TD Economics

Perspective

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It's Always Darkest Before Dawn

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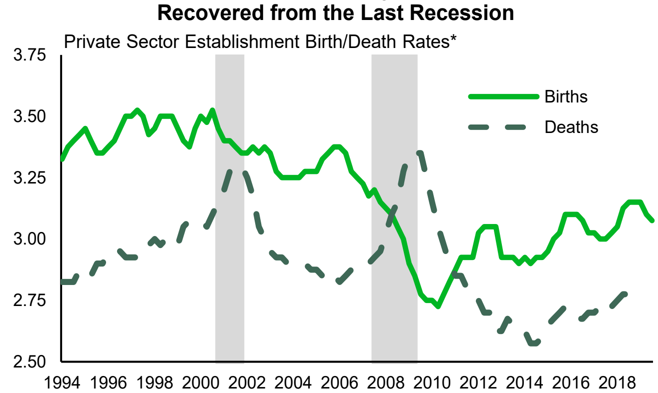
The ebbing of government policies that clamped down on business activity is ushering in the early stages of an economic recovery. However, this represents mere slivers of sunlight piercing through the long shadows of heavily depressed data for the months of March and April. Risks have yet to recede and the next steps that governments take to balance the lives versus livelihood debate will ultimately determine the depth and persistence of the economic scars. As we've previously written, outcomes on extremely high youth unemployment already have the tell-tale signs that the healing process could be a decade-long journey for this group of individuals. The claw back of some jobs in May across the U.S. and Canada was positive, but reflects roughly 10% of the total lost in just two months, with the younger labor force still heavily marginalized (particularly those aged 20-24 years).

The only cure for a recession is strong demand for workers. It's becoming clear that this economic recovery will be bounded by required physical distancing rules that will leave many businesses in the lurch to maintain sustainable operations. We've addressed this break down in a recent paper that characterized the outlook by industry into one of the letter-groupings of L, U or V. More than 60% of the industries were placed within the U cycle, and the L captured another 10%. By extension, this means employment within these businesses will fail to normalize within a one-year or more timeframe, and economic hardships will be borne by increased bankruptcies and joblessness.

Of course, nobody knows for sure the path because the dispersion of uncertainty in this cycle contains two unique and compounding factors. The first are the government rules that prevent or delay the re-opening of viable businesses. Once this hurdle is passed, the second is higher operating costs that come with reduced occupancy or service requirements upon re-opening, along with necessary safety-related costs for staff and clients. This changes the arithmetic of 'survival of the fittest' that typically occurs during recessions. It also creates a higher barrier of entry for new businesses into the marketplace to help absorb excess labor. In Chart 1, we've captured the birth and death rates of American businesses during the past two recession cycles. It's not surprising that the business 'death' rate soars amidst a recession. However, the birth of new firms following the global financial crisis failed to ever recover to its pre-crisis state. The experience is little different for Canadian firms.

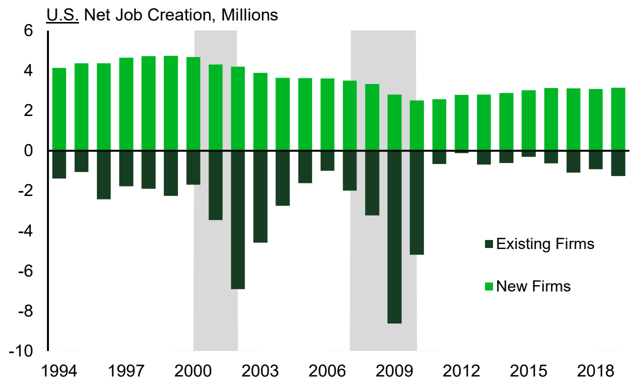
This has confounded economists, setting into motion a significant body of research on business dynamism, growth and destruction theories. There's no single factor that seems to dominate, but barriers to entry for new firms have become higher due in part to oligopolistic outcomes from the dominance of digital platforms, along with a stronger reliance on intellectual property that is costly to develop but

Chart 1: U.S. Business Dynamism Never Recovered from the Last Recession



*Births/deaths percent of current and previous total establishments.
Source: BLS, TD Economics.

Chart 2: New Firms Create All the Net New Jobs



Source: BLS, TD Economics

costless to replicate. The nature of this recession will likely augment these factors via the hard push into the digital world where market leaders are well entrenched, while any new entrant into a high-touch client business (like restaurants, bars or bricks and mortar retailers) will face reduced occupancy requirements and higher operating costs that will constrain profitability and financing options. As Chart 2 shows, firm creation is what ultimately leads to job creation, not the actions of mature, existing firms.

So, the setting and duration of government physical policy measures becomes one of the most defining features of this recession, and the scarring that it creates determines the recovery pathway. A V-shaped recovery is a remote possibility due to the gradual approach to re-opening, the threat that a second infection wave will prompt some governments to retighten policies, and the evidence that businesses are not fully maximizing existing government programs to retain workers (via the PPP in the U.S. and the wage subsidy in Canada). This leaves three remaining business cycle options: L, U and W.

However, starting with the letter is actually counter-intuitive. The shape of the business cycle is the outcome, not the starting point. For instance, a second infection wave scenario often gets characterized as a high-risk of a W-cycle. But, there's an equally high probability of an L-outcome should a retightening of physical distance measures kick another leg out of a stool now resting on only three legs.

Defining The Four Stages Of This Economic Cycle

How do you know which path we're on? Here's a thought framework to help simplify a nuanced and complex outlook. Each letter of the business cycle can be broken down into four stages: protect, recover, strengthen and function. If these sound familiar, it may be because you've suffered an injury and went through physiotherapy or rehabilitation. Whether the business cycle is L or U shaped ultimately depends on how long we remain in Stages 1 and 2 versus 3. Here's the logic:

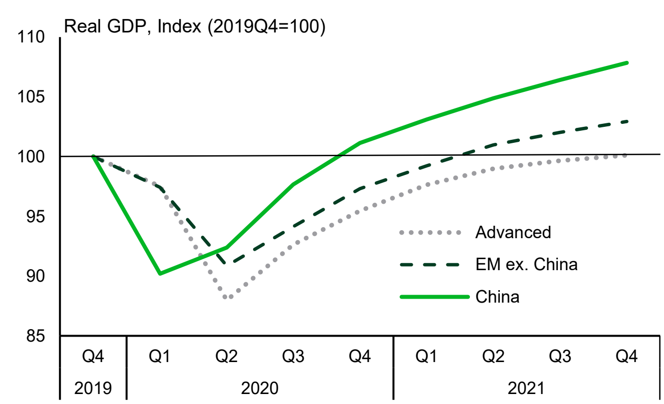
Stage 1: Protect

- This refers to protecting the injury, typically associated with a period of physical rest. In our economic context, it would reflect the February to mid-May period that literally limited the movement of people and business activity to protect hospital capacity and at-risk individuals. The economy was placed firmly on its back, into a period of rest.
- In Chart 3, this is captured by the steep drop in economic activity across countries extending until the second quarter.

Stage 2: Recover

- In terms of a physical injury, this is where you try to regain some mobility, often via rehabilitation exercises. For the economic injury, recovery is defined as the period between June and the end of this year within our forecast, but may potentially extend longer.
- This period reflects a gradual and selective re-opening of businesses under the watchful eye of health authorities for any signs of reinjury via rapid infection rates and an emergence of hospital capacity pressures.
- The notion of regaining mobility from a physical injury draws sharp parallels to this economic cycle

Chart 3: Protect, Recover, Strengthen and Function



Source: TD Economics

because we are literally monitoring people's mobility data provided by Google and Apple, as well as high frequency credit flow data to gauge the extent of consumer re-engagement.

- On this front, there are positive signs that households are willing to re-engage as governments dial back physical distancing policies, but it's very early days. The summer months will be more telling on the extent to which employers rehire workers. The rebound in jobs during May was promising, but still represents a small fraction of the total jobs lost. And, the U.S. report showed a rising number of people classified as a permanent job loss, rather than temporarily furloughed.
- The Recover Stage is a step in the right direction, but still reflects an economy operating at reduced capacity. In our forecast, by year end, we hope the economy will have succeeded in recapturing between 50-60% of past activity. This is akin to being able to walk on a previously broken ankle, but not yet run, pivot or jump.

The length of time an economy spends in Stage 2 will ultimately define whether the cycle carries an L or U shape. Imagine a second wave of infections occurs over the summer or the fall. Do governments put the economy back into Protect Stage, or do they require businesses to simply spend more time in a holding pattern within the second stage of the recovery? The first outcome would likely carve out an L-shaped (or W) business cycle, the latter would instead widen out the U-profile by allowing mobility, but at a reduced capacity. Both outcomes, however, lengthen the time to reach Stage 3 (Strengthen), and time is the enemy of business survivorship when restrained from operating at full capacity.

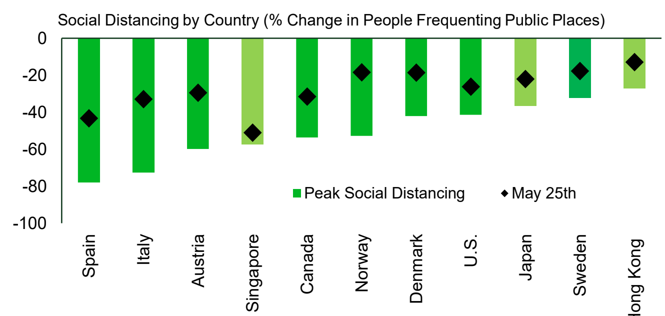
Stage 3: Strengthen

- This is the stage in the economic recovery that becomes crucial to forming the sturdiness of the upswing in the business cycle letter. We suspect this will be captured in 2021 if governments pursue a risk management approach to maintain economic operations, rather than place the economy back into the rest period seen in the first quarter of this year.
- The exit from the Recover Stage occurs when confidence exists on the momentum underpinning spending and investment activity. This pivots the economic rehabilitation dynamics into a higher marginal propensity to spend, which in turn becomes a job multiplier. Just like a muscle, it needs to continue to build on itself for strength and versatility, such that re-injury becomes less probable.

Stage 4: Function

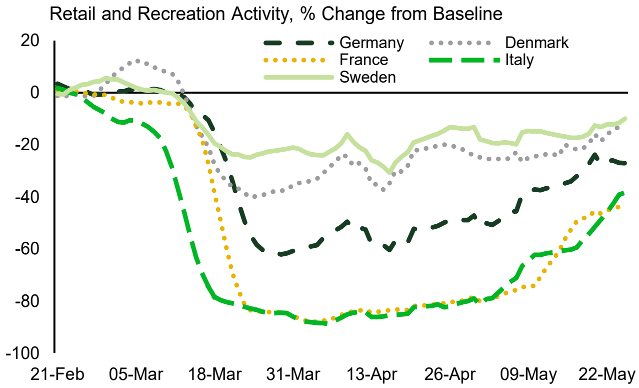
- Now the ankle has not only healed, but you've returned to prior fearless habits of running, jumping and sprinting.
- For our economic rehabilitation, this is the point in Chart 3 where the economy has returned to pre-crisis levels of activity. In doing so, it has recaptured its full range of motion and is looking to make up for lost time.
- For the U.S., we place this timing at the end of 2021. For Canada, it's at least one quarter later into 2022. And for other countries, like Italy, it's more likely to be in 2023 and potentially longer.
- The variance reflects different outcomes on physical distancing and the injury sustained to capital and labor market disruptions. As Chart 4 shows, Italy (along with Spain and France) had to undertake the most severe physical distancing measures. Italy's impaired government finances limited its support to businesses and households. When combined with a high dependence on tourism-related industries for economic growth, this places it in a longer Recover Stage, leaving it further from the mark on Strength and Function.

Chart 4: Social Distancing Decreasing, Even as Worries Emerge over Second Wave in Asia



Source: Google, TD Economics
Note: The chart shows how people have avoided public places compared to a baseline of February 15. Data are based on a 7-day moving average and are the average of trends seen in retail and recreation, grocery and pharmacy, transit stations and workplaces. More negative = More social distancing.

Chart 5: Retail Activity is Starting to Improve but There is Significant Variation Across Countries



Source:Google, TD Economics. Note: Data are reported as a 7-day moving average.

The Only Cure For A Recession Is Jobs

With this 4-stage framework, we can now review the preliminary data on the recovery signals, as countries ease physical distancing policies and exit Stage 1 (Protect). Chart 5 captures retail and recreation activity across European countries, which are a couple weeks ahead of North America in the dialing back of policies. Across a broad group of countries, the metrics are turning up, imparting some confidence that consumer behaviors will mean revert once the restraint is released.

However, it's also obvious that countries that embarked on more stringent measures are further away from returning to their pre-crisis mobility status. It's also important to remember that this data only capture the visitation of locations, and not purchases or the marginal propensity to consume. Window shopping will do little to revive the economy. But at least we can say that there's some degree of pent-up demand that's revealed by how individuals are choosing to spend their time as businesses reopen.

For the U.S. and Canada, the same patterns come through, but here we do have high-frequency credit data to complement the mobility metrics. A few things stand out with Charts 6 and 7, where we placed a handful of comparators. First, the U.S. has maintained less social distancing relative to Canada at the aggregate level, and thus the economic recovery has a shorter distance to travel. A U.S. state hard-hit by infections, like New York, is the outlier and not the norm. In contrast, Canada had a more common approach across the provinces in physical distancing tactics. Although policies within Canada are now easing, the aggregate sits today almost where peak levels of the U.S. rested during April. This suggests that Canada's recovery stage may be longer in duration than the U.S., particularly when compounded with the troubles of the energy sector. It's a key reason why we have a more delayed Canadian economic cycle into Stages 3 and 4.

The good news is that credit flow data on both sides of the border show that households are willing to spend at establishments once government policy changes. However, the data is very much in an early stage and lacks the markings of strength. Also, there's some superficiality created by substitution effects. If you can't travel for pleasure, even across your own country (as is deterred by many provinces within Canada, but less so among U.S. states), then you'll front-load and direct some of those funds to home activities like fixer-upper projects, a new barbecue and gardening.

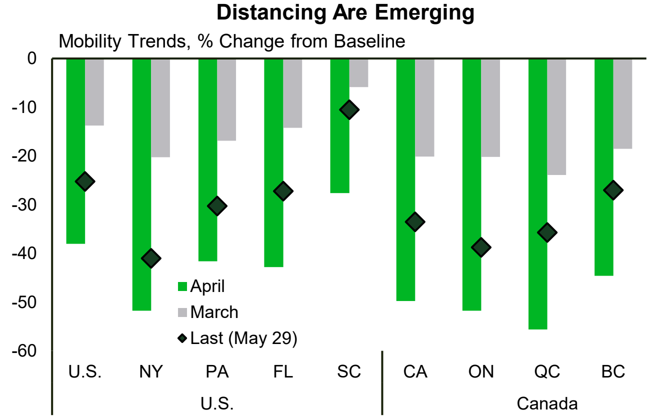
This substitution may not only equate to lower levels of spending in aggregate, but likely also bears lower economic multipliers. For instance, planting a backyard garden carries neither the same expenditure amount, nor job creation as travelling to a domestic resort area where your activity supports local community restaurants, sport equipment rentals, hotel staff and the respective incomes throughout that chain.

The extent that physical distancing policies maintain a negative weight on high-multiplier industries speaks to the difficulty of finding a quick exit from the Recover to the Strengthen stage.

Lives Versus Livelihood

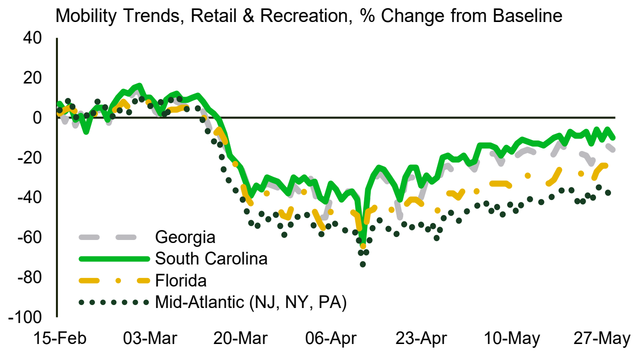
This gets us into a sensitive and divisive issue, the lives versus livelihood debate. We know getting back to 'normal' in the context of a pre-virus word is unrealistic in the

Chart 6:Signs of Easing in Physical Distancing Are Emerging



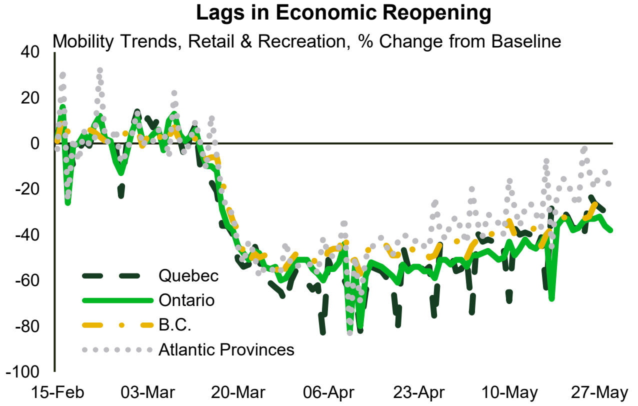
Source: Google, TD Economics

Chart 7-a: Southern States Lead the Way in Economic Reopening



Note: The baseline period extends from January to early-February. Last observation: May 29, 2020. Source: Google Mobility Reports, TD Economics

Chart 7-b: Atlantic Provinces Lead, While Ontario Lags in Economic Reopening



Note: The baseline period extends from January to early-February. Last observation: May 29, 2020. Source: Google Mobility Reports, TD Economics

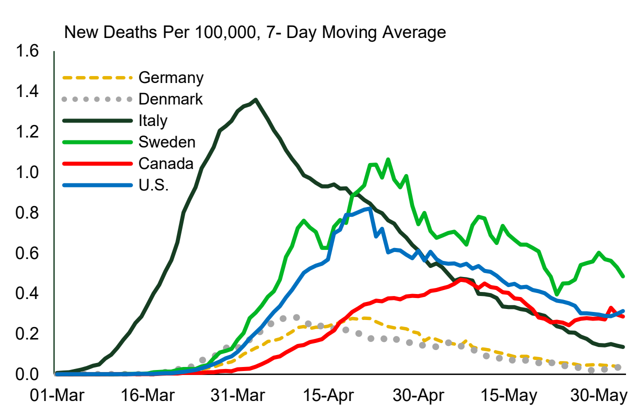
near-term, as there will remain some element of physical distancing. And, the greatest concerns being communicated by government and health officials is the risk that re-opening strategies trigger a second wave of virus infections. This seems quite possible. Eradicating the virus from a large population in the absence of a vaccine would require immense and long-term economic hardships that's not only financially unsustainable, but also leads to its own negative health outcomes across the population, broader than those currently most vulnerable to the virus. We cannot presume that a second wave of infections will cause regional governments to throttle back their economies into Stage 1 (Protect: rest the injury).

Let's start with reports indicating second waves are hitting some Asian countries, contributing to a dialing back up of physical distancing policies by authorities. As evidenced back on Chart 4, regions like Japan, Singapore and Hong Kong never put in place the strict measures of Europe and North America. Dialing up is still 'dialed down' from our perspective. Singapore looks to be the exception, but only because it has very recently put in measures comparable to European and North American countries from a prior lower starting point. The country also has a unique set of circumstances as one of the most densely populated countries in the world, where migrant workers amount to nearly 1.5 million, within a population of almost 6 million. These workers live in tight quarters with relatively insufficient sanitary requirements. Addressing this at the get-go could have avoided more recent measures on physical distancing for the broader population. This is perhaps most similar to the senior resident outbreaks that have occurred across a number of North American cities, or the meat-plant outbreaks where missteps on policies to protect workers created immense concern for the regional health system, community and broader population.

The question really is whether governments have built the resources in the past four months to be better positioned for a second wave that does not require draconian economic measures in order to protect the vulnerable portion of the population. Country experiences have shown there's not a one-size-fits-all approach. A number of Asian countries have leveraged technology for quick containment via contact-and-trace, while others, like Germany, have demonstrated tremendous success with a low mortality rate using a less sophisticated manual or human contact-and-trace process that requires significant staffing and creative use of furloughed workers from other fields.

Many countries reacted to the painful experience of Italy, which bears one of the highest death rates per capita from the virus (Chart 8). But, the post mortem of the experi-

Chart 8: Curves Have Flattened Across Countries



Source: OWID, TD Economics. Last data point June 3, 2020 ence suggests the swiftness of the appearance of the virus resulted in a high level of unpreparedness in medical supplies (personal protective equipment, ventilators etc), protocols, staffing and other factors that heavily exposed the most vulnerable of the population and pressured the hospital system to the brink. Italy's ISS health institute recently identified that 96% of the virus fatalities had previous illnesses. In turn, the vast majority of these reflected the elderly, particularly those over the age of 80. Italy was not alone in being caught flat-footed over the January to March period. All European and North American countries struggled to put in place sufficient supplies and testing kits, that came with lags in developing and sourcing. Since then, innovative solutions have occurred, public and workplace policies have been adjusted and hard lessons have been learned.

The Past Does Not Predict The Future

As countries continue to review their data and policies, knowing better is doing better. In addition, improved treatment options can further reduce the vulnerability within the at-risk population. And this is why forecasting the path forward in the event of a second wave is not completely obvious or a direct function of the past experience. Governments may choose a different approach via targeted policies rather than the broad shutdown of industries, services and jobs that subsequently transfers health and financial risks into an even larger portion of the population. The outcome lacks sustainability in the event that the virus is with us for the next one to two years absent a vaccine.

However, even if a more soft-policy approach is followed, it's still highly unlikely that the economy will be back at full capacity until health and safety concerns can be fully addressed, and this likely requires a vaccine as the solution or, at the very least, a highly effective treatment. So, while we currently feel comfortable with a "U" shaped forecast for the U.S. and Canada, we will continue to take our lead and adjust based on the policy path forward. Governments are driving the bus on this forecast, not the economists. And once the economy hits Stages 3 and 4 (Strengthen and Function), only then will we be able to cast our eyes behind us and begin to address the mountain of debt that has accumulated among households, businesses and governments. That's a chapter for another day.