With over 40 million unemployment claims filed in the first weeks of the pandemic, the economy has clearly been subjected to stresses not seen since the Great Depression. And yet, to this point, the public seems to remain optimistic that the medical threat will be successfully resolved before the economy suffers major long-term damage. For example, U.S. equity prices, which often reflect public sentiment fairly well, are already closing in on their former highs. In all honesty, public optimism may expect a faster recovery than the economy will be able to deliver. But perhaps public optimism is based less on the timing of the economic recovery than the confidence conditions will eventually normalize.

More than most economic downturns, this one struck right at the heart of the U.S. economy by undercutting the consumer’s critical contribution to growth. Not only does consumer spending dominate the economy, the relatively stable spending on services and consumable goods helps stabilize the economy during recessions. Clearly, however, not when consumers cannot shop. As states allow businesses to reopen, we will see how quickly economic activity will recover. Financially, consumers seem to be in excellent shape. Cash that should have built up could support a strong surge of spending. For that to happen, however, consumers will need to feel optimistic about both the security of their jobs and their ability to avoid becoming seriously ill.

Many businesses face the challenge of adapting to the current situation as they await a return to more favorable conditions over the next year or so. Some firms may struggle to survive. Those that can only operate at a fraction of their former volumes because of distancing requirements, or have to incur major expenses to operate safely, may not last. While some costs may be passed along to the consumer, it is hard to imagine that price increases can fully bridge large profitability gaps.

And some firms were not strongly capitalized to begin with, while many more have been weakened by weeks of significantly reduced operations. Already, some firms that have struggled in recent years have filed for bankruptcy protection. A significant period of restricted revenue, or future shutdowns necessitated by renewed outbreaks of COVID-19, could push many more firms over the financial edge.

The government has done more to combat the economic contraction than anyone might have dreamed possible. In some ways, the Federal Reserve’s overwhelming monetary stimulus and the Federal government’s fiscal support should accomplish what economists have argued would have avoided some of the Great Depression’s economic destruction. In the coming months and years, we will have an opportunity to see whether those economic prescriptions work as well in practice as they do in theory. Even so, the current combination of monetary accommodation and fiscal supplements still requires that consumers and businesses feel confident enough to spend.

Public confidence will be critical to what happens to the economy in the coming months. Certainly, a major outbreak of new cases would be a major blow both to the economy and to public confidence. And rising bankruptcies would mean the loss of jobs as
well as businesses. While many people seem anxious to try getting back to what they knew as normal, some significant medical and operational challenges remain. Optimism that we will overcome the virus seems justified. How soon we do so, however, and the operating concessions that will be required along the way, will determine how fast the economy can resume its sustainable long-term growth trend.

The consumer

Consumers have remained reasonably upbeat to this point. The University of Michigan Consumer Confidence Survey dropped to 71.8, a level last seen at the end of 2011, but remains well above the 56.4 level reached at the low of the last recession. The public seems to believe that the coronavirus will be conquered soon, through a vaccine or other medical treatments. That may be why 90% or so of those who have been laid off reportedly think their unemployment will just be temporary and that they will return to their same jobs.

Based on the aggregate numbers, consumers should be in very good financial shape. Due in large part to the various government programs, personal income rose 11.7% in April and is up 9.4% for the year to date. That is well ahead of the 4.4% AR (annualized return) of personal income since the bottom of the last recession. And as income increased sharply, April’s consumption expenditures fell 16.9%, declining 19.1% year to date (YTD). With cash coming in rising sharply and expenditures falling, consumers (in aggregate) should have been left with significant cash reserves. If the economy can restart soon, that cash could help to fuel a sharp snapback. If the recovery takes more time, the extra cash will help buffer any lasting damage to consumers and to longer-term economic growth.

Retail sales have declined in line with overall consumption, falling 16.4% for the month of April and down 23.1% YTD. But retailers have felt the financial stress more than many industry groups, as an oversupply of retail capacity and intense competition had already weakened some retailers. Bankruptcy filings by J.C. Penney, Neiman Marcus, J. Crew, and Pier 1 may be only the start of a broader shakeout.

On the other hand, housing looks like it could be an area of strength as the economy recovers. Both new and existing home sales showed solid growth over the last year, as demographic and income factors fostered a stronger demand for housing. If anything, the lockdown may have highlighted the advantages of having more personal living space. Unless home buyers become worried about employment prospects, housing could again help support stronger economic growth as the economy resumes operation.

Business activity

Like many who hope medical researchers will soon find a vaccine or effective treatments for COVID-19, business operators are more optimistic about business conditions a year from now than they are about current conditions. But the latest monthly poll conducted by Chief Executive Magazine also shows that CEOs have become a little more cautious about expectations for the next year. While they have become a little less negative about how their own firms will fare, they still see some significant challenges. The latest poll shows that 62% of the CEOs believe their own firm's revenues will decrease, and 57% believe their profits will decline. Moreover, 42% expect to have fewer employees, and 50% expect to spend less on capital spending. Like many economists, therefore, the CEOs surveyed seem to believe it will take an extended period of time for the economy to fully recover from the pandemic.

Hopefully the U.S. economy will bottom in the second quarter, as states reduce constraints and overseas economies begin to recover. Most forecasts anticipate a sharp initial rebound and then a more gradual growth back to where the pandemic began. Social distancing and other increased operating costs will likely remain a constraint on revenue and profitability for some time. And there is always the risk of secondary outbreaks of COVID-19. Thus, while the recovery has hopefully begun, the return to “normal” will not come quickly or easily.

The weak financial condition of many firms may also prove to be a problem. Low interest rates and a broad willingness to lend has reportedly allowed many weak firms to survive in recent years. The deteriorating operating environment has pushed a number of firms (e.g., J.C. Penney and Hertz) to file for bankruptcy protection. Without deep financial resources, even firms that had good operating fundamentals before the pandemic could be at risk if they suffer reduced sales or sharply increased operating costs. That is probably especially true for smaller companies. The longer the operating environment is affected by fears of the virus, the more financial stress will become a problem.
Businesses have expanded their use of credit rather dramatically. The total amount of commercial and industrial (C&I) loans outstanding has risen almost 29%, as businesses presumably drew down existing credit lines or secured additional funding. A little over 7% of banks reported an increased demand for C&I loans. At the same time, banks are less willing to extend loans. Roughly 40% of banks report tightening lending standards, and 30% of larger banks and 40% of smaller banks report increasing the spreads of what they charge over their own cost of money. Clearly, tighter lending standards and higher rates will complicate the efforts of struggling firms to fund their business needs.

While the last year was difficult for the industrial economy, the pandemic has inflicted another major blow. Industrial production dropped 15.3% in April, to a level last seen in early 2010. The 18.5% drop in manufacturing takes production back to levels seen only briefly in May and June of 2009. And oil and gas drilling has plunged 27.6% in April, dropping 44.3% in total over the last year. Industrial activity has been rocked by reduced demand both in overseas markets and here at home. The extent and duration of the damage suggests recovery in this area will not come quickly or easily.

Exports and international economies

The worldwide battle against the coronavirus has left most global economies in a rather similar position. Most have experienced a fairly modest GDP decline in the first quarter but expect a much more severe drop in the second quarter. And most economies that locked down are now trying to reopen, which hopefully means the world has seen the global economic low. In terms of U.S. trade, the real value of exports was essentially flat for 2019, and dropped 2.3% in the first quarter of 2020. Since the value of inflation-adjusted imports dropped 4.1% in the first quarter, however, the net effect of trade on U.S. GDP growth was positive.

GDP for the Eurozone declined 3.8% for the first quarter, as broad economic restrictions were imposed to limit the spread of the coronavirus. Economists expect a larger decline for the second quarter when those limitations were more broadly in effect. Now, the number of new COVID-19 cases and deaths seems under much better control, and many European economies are trying to reopen. The improvement of the Markit survey of manufacturing purchasing managers (PMI) for the Eurozone to 39.5 in May from April’s low of 33.4 suggests that the region may have reached an important turning point. (Readings over 50 indicate economic expansion and below 50 shows contraction.) That area remains heavily leveraged to exports, however, so a strong rebound seems unlikely until overall global growth strengthens. Moreover, the Eurozone services PMI remained at a low reading of 28.7. As in many other regions of the world, European consumption spending has provided little help.

The United Kingdom’s economy contracted by 2.0% in the first quarter, with forecasts of a much larger contraction in the second quarter. The May Manufacturing PMI reading of 40.7, up from 32.6 in April, is largely on par with the reading in other countries. The Services PMI improved from April’s extremely low 13.4 to a reading of 27.8 in May, which is also comparable to other countries. The numbers of new COVID-19 cases and deaths have declined significantly, but they remain well above the levels of some of other countries in Europe and may therefore continue to hinder the U.K.’s recovery.

Japan has not suffered nearly as much as other countries from COVID-19 and seems to be experiencing relatively few new cases. The 0.9% decline of Japanese GDP was milder than the decline in other major countries, and some of the economic damage may have been due to Japan’s tax increase late last year. The projected decline of GDP for the second quarter also seems milder than in other developed economies. And yet the May Manufacturing PMI declined to 38.4, which is on par with other global economies. That suggests global economic conditions will remain a critical driving force for Japan’s growth going forward. The Services PMI rebounded from 21.5 to 25.3 in May, which offers little hope that domestic growth will offset any significant manufacturing weakness.

According to the latest monthly poll of CEOs conducted by Chief Executive Magazine, over the next year:

- **62%** believe their own firm’s revenues will decrease.
- **57%** believe their profits will decline.
- **42%** expect to have fewer employees.
- **50%** expect to spend less on capital spending.
The economic effects of the global pandemic seem likely to bring Australia’s almost 30-year economic expansion to an end. And yet the 0.3% contraction was modest compared with what other countries experienced. Forecasts of contraction in the second quarter also appear to be milder than in many other countries. Australia’s Manufacturing PMI stands at 41.6, up from 35.8, which is also stronger than in other countries. Yet the Services PMI reading of 27.1 for May fell from 38.7 the previous month, reflecting a deteriorating outlook for domestic consumer demand.

As one of the first countries to recover from the COVID-19 outbreak, China’s economy provides potential insight into the timing and problems other countries may experience as they attempt to come back from broad shutdowns. At this point, many of China’s businesses appear to be ready to resume stronger activity. And the Markit Manufacturing PMI for May stood at 50.7, not far off its peak levels at the end of 2019. Yet a recent Wall Street Journal article detailed how China’s manufacturing comeback has outpaced its new export orders. Consequently, as other countries struggle to reopen safely, China’s export economy seems likely to slow over at least the shorter term. China’s consumption spending has become a more important part of the economy. While the Services PMI reading of 44.4, up from 43.0, is stronger than in other major economies of the world, it still shows slower consumer spending. Given the vital role that exports play in the Chinese economy, it appears China’s economy may remain hobbled until orders from the rest of the world improve.

For questions, please contact your KeyBank Relationship Manager.

About Bruce McCain

Bruce McCain serves as a consultant providing perspectives on the economy and the market to both investors and business operators. He has appeared regularly on CNBC and Bloomberg providing market perspectives and has been quoted in The Wall Street Journal, Investor’s Business Daily, and MarketWatch as well as published articles on Forbes.com. He retired from KeyBank in 2019 after 32 years.