Our 2020 economic theme is “The Dominos are Wobbling.” We believe recent shocks will cause the economic dominos to topple over, leading to a technical recession in 2020. In January, we expected another year of modest economic growth riddled with uncertainty which would leave the dominos wobbling, but not tumbling into a recession. However, COVID-19 and a simultaneous oil shock have increased the probability of a global recession. Our forecast for U.S. real GDP quarter by quarter is as follows:

- 0.8% in Q1
- -2.4% in Q2
- -0.4% in Q3
- 1.8% in Q4

For the calendar year, we anticipate GDP to be positive in the 0.4 to 1.0% range.

The Economy

The first two months of the year showed signs of economic improvement. Manufacturing was rebounding, the labor market was solid, and the stock market, a leading indicator, peaked on Feb. 19. The U.S. economy was on a firm foundation heading into these shocks.

This recession will not be caused by the typical factors: economic imbalances, excess, inflation and increasing interest rates. It will be caused by “black swans”, or shocks. There is historical data on recessions caused by black swans. Further, there is empirical evidence of shocks that temporarily shutter economic activity. The 9/11 terrorist attack and the Japanese tsunami in 2011 were black swans that shut down economies. There is one material difference between then and now, however; during those events, consumers were encouraged to continue life as usual and spend. Today, the message is self-imposed quarantines, which will certainly reduce spending.

Perhaps some good news is that recessions caused by external shocks have been shallow and short-lived. After 9/11, the U.S. experienced a -1.7% contraction in third quarter GDP. By the fourth quarter, GDP was up 1.1% and headed higher from there. Japan saw a similar pattern
after the tsunami. Activity plunged 8.4% from February to April 2011. Then came the recovery.

**Shock 1: COVID -19**

COVID-19 is a black swan, a surprise that has a meaningful impact. There are so many unknowns at this time and an important, yet unanswerable question is, how long will it last? Based on the virus’s reproduction rate in China and Italy, the U.S. is in the early stages of the number of new cases. We do know that the spread of the virus can be contained. China has taken draconian efforts to quarantine millions of people and close numerous businesses and factories – actions that may be easier to execute under a dictatorship than a democracy.

In the U.S., we are seeing self-imposed quarantines, events and gatherings canceled, and businesses suggesting employees stay home if they can. The result of this will be that economic activity grinds to halt, corporate earnings evaporate and stock markets enter bear markets.

**Shock 2: Oil**

In early March, negotiations within the OPEC+ alliance (Russia + Saudi Arabia) broke down, causing oil prices to sharply sell off as everyone is free to “pump at will” and increase supply while aggregate demand is waning.

We have seen shocks in the energy space before. From 2014 to 2016, oil prices declined by 60%. At the time, capital expenditures, or business spending, declined significantly, impacting GDP. However, the consumer benefited, harvesting additional discretionary income, which in turn grew consumption and boosted GDP.

Today, the consumer will benefit from lower prices; however, they are not encouraged to spend. And in some cases, they can’t spend: there are no more tickets to sporting events.

**Financial Markets**

**Stocks**

The stock market is a leading indicator. Currently, it’s down peak to trough well over 25%, indicating a bear market (down 20% or more is defined as a bear market). The average decline in a bear market is 25.6% when the economy does not experience a recession. If we experience a recession, the average decline is 34.6%, suggesting further downside risk in equity prices.

There is clearly some panic selling due to uncertainty. Typically, a 15% correction takes four months to play out. It took a mere 22 days for the S&P 500 to fall 26.7%.

**Bonds**

The U.S. bond markets are treated as a safe harbor during periods of uncertainty. As the current drama has unfolded, investors stampeded into bond markets, driving interest rates dramatically lower at breakneck speeds.

Rates burst through previous all-time lows as investors prepared for the worst-case scenario to unfold. While the Fed jumped in on March 3 with an intra-meeting, “emergency” cut to rates, the bond markets stampeded further ahead, and rates continued to plummet. This seemed to indicate that the Fed would soon be cutting rates to zero.

The bond market was right. On Sunday, March 15, prior to global markets opening, the Fed, in its second intra-meeting decision, slashed fed fund rates by 1.00%, taking the rate back to its crisis-era target of 0.25%. In addition, the Fed will launch another quantitative easing (QE), buying $500 billion of Treasuries and $200 billion in mortgage backed securities. The Fed cut the discount rate, the rate banks pay the Fed to borrow, to 0.25%. And finally, the Fed halved the cost of dollar liquidity swaps offered via other central banks.

The Fed is all in, attempting to stabilize economic growth, achieve maximum employment, calm financial markets and provide liquidity to prevent markets from seizing up. Lower interest rates are a potential remedy for fading economic growth. However, we do not think the material Fed action will prevent the U.S. economy from entering a technical recession. QE’s goal is to support the orderly operation of the Treasury market. The U.S. Treasury market is the global safe harbor in times of turbulence.

Monetary policy may soften the recession blow; however, we do expect changes to fiscal policy. Currently, the overall stimulus package is incomplete – perhaps the stock market agrees as it continues to sell off. Changes in taxes or unemployment benefits may boost consumer confidence and spending. We are firm believers that the Fed can not do it alone.

**Conclusion**

We think the economy in 2020 can grow in the range of 0.4-1.0% even while experiencing a recession in the second and third quarters of the year.

Vast amounts of monetary and fiscal stimulus will be pumped into the economy, perhaps providing a launching pad for economic activity later in the year and into 2021.

**DISCLAIMER:**

This article is for informational purposes only and is not intended to be investment advice. The projections in this article are based on information as of a specific time and are subject to change. Please contact your investment advisor with any questions.