US ECONOMIC UPDATE 26 MAY 2020

APRIL CRASH, TENTATIVE RECOVERY IN MAY

NAB Group Economics

April partial indicators confirm that Q2 GDP is set for a massive fall and the unemployment rate is already at a record high. While activity likely bottomed in April as most US states are gradually 're-opening' their economies, the recovery is likely to take a long period of time, with risks weighted to the downside.

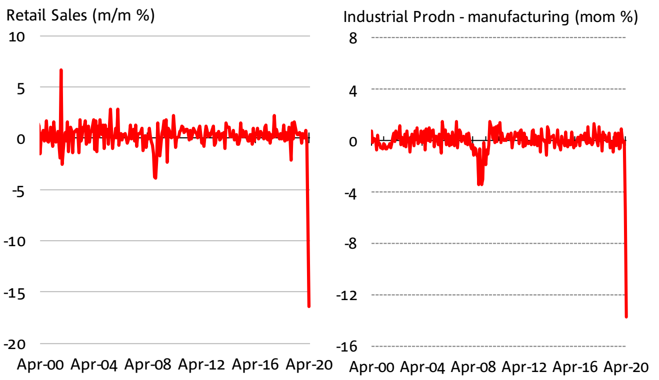
Q1 GDP

US GDP fell by 1.2% q/q in Q1, its first decline in six years and its largest fall since the end of 2008.

With the fall in GDP concentrated in the second half of March due to a major ramping up of COVID-19 containment measures, we had expected much worse to come in Q2, and early indicators for the quarter confirm this.

Retail sales plunged by 16% m/m in April (a decline over the last two months of 23%) as did manufacturing industrial production (-14% m/m for a two month fall of 19%); extraordinary declines by past standards. Similarly, housing starts declined 30% in April for a two month fall of 43% and housing sales have also fallen appreciably.

April partial indicators terrible – as expected



Source: Census Bureau, NAB

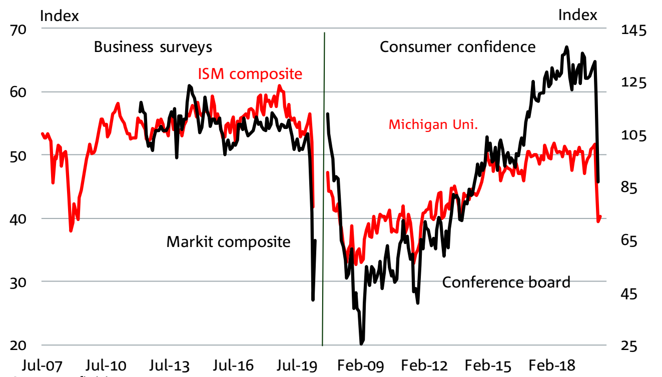
Source: Refinitiv (Federal Reserve)

Our forecast growth rate for Q2 GDP is -14.6% q/q, but this assumes that the fall from the pre-Coronavirus level of activity was more like 20%. However, we expect that the bottom in activity was reached in April and that growth resumed in May.

We maintain this view even though available business surveys for May remained below breakeven.

While the business surveys formally ask for the change since last month (with a reading below 50 indicating contraction) there is some evidence that respondents time frame is longer. As a result, we take comfort that surveys for May (Markit in chart below) showed some improvement. Consumer confidence, which plunged in April, also appears to have stabilised in May.

Surveys – April the worst, May better but still bad



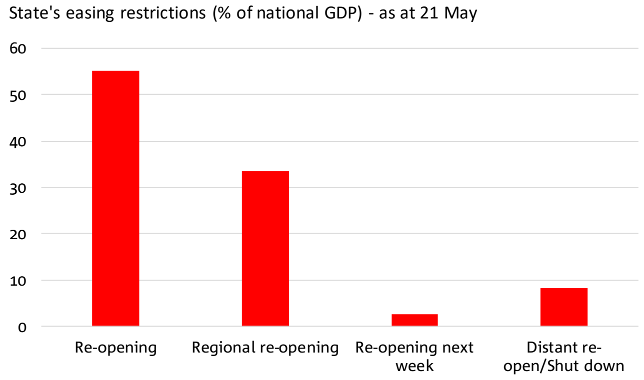
Source: Refinitiv

Our expectation for a recovery in activity in May is based around an easing in government restrictions on activity that started in late April. Media reports indicate all states have started 're-opening'.

However, the degree of easing in restrictions varies considerably. The New York Times categorises states as 're-opening' once stay-at-home orders are rescinded or a major sector is permitted to re-open (or multiple smaller sectors). On this basis, weighted by state share of GDP, around 55% of states have re-opened, around a further 35% have allowed some parts of the state to re-open or will re-open the next week (as at 21 May). 8% of states effectively remain shut down for now.

Date **May 2020** | Author Tony Kelly – Senior Economist

Re-opening' underway across most states

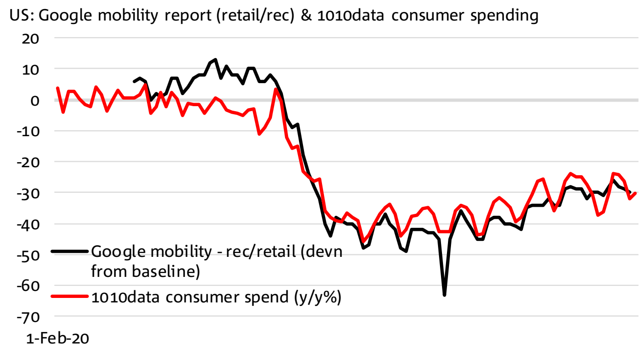


No state that is 're-opening', as far as we aware, has gone back to business as normal. The easing in restrictions is happening in a staged manner with, for example, capacity limits at restaurants gradually being eased. Moreover, the community is likely to remain cautious and continue to adhere to 'social distancing', at least to some extent, for a while to come.

Even with only a partial re-start, there may be a big jump in activity given the very low starting point. Motor vehicle production declined by 96% over the two months to April reflecting widespread plant shutdowns; but many of these plants have, or are planning to, resume operations in May.

High frequency indicators also suggest that activity bottomed out in April and has either stayed flat or started to pick up through May. A couple of these indicators are highlighted in the chart below.

Indicators point to partial recovery in May

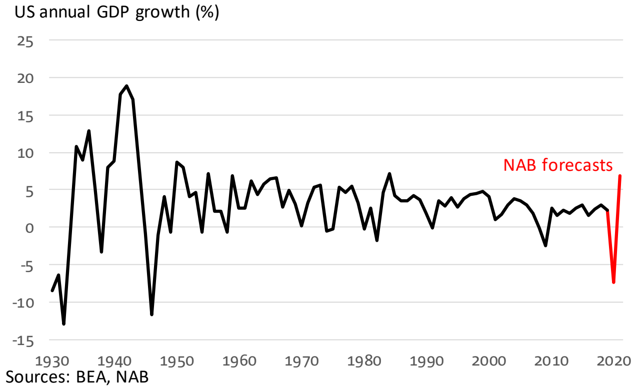


As a result, while on average Q2 will almost certainly show an exceptionally large fall, we expect growth will recover in the second half of the year. The net result is still likely to be the largest fall in annual GDP since the move away from military spending post-WW II (and before that the Great Depression).

There are a range of reasons why we consider that a full recovery will take an extended time. These include:

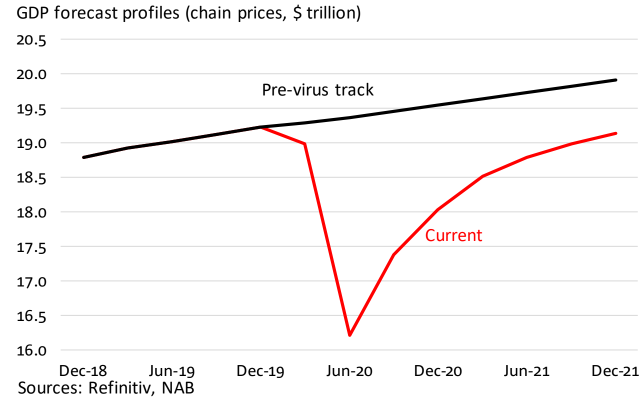
- Likely continued risk aversion by both businesses and consumers. Unless a vaccine is developed, activities seen as risky (travel, concerts etc) may be shunned. Risk aversion may also arise from

GDP growth in 2020 likely weakest since 1940s



Sources: BEA, NAB

Recovery to take time



Sources: Refinitiv, NAB

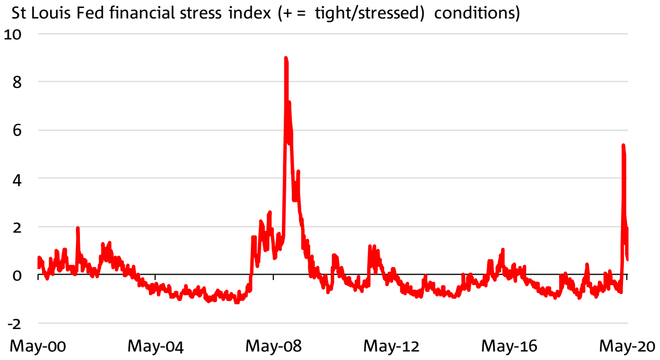
concerns of further waves of the virus and a desire to avoid major financial commitments.

- Many businesses will simply shut-up shop. While in any one year there are large number of businesses closing (and opening) it being concentrated in a short period of time is hard for the economy to digest.
- Lost income and damage done to many individual and business balance sheets will necessitate ongoing restraint. US corporates were already highly geared pre-COVID-19 and many have taken on extra debt to meet the cashflow squeeze caused by the response to the virus. Reinforcing this, financial conditions (credit spreads, lending standards) are likely to be tighter than they were pre-virus.
- These factors are likely to lead to lower rates of investment by businesses. This suggests a slower pace of capital deepening and lower future productivity growth.
- This will also slow the fall in unemployment providing another headwind to consumer activity. In April the unemployment rate jumped to its highest level in history (records began in 1948) and is set to rise further in May given continued large-scale job layoffs.
- Fiscal damage – the Congressional Budget Office is projecting federal government fiscal deficits of 18% in 2020 and 10% in 2021 – the largest since

WWII. Congress is already discussing another stimulus bill which will only add to these projections. As a result, the stock of debt (as a % GDP) is set to reach a record high. At some point Congress will be forced to address the poor fiscal position. This probably won't happen until the recovery is advanced (at the earliest) but the fallout will be more immediate at the state level as revenues fall and balanced budget requirements kick in.

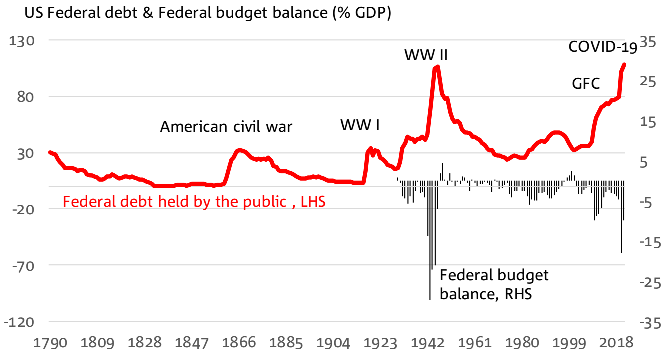
- Even once concerns over the virus fade there is likely to be permanent and substantial structural change. While there has been a move for a while to increased working from home and on-line shopping, the process has likely been accelerated. Reports suggest that many businesses do not plan to utilise as much office space in the future. Similarly, remote learning may disrupt the University sector. Increased teleconferencing will affect the travel and accommodation sectors, even assuming tourism eventually recovers. Moving resources (including people) from sectors in decline to new areas takes time; in the case of people who lose their job many may just fall out of the labour force permanently.

Financial conditions have eased but remain tighter than pre COVID-19



Source: St Louis Federal Reserve

Large budget deficits, debt to reach a new high



Source: CBO

Of course, these structural changes also represent a potential source of productivity improvement to the economy, so it is not all one way. Sectors that facilitate remote working, for example, will expand. Moreover, there may be spin-off benefits from the huge investment in vaccines and treatments for the Coronavirus.

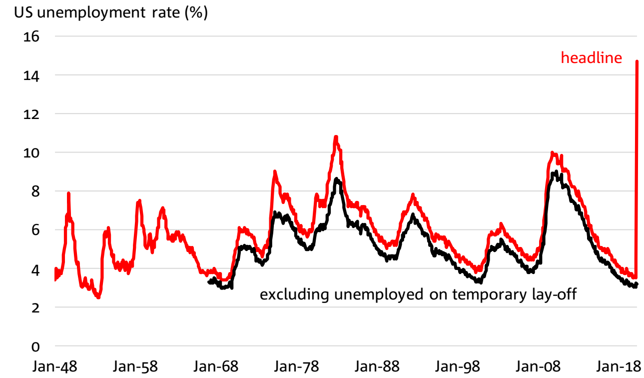
Overall, reflecting the steep fall in activity seen through to April, and the prospect of an incomplete recovery for some time, we are forecasting growth of -7.4% in 2020 followed by 6.8% in 2021.

There are a number of risks around these forecasts, generally weighted to the downside.

Downside risks include second or more waves of COVID-19 infections, overseas developments (including geo-political developments such as a deterioration in US-China relations and a resumption of the trade and technology war). The large fall in activity, and lengthy time to recover, may have a major deflationary impact, effectively raising real interest rates in an environment where the Fed cannot push rates much lower.

On the upside, the uniqueness of this recession means that it is possible that we are underestimating how quickly the economy may recover. As noted before, the unemployment rate has moved to a record high. However, the Bureau of Labour Statistics reports the proportion of unemployed who are on a temporary lay-off. Excluding this category, the unemployment rate has barely budged offering up the prospect of a quick fall in the unemployment rate.

Unemployment at a record high – but most consider it to be temporary



However, the BLS has included workers who are unsure of whether they will have a job to return to in this category, casting some doubt on the data. Moreover, while that may have been a worker's understanding at the time they were laid off, the length of the shutdowns in many states means that many of the jobs lost are likely to end up being permanent.

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U.S. ECONOMIC & FINANCIAL FORECASTS

	Year Average Chng %				Quarterly Chng %									
					2019		2020				2021			
	2018	2019	2020	2021	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components														
Household consumption	3.0	2.6	-9.5	7.8	0.8	0.5	-1.9	**-18.4**	**10.2**	**4.8**	**2.8**	**1.4**	**0.9**	**0.8**
Private fixed investment	4.6	1.3	-9.2	5.0	-0.2	-0.1	-0.6	**-12.7**	**1.5**	**2.2**	**3.1**	**2.4**	**1.8**	**1.4**
Government spending	1.7	2.3	2.6	4.3	0.4	0.6	0.2	**0.4**	**1.5**	**1.3**	**1.3**	**1.0**	**0.7**	**0.4**
Inventories*	0.1	0.1	-0.6	0.4	0.0	-0.3	-0.2	**-0.4**	**0.4**	**0.1**	**0.2**	**0.0**	**0.0**	**0.0**
Net exports*	-0.4	-0.2	0.7	-0.2	0.0	0.5	0.4	**0.1**	**-0.2**	**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**
Real GDP	**2.9**	**2.3**	**-7.4**	**6.8**	**0.5**	**0.5**	**-1.2**	**-14.6**	**7.2**	**3.7**	**2.7**	**1.5**	**1.0**	**0.8**
Note: GDP (annualised rate)					*2.1*	*2.1*	*-4.8*	*-46.8*	*32.1*	*15.8*	*11.2*	*6.1*	*4.1*	*3.2*
US Other Key Indicators (end of period)														
PCE deflator-headline														
Headline	1.9	1.4	0.3	2.1	0.4	0.3	0.3	**-0.5**	**0.0**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Core	1.9	1.6	0.4	1.5	0.5	0.3	0.4	**-0.3**	**0.0**	**0.3**	**0.3**	**0.4**	**0.4**	**0.4**
Unemployment rate - qtly average (%)	**3.8**	**3.5**	**10.2**	**6.8**	**3.6**	**3.5**	**3.8**	**18.2**	**12.5**	**10.2**	**9.8**	**8.0**	**7.1**	**6.8**
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

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