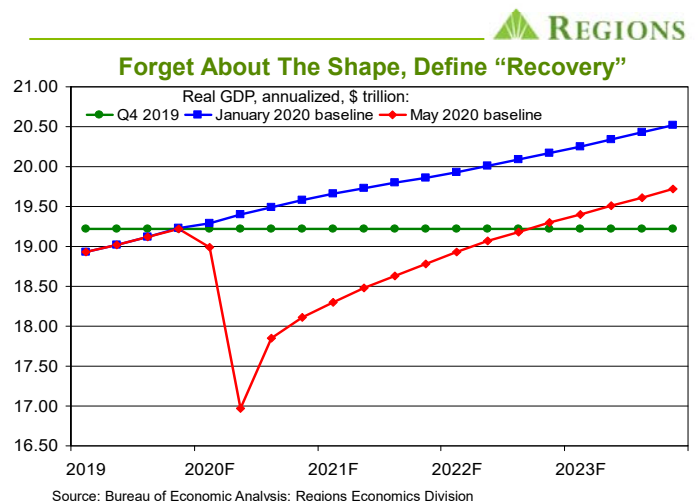
In other words, while the April employment report and the April ISM Manufacturing survey offer an unsettling preview, we are still a long way from knowing what the downturn will actually look like. And, while the BEA’s initial estimate shows real GDP contracted at an annualized rate of 4.8 percent in Q1, that estimate is based on highly incomplete source data and the pending revisions will likely be much larger than is typical of the initial estimate of GDP in any given quarter. While we expect the first estimate of Q1 GDP to be revised lower, the reality is that, whatever the final number turns out to be, the contraction in real GDP in Q1 will pale in comparison to the contraction we and other analysts expect for Q2.

This gets us back to another point we made in our April *Outlook*, which is that, despite no one yet knowing neither the magnitude nor the duration of the downturn, so many people are spending so much time debating what the subsequent recovery will look like. More and more, however, that debate has been one over shape rather than substance. Literally. To an increasing degree, we are being asked by colleagues, clients, and members of the media to reduce our view down to the specific shape the recovery will take on, as are other economists. The answers we’ve seen include letters of the alphabet, algebraic symbols, and logos of cool, hip, and happening corporations.

Our preferred shape, as we noted in last month’s *Outlook*, is a question mark. Sure, we know you’re not supposed to answer a question with a question, but as far as we know, there is no such

prohibition on answering a question with a question mark. This simply reflects our overall lack of faith in forecasts made in this environment given how many unknowns remain in the equation. On a more fundamental level, however, we think that the incessant focus on the shape of the recovery is the wrong way to think about the economy’s road back from the damage done by the COVID-19 virus and the efforts to stem its spread.

Rather than focusing on the shape of the recovery, it would be more useful to decide exactly what constitutes “recovery.” The tendency is to focus on the rate at which the economy will grow once it hits bottom, which we and most others agree will be Q2 2020. That can, however, lead to faulty conclusions, thanks in part to the manner in which the GDP data are commonly presented and reported on. Most of the discussion of the GDP data focuses on the annualized rate of change in real GDP, a practice which, as we’ve often noted, we seriously dislike. Annualized rates of change exaggerate the actual changes in the level of activity, in this case real GDP, from one period to the next, which is even more of an issue when there are swings as sharp as we’ll see in the Q2 data. Many forecasts anticipate an annualized contraction in real GDP of around 30 percent in Q2, but that’s a long way from real GDP actually declining by 30 percent in Q2. By the same token, the first quarter of recovery could easily see a double-digit annualized rate of real GDP growth, which could lead many to assume that the economy had embarked on a “V-shaped” recovery, though this assumption would almost surely prove to be mistaken.



To us, rather than the annualized rates of real GDP growth, the level of real GDP will be a far more relevant marker of recovery. Specifically, how long will it take for the level of real GDP to return to the level as of Q4 2019, the last quarter before the COVID-19 virus wreaked havoc on the U.S. economy. The chart above shows the level of real GDP anticipated by our May 2020 baseline forecast, indicated by the red line. To be clear, our degree of

confidence in this forecast is very low, but we're using it here to illustrate our point. From the trough in Q2 2020, our forecast anticipates it will take nine quarters for the level of real GDP to return to the level of Q4 2019. Even if we allow for faster growth than our forecast anticipates, this would, in a realistic assessment, pull this "milestone" ahead by two, or maybe even three, quarters, so the broader point is that this is likely to be a long, slow slog.

This point, however, would be lost in a discussion centered around annualized rates of real GDP growth. Moreover, the above chart also shows the path of real GDP anticipated in our January 2020 baseline forecast, indicated by the blue line. As we discussed in detail in our January *Outlook*, our 2020 forecast anticipated only middling growth, with real GDP growth of 1.9 percent in 2020, 1.7 percent in 2021, and 1.4 percent in 2022. Still, our May 2020 forecast would leave the level of real GDP as of Q4 2023 3.9 percent below that of our January 2020 baseline forecast. We can make similar comparisons across other indicators. For instance, relative to our January 2020 baseline forecast, our May 2020 baseline forecast anticipates that, as of Q4 2023, the level of nonfarm employment will be lower and the unemployment rate will be higher, which in turn has implications for personal income and consumer spending, and there are similar discrepancies in our forecasts of industrial sector activity and housing market activity.

Again, the point here isn't whether our May 2020 forecast will be on or near the mark, or whether our January 2020 forecast would have been in the absence of the COVID-19 virus. Instead, the point is that there is going to be lasting damage done by the short but nonetheless violent economic downturn we are now in the midst of. To be sure, how much damage and how long will it last remain open questions at this point. Given the high degree of uncertainty around the economic outlook, which to no small degree is a direct function of the high degree of uncertainty around the public health outlook, we are running forecasts for alternative scenarios, both better than and worse than our baseline outlook. While the worse case scenario speaks for itself, even in the best case scenario we can plausibly conjure up, it would take several quarters to make up the decline in real GDP we expect over 1H 2020.

This is a point that can easily get lost in a discussion revolving around annualized rates of real GDP growth. And this gets us back to the question of how one defines a recovery. Even our relatively subdued May baseline forecast anticipates double-digit annualized real GDP growth in the initial quarter of recovery (Q3), followed by a few quarters in which annualized real GDP growth averages over 4.5 percent. While that may suffice for some, to us recovery won't occur until the level of real GDP has returned to where it was prior to the downturn, which we think will take several quarters to occur.

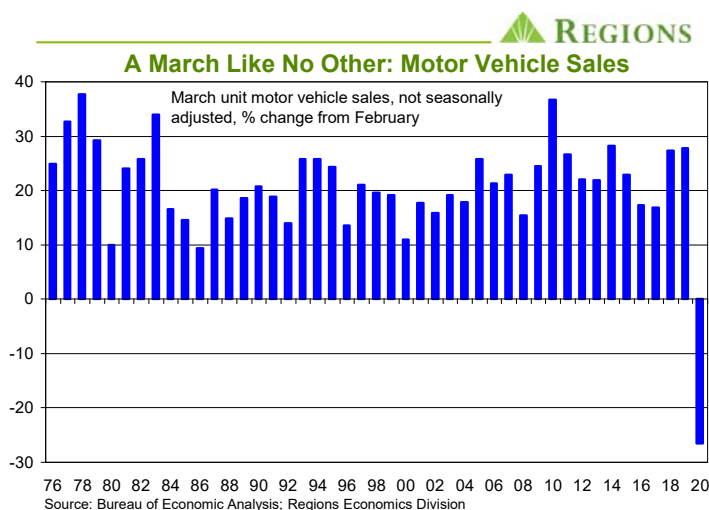
## *Q1 GDP: Bad Is Here, Worse Is On The Way...*

As noted above, the BEA's initial estimate of Q1 2020 GDP shows real GDP contracted at an annualized rate of 4.8 percent. In more normal times, this would likely merit much more attention than it has gotten, as there are only seven quarters on record with larger contractions in real GDP. In these decidedly not so normal times, however, the contraction in real GDP in Q1 has more or less been

relegated to the "oh, by the way" category, given the far more severe contraction in real GDP on tap for Q2. And while we expect that when all is said, done, and revised, the contraction in real GDP in Q1 will be larger than the BEA first estimated, it will still be no match for what's coming in the Q2 data. Even so, there are a few points about the initial estimate of Q1 GDP that bear mention.

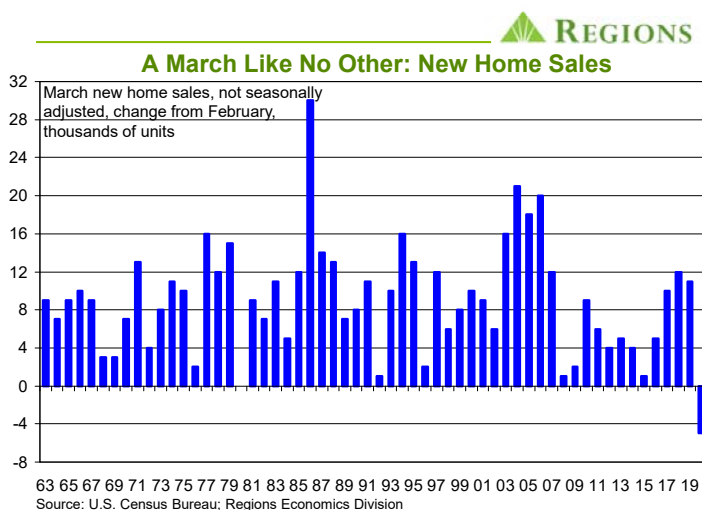
For instance, real private domestic demand, or, combined business and household spending, contracted at an annualized rate of 6.6 percent in Q1, easily outpacing the contraction in top-line real GDP. Inflation adjusted consumer spending contracted at a rate of 7.6 percent, the largest quarterly contraction since Q2 1980, with real spending on services contracting at a rate of 10.2 percent, the largest such contraction on record. To be sure, these contractions are much smaller than those on the way in the Q2 data, but what makes them noteworthy is they represent basically half a month of damage from the COVID-19 virus and the efforts to stem its spread. That point can be made more broadly, i.e., the contraction in real GDP in Q1 reflects the sudden stop across a wide swath of economic activity over the back half of March, more than negating what had been over two months of steady, even if by no means spectacular, growth.

One way to put the extent of the disruption in economic activity over the back half of March in perspective is to look at the raw, or, not seasonally adjusted, data. We say this because, in any given year, March is typically one of the strongest months for economic activity as winter gives way to spring. While this March started out much as any other, it was an entirely different story by the end of the month, which we can best illustrate with data on motor vehicle sales and new home sales.



The above chart shows the percentage change in not seasonally adjusted unit motor vehicle sales between February and March. In its current iteration, the BEA's data on motor vehicle sales go back to 1976, and 2020 is the first March in this entire span to see a decline in unadjusted unit motor vehicle sales. Moreover, that decline reflects the extent to which sales dropped off over the back half of the month, as industry reports showed sales had been strong over the first half of March. We saw the same patterns in new home sales, i.e., sales were robust over the first half of the month before virtually grinding to a halt over the back half of March. The net result was a decline in not seasonally adjusted new

home sales in March for the first time in the life of the data, which go back to 1963, as shown in the following chart (we didn't forget the bar for March 1980, new home sales were flat in that month).



Keep in mind that, as March is typically a seasonally strong month, any weakness in the raw data is amplified by seasonal adjustment, and this was the case across the range of economic data series for the month of March this year. Annualizing these seasonally adjusted changes further distorts the actual changes, hence our serious dislike for this practice, as we noted above. In any event, the raw data do a more than adequate job of telling the story, and given the extent to which economic activity was shuttered for the entire month, the declines in the April data will easily surpass those seen in the March data. Even allowing for activity beginning to rebound in May and June, April's decline will be enough to bring about the sizable (annualized) contraction in real GDP in Q2.

While we expect real GDP to contract at an annualized rate of over 30 percent in Q2, the contraction in private domestic demand will be even more severe. As we've discovered, the first reaction people have when they see these numbers is to ask why our forecast doesn't account for all of the fiscal and monetary policy measures taken in response to the COVID-19 virus. The short, but admittedly perhaps hard to accept, answer is "it does." Part of the difference between our forecasts for top-line GDP and private domestic demand is what will be significantly faster growth in federal government spending, reflecting the effects of the CARES Act and other spending related to the COVID-19 virus.

The effects of the CARES Act will be even more visible in the Q2 data on personal income, specifically, the "rebate" checks of amounts ranging up to \$1,200 per eligible individual and the additional \$600 per week in Unemployment Insurance benefits (on top of state payments). This surge in transfer payments will more than offset what will be a significant contraction in wage and salary earnings, to the point that our forecast anticipates that disposable personal income will rise in Q2 despite the massive job losses booked in April and another, albeit much smaller, decline likely in May. Still, given that, at least for now, the rebate checks are one-off and the supplemental Unemployment Insurance benefits expire at the end of July, this sets up a sizable contraction in disposable personal income in Q3. While our forecast anticipates that employment will have begun to recover by the end of Q2, what

will be sluggish growth in labor earnings in the early stages of the recovery will be no match for the sharp drop-off in transfer payments. If we are correct on this point, it could temper any rebound in consumer spending over 2H 2020.

### *Oh No, There They Go Again . . .*

If we've said it once, we've said it a million times. Okay, we haven't actually said it a million times, it just seems that way, as our long-time readers well know. Either way, we're going to say it again – the most meaningless number in just about any economic data release you look at is the headline number, and if you want to know the true story, you have to go through the details of the data. The ISM surveys of activity in the manufacturing and non-manufacturing sectors in March and, to an even greater degree, April offer yet another illustration of our general rule.

Sure, we know what you're thinking – the ISM Manufacturing Index fell below the 50.0 percent break between contraction and expansion in March and fell further below it in April, while the ISM Non-Manufacturing Index tumbled all the way down to 41.8 percent in April, so what could be worse than these headline numbers? A lot, as it turns out. This is painfully apparent in the details beneath these headline numbers.

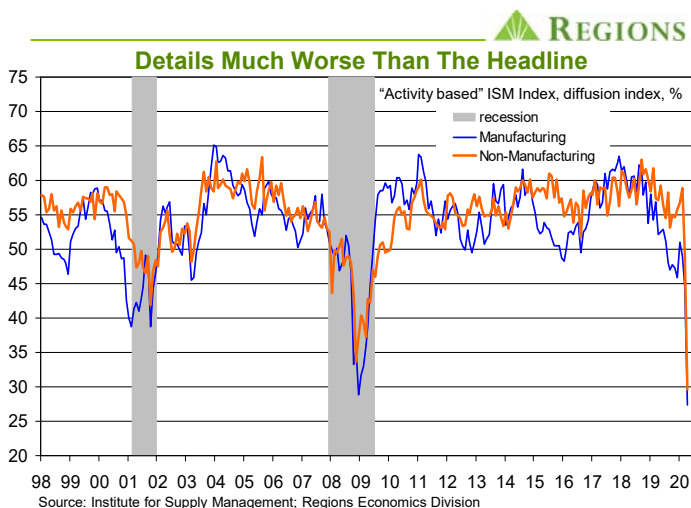
In their calculations, slower supplier delivery times work to push the headline index numbers in the ISM's surveys higher. The premise is that slower delivery times are a sign of greater demand and, as such, act as a positive factor in the ISM's indexes. The measure of supplier delivery times, however, makes no distinction between stronger demand and impaired supply chains. In the ISM's manufacturing and non-manufacturing surveys, supplier delivery times slowed sharply in March and even more so in April, and it is clearly the fallout from the COVID-19 virus, not stronger demand, that pushed out delivery times. ISM has acknowledged this point, but nonetheless it works to support the headline index numbers. So, those who have gone no further than the headline index numbers have concluded that activity has held up better than could have been expected, which is not the case.

To be clear, this is not intended as a criticism of ISM, as they cannot be expected to change their methodology each time special circumstances arise. Instead, our point is that the sub-indexes measuring new orders, employment, and production (the manufacturing survey)/business activity (the non-manufacturing survey) are more telling indicators of the economic impacts of the COVID-19 virus and the efforts to stem its spread.

In the ISM's manufacturing survey, the production index fell to 27.5 percent in April from 47.7 percent in March, the new orders index fell to 27.1 percent in April from 42.2 percent in March, and the employment index fell to 27.5 percent in April from 43.8 percent in March, yet the decline in the headline index was more limited, going from 49.1 percent in March to 41.5 percent in April. The same pattern is seen in the ISM's April non-manufacturing survey, with the index of business activity falling to 26.0 percent (an all-time low), the new orders index falling to 32.9 percent, and the employment index falling to 30.0 percent, yet the headline index registered 41.8 percent. In each survey, it was a sharp increase in supplier delivery times that limited the decline in the headline index. Again, while both headline index numbers show



that activity contracted in April, the headline numbers understate the extent of the contractions.



Given the distortions that can arise from swings in supplier delivery times, and in the case of the manufacturing survey from swings in inventories, we track a composite of the ISM's indexes on new orders, employment, and production/business activity, which we show in the above chart. We see these composites, in which the three sub-indexes are equally weighted, as better gauges of underlying economic conditions in the two sectors. In April, our composite for the non-manufacturing sector fell to 29.63 percent, while our composite for the manufacturing sector fell to 27.36 percent, each the lowest in the life of the data. That each of our composites stand at lower levels than at the depths of the 2007-09 recession isn't necessarily surprising, but what is surprising, if not stunning, is the speed with which they got there.

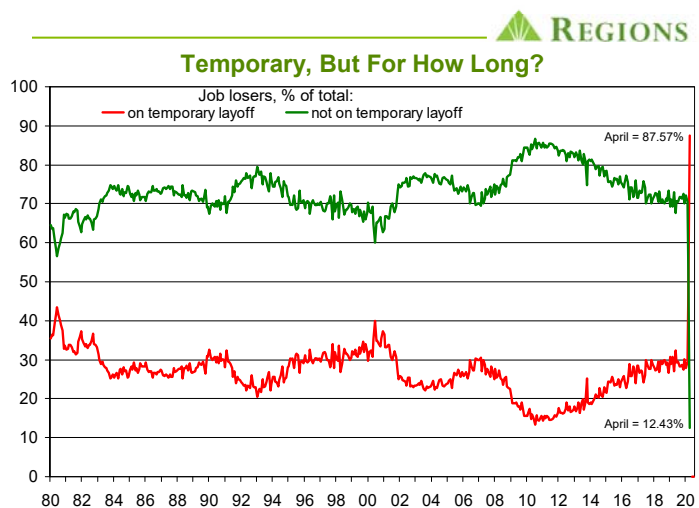
As with the economy as a whole, the question at this point is where our composites go from here. While we think the worst of the declines in orders, employment, and output will have come in April, we cannot rule out further declines in May. Though various parts of the economy are being opened back up, that is happening at a gradual pace. That there are differences across states means there will also be differences across industry groups. An additional challenge stems from the fact that supply chains are in many cases global in structure, making U.S. producers and, perhaps to a lesser extent, service providers reliant on global economic activity being opened back up.

One of the best indicators will be the new orders indexes from the ISM's surveys, which have long been amongst our favorite forward looking indicators. This will be particularly true in the months ahead given that backlogs of unfilled orders have been pared down so sharply over recent months, such that it will take meaningful and sustained increases in new orders to spark faster growth in employment and output. We will continue to track our composites based in the ISM data, while cautioning that supplier delivery times will continue to distort the headline index numbers – as activity normalizes, faster delivery times will work to blunt any increases in the headline numbers stemming from faster growth in new orders, employment, and production. So, once again, the details beneath the ISM's headline numbers will be a better gauge of the progression of the recovery in the broader economy.

## April Employment Report

The sudden stop in economic activity in mid-March decimated the labor market. Total nonfarm employment fell by 20.500 million jobs in April, with private sector payrolls down by 19.520 million jobs and public sector payrolls down by 980,000 jobs. While no industry group was spared, with payrolls declining across each of the broad industry groups, job losses were more heavily concentrated amongst those with shorter workweeks and lower wages. The pronounced shift in the mix of jobs led to a 4.7 percent month-over-month increase in average hourly earnings and an increase in the average length of the workweek.

The unemployment rate rose to 14.7 percent in April, but this estimate understates the damage done to the labor market. BLS notes that an inconsistency in reporting – large numbers of people reported they were absent from work rather than unemployed – led to the unemployment rate being understated by about five percentage points on a not seasonally adjusted basis. The U6 rate, which also accounts for underemployment and those marginally attached to the labor force, rose to 22.8 percent, as the number of those still working but reduced to part-time hours rose to 10.887 million in April, up over 5.1 million from March. The total number of underutilized labor resources (or, the numerator in the U6 calculation) rose to 36.176 million people in April, easily surpassing the peak of 26.934 million during the 2007-09 recession.



Of those who lost jobs in April, the vast majority reported they were on temporary layoff as opposed to having lost their job permanently – the first time temporary layoffs have ever topped permanent job losses in a given month. The great unknown going forward is the degree to which what started out as temporary job losses morph into permanent job losses.

We are mindful of the fact that each job lost over the past several weeks comes with a name and a human story. The April employment report and the initial estimate of Q1 GDP at least help us size the hole the economy will have to dig its way out of. Clearly, the public health outcome remains highly uncertain. The massive fiscal and monetary policy response has been intended to keep what started as a liquidity crisis from turning into a solvency crisis and, in turn, preventing job losses from becoming permanent. Only time will tell how effective the policy response has been.