Perspective

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The Power of LUV

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Even working from home, demand for commentary and analysis on the economic outlook does not take a day off. The following Perspective is based on a speech to internal stakeholders outlining our current thinking on the following topics:

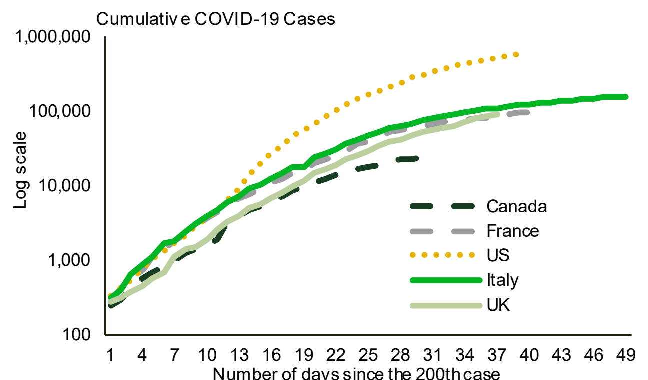
- The economic forecast and the shape of the business cycle
- Potential labor market dynamics in relation to recent government policies
- International experiences on "reopening" the economy
- Implications for monetary policy and interest rates

Please forgive my less stylistic writing, as this was a "lift and shift" of text from my discussion.

Forecasts reflect a longer period of economic disruption

- Three weeks ago, we adjusted our forecast for a longer period of social distancing based on messaging coming from health and government officials. So far, there has been little reason to move off that stance.
    - In late February, our forecast embedded an assumption that mid-April would mark the beginning of an ebbing in social distancing measures. That assumption was pushed back to late-May in the subsequent update.
    - Doing so naturally led to a deeper contraction in economic activity in the second quarter.
- Most analysis tends to focus on national figures, but domestic and international experiences indicate that the economic impact can (and will likely) vary significantly across U.S. states and Canadian provinces in terms of:
    - the timing of re-opening the economy;
    - the degree to which the economy will re-open;
    - the industries that will be first out of the gate;
    - and the new normal, with several industries potentially operating at less capacity than previously

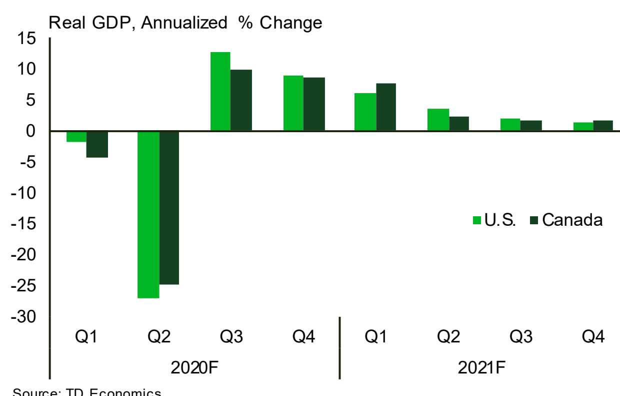
Chart 1: The COVID-19 Curve is Slowly Bending



Source: ECDC, TD Economics

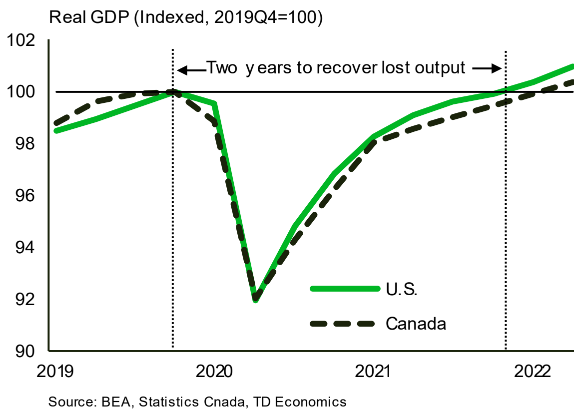
Unique features of the North American outlook

- I'm sure you've seen in the media that we face super-sized contractions in real economic output in the current quarter:
    - U.S. Q2 real GDP = -27% (annualized)
    - Canada Q2 real GDP = -25% (annualized)
- Both of these follow contractions in Q1 where the negative impact from shutdowns in the latter half of March more than overwhelmed the growth that occurred in the prior two months.
    - In that quarter, Canada's decline is more heavily front loaded than the U.S. because of more stringent and earlier containment measures, coupled with a higher dependency on the energy sector for output.
    - Given the depth and scope across industries, there is no longer a debate about whether this is a recession.
- For the entire year of 2020, Canada's economy is expected to contract by over 4%, while the U.S. is expected to pull back by 3.5%.
    - These forecasts are a percentage point deeper than the worst post-war historical recession for each country. For the U.S. this was marked by the global financial crisis; while Canada's worst experience was during the 1980s.
- At this point, whether we see Q2 contraction of 20%, 30% or 40% should not be the focus of discussion, because all of these figures are historic.
    - What matters is the timing and the scale of the rebound. Most forecasters, including us, have built in an expectation for a rebound in the second half of this year (Chart 2).
    - This is a crucial assumption that we're required to make to develop a forecast, but it's also where the vulnerability lies because the outcome is completely dependent on virus-related developments and government policies. It's not tied to a specific economic trigger, such as low interest rates creating an incentive to buy a new home.



Clearing up confusion on the shape of the economic recovery (L, U, V or even W)

- By extension, the assumptions underpinning the recovery defines the shape of the business cycle.
- This is one of the questions most asked by clients.
    - Which pattern will the economic cycle follow.? The 'L' is the worst outcome, implying a long period of stagnation.
- The shape matters because of the policy implications:
    - It informs on future central bank action, in terms of when they will be in a position to cease asset purchases and/or normalize interest rates.
    - The cycle shape crucially defines the share of job losses that will be temporary vs. permanent. A rising share of permanent job losses moves us along the path of a wide U or L cycle, reflecting persistent economic hardship.
    - In that situation, the ability for government policy to stop-gap business closures and household incomes becomes more limited.
- Because we are anticipating a rebound in the second half of the year, the cycle is often characterized as V-shaped by those reviewing our forecast figures.
    - A deep contraction gives way to growth of roughly 10% in the second half of the year (which is large by historical standards).



- But, this is misleading. We can't truly characterize this cycle as V-shaped.
  - Our outlook does NOT bake in a full recovery in 2020, even with a double-digit rebound (Chart 3).
  - By the end of this year, we anticipate Canada will recover only 50% of the lost economic activity from the first half of this year.
  - For the US, we think it'll be about 60%.
  - Canada's real GDP will not eclipse pre-crisis levels until the second quarter of 2022 (a full two years from the shock), while the U.S. may get there a quarter or so earlier.
  - The recovery in the **level** of activity is very much U-shaped, even though the growth rates give the impression of a V. This causes some confusion with clients or in how recoveries may be portrayed in the media. For this reason, some are characterizing the cycle as looking like the Nike Swoosh, marking a compromise between the two shapes.

What does this mean for the labor market?

- It's hard to escape headlines capturing an astonishing rate of job losses.
  - All the job gains over the past three years in Canada were lost in March. And we're not done. We think April will produce another two million or more in job losses.
  - For the U.S., the 700,000 job cut in March is is a drop in the bucket of what's to come. Initial unemployment insurance claims are topping 17 million, and this will get captured in the April payrolls report. By that time, the American economy will likely have erased all the jobs created in the past seven years.
- This is why there will be historic jumps in the unemployment rate for both countries in April.
  - Our forecast for Canada is at 16% in April. For the U.S., we estimated 12% for the month, but given the rapid rise in jobless claims, this figure looks too shy. It's more likely to be in a similar ballpark to Canada, in the high teens.
  - Thereafter, the combination of some relaxation in social distancing measures and various government programs should allow the unemployment rates to level off and recede.
  - Even as this occurs, we don't anticipate a return to pre-crisis levels through all of this year and next; there will be some residual scarring left on the labour market.

Government programs help define cycle shape

- Government support on both sides of the border are critical in keeping businesses and households afloat and mitigating the financial hardship from the sudden stoppage in economic activity.
- The U.S. has in place the paycheck protection program (PPP) and a very generous top-up of unemployment insurance claims, plus one-time rebate cheques of $1200/adult and $500/child.
- Canada has in place two main labour support programs under the Canada Emergency Response Benefit (CERB) and the Canada Emergency Wage Subsidy (CEWS) program that encourages employers to retain workers.

U.S. programs should help mitigate wealth shock

- The $600/week in extra UI benefits under the Federal Pandemic Unemployment Compensation (FPUC) is generous and covers nearly the full amount of lost income for many impacted workers (at least until the end of July).

- Unemployment benefits, rules and maximums vary by state. So, let's use New York and Florida's replacement rates and maximums as an example. Our estimates indicate that the average full-time worker in leisure & hospitality and retail will be better off under the benefit top-off plan. Those who work in professional, information, utilities, and finance sector would have a 50-60% replacement rate of their incomes in Florida, and it would be about 10 percentage points higher in New York.
- For this latter group, this isn't too bad an outcome considering that these workers are less impacted, so far. Of the 700K job losses in March, only 50K were in this group of industries that have the lower income replacement rates.
- April will be the more defining moment, as 17 million job losses come into focus, particularly if there's greater bleed-through to higher incomes areas.
- But, on this, the PPP program should also help backstop incomes, where it's been reported that demand has quickly exceeded the supply of funds. At least 75% of the funds need to be directed to payrolls and there's a retention element to having these funds converted from a loan to a grant. This should help reduce financial strain and place the unemployment rate on a downward path in the months ahead as employers fulfill those commitments.

Canada's path on income support differs

- Canada's CERB program is not income dependent. This means that for those earning two-thirds of the median hourly wage, 83% of their employment income is covered.
- In contrast, the wage subsidy safeguards income up to the median of $58.7K salary/year, for those employers who opt into the program.
- Under both programs, the lower wage segment of the population has a higher income replacement rate. Regionally, this means there's greater downside economic risks for Ontario, Alberta, and B.C. where incomes exceed the national average.
    - Alberta's income is about 123% above the national average
    - Major urban centers in Ontario, such as Ottawa and Toronto are about 115-120% above average national income
    - Vancouver is also above the national, but by a slimmer margin.
- Even for those employers who want to opt into the wage subsidy program, the higher the earnings in a region, the more challenging it will be for an employer to top-up the remaining 25% of salaries.
    - As a result, employers may choose to lower those incomes for a period of time, or prefer to keep employees on EI or CERB benefits. In this way, these workers won't be left 'whole' or come out of this hibernation period with guns firing in consumer behavior.

The broad take away is three-fold:

- First, the U.S. may have more success than Canada in preventing a temporary income shock from becoming a more permanent wealth shock.
- Second, replacement rates on incomes are reasonably good for lower income households and decent for higher income households, particularly given the latter are more likely to have savings to draw on relative to lower income folks. This should offer a bit of comfort that income supports are better than previous economic downturns and will leave households in a better position to resume activity post-crisis.
- Third, the programs also demonstrate that there will be income gaps and wealth impacts. A number of people will exit this cycle with more income insecurity and debt, particularly given the high absolute amount of job losses. This combination tends to lead to cautious spending behavior, suggesting it's not going to be an immediate snap-back in lost activity.

Bridging the gap in the forecast

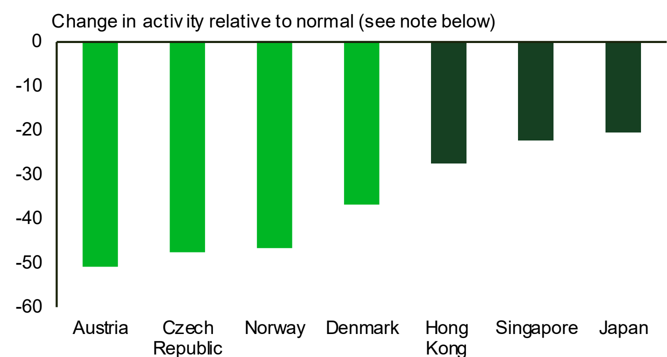
- Regardless of the approach, success will be determined by the ability to keep families in a holding pattern and provide for food, shelter and other necessities until the economy reopens.
- Although the goal is to provide households with steadier legs once job restrictions lift, that does not

mean they'll be in the same or better position had the pandemic never occurred.

- Within our forecast, consumer spending profiles don't return to pre-crisis levels until the middle of next year, at the earliest.
    - That's a better outcome than the overall economy because we believe the business investment cycle will carry the brunt of the pandemic scars, potentially not returning to the pre-crisis level for three to four years.
- Before the health crisis, Canada and the U.S. were already experiencing weak business investment. In fact, the U.S. had three quarters of business investment contraction during a healthy expansion. This too was unprecedented, as trade wars undermined global growth dynamics and created business uncertainty.
- It's hard to imagine conditions that would propel strong investment intentions, given that global growth prospects have now become more impaired.
- This is where our social distancing assumptions become so critical to the forecast. If instead of easing in May, stringent measures last through the summer, we move towards an even wider U and even, L shaped recovery. Government measures would become less effective in building the backdrop to incent future investment.

Nascent signs of a staggered return of activity

- Since there are not prescriptive plans yet on how and when governments intend to re-open the economy, we are using the experiences of other countries as leading indicators.
- The first in, is also the first out:
    - China's preliminary forward-looking data has been promising, with rebounds in both manufacturing and service industries back into expansion territory.
- Europe is next on timing:
    - A number are attempting to relax restrictions: Austria, Czech Republic, Denmark, and Norway.
    - This relaxation is occurring with a narrow focus among a select group of services, such as education facilities in the case of Denmark, or hardware and gardening stores in the case of Austria.
    - The decisions to re-start segments of the economy do not appear to be based on zero new virus cases, but rather capture a stark shift in recovery rates versus death rates that alleviates pressure on the medical system to address new cases.
    - Case in point, on Monday, Spain recorded roughly 3,500 new coronavirus cases. This compares to more than 8,000 new infections a day at its height. Yet, the government allowed hundreds of thousands of people to return to work for the first time since the lockdown, with a focus on workers in manufacturing and construction. This was a first step in broadening out labor market access beyond those categorized solely as essential workers.
- These decisions in Europe are occurring at about the four to five-week mark following social distancing measures, with some clear exceptions like Italy and France.



Source: Google, TD Economics
Note: The chart shows how people have avoided public places compared to a baseline of mid-February. This chart is the average of trends seen in retail and recreation, grocery and pharmacy, transit stations and workplaces. More negative = More social distancing.

The risk of a "W" outcome

- The danger of wide scale relaxation is captured by the second wave of the virus hitting some Asian economies such as Singapore, Japan and Hong Kong.

  - When you hear about these statistics, it's important to keep in mind that these regions with second waves did a lot less social distancing relative to the European countries that are now planning to relax measures. This is evident in trends in retail transit, recreation, and workplaces (Chart 4).
  - So, it's possible to have one group of countries ease from stringent measures, while another tightens the grip from a more lax starting point. This speaks to the point that there's not a one-size-fits-all approach.

What to watch for

- With the retooling of manufacturing towards virus-containment efforts, the signals on the business cycle will be a bit distorted relative to past cycles.
  - Clothing manufactures like GAP, New Balance and Canada Goose are making hospital scrubs and masks. GM is making ventilators, and alcohol companies are making hand sanitizers.
  - In a typical recession, it's the manufacturing sector that is the leading indicator to how close we are to the exit door, but this won't be the case this time. Instead, it will be the service sector, and we'll need to rely on unconventional metrics like commuter traffic and restaurant bookings.
  - For the U.S., you've been hearing about the spike in initial jobless claims, but continuing claims will tell us the difference between furloughed and fired workers. It's important to not just focus on those headlines of job losses, if workers are being recalled in the background.
  - On this point, the re-tooling of the American workforce has created demand for more than 800,000 new jobs, from delivery services to medical needs. Amazon alone took on 100,000 new workers, and wants to add another 75,000. This is small by comparison to the national scale of job losses, but it tells us there's more than meets the eye in traditional metrics.
- We're at least a month away from this data giving us any clues of a turning point. If it does not, it would suggest a longer recession.
  - At this point, all we can say with a fair degree of confidence is that relaxation of social distancing measures will be uneven across industries and regions.
  - Although it's still reasonable to expect a rebound in economic activity, a quick snap back to pre-crisis levels seems more elusive.

What's a central bank to do?

- As you probably guessed, it's hard to pin down when central banks will begin to normalize rates, but the process is likely a couple years off (and perhaps longer).
  - Central banks are doing a lot of heavy lifting in asset purchases to ensure market confidence and liquidity. The Fed is buying everything under the sun from federal government debt, to municipal to corporate issuances.
  - If they follow the pattern of the past, which we believe they will, the central bank will first cease asset purchases and allow some unwinding of the balance sheet before raising interest rates.
  - For Canada, the pandemic is only one of two shocks, the other being to the energy sector. So, it's unlikely that the Bank of Canada will move ahead of the Federal Reserve even if the housing market heats back up due to supply constraints. As noted previously, Canada's economic recession will likely have more depth and could face a slightly slower rebound due to the challenges of the energy sector.

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