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What Will a Post-COVID-19 Economy Look Like?

Yes, it is way too soon to be discussing the condition of our economy in a post-COVID-19 world, just as the pandemic appears to be peaking in some locales, but be assured that these conversations already are taking place in C-suites and boardrooms across the country.

As the speed and intensity of the unfolding contraction become more evident each week, we are confounded by those economists and other experts who continue to opine that the U.S. economy will experience a sharp or V-shaped recovery. However, their numbers have declined in recent weeks. Such optimism is either blatant cheerleading, wishful thinking or deep denial about facts on the ground.

Judging by the fierce rally in equity markets since the lows of late March, investors continue to place unwavering faith in the Fed's determination to save financial markets from their excesses and mitigate an economic downturn that has only just begun — or, at the least, to encourage the inflation of financial asset prices irrespective of rapidly deteriorating fundamentals.

Some sectors of the economy may bounce back quickly once the pandemic crests and stay-at-home orders are lifted, especially from the pent-up demand of postponed orders of hard goods that begin to come through in the back half of the year. However, many industries cannot make up lost business due to COVID-19. For instance, nobody will get three haircuts monthly or rent a car every weekend for a few months to make up for their downtime during stay-in-place orders. That business activity is irretrievably lost, and the best hope for these companies is an eventual resumption of normal pre-COVID-19 demand. Even that may be an unrealistic expectation for consumer-dependent companies, many of which have customers who will be suffering financially and/or slowly coming back to public life at a pace that comports with their comfort, irrespective of experts' advice.

A quick review of the S&P 500 by industry sector indicates that about one-third of companies in the index belong to industries that will be slow to rebound once the economy reopens. That fact alone would seem to diminish the likelihood of a quick rebound nationally. In short, there are more reasons than not to believe that the prospect of a V-shaped recovery is a long shot.

Helicopter Money Alone Won't Avert a Sharp Economic Contraction: The Federal Reserve and U.S. Treasury have earmarked several trillion dollars for various forms of financial relief to businesses of all sizes, mostly in the form of low-interest-rate loans that recipients must repay within a few years. These programs were drawn up quickly, given the urgency of the crisis, and must be implemented with the utmost speed and efficiency to serve their intended purpose. We are talking about millions of loan applications that must be processed and executed, with money distributed in short order. Most small businesses cannot wait months for financial relief to arrive, and implementation glitches or delays can potentially undermine the best intentions of these programs. The hurried rollout and quick exhaustion of loan capacity under Paycheck Protection Program of the Small Business Administration (SBA) provision of the Coronavirus Aid, Relief, and Economic Security (CARES) Act doesn't provide much encouragement that the program is reaching its intended beneficiaries–small businesses. As with the virus itself, undue delays in implementing this patchwork of relief measures can be fatal for many smaller businesses. It's naïve to walk by the hundreds of shuttered storefronts of Manhattan and believe that all these businesses will be back once the checks arrive and state or local officials lift the shelter-in-place orders.

Furthermore, the intention of much of this financial relief is to keep workers' paychecks flowing, with the condition of maintaining employment near pre-COVID levels rather than subsidizing lost business and profits or providing new liquidity. Forgivable loans made under the Paycheck Protection Plan of the CARES Act require that a high percentage of the loans be used for payroll. These requirements simply can't be met by many businesses, particularly smaller ones, that may need to reduce payrolls materially and indefinitely if they are to survive. For larger companies eyeing relief from the Treasury's $500 billion emergency relief facility (Title IV of the CARES Act), one condition of such assistance requires that recipients certify that 90% of pre-COVID employment levels be maintained at full salary through September or be restored within four months after HHS declares this emergency crisis over. These conditions will be difficult to meet for many hopeful applicants.

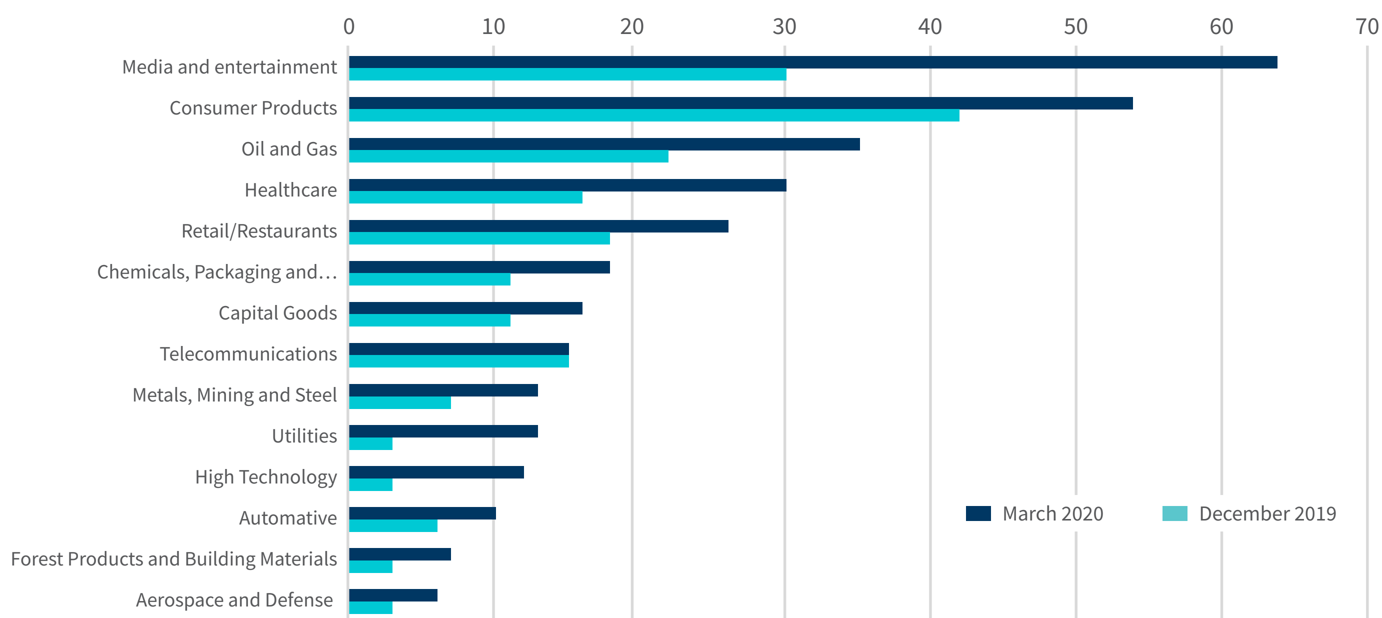
Many Americans Will Continue to Practice Social Distancing Long After the All-Clear Is Given: It also would be naïve to believe that most Americans will resume their pre-COVID-19 lifestyles once shelter-in-place orders cease and businesses reopen, as fears of a recurrence of the virus will keep many of us away from crowded venues and large gatherings for many months after it's declared safe to return to work. Dr. Anthony Fauci, Governor Andrew Cuomo and others have openly voiced concerns of a resurgence or second wave of the virus later in the year. A recently published study of COVID-19's contagion in China by researchers at Los Alamos National Laboratory indicated that its transmission rate there could be nearly twice as high as previously believed, a troubling finding that suggests a significantly larger percentage of the population would need immunity from COVID-19 in order to achieve a "herd immunity" level that would prevent widespread contagion. Increasingly it seems that nothing short of a vaccine will permit most Americans to let their guard down completely. This lingering apprehension to resume a full public life will delay recovery for large sectors of the economy, mostly concentrated in the travel and leisure, lodging, transportation and entertainment segments. It likely will be a considerable time before we again see crowds or long lines at these types of venues, especially popular summer destinations. The entirety of 2020 already seems like a lost cause for many of them. It is hard to envision a quick and robust economic recovery without the participation of these sectors.

COVID-19 Will Cause Many Americans to Reevaluate Their Spending Priorities: It's no secret that a fairly large percentage of working Americans live paycheck to paycheck, with little in the way of savings or assets. The Federal Reserve's Annual Report on the Economic Well-Being of Households consistently indicates that more than 25% of households with credit cards carry balances most or all of the time, while close to 40% of respondents could not pay an unexpected $400 bill without borrowing. These indicators amount to tens of millions of U.S. households — many of which are considered middle class — that are always vulnerable financially. Few workers ever imagined a scenario in which their livelihoods could be interrupted so abruptly for an indefinite period. Stay-at-home orders have given many furloughed workers lots of time to reflect on their spending and lifestyle choices, and it would be surprising if pre-COVID-19 spending patterns and amounts resumed intact once furloughed workers return to their jobs. Also be assured that all furloughed workers won't be called back, as consumer-facing employers will contend with fewer customers for many months to come.

Huge State and Local Budget Cuts Are Coming: Many states have spent billions fighting COVID-19, and the hardest hit hotspots have lost billions more in tax revenue from business shutdowns. This has created massive budget deficits that must be addressed quickly. For instance, New York City has already announced $1.3 billion in proposed spending cuts. Expect to see similar measures enacted in statehouses and city halls across the nation. This will entail sharp cuts in investment, services and employment at state and local levels, perhaps for several years, offsetting some of the private sector rebound that's expected once recovery begins.

Most Speculative-Grade Companies Won't Be Recipients of Financial Relief: Despite the Fed's audacious efforts to infiltrate nearly every corner of credit markets and Treasury's efforts to make loans available to impacted businesses, most large spec-grade companies don't appear to be in line for relief, given the debt and leverage limits imposed as an eligibility requirement for most of these lending facilities. Additionally, there likely would be strong political and public opposition to the prospect of federal financial assistance for industries and companies, such as the energy sector, that were already beleaguered before COVID-19. For those left out in the cold, borrowing rates have soared in leveraged credit markets for deep junk borrowers, if they can access funding at all. This will surely result in an appreciable increase in default and restructuring activity in the months ahead, though it may take a couple of months for bankruptcy filings to accelerate. (It should be noted that credit rating agencies consider any debt-related missed

Exhibit 1 - Standard & Poor's Weakest Link Issuers



payment to be an event of default, and the number of missed payments has soared in April.) Many lenders and other creditors likely will be reluctant to declare defaults or begin foreclosure proceedings while the economy is still reeling from the effects of stay-at-home orders, but their patience and options will dwindle should an economic downturn drag on for many months.

A couple of months ago, we warned about the problem of issuers rated "deep junk" (B- or worse), who now account for 30% of all spec-grade issuers — an unprecedented share of the high-yield market. S&P has a subset of deep-junk issuers it calls "Weakest Links," which are issuers rated B- or worse that also have negative outlooks or are on Credit Watch with negative implications. (Think of these issuers as the worst of the worst.) The number of Weakest Link issuers in the United States was at a ten-year high at the end of 2019, long before the arrival of COVID-19, and has since soared to 328 issuers from 197 in December, a 66% increase in just three months. S&P notes that Weakest Links are eight times as likely to default as all spec-grade issuers.

We evaluated the change in Weakest Links by industry sector between December and March (**Exhibit 1**), as those changes would reflect the industries that S&P expects to be hardest hit by the lingering impact of the pandemic and accompanying downturn. Industries that experienced the largest increase in the number of Weakest Links are exactly those you might expect to see, led by media and entertainment, which has the double misfortune of being highly leveraged generally and being particularly susceptible to the economic effects of COVID-19. Media and entertainment is a noteworthy standout, with its Weakest Link count more than doubling since the end of 2019. Consumer products, energy, healthcare and retail/restaurants round out the top five sectors, which collectively account for 65% of all Weakest Links.

For those still expecting a quick recovery, we recall the old saying that a chain is only as strong as its weakest link — and the chain that is the U.S. economy has many weak links at the moment.

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