Opposing economic forces formed in the wake of the COVID-19 outbreak are pulling the US economy in different directions. But as our Global Chief Economist and Global Head of Macroeconomic Strategy Frances Donald notes, economic headwinds are gathering strength and look set to outweigh the positive developments. In her view, the coming months could be challenging.

US economic outlook: macroeconomic headwinds vs. tailwinds

Round one: headwinds prevail

There can be little doubt that we're in unchartered territory from a macroeconomic perspective and the investment landscape is shifting rapidly. We compiled what we've learned in the past two to three weeks that has influenced our three- to six-month month view. Try as we might to focus on bright spots, we concede that macro headwinds outweigh tailwinds in terms of number, likelihood of occurrence, and their likely impact on US growth.

Broadly speaking, our view is that the macro narrative will transition from the tailwinds created by the now fully priced stimulus measures implemented—along with the reopening of the global economy—to one focused on headwinds created by a second wave of *economic* stress, which is amplified by heightened geopolitical risks and a near-term slowing of both monetary and fiscal support.

Macro tailwinds:

1) High-frequency data tells us that the worst COVID-19-related weekly drawdowns of US data are behind us. From here on, economic data will continue to weaken, but at a milder pace. We also expect monthly data in May to show incremental improvements over April data.
2) We've witnessed a swift reaction to trim cost structure within the private sector, which can imply improved business profitability post-recession.
3) Consumer fundamentals are stronger than they were in 2008: US house prices are still rising mildly, mortgage activity is stabilizing, bank deposits are higher, and savings rates are rising.[1]
4) Oil prices have stabilized, reducing market volatility and lifting inflation expectations (slightly). [1]
5) Household checks from the US federal government are replacing 30% of lost incomes, limiting the shock of record-high unemployment.[2] Plus, 32% of small businesses in the United States have applied for Paycheck Protection Program loans.[3]
6) The Fed has, so far, calmed the initial signs of a credit crisis as spreads eased in many parts of the fixed-income market.
7) The recent ramp up in research efforts continues as scientists seek to identify effective treatments and vaccines for COVID-19.

Macro headwinds:

1) In our view, the move toward easing lockdown restrictions in May in most US states is raising the likelihood of a second wave of an economic hit to the country. Expect to see more credit downgrades, an extension in the duration of unemployment among those who are actively

[1] Bloomberg, as of 14 May 2020.
[2] Macquarie Bank, 28 April 2020.
[3] "Small Business Coronavirus Impact Poll," U.S. Chamber of Commerce, 5 May 2020.

seeking work, and a reduced likelihood of an inventory "rebuild" taking place.
2) US-China trade tensions are flaring up again and we don't think markets are prepared for a deterioration in relations.
3) US Federal Reserve (Fed) Chair Jerome Powell noted the distinction between liquidity and solvency, and implied that the Fed can support the former, but not solvency for much longer.[4] We believe we're approaching peak monetary policy effectiveness.
4) We see a high—and rising—likelihood that fiscal hawks could slow the breadth, size, scope, and timing of any additional fiscal stimulus, which we think is sorely needed.
5) Near-term deflationary pressures are accelerating globally. This can be seen in global consumer and producer price indexes, and economic survey data in the United States, China, and other major economies.[1]
6) Greater US Treasury supply coincided with the Fed's decision to slow its bond purchases, thereby nudging the long end of the US yield curve higher.[1]
7) Emerging-market currencies are still under significant pressure as the US dollar (USD) remains strong.

In our view, four of these headwinds deserve particular attention, especially in the next month or so.

Peak monetary policy

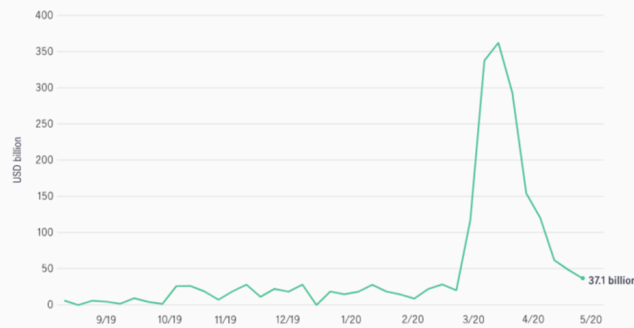
It's highly likely that we're reaching peak monetary policy—which isn't to say the Fed (and other central banks) are no longer easing. Instead, that the effectiveness of monetary policies has hit its limit, and the Fed will increasingly be passing the growth baton to fiscal stimulus. Several developments in recent weeks pointed in this direction:

- On May 13, Chair Powell repeatedly emphasized the limits of monetary policy. What struck us most was his comment that "the passage of time is what takes you from a liquidity problem to a solvency problem,"[2] and that fiscal policy was necessary, even if it were costly. To us, his comments underscored the challenges posed by the rising risk of default levels ahead. It also suggests that the Fed understands it cannot save us from cascading credit events, and that at best, its role is to prevent financial contagion from taking place.
- The Fed's been tapering its purchases of US Treasuries since the end of March as market function regained a semblance of normality. While Chair Powell framed this as a positive development, the taper has been drastic: Fed purchases of US Treasuries fell from over US$350 billion a week to just under US$50 billion a week. Crucially, the dip in Fed-buying is taking place as Treasury issuance is surging: The US Treasury's borrowing needs hit US$3 trillion in the second quarter, which is six times its requirement in the January-to-March quarter.[5] In our view, more Fed tapering and continued upside surprises on the issuance front will likely push the longer end of the yield curve higher and steepen it.
- We take the Fed's continued pushback on negative rates last week seriously. As Chair Powell noted, *all* FOMC officials agreed that negative rates weren't an attractive tool for the United States.[6] In view of that, what tools does the Fed have at its disposal? The US central bank can expand its quantitative easing program, refine forward guidance, and engage in yield caps or implement yield curve control—all of which we expect to happen over time. But in our view, the Fed won't push the federal funds rate into negative territory, and market participants should listen to the central bank's message.

[4] "Current Economic Issues," federalreserve.gov, 13 May 2020.

[5] "Treasury Announces Marketable Borrowing Estimates," home.treasury.gov, 4 May 2020.

[6] "Less than zero? Fed's Powell shows no love for negative rates," Reuters, 13 May 2020.



Source: U.S. Federal Reserve, Macrobond, as of May 20, 2020.

Fiscal policy: scope for disappointment

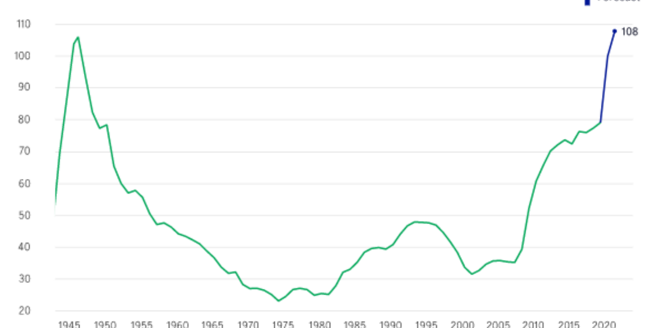
We think there's plenty of scope for disappointment in the months ahead. As existing stimulus runs out, future programs could falter on three fronts: timing, size, and execution. To be clear, we *do* believe that additional stimulus will arrive at some point and that the coming election could provide plenty of incentives for policy action. However, in our view, there will be a lag between when stimulus is most needed—in the next month or two—and when its impact begins to trickle into the real economy, which is later this summer.

The US federal government has implemented four sizable programs so far, totaling US$3.2 trillion, which have been important for buttressing household incomes and keeping down small business costs. However, many of the initiatives are temporary: Stimulus checks were only issued once, the emergency Unemployment Insurance top-up expires on July 31 (an issue that's proven to be politically divisive), and the Paycheck Protection Program (PPP) aimed at small businesses covers only eight weeks of expenses. Tellingly, demand for PPP has been lukewarm—two weeks after the program was relaunched on April 27, more than 40% of the money allocated to the program was left untouched. [7] Feedback from small businesses suggest that the stringent conditions attached to the program made it less appealing; for instance, for the loan to be "forgivable," businesses must commit 80% of the loan to wages and rehire all of their staff by the end of June, regardless of economic conditions. These are near-impossible demands—even the most optimistic economists among us aren't expecting businesses to be back to 100% capacity by June 30.

The passage of any new stimulus programs might take longer than it should. The reception to House Democrats' US$3 trillion relief plan in Capitol Hill has been mixed—questions are being asked about the size of the proposed stimulus and its promised timing.

The hawkish response to the House Democrats' proposal could perhaps be traced back to new estimates from nonpartisan sources such as the US Congressional Budget Office, which showed that the United States is heading for record levels of debt along with deficits that hearken back to the 1940s, during World War II.[8] That level of spending implies a future moment of austerity/rising taxes—or debt monetization—neither of which is particularly attractive. We expect calls for restraint to escalate.

On a related, but separate, note, although US government spending at the federal level has been aggressive, it's a different story at a more local level: State and local governments are already being forced into prescribing austerity measures as revenue shortfalls accelerate; they're shedding jobs at a furious rate. This is a problematic development since state and local government jobs represent 10% of total nonfarm payrolls.[1] While the federal government is likely to step up its support for workers at the state and local level, we're unsure these measures, when they arrive, will be sufficient in timing and size.



Source: U.S. Congressional Budget Office, Macrobond, as of May 20, 2020.

[7] "Demand for Small Business Loans Cools," *Wall Street Journal*, 8 May 2020.

[8] US Congressional Budget Office, April 2020.

The market isn't prepared for renewed trade tensions

A myriad of headlines reemerged in recent weeks suggesting that US-China relations could take a turn for the worse. In our view, financial markets are ill prepared for a resurgence in trade tensions. The US Trade Policy Uncertainty Index has tanked since both sides agreed to the phase one trade deal in December.

It's difficult to tell whether Washington will work hard to avoid a trade conflict with Beijing in order to lift the stock market. In contrast, we're inclined to think that *more* political capital could be gained from striking an aggressive tone ahead of the US election (and perhaps then resolving any issues by November) than focusing on supporting the stock market.

It's also worth noting that Beijing's approach to managing US-China trade relations might have changed recently. In our view, China has pivoted from an engagement strategy to one that seeks to control or influence what happens next.

From a second wave of COVID-19 outbreak to a second wave of economic slowdown

Finally, while the market has likely priced some probability of a second wave of COVID-19 outbreak, we don't believe it has appropriately discounted an *economic* second wave that could develop in the coming three to six months. This economic second wave is likely to be characterized by (i) rising delinquencies and further credit downgrades, (ii) additional and more permanent layoffs that begin to more directly affect medium and higher-income jobs, (iii) a lengthening in the duration of unemployment, (iv) wage declines, (v) a further drawdown in inventories with no restocking activity, and (vi) a growth-detracting rise in precautionary savings.

In particular, we find the following two data points worrying:

- Confidence data suggests both households and businesses are fully anticipating the current economic contraction to be a one-off that will be somewhat short in duration. Worryingly, expectations about the future are mostly unchanged even as confidence over present conditions tanks. With 80% of job losers proclaiming their unemployment only temporary, we think chances of downside surprises for households is particularly high.[1]
- We're also closely monitoring corporate downgrade activity in the United States and abroad, which has surged. Research suggests approximately 40% of the US investment-grade nonfinancial corporate credit market is at risk of falling into the high-yield category in the current down cycle.[99] While stimulus measures might delay another round of corporate credit downgrades, we suspect they'll be an important and difficult component of the economic second wave ahead.

It's fair to say that the next few months look set to be challenging for the United States, barring a significant medical breakthrough. In our view, policymakers will need to not only act swiftly, but also be receptive to look beyond traditional approaches in their search for the right policy mix. Above all, they'll need to see beyond party lines and act swiftly to save jobs and steer the economy back to growth.

[9] Citi Economics, as of 13 May 2020.

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