COVID-19 – How deep, how long?

It used to be said the economy is like a large supertanker, where even if the engines were suddenly turned off, inertia would keep the ship traveling a great distance before stopping. That was before COVID-19. With the International Monetary Fund (IMF) recently proclaiming the global economy was at a standstill, and the World Trade Organization (WTO) forecasting global trade flows would drop by a third, it's fair to say the engines have indeed been turned off. Instead of travelling into open waters, as is normally the case, the ship has run aground and come to an abrupt stop. For policymakers and business leaders alike, the first order of business will be getting afloat, and the second will be restarting the engines. Both will not be easy, and both go to the question of how deep the recession, and how long until things return to normal?

A Sharp and Abrupt Downturn

With the full duration of the pandemic still unknown, it is near impossible to put a number on either the depth or the length of the current downturn, but based on what we do know, and learning from experiences in other countries, it is a worthy exercise to at least have a set of working assumptions to better allow for the necessary planning in the coming weeks and months.

Certainly, there have been glimmers of hope in the past few days, most notably in Italy, Spain and even in New York State, and so it would appear the worst-case scenario will be avoided. That doesn't mean the economy will bounce back immediately, but it does put a cap on the downside, allowing forecasters to start drafting a variety of scenarios. A review of the latest forecasts for the US economy by some of North America's largest banks shows a surprising degree of consensus. As of the end of March/beginning of April; Goldman Sachs, Morgan Stanley, J.P. Morgan, Wells Fargo, and TD Bank show 2nd quarter GDP contracting at 34%, 38%, 25%, 15%, and 27% (annualized) respectively. To put these numbers into context, the worst quarter during the GFC was -3.9% (Q2 2009).

Of perhaps more interest is, how these same forecasters see economic growth in the 3rd and 4th quarters? Here there is less agreement. At one extreme Morgan Stanley sees the U.S. economy posting a sharp snapback in the 3rd quarter with annualized growth of 21%. By contrast Wells Fargo expects 3rd quarter GDP to come in at -6%. For the 4th quarter, most forecasters suggest growth will be in the high single digits/low double digits. Of note, from peak to trough the U.S economy is expected to contract by approximately 10%, compared with less than 3% experienced in past recessions going back to the end of the second World War.

US GDP, % annualized*	Q2 2020	Q3 2020	Q4 2020
Goldman Sachs	-34%	19%	10%
Morgan Stanley	-38%	21%	16%
J.P. Morgan	-25%	8%	4%
Wells Fargo	-15%	-6%	4%
TD Bank	-27%	13%	9%
Average	**-28%**	**11%**	**9%**

* as of late March/early April 2020

It is very difficult to fully appreciate the enormity of these downgrades, particularly to an economy the size of the United States (approximately $19.2 trillion), where the prospect of losing 10% of the economy is truly unnerving. While the global economy is not expected to shrink by the same amount, the world's economy is expected to contract by upwards of 6%, highlighting no region of the world will be immune to these highly challenging conditions. This point needs to be kept in mind as countries, and companies look to exports as a way out of the malaise. Certainly, the service sector of the economy, through social distancing and other measures will be particularly hard hit, however manufacturing and the natural resource sector, including energy, will also be greatly impacted. Looking to past recessions, and the GFC in 2008/09 in particular, it may not be instructive, as the cause of past economic downturns were very different than anything experienced before, with the possible exception of the Spanish Flu of 1918. What may be useful, however, is looking back at credit markets during the GFC and see how spreads moved and subsequently the direction of the economy. Without doubt, credit markets will be front and center for policymakers in the coming months. In that respect, we do have a playbook which should go some way towards mitigating some of the economic damage that would otherwise occur.

V, U, L, W or Nike Swoosh?

Now that the downturn is upon us, and we are almost certainly in recession, what matters most is the recovery. Will it be a sharp rebound ("V"), a more prolonged rebound ("U"), a very protracted rebound ("L"), a series of mini rebounds ("W"), or more in the shape of the Nike "Swoosh". The forecasts shown above suggest the recovery will be shaped more like the letter U, or perhaps the Nike Swoosh, marked by a very sharp downturn, followed by a medium length bottom and then a fairly long, but steady recovery. Either scenario means businesses should not expect a full return to normalcy until well into next year, with or without a vaccine.

Commercial Real Estate

As a consequence, the demand for commercial real estate will be materially below what would be considered normal for a fairly extended period. With jobless claims surging to levels far in excess of anything recorded in prior downturns, the number of unemployed in the United States is expected to exceed 18 million at the peak, from approximately six million at the end of February 2020. This would equate to employment falling by 8%. For the office market it would therefore not be unreasonable to expect a similar contraction in occupied space. Of note, a feature of most recessions is 10% to 15% of people laid off never get rehired, at least not in the same capacity.

Accounting for new construction, the US office vacancy rate could therefore easily double in the next 12 to 24 months to nearly 20%. Industrial markets would also not be spared. Historically the demand for warehouse space has moved in lockstep with the general economy. If the economy does shrink by 10%, leased warehouse space could also do the same. A very large caveat must be the surge in online retail, which will no doubt bolster the demand for (big bay) warehouse space. Retail will almost certainly be the most impacted. Employment, consumer confidence, the wealth effect, and of course social distancing, will create wide swathes of vacant retail space across every retail format and every retail niche perhaps except for warehouse stores.

Closing Thoughts

We will not have a depression. A very severe recession yes, but not a depression. At some point this crisis will end, but in the interim the economy, and society as a whole, will go through a very unsettling period. Developed economies are built on a series of buffers and cushions that will take away some of the pain, but there will be casualties. Business as usual is something we all want to get back to as soon as possible, but many assumptions underpinning the business world will need to be reevaluated. Globalization, urban density, mass transit, workplace design, to name a few, will all be scrutinized as we move into the not so distant post COVID-19 world.

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This is the second in a series of Cresa Viewpoints covering the COVID-19 crisis.

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