Destination Unknown: The Data Will Be Our Guide

If you're one of our longer-term readers and it seems to you that there is something missing from this month's *Outlook*, you're correct. You may have also felt that way about last month's edition, and, again, you're correct, even if you can't quite put your finger on exactly what it is that's missing. Could what's missing be anything even remotely interesting, insightful, or meaningful in four pages of text? Well, sure, but, that's no different in these two latest editions than it's always been. No, wait, what? Be that as it may, what is missing is our monthly forecast summary table, which has been a staple of our monthly pieces for as long as we've been doing monthly pieces. Which is a long time. A really long time.

No, it's not that we've forgotten to include them. And, no, it's not that we don't like what our forecasting models are saying. Instead, to put it quite simply, we simply do not see the point in publishing forecasts in which we have no confidence. And, to be perfectly honest, at present we have no confidence in any forecast of the U.S. economy, or the global economy for that matter, that looks out over the next several quarters, regardless of who makes that forecast. As you've no doubt seen and heard, there are plenty of forecasts still being published, each updated version worse than the last, and, the worse the forecast, the more attention it grabs. All of which gives new meaning to the phrase "race to the bottom," the bottom in this case being how far GDP will drop and how long it will take to get there. With each new piece of data, the forecasted declines in GDP get bigger and bigger, but at the same time, the rebounds get faster.

We'll leave it to those still publishing each and every new update of their forecasts, and to those still consuming these forecasts, to decide how much confidence they have, or should have, in any of them. To be clear, we are making no judgments on those who continue to put their macro forecasts out there, as everyone is free to make their own choices for their own reasons. And while we continue to produce forecasts, for multiple scenarios, those are for internal use, to help shape planning, and for use in conducting discussions with clients, which are taking place at a minimum of once a week. While we repeatedly stress the unusually high degree of uncertainty around our forecasts, such caveats seem to go missing in the media's breathless accounts of each new dire forecast, with the "headline" number all but taken as a given.

We simply believe that our publishing a forecast based on so many assumptions around so many critical unknowns and in which we have little, if any, confidence does nothing to improve anyone's understanding of what is going on around us. One, but by no means the only, telling illustration of our point is a post by an economist at the Federal Reserve Bank of St. Louis, in which he discusses his "back of the envelope" estimates of how high the

unemployment rate might climb in Q2 2020. While his point estimate is 32.1 percent, he notes that this estimate is predicated on a series of assumptions that, depending on which are altered and to what degree, yields a range of estimates putting the Q2 unemployment rate somewhere between 10.5 percent and 40.6 percent. Okay, and this is useful how? It will come as no surprise to you that this post has gotten a considerable degree of attention in the media. It will come as a shock to you, however, that the number getting all of the attention in the media is 40.6 percent, because, oddly enough, "the unemployment rate may not rise higher than 10.5 percent" isn't likely to get as many clicks as "the unemployment rate could hit 40.6 percent." Go figure. In terms of adding anything meaningful to help process what is going on around us, this range is only marginally more useful than a statement we can make with 100 percent certainty without having to make a single assumption: the unemployment rate will fall somewhere between 0.0 percent and 100.0 percent in Q2.

Here is how we can best summarize anyone's ability to forecast the path of the U.S. economy in the months ahead: all of us know it will be bad, none of us know how bad it will be. The reality is that we are in the midst of an episode the likes of which has never been seen before. There is simply no precedent for the abrupt shutting down of such a wide swath of the U.S. economy that we are experiencing in response to the coronavirus. But, first and foremost, we are experiencing a public health crisis and, at present, how severe this crisis will ultimately prove to be and how long it will persist are simply unknowable. Any economic forecast made right now requires the forecaster to make assumptions, whether explicit or implicit, on these points. It remains to be seen how valid these assumptions, ours included, will turn out to be.

In the remainder of this discussion, we'll address some of the issues that make it impossible to have much, if any, confidence in any forecast being made at present. Doing so will allow us to raise some points we think are important to keep in mind for those of you trying to process the seemingly endless wave of increasingly dire forecasts. The obvious focus of attention around these forecasts is the coming contraction in real GDP in Q2, which could easily be the largest quarterly contraction in real GDP on record. By now, you've probably seen any number of forecasts of Q2 GDP, some with annualized contractions of over 40 percent. But, in how many of these accounts have you seen any reference to, or how many such references do you remember, of Q1 GDP?

This raises the first point we think it important that you keep in mind. It is, as of this writing, early April, meaning we are only now starting to get the data for March which will ultimately figure into the estimation of Q1 GDP. In other words, we do not yet have complete data for Q1, and won't have the BEA's initial estimate of Q1 GDP until April 29. Furthermore, that estimate will be based on highly incomplete source data, while the data that are available at that point in time will be subject to revision in May and June. So,

these forecasts of shockingly large contractions in GDP in Q2 are based on forecasts of Q1 real GDP which, at present, are based on highly incomplete data. We'd say stop us if you've heard this one before, but, we're fairly sure you haven't.

This raises a related issue that we've addressed before, including in the most recent editions of our weekly *Economic Preview*. For most data series, the cut-off point for data collection comes well before the end of the month. Given that shutdowns in economic activity became increasingly widespread as March wore on, our premise has been that the March data will not fully capture the deterioration in economic conditions which took place later in the month. This "timing effect" is, as we expected would be the case, apparent in the Conference Board's *Consumer Confidence Index* for March and the March employment report, and will also be apparent in the upcoming releases of March data on retail sales, residential construction, and new home sales, among others. For instance, March consumer confidence fell by less than many had expected, but the data incorporated responses only through March 19, while the survey reference period for the March employment report was the week ending March 14, or, the week before the massive spike in Unemployment Insurance filings that reflected the initial wave of layoffs due to the effects of the coronavirus.

Our point here is that, while there is no denying by the end of March a significant portion of economic activity in the U.S. and abroad had come to a screeching halt, it is highly unlikely the economic data for the month of March will have picked up the full extent of this shutdown. To the extent the March data feed into the estimate of Q1 GDP, this means Q1 GDP will not look as bad as was actually the case. For those of us making forecasts of GDP, we must make assumptions as to the degree to which the March data will capture the shutting down of a wide swath of the economy, which in turn shapes any forecast of Q1 and Q2 GDP.

One could be excused for wondering what difference any of this makes. Eventually, when all is said, done, and revised, the numbers will tell us what has happened, but in the interim, as we live through this, what we see around us and how we feel about it will likely be of as much, if not more, relevance than whatever the data are telling us. You'll get no argument from us on those points, but, in terms of the matter at hand, the March data are the jumping off point for any forecast of Q2 GDP. Think about it this way. In any given quarter, if the value of any given data series in the final month of the quarter is materially below (above) the quarterly average, it sets the base for the subsequent quarter to look much worse (better). As such, it very much matters how much of the sharp drop-off in economic activity that took place as the month progressed is captured in the March data. Moreover, the March data are likely to be plagued by other issues, such as what for many series could be abnormally low response/collection rates, and seasonal adjustment factors simply not equipped to deal with abrupt changes of the magnitude likely seen in March.

So, right off the bat, timing issues and questions over the quality of the data mean any forecasts of Q1 and Q2 GDP are even more reliant on assumptions made by the forecaster than is normally the case. Go back to the earlier example of the Q2 unemployment rate. One key determinant of the unemployment rates reported over the next few months will be whether, and when, those who have been laid off begin to actively look for another job. In order

to be included in the count of the labor force, those without jobs must be either on layoff awaiting recall or actively looking for a job. With so much of the population more or less confined to home and with so much of the economy having been shut down, we think it highly unlikely that a meaningful share of those lost jobs over recent weeks, and those who will in the weeks ahead, will be actively looking for work for some time to come.

To the extent members of this group are not counted in the labor force, the unemployment rate will be lower than would otherwise be the case and thus won't be an accurate indicator of the damage done to the labor market by the effects of the coronavirus. Any of us making forecasts must make assumptions around this point, but even relatively modest differences in assumptions can yield material differences in forecasted unemployment rates. The higher the number of recent job losers who actively look for another job, the higher will be the U3 unemployment rate, but anyone issuing, or reporting on, forecasts of the unemployment rate, particularly with rates of 30 percent or higher, should make it very clear what assumptions are beneath that forecast.

As a side note, the broader U6 measure, which accounts for both unemployment and underemployment, will be a better indicator of the hit to the labor market. Those who have not been laid off but have had their hours cut to below full-time hours will fall into the "part-time for economic reasons" category, included in the count the underemployed. As such, diminished hours worked will push the U6 measure higher without a corresponding rise in the U3 measure. Moreover, the U6 measure also captures "discouraged workers," i.e., those who want a job but are not actively looking for work. Recent job losers not actively looking for work will not be counted as unemployed but will turn up in the U6 measure. As such, the U6 measure will likely rise faster than the U3 measure in the early reports reflecting the impact of the coronavirus.

The unemployment rate is only one example, and a relatively simple one at that, but think about how many assumptions go into any forecast of the path of GDP over the next several quarters. Keep in mind that one does not forecast top-line GDP, one starts with forecasts of the underlying components and aggregates up to top-line GDP. Then throw in what will surely be issues with the timing of and the quality of the data over coming months. It is reasonable to ask how this is any different now than it ever is. And, sure, even in the most "normal" of times, economic forecasting can be, well, let's say humbling – a quirk in the data, atypical weather, random shocks, or any number of other factors can make even the best of forecasters look silly.

What is different now is the speed and the magnitude of the changes that have swept over the U.S. economy combined with uncertainty as to how long much of the economy will remain shuttered. None of us have any precedent to draw on, and on top of the number of assumptions that are being fed into any forecast, we are having to make assumptions about things we've never had to make assumptions about in the past. Our point isn't that any forecasts made at present are inherently worthless. But, how much value is being added by rolling out each and every revised forecast given how dramatically forecasts are changing with each new piece of data or each piece of news on the virus front? Particularly given that the sole focus of much of the media coverage these forecasts get is the size of the coming contraction in real GDP in

Q2. So, while we continue to produce our forecasts, we just don't see the point of adding to the noise by pumping each and every new forecast out there as though they're somehow breaking new ground – they're not. The signal is quite clear by now.

As time goes on and more data come in, we'll feel we have a firmer basis on which to produce forecasts in which we can have a higher degree of confidence than we have in our forecasts at present. At that point, we'll go back to publishing our forecast summary table in our *Outlook* pieces. Between now and then, well, keep in mind the BEA will not release their initial estimate of Q2 GDP until July 30. Imagine how many times any forecast of Q2 GDP which has been made within the past few weeks has already been, and will again be, revised by then, and think how different these forecasts are likely to look by then. Which is kind of our point.

"Up And Running" Not The Same As "Back To Normal"

The flip side of forecasting what the downturn might look like is forecasting what the subsequent rebound might look like. As you can well imagine by this point, we have no more confidence in forecasts being made at present of the rebound than we do in forecasts of the downturn. Again, this includes our own forecasts. Yet, each passing day seems to bring another round of debate over what "shape" the rebound will take on – will it be a "V" or an "L" or a "U" or some other letter, or some special character. Might we suggest that a question mark would be more appropriate?

It's hard to have much, if any, conviction in any call on what the shape of the recovery will be given that we still do not know what the downturn will look like or how long it will persist. While the issues we raised above regarding forecasts being made at present still apply here, we think it useful to raise some points to keep in mind as economic activity begins to come back online. These are but some of the many factors that will shape what the recovery will actually look like when it comes.

We'll start with the timing. As we noted above, we are experiencing a public health crisis. Until the threat posed by the coronavirus has abated, and until people feel safe and no longer fear for their health, there is no economic recovery, regardless of how much "stimulus" is pushed into the system. Clearly, the longer people remain largely confined to their homes and large parts of the economy remain effectively shut down, the more damage there is to the basic infrastructure of the economy, which diminishes the likelihood of a rapid and broad based rebound. While at present we and most others are assuming economic activity will have begun to come back online by the end of Q2, that is by no means a given at this point in time.

Whenever economic activity does begin to come back online, it is not unreasonable to expect the initial quarter of recovery will see a very rapid rate of real GDP growth, and a quarter of double-digit annualized growth is possible, if not likely. It is reasonable to expect that as lockdowns are lifted and businesses resume operations, there could be a sizable burst of spending as people become free to move about and are eager to recapture some semblance of normalcy. To the extent consumers have extra cash on hand, whether from not having already spent all of the money distributed via checks as part of the CARES Act, having refinanced

a mortgage, or from still-low energy prices, that would provide added fuel for a spurt of spending. At the same time, what will almost surely be an even higher level of federal government spending would also contribute to an initial period of rapid growth.

But, even should this prove to be the case, to us the relevant question at that point would be "okay, now what?" We would see it as highly unlikely that any initial burst of consumer spending would be sustained over subsequent months. This is mainly due to our thinking that, while firms will begin bringing back workers, they will do so at a fairly slow pace, at least initially.

Additionally, significant declines in equity prices will have led to a significant hit to household net worth, and it will take a considerable time for equity prices to approach their pre-downturn peaks. As people, particularly older workers nearing retirement, reassess their financial position, the desire to play "catch up" could result in increased saving, weighing on growth in discretionary consumer spending. Additionally, many households will have fallen behind on debt service payments – mortgages, auto loans, credit cards – which means higher shares of disposable income go to catching up on these obligations. This would also act as a drag on growth in discretionary consumer spending. We do expect discretionary spending to remain impaired for some time, which would clearly shape the path of the recovery.

Then there is the broader question of what "normal" looks like in the post-virus world (to the extent there is such a thing). Will people be as willing to do things like travel, and attend sporting events, arts performances, movies, and music festivals, to name a few examples, as they had been before the coronavirus? If not, does spending in these areas simply get replaced by other forms of spending, and to the same extent? Or, do people become more focused on building up savings in light of what they have just lived through – a rapid decline in economic activity that resulted in millions of lost jobs and seemingly in an instant wiped out a vast share of household wealth?

We can ask similar questions regarding how firms will move forward in the post-virus world. Will they bring head counts back up to where they were prior to the coronavirus, or will they manage with a smaller workforce, and regardless of the ultimate level of hiring, how quickly will firms get there? There is also the matter of firms who do not make it through the downturn, raising the question of how many permanent job losses will have resulted and how quickly these displaced workers can find new jobs.

There is a very long list of similar questions we could ask and, at this point, the answer to every one of these questions is exactly the same: "we don't know." Again, touching on the earlier discussion, making any kind of a forecast requires one to make assumptions on these points, which further reinforces our lack of confidence in any forecasts being made at present. Either way, it seems most unrealistic to think we'll see something akin to flipping a switch and seeing either the composition and pace of economic activity return to where they were prior to the coronavirus.
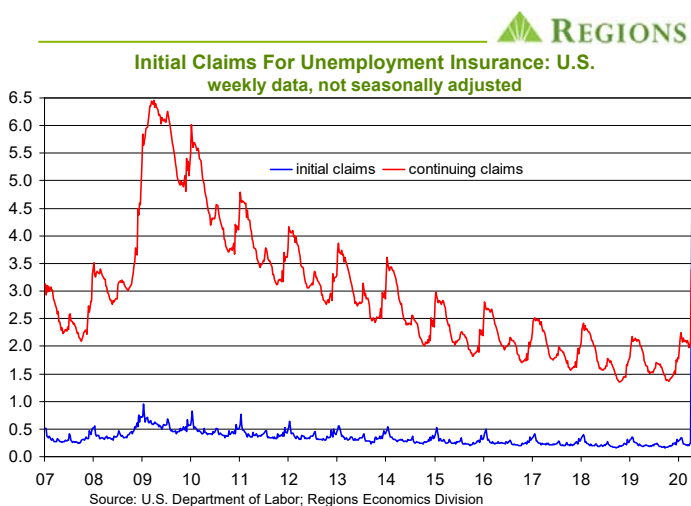
To be sure, an unprecedented fiscal and monetary policy response will mitigate the damage done to the economy, but these moves cannot fend off what will be a significant contraction in real GDP and a spike in the unemployment rate in Q2. Though the $2 trillion CARES Act is generally referred to as a "stimulus" package, that

isn't the proper term here. We see this more as preserving as much of the basic infrastructure of the economy as possible under the circumstances, as opposed to stimulating faster economic growth. While it may seem like we're quibbling over semantics, the distinction matters. The longer lockdowns remain in place and economic activity remains suppressed, the greater the likelihood another similarly sized bill will be passed into law.

We also think it important to note that, regardless of what the final total of these bills ends up being, assessing their impact on the economy isn't as simple as just counting that total in the estimate of GDP, as we've seen some do. The direct impact of the CARES Act on GDP is somewhat limited. This doesn't mean all of the spending will not eventually turn up in GDP, instead it is a matter of the degree to which this will occur and the pace at which it will do so. The answers to these questions are amongst the factors that, while unknown at present, will help shape the recovery. For now, though, they are yet another set of assumptions incorporated into any forecast of the path GDP over the next several quarters.

The Data We're Watching Most Closely

Given that we've raised concerns over the timing of and the quality of much of the economic data during this period, we think it worth ending with a brief discussion of the data we are relying on the most to assess the effects of the coronavirus on the U.S. economy. One critical element is timeliness – higher frequency data, i.e., daily or weekly, offer as close to a "real time" view as there is, far more so than is the case with lower frequency data, i.e., monthly or quarterly. Perhaps the most important higher frequency data series is weekly claims for Unemployment Insurance (UI). To be sure, this is not a new series nor are we only now finding value in it, but, given what was such a prolonged period of steadily improving labor market conditions, it had been quite some time since the claims data had anything new to tell us. That has clearly changed, as seen in the chart below.

Initial Claims For Unemployment Insurance: U.S.
weekly data, not seasonally adjusted

Source: U.S. Department of Labor; Regions Economics Division

Initial claims, or, the number of people filing for Unemployment Insurance benefits each week, exploded over the final two weeks of March, with 2.920 million filings in the week ending March 21 and 5.824 million filings in the week ending March 28 (while the

seasonally adjusted data are reported in the media, we prefer to use the not seasonally adjusted data). Note that this spike went largely uncaptured in the March employment report, as it came after the end of the establishment survey period (the week ending March 14). But, this spike and any that may follow through mid-April, will be reflected in the April employment report (due on May 8). The spike in claims reflects increasingly widespread lockdowns and the shuttering of "non-essential" businesses as March wore on, and point to the stunningly rapid pace at which firms shed workers. For some perspective, during the 2007-09 recession, the U.S. economy shed just over 8.7 million jobs, but it took 25 months for that to occur, while at present that total was hit in two weeks.

Ultimately, initial claims will peak and then are likely to fall sharply, but it will be critical to see whether they level off at a still-high number or continue to decline. As the economy begins to recover, however, continuing claims, or, the number of people drawing UI benefits each week, will be a signal of the speed with which the labor market, and in turn the broader economy, is recovering. As people begin to return to their old jobs or find new jobs, they will fall off the UI rolls, and continuing claims will fall. The rate at which this occurs will be a meaningful indicator.

Morning Consult's daily reads on consumer confidence, based on daily surveys of 7,500 people in the U.S., has proven a valuable guide to the rate at which consumer confidence has fallen off. Though the sharp declines in equity prices took a toll on consumer confidence, the rate of decline picked up dramatically when labor market conditions began to erode. While that may seem an obvious link, this will be an important series to watch once we're on the other side of the virus. As we discussed above, we have questions about whether, or to what extent, spending patterns will have changed, and one key to answering these questions will be consumer confidence. That jobs begin to come back does not necessarily mean consumer confidence will bounce back, at least not initially. We also follow Bloomberg's weekly *Consumer Comfort Index* for an additional higher frequency read on consumer sentiment, while Moody's Analytics' weekly survey of business confidence is a valuable read on global business sentiment. We expect business investment to be a notable laggard once the economy does begin to recover, and it will not be until we see a meaningful upturn in business confidence that we'll adopt a more constructive view on capital spending.

Weekly applications for mortgage loans are also a useful indicator. Applications for purchase loans have obviously fallen off sharply in recent weeks but will be an indicator of the beginnings of recovery in the housing market. At the same time, mortgage refinancings have remained highly responsive to lower interest rates which, as we noted above, is a potentially significant source of cash in the household sector, at least some of which will be spent at some point. Also, credit spreads are an important indicator of potential stresses on corporate balance sheets. Our regular readers know that the state of corporate balance sheets has for some time been a main concern of ours, and those concerns are greatly magnified in the current environment.

Finally, while it may be something that can go without saying, we're going to say it anyway. The most important data anyone can watch in the weeks/months ahead are the data on testing for the coronavirus. Unless and until there is improvement on this front, there is no improvement anywhere else.