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Get Ready for an Onslaught of Economic Happy Talk

Financial markets surged to post-COVID-19 highs on the heels of a shockingly strong May employment report from the Department of Labor that was misleading at best in its estimation of the U.S. unemployment rate. Consensus expectations of an unemployment rate approaching 20% were blown away by a report that instead said unemployment moved lower, to 13.3% from 14.7% in April.

That data point gave ammunition to those advocating that a V-shaped recovery will ensue. Market commentators marveled at the resilient U.S. economy springing back to life so quickly after weeks of shutdown. The White House took a victory lap the morning that the report was released. Such optimism was misplaced, based on a full reading of the report.

A prominent disclosure on page six of The Employment Situation (a.k.a. the "Jobs Report") for May 2020 clearly explained that the unexpected drop in the unemployment rate was the result of a significant misclassification of unemployed workers who are expecting to be called back as employed workers, instead of unemployed on temporary layoff.

The Bureau of Labor Statistics (BLS) said it was investigating why this misclassification error was occurring but would leave the survey results as initially recorded for now. There was nothing nefarious about this error; it was fully disclosed in a call-out box.

However, the size of the misclassification error was material, with BLS stating, *"If the workers who were recorded as employed but absent from work due to "other reasons" (over and above the number absent for other reasons in a typical May) had been classified as unemployed on temporary layoff, the overall unemployment rate would have been about 3 percentage points higher than reported."*

That's a whopper of a difference. Had the misclassification errors not occurred, the unemployment rate would have been 16.3% in May instead of the reported rate of 13.3%. This implies that the number of unemployed Americans would have increased by 2.3 million in May, instead of the reported decrease of 2.1 million.

Perhaps more surprising than the disclosure itself is the fact that markets and commentators essentially ignored it. Trading algorithms don't delve into sidebar disclosures in these types of reports, nor do momentum traders, day traders, retail investors or market cheerleaders. To be clear, there was also some good news in the May Jobs Report, and generally it was better than the dismal consensus expectations of most economists. But there also was an elephant in the room that nobody wanted to acknowledge because it wasn't consistent with the euphoric narrative gripping financial markets.

As we head into a critical election season with the economy at an inflection point, shaping the public's perception about the condition and direction of the economy will become a political obsession on both sides of the aisle. Last month, Kevin Hassett, senior economic advisor to the White House, and Larry Kudlow, Director of the U.S. National Economic Council, both commented that the third quarter will be the biggest growth quarter in American history. Is that as impressive as it sounds? Hardly. This type of context-free commentary serves to obscure the underlying reality that the U.S. economy has a mighty deep hole to climb out of, and it will take considerably longer than the happy talk suggests.

Large sectors of the U.S. economy were deliberately shut down for at least two months of the second quarter in response to the coronavirus pandemic. Economic activity was very nearly brought to a halt across major industries, such as retail, travel and leisure, lodging, dining and entertainment events. Consequently, economic growth in 2Q20 will experience the largest quarterly contraction since the Great Depression. The shutdown of the economy was not an organic event; it was implemented by states' decrees promulgated to curtail the spread of the virus. Now that the national economy is being reopened, is it so surprising that economic growth will rebound? Not at all. When you fall into a ditch, the only direction is up. The pertinent issue to ponder is not the size of that first step up but the time it will take to get out of the ditch. From that perspective, the outlook is discouraging, and it will take quite a while to claw our way out of this hole.

While we are reading plenty about "green shoots" and "encouraging signs," these observations are hardly revelatory. When air travel and hotel stays are down 80%-90% in April, subsequent months are almost certainly going to improve directionally. When the economy bleeds 20 million jobs in April, the worst month in history for job losses, it is a virtual certainty that the ensuing months will be better — as in, "less bad." These don't really represent "improving trends" as much as they signify that we've hit the bottom of the ditch and there is nowhere to go but up. But how far and how fast?

To appreciate the cavernous size of this ditch, consider that U.S. economic activity, as measured by GDP, will show a contraction of nearly one-third in 2Q20. This decrease is measured on an annualized consecutive quarterly basis. In other words, when GDP in 2Q20 is measured, seasonally adjusted and annualized, it will have contracted by about 30% compared to GDP in 1Q20. This decrease is so severe that GDP in 3Q20 is certain to increase compared to 2Q20, especially considering that the economy is being reopened. Ironically, the severity of the downturn in 2Q20 makes it likely that, *technically speaking*, this will be labeled as a two-quarter recession because contractions are measured on a consecutive quarterly basis, and it would be almost impossible for the economy to shrink further relative to a 2Q20 baseline. So, some will characterize this painful episode as a short, severe recession followed by a robust rebound. Semantics and labels aside, the economic effects of the shutdown will persist well into 2021 and beyond.

If we want some sense of how long it will take to get back to "normal," let's look at GDP forecasts on a year-over-year basis (rather than consecutive quarters) over the next couple of years and see when real GDP is expected to get back to 2019 levels. To do this, we took the mean forecast of real quarterly GDP growth (YoY) from more than 50 economists tracked by Bloomberg and converted this into annualized GDP estimates (Exhibit 1). **This examination indicates that real quarterly GDP going forward won't exceed a corresponding 2019 quarter until 1Q22.** That's more than 18 months until the U.S. economy will be out of the ditch. For industries particularly sensitive to COVID-19's lingering effects, it likely will take considerably longer.

More ominously, consensus economic forecasts from Bloomberg also indicate that the projected unemployment rate will remain near 10% at year-end and approximately 7.5% at the end of 2021 — in other words, some 18 months hence the unemployment rate is expected to be more than double the rate prior to the pandemic(Exhibit 1). While the prevailing assumption is that most furloughed workers will be rehired once the economy fully reopens (they will be), the average unemployment rate estimate of economists translates into six million more unemployed Americans at the end of 2021 than there were in February 2020. If that sounds implausible, consider that 32 million Americans are employed in the retail/restaurants and leisure and hospitality sectors, where most job losses have occurred. What percentage of those jobs won't be coming back?

Several industries are preparing for a prolonged contraction. Most healthy retailers have accelerated their store closing plans since COVID-19 struck, not to mention those being shuttered in bankruptcy. The active U.S. rig count in the oil and gas sector is at a 20-year low and has easily eclipsed the trough of the 2016 energy bust. The airline sector is planning for material layoffs after September 30 (in order to comply with the layoff prohibition provision of the CARES Act for companies receiving federal assistance) in anticipation of reduced air travel for several years to come.

Industry advocate IATA doesn't expect global passenger air travel to match 2019 levels until 2023. Car rental companies have cancelled a large percentage of planned new vehicle purchases over the next year, which will impact automobile OEMs as well. These hardly sound like measures taken by companies expecting a quick economic rebound.

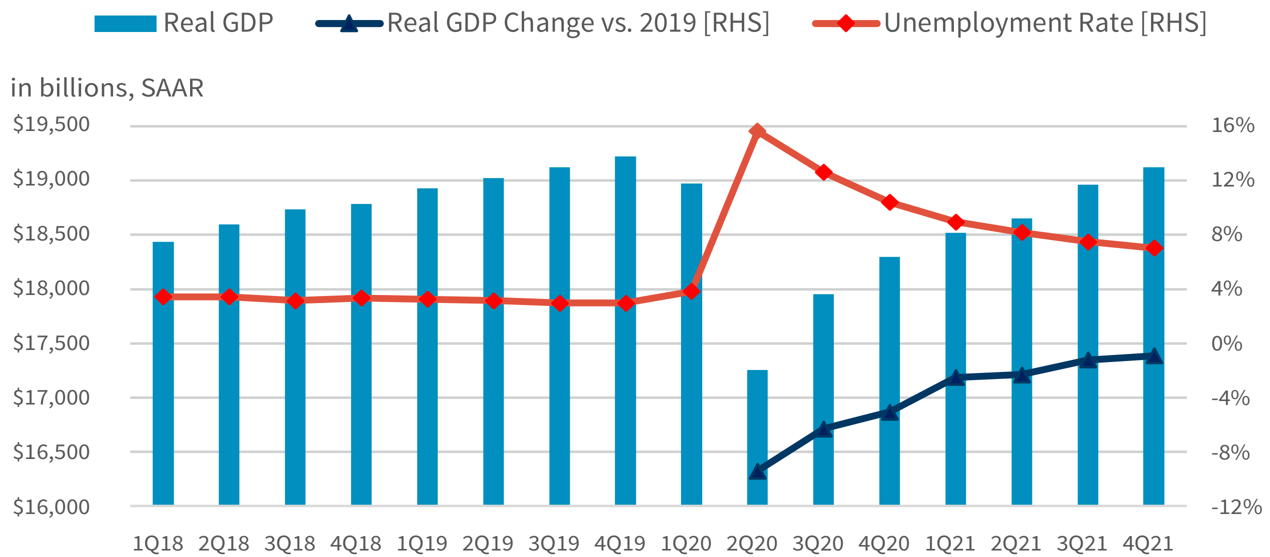
The prospect of a fast-tracked COVID-19 vaccine in 2021 is distracting from the larger issue of the cumulative economic damage that will restrain spending growth long after the virus fades from the headlines. As we begin to pivot away from a shutdown mentality, the central issue confronting the U.S. economy will be the magnitude of the financial setback for millions of consumers and its enduring impact on their spending. Various federal initiatives and programs intended to keep paychecks and financial assistance flowing to Americans impacted by the shutdown have been effective to date in keeping many laid-off and furloughed workers mostly whole. But stimulus checks have been spent, federal unemployment benefits are scheduled to end in late July, and pay cuts reportedly have become more prevalent in stressed industries. Furthermore, companies that have avoided layoffs to comply with the Paycheck Protection Program or other emergency federal loans soon will no longer be bound to maintain their payrolls. Yes, many millions of furloughed workers will be recalled in the coming months. That was understood from the start. However, several million other workers won't be fortunate enough to return to their jobs, and their financial safety net soon will be wearing thin.

Economic growth will resume in 3Q20 and beyond. Nobody disputes this. Businesses will be reopening quickly this summer, and pent-up consumer demand resulting from many weeks of being housebound will need to be met. Because the bar is so low, many economic statistics in the second half of this year will seem formidable when presented on a consecutive monthly or quarterly basis.

A culling of the weakest competitors in the corporate landscape has been accelerated by the pandemic and will continue even as our economy begins to emerge from the abyss. S&P and Moody's are both forecasting a low-double-digit speculative grade corporate default rate by early 2021 compared to 4.5% currently, which would rival the heights we saw during the Great Recession.

There will be significant second-order effects as this scenario plays out, such as the impact of failing retailers on landlords and real estate. Can a resurgent economy and rebounding financial markets coexist with high unemployment and a sharp upswing in business distress, defaults and bankruptcies? Only if enough people continue to believe all the happy talk.

Exhibit 1 - Real U.S. GDP and Unemployment Rate



Source: Bloomberg

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