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Are We Heading for a Historic Economic Collapse? Why the U.S. GDP Could Fall by 40%.

By Randall W. Forsyth Updated April 12, 2020 / Original April 10, 2020

Photograph by JOHANNES EISELE/AFP via Getty Images

When straightforward descriptions can't adequately portray an event or phenomenon, metaphors abound. So it has been with the coronavirus' devastating impact on society and the economy.

The pandemic has been called a war against an invisible enemy that therefore requires government mobilization. It has also been termed a natural disaster, but unlike earthquakes or hurricanes, it's global and without a certain end date. Economically, it's arguably a man-made misfortune because the lockdown of people and the virtual cessation of many businesses resulted from government dictates.

All are fitting labels, to an extent. But more important than how to describe Covid-19 and its terrible impact—obvious in some 100,000 global deaths and massive U.S. unemployment and loss of income—is the question of when the virus will retreat and an economic recovery will begin. The financial markets appear positively sanguine that a revival is near, with stocks and risky corporate debt securities rallying strongly in the past week, mainly as a result of Federal Reserve actions.

If the economic contraction is chiefly man-made, it should be relatively simple to reverse. If, however, it depends more on when the virus' health impact recedes, the timing is more uncertain. An economic comeback will also depend on how willing business and labor are to re-engage once the all-clear is sounded.

The stock market evidently saw reason to cheer this past holiday-shortened week, with the S&P 500 index popping up 12.1%. That was its best showing since the week ended on Oct. 11, 1974, when it was emerging from a bloody bear market that had sliced 45% from its peak value. The large-capitalization benchmark has now rebounded nearly 25% from its March 23 low, suggesting that a recovery may be at hand.

What could Mr. Market be thinking?

After examining stock prices' past relationship with U.S. economic growth, Deutsche Bank macro strategist Alan Ruskin concludes that equities' recent behavior would suggest a short, shallow recession ahead and a quick recovery, rather than an economic collapse of historic proportions. But the latter most definitely is what the U.S. economy is undergoing. With nearly 17 million Americans filing for jobless benefits in the past three weeks, economists are starting to make stabs at how fast it is shrinking.

The most horrific number I've seen is J.P. Morgan economists' estimate that U.S. gross domestic product is collapsing at a 40% annual rate, a revision from their previous calculation of 25%. It has been said that economists use decimal points in their forecasts to show they have a sense of humor. These numbers are nothing to joke about.

That economic activity has ground to a halt in many sectors, as mandated by the need to quarantine, is obvious in the lack of traffic on highways, and in the air. (Flights are down some 95% from the total a year ago, according to Transportation Security Administration screenings, to levels not seen since after 9/11.)

"The most important factor driving the near-term path of the economy and the labor market is the progression of the virus and the length of the restrictions on activity put in place to contain it," the bank's economists state. But how this unfolds remains unknown. "You don't make the timeline; the virus makes the timeline," as Dr. Anthony Fauci, director of the National Institute of Allergy and Infectious Diseases, has famously said.

Still, you have to make some assumptions. J.P. Morgan sees restrictions on activities and stay-at-home orders continuing through May, with a rebound starting in June. After that, the bank looks for GDP to surge at a 23% annual clip in the third quarter and 13% in the fourth quarter. That sounds stupendous, but after climbing out of the deep hole in which it now sits, GDP in the fourth quarter would still be 6.9% lower than it was a year earlier.

Cornerstone Macro's Nancy Lazar is more skeptical. After falling at a 20% rate in the second quarter, she sees U.S. GDP continuing to decline in the third, albeit at a far more moderate 2%.

David Levy, who heads the Jerome Levy Forecasting Center, sees the worst hit in the current quarter, but thinks the third still will be bad, as businesses continue to shed inventories and cut capital investment. He is skeptical about a third-quarter bounceback.

The shape of a potential recovery is being described in terms of letters that represent graphically the economy's eventual comeback, from a vigorous V to a lugubrious L, with variations such as U and W.

Given the high degree of uncertainty, RBC Capital Markets economists Tom Porcelli and Jacob Oubina offer no less than five scenarios, depending on the changing data, including when Covid-19's infamous "death curve" flattens. That could be in early June, according to the IHME Murray Model, named for its author, University of Washington professor Christopher Murray. Alternatively, the peak could come sooner…or later.

RBC ascribes a 35% probability to a V-shape recovery, with the virus contained, a lower death rate than expected, and the economy returning to trend by the end of the third quarter.

Equally likely, however, is a "double dip" with a relapse of the virus in autumn. In that case, the economistsposit, the drop in GDP in the fourth quarter would be less severe than the one in the second because we'd be better prepared to reimpose social distancing, and the health-care system would be better equipped.

A "check mark" recovery—picture a shorter downstroke and a longer upstroke with a flatter slope—is given a 20% probability by RBC. In that scenario, infection and death rates would remain elevated, although increased antibody tests beginning next month might nonetheless allow the economy to open up gradually.

An "EKG-shape" (like the blips of an electrocardiogram chart) comeback would be the best-case scenario, with low fatality rates and the effects of stimulus allowing the economy to come roaring back; the economists give that a 5% chance.

Finally, there's the "long-U" recovery, with no letup in virus risk. That would ensure an elongated period of weak growth, such as what followed the financial crisis.

While the current economic contraction is unique, given that it was government-mandated to fight a public health crisis, Goldman Sachs economists think there is a precedent in the 1981-82 recession. That also was "man-made," with growth subordinated to another societal goal—in that case, to break the stubborn inflation of the early 1980s, they write in a research note.

After the recession engineered by the Paul Volcker–led Fed, which had raised interest rates as high as 20%, the labor market's revival was particularly robust, Goldman relates. That was because many of the 2.5 million temporarily jobless workers were rehired once the central bank relented.

"When economic downturns are deliberately induced and negative growth policies are perceived as temporary, firms may be incentivized to minimize permanent layoffs (and the associated costs and revenue disruptions they produced)," the bank's economists write.

There are significant risks today to this favorable outcome, including a more gradual lifting of activity restrictions, business "exits," and "financial spillovers," along with the specter of resurgence of the virus, they add.

What is imponderable is how we will respond when we are freed from house arrest and businesses are permitted to reopen.

The Jerome Levy Forecasting Center's David Levy wonders how much retired baby boomers will want to travel, considering the health risks. Even people with money might be scared to do anything this summer, he adds, given the "jolt" to household wealth. The value of U.S. stock holdings is down some $6.9 trillion from the Feb. 19 peak, even after a jump of $3.3 trillion in the latest week, according to Wilshire Associates. However, he adds, "I'm optimistic about the U.S. getting through this. The government basically did the right thing to throw money at the economy."

While Washington's huge spending packages will help America get back on its feet, the rest of the world may not fare as well. Especially hard-hit will be emerging economies, which have basically gotten by on foreign borrowing after their export boom got off track in the last recession.

The only certainty about the outlook is that the U.S. economy is undergoing a severe contraction without precedent in history, even during the depths of the Great Depression of the 1930s. Yet just because this recession was mandated by government policies doesn't mean it can be reversed as easily.

While the policy response has been unprecedented, with more than $2 trillion in fiscal measures and trillions more in liquidity provisions from the Fed via a dizzying alphabet soup of facilities, these actions are attempts to fill the gaps left by the enforced shutdown of a large swath of the U.S. economy.

Even well-intentioned schemes, such as the Payroll Protection Program of forgivable loans to small businesses, have been fraught with problems. And another round of stimulus will be needed to tide over those hurt in this crisis, especially states and localities that, unlike the federal government, can't borrow without limit and in many cases must balance their budgets.

So far, the actions by Congress and the Trump administration, along with the Fed, have encouraged the equity and credit markets to stage strong recoveries. The outlook for the economy is far less certain, not least of all because it will be determined by the course taken by the coronavirus. And that course, as we see daily, is far from predictable.

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