

US ECONOMIC UPDATE

MARCH 2020



The US economy is undergoing a severe contraction

NAB Group Economics

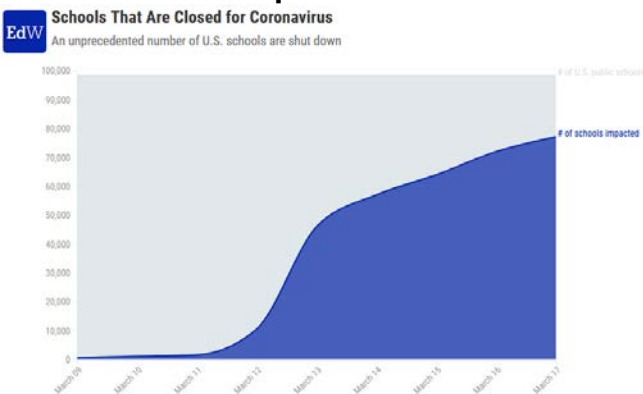
The rapid escalation in Coronavirus containment measures and the broader community reaction will see a major contraction in economic activity. For now, we are not forecasting a meaningful return to growth until Q4 2020 but this is highly conditional on when there is a substantial unwinding of containment measures. It also relies on policy successfully mitigating the negative second round effects from the immediate, containment related, fall in the economy which have the potential to cause a more protracted recession.

Events around the Coronavirus (Covid-19) have moved at a phenomenal speed. In our Global Forward View released in mid-March we marked down US growth – particularly in Q2 – as containment measures started to be rolled out in the US. We noted that (globally) a risk to the forecasts was for a further ramping up in containment measures.

This risk to the forecasts has been realised in a spectacular way, both in other countries (countrywide lockdowns in Europe) and in the US. Similarly, in the US, the rapid increase in Coronavirus case numbers has seemingly almost been matched by the growth in US containment measures.

This can be illustrated by school closures which were relatively few in early-to-mid March but by 17 March covered around three-quarters of schools.

School closures widespread



Source: Education Week • Data Visualization by Emma Patti Harris

Source: www.edweek.org

In addition to school closures, depending on the State or county, measures include shelter-in-place/closure of non-essential businesses (including for the whole of California) or mandatory closure of certain businesses (such as cafes, only take-away from restaurants, theatres, cinemas).

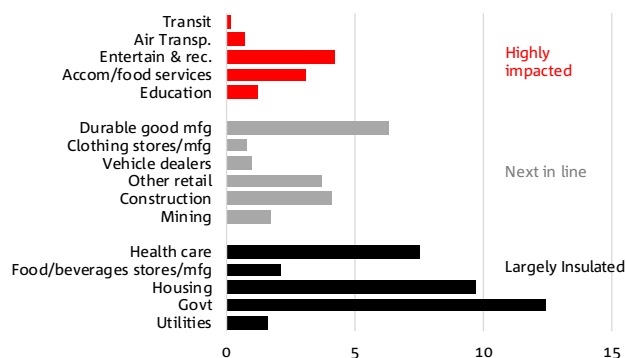
The Federal government has also put out guidelines for people to follow. This includes avoiding groups of 10 or more people as well as unnecessary travel. This is guidance only for a fifteen-day period (starting 16 March) but it is unlikely to be the last word and state/city restrictions are coming in over the top.

Businesses and individuals are also reacting and putting in place their own measures. Businesses are getting staff to work from home where possible (which will affect activity near office locations, transport services) or, at the extreme, closure (e.g. the NBA season has been suspended). Individuals are also limiting social interaction, affecting many industries (particularly service sectors) even in advance of any official containment measures.

The immediate impact of travel bans from certain countries and the other containment measures was clearly felt by some sectors far more than others – particularly airlines, tourism, entertainment and, given the widespread school and university closures, education. Partial indicators for these sectors are showing extremely large falls to date with falls reportedly as high as 75-85% in certain sub-sectors. Education may be less impacted to the extent it can provide on-line delivery. As a rough guide these industries made up around 9% of GDP.

Some industries more exposed than others at the start...but impact is spreading

GVA of selected industries (% of GDP)



However, the impacts will not be limited to these sectors. In some cities all 'non-essential' activity has been shut down. In any event, a broader range of retailers and businesses will be affected as the direct job and income losses from containment measures spill over to other sectors as businesses reduce spending to stay solvent or as people who have lost their job cut back.

More generally, there is currently a high degree of risk aversion. As a result, discretionary purchases by households, (where still possible given the widespread business closures) will be put off. This will affect discretionary retailers and manufacturers of these goods. Businesses focussed on survival and facing an uncertain environment will defer investment.

Some industries will be less affected (and may even expand) such as the health care sector (and pharmaceutical production), retailers selling essentials (groceries), as well as housing services (accommodation – as opposed to construction of new dwellings which could be put on hold).

Further, the need for many parents to stay at home to look after their children could disrupt all businesses. Similarly, social distancing measures and concerns over virus spread may lead to business outside of the high-risk ones closing – for example, due to health concerns the United Autoworkers had been pushing for motor vehicle manufacturers to shut down and reports indicate that more than 100 car and engine plants will indeed do so (probably helped along by falling sales). Unlike office workers there is no work from home option for many industries.

The contraction in business activity is not just unfolding in the US – China activity cratered in February and the recovery in March has been slow. European containment measures have become increasingly aggressive (the lockdown in a small part of Italy has now spread across several countries). This represents a large external demand shock to US exporters. Supply disruptions may also affect the ability of US manufacturers to continue production.

Fallout depends on a range of factors

All this adds up to an extremely large shock to the US economy. How large and of what duration occurs is going to depend on a range of factors. Critical amongst them include:

- By what degree existing containment measures are ramped up, their duration and how quickly they are wound back. This will depend on virus spread, success (or otherwise) of the measures, improvements in treatment of Covid-19 cases which lessen mortality concerns and so on. The simple act of businesses re-opening should provide an immediate bounce in activity.
- How businesses respond – laying off workers or placing them on unpaid leave or retaining in hope the shock is only short-lived; of course, given many businesses will face extreme cash flow pressures, lay-offs may be forced.
- Does the financial system hold up – providing credit to solvent, but temporarily cash flow squeezed firms. A failure of a major financial firm or investment fund will add to the panic. At the least the banking system appears to be in a healthier shape than prior to the GFC with greater capital buffers.
- With the US corporate sector highly geared will there be a wave of corporate failures. If businesses are permanently closed due to bankruptcy it won't be possible for employees to return to their previous role once containment measures ease.
- The effectiveness of the policy response in mitigating these pressures.

Policy response

The policy response has been rapid, particularly from the Fed. The fiscal process is always slower (requiring agreement across many different parties and new legislation). A listing of measures (covering the Federal government and Federal Reserve) are in the attached table.

The Fed has cut the fed funds rate and instituted a rapidly growing number of other programs to support liquidity in financial markets and hence credit flow. Swap lines have also been established with other central banks to address US dollar funding pressures.

The Fed Chair's view is that, at the current moment, the liquidity programs are more important than the rate cuts (the latter will become more important during the recovery).

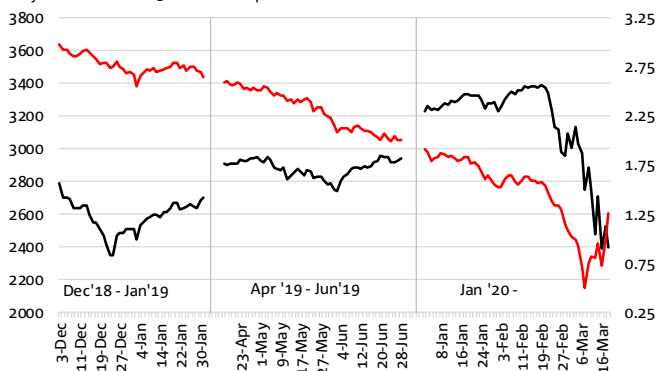
The Fed work's is almost certainly not finished as markets remain highly stressed as can be seen in the unusual spike in long-term bond yields. In line with more typical experience, yields initially fell as stock

prices plunged; however, they have since spiked higher reflecting several factors including a high demand for cash as well as the looming large supply of government bonds to be absorbed due to the stimulus programmes being mooted.

Government bond yields are key pricing benchmarks and so problems in these markets spread through the entire financial system. Mortgage rates are priced off long-dated bond yields, and so one impact is that a key monetary policy transmission mechanism (lower mortgage rates) is not working properly. Put another way even with the fed funds rate almost at zero, monetary conditions are not 'easy' but 'tight'.

Market stress and dislocation a concern

10yr bonds and S&P500 - recent episodes of stock declines



Several, relatively small, fiscal packages, have been passed by Congress. Initially they were targeted at providing health and related funding for the Coronavirus. The most recent – around \$100b – included expanding paid leave entitlements (at a risk of adding a further burden on some business at a time they can least afford it).

Work is underway on a much larger fiscal package, a so called “Phase 3” package reportedly around \$2 trillion (getting close to 10% of GDP). This may include cash handouts to individuals, direct assistance to some of the worst affected industries (e.g. airlines) and assistance for small businesses. However, it is subject to negotiation as there are differences within Congress about the measures. It is possible this is resolved by making the package bigger so everyone gets what they want.

While it will be called a ‘stimulus’ it is unclear how much it will be able to stimulate activity – you can’t spend at shops which are closed (or where you are not allowed to go out for non-essential reasons). Risk aversion and uncertainty is high, so cash is likely to be used to shore up balance sheets. However, for people who have lost their jobs it might support spending, even if only more essential items, and in areas not locked down there may be some extra spending at the margin.

The ‘stimulus’ – and Fed policy – is really about helping financially stressed businesses and individuals survive the period where severe containment measures are in place. The more they

can do this the quicker the bounce back, and the smaller the longer-term damage to the economy, will be. Of course, activity – and incomes – are falling as we speak and the Phase 3 stimulus is yet to be passed and, what may even take longer, the money distributed.

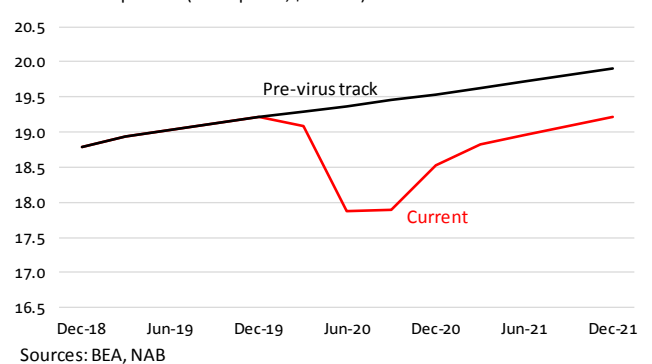
Forecast summary

There is an enormous uncertainty around any forecast right now. Key factors such as what further containment measures might be put in place and when they might be eased are, to use the Fed Chair’s expression, “unknowable”.

Even with containment measures only really ramping up from mid-March we are factoring in a 0.7% q/q fall in Q1 GDP. The full effects will be evident in Q2, which is likely to see an extremely large fall in activity; our current estimate is -6.3% q/q which, if it were to occur, would be larger than any single quarterly fall during the GFC.

US economy set for a large, sharp contraction

GDP forecast profiles (chain prices, \$trillion)

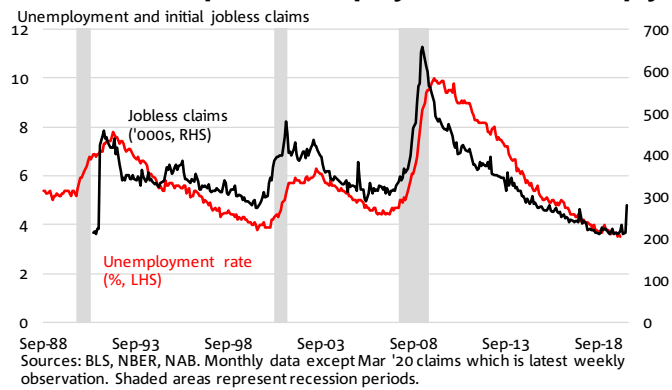


We would not place too much emphasis on the specific number - there are particularly large error bounds around any forecast in the current environment. For example, while California has put in place a shelter-in-place order for the whole state, the list of ‘critical’ industries is long and the duration of the order is not known, so working out how much activity, and for how long, will be shut down is problematic. Moreover, it is quite possible (if not likely) that containment measures will ramp up further in coming weeks. What the forecast is intended to highlight is that a major contraction in the US economy is underway. Illustrating the potential range of estimates, the head of the St Louis Federal Reserve has said that that GDP could fall by 50% (and unemployment could reach 30%).

This is already evident in jobless claims, which spiked in the latest week. Reports coming from states labour offices suggest it will be far worst in the next report. Our models would normally suggest, given our GDP forecast, an increase in the unemployment rate to a peak over 8% early next year. However, while unemployment normally lags activity, given the sudden, complete, stop to activity this time around

for many businesses, there is good reason to think the peak may come sooner and we allow for a faster run-up in unemployment than normal. The hardest impacted sectors have also been the labour-intensive services sectors suggesting some upside risk. Against this, to be counted as unemployed you need to be actively looking for a job, and it is unclear to what extent people will do so in the current environment.

Jobless claims spike...unemployment to rise sharply

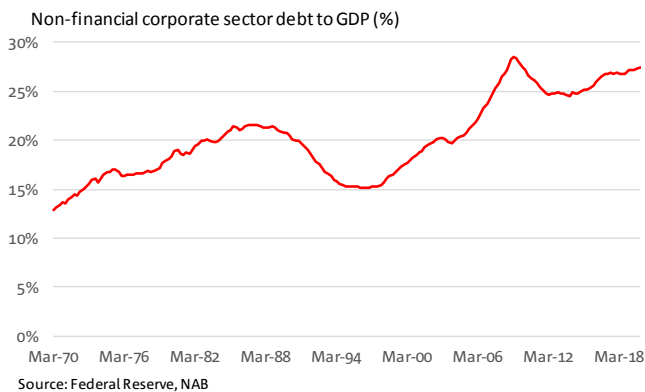


Unlike the GFC where it was unclear what could cause a turnaround, the trigger this time is clearer – an easing in containment measures.

We are assuming there is some easing of containment efforts in the later part of Q3 (and perhaps some adaption to the current environment by then), but that the negative dynamics caused by the initial crunch in activity keep growth roughly flat in Q3.

In particular, the high gearing of US corporates increases the risk of many (permanent) business closures and layoffs – and the lower activity and spending this brings about will constrain the recovery. Continuing financial market stress and elevated spreads only adds to this risk. For these reasons we would still assess risks as being skewed to the downside.

US corporates high gearing risks amplifying the shock



However, we assume that when containment measures are substantially wound back there will be a bounce in activity, which we have pencilled in for Q4. Obviously, there is a large degree of uncertainty around how long containment measures remain in place and this is a key source of uncertainty for the forecasts.

While there will be a bounce in activity once the crisis abates, we don't expect an immediate full recovery. Some businesses will have closed for good, meaning employees won't have a job to go back to. Even for those that survive, the damage to balance sheets – and the likely winding back of gearing levels – will weigh on activity. Lower employment and a period of foregone income for many households is also likely to leave a permanent hole in household budgets. Given the size of the latest stimulus package being discussed, the US government deficit will likely be well north of 10% of GDP – while some of this will be due to only temporary spending and lost tax revenue, this will create pressure for ongoing spending restraint (or tax increases) in the future.

CONTACT THE AUTHOR

Tony Kelly
Senior Economist
Antony.Kelly@nab.com.au

US Economic Policy Response

Measure	Summary	Date
Federal Reserve		
Fed funds rate	Reduced by 150bps over two meetings. Target range now 0 to 0.25%	3 March (50bp), 15 Mar (100bp)
Discount window	Reduced by 150bp (to 0.25%) – the ‘window’ is a source of lending to depository institutions (banks)	15 March
Reserve requirements	Bank reserve requirements reduced to zero.	15 March
Asset purchases & other liquidity measures	\$500 billion of Treasury securities and \$200b of agency mortgage-backed securities over coming months. Fed also active in Repo market with up to \$500b on offer on some days	15 March (securities)
Commercial paper funding facility & primary dealer credit facility	CP: Purchase from eligible issuers (based on credit ratings at 17 Mar) three-month U.S. dollar-denominated commercial paper Dealer facility: will offer overnight and term funding (up to 90 days) from March 20, 2020 (and in place for least six months). Stocks and investment grade securities can be used as collateral.	17 March
Money Market Mutual Fund Liquidity Facility	MMLF will make loans available to eligible financial institutions secured by high-quality assets purchased by the financial institution from money market mutual funds	18 March
New or enhanced swap lines with other central banks	Temporary U.S. dollar liquidity arrangements (swap lines) established with a range of other central banks (including RBA), or where there was a standing arrangement, lowered the pricing and extended the maturity	15 & 19 March
Government		
Initial Covid package – stimulus “Phase 1”	\$8b package (< 0.1% of GDP) directed at medical preparedness	6 March
Administration decisions, announcements & emergency declaration	Low interest loans from SBA, in affected states and territories, to help small businesses overcome temporary economic disruptions caused by the virus. Will need Congress to increase program funding by an \$50 billion Emergency declaration – frees up to \$50b of funding for the states. At same time announced waiver on interest on student loans and oil purchases Tax deferral - April 15 deadline to pay taxes owed for many individuals and businesses pushed back 90 extra days. Individuals can defer up to \$1 million of tax liability and corporations get an extension on up to \$10 million. Frees up to \$300b of liquidity.	11 March 13 March 17 March (Tax deferral)
Stimulus – “Phase 2”	Virus testing, unemployment insurance and food assistance aid to states, paid family/sick leave at a cost of approx. \$100b.	18 March (approved by Congress)
Stimulus – “Phase 3”	Reports of a \$2 trillion package – still being negotiated but may include cash handouts to families, support for airlines and other affected industries, and small business assistance.	Unclear

U.S. ECONOMIC & FINANCIAL FORECASTS

	Year Average Chng %				Quarterly Chng %									
	2018	2019	2020	2021	2019 Q3	2019 Q4	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3	2021 Q4
US GDP and Components														
Household consumption	3.0	2.6	-4.8	4.5	0.8	0.4	-0.9	-8.1	0.2	5.1	1.8	0.6	0.6	0.6
Private fixed investment	4.6	1.3	-4.3	0.7	-0.2	-0.1	0.3	-4.2	-2.6	0.3	1.1	1.2	1.3	1.1
Government spending	1.7	2.3	3.1	3.7	0.4	0.6	0.5	0.9	1.0	1.4	1.0	0.8	0.4	0.4
Inventories*	0.1	0.1	-0.5	0.3	0.0	-0.3	-0.2	-0.2	0.2	0.2	0.1	0.0	0.0	0.0
Net exports*	-0.4	-0.2	0.1	-0.3	0.0	0.5	0.0	-0.2	0.0	-0.2	-0.1	0.0	0.0	0.0
Real GDP	2.9	2.3	-3.8	3.7	0.5	0.5	-0.7	-6.3	0.0	3.6	1.6	0.8	0.7	0.7
<i>Note: GDP (annualised rate)</i>					2.1	2.1	-2.7	-23.0	0.1	15.1	6.5	3.1	2.8	2.7
US Other Key Indicators (end of period)														
PCE deflator-headline														
Headline	1.9	1.4	0.9	1.8	0.4	0.3	0.1	-0.5	0.5	0.8	0.5	0.4	0.4	0.5
Core	1.9	1.6	1.3	1.7	0.5	0.3	0.3	0.1	0.4	0.4	0.4	0.4	0.4	0.5
Unemployment rate - qtls average (%)	3.8	3.5	8.1	6.3	3.6	3.5	3.8	7.6	8.2	8.1	7.7	7.0	6.6	6.3
US Key Interest Rates (end of period)														
Fed funds rate (top of target range)	2.50	1.75	0.25	0.25	2.50	1.75	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25

Source: NAB Group Economics

*Contribution to real GDP growth

Group Economics

Alan Oster
Group Chief Economist
+61 3 8634 2927

Dean Pearson
Head of Behavioural & Industry
Economics
+(61 3) 8634 2331

John Sharma
Economist
+(61 3) 8634 4514

Jacqui Brand
Personal Assistant
+61 3 8634 2181

Australian Economics and Commodities

Gareth Spence
Senior Economist
+(61 0)436 606 175

Phin Ziebell
Economist – Australia
+61 (0) 475 940 662

Behavioural & Industry Economics

Robert De lure
Senior Economist – Behavioural
& Industry Economics
+(61 3) 8634 4611

Brien McDonald
Senior Economist – Behavioural
& Industry Economics
+(61 3) 8634 3837

Steven Wu
Economist – Behavioural &
Industry Economics
+(613) 9208 2929

International Economics

Tony Kelly
Senior Economist
+(61 3) 9208 5049

Gerard Burg
Senior Economist – International
+(61 3) 8634 2788

Global Markets Research

Ivan Colhoun
Global Head of Research
+61 2 9237 1836

Important Notice

This document has been prepared by National Australia Bank Limited ABN 12 004 044 937 AFSL 230686 ("NAB"). Any advice contained in this document has been prepared without taking into account your objectives, financial situation or needs. Before acting on any advice in this document, NAB recommends that you consider whether the advice is appropriate for your circumstances.

NAB recommends that you obtain and consider the relevant Product Disclosure Statement or other disclosure document, before making any decision about a product including whether to acquire or to continue to hold it.

Please click [here](#) to view our disclaimer and terms of use.