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WEALTH MANAGEMENT FOR A FLOURISHING RETIREMENT

Coronavirus Economic Update & Recovery Scenarios

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What will the economic recovery look like? It's the million-dollar question.

Will it be V-shaped, with the economy bouncing back as swiftly as it fell? Or will it be more like the Nike swoosh – a swift drop, with a long but straight road back to the top? Or maybe it will be like a rollercoaster, with plenty of stops, starts, hills, and valleys before the ride comes to a stop? As we continue battling the coronavirus, the answer will influence how soon life returns to normal – and what *normal* actually is.

Economists often use **recession shapes** to characterize recessions and their recoveries. These shapes commonly take the form of letters in the alphabet, like V, U, W, and L. Modern history provides many examples of each type of recovery. Currently, there are good arguments to be made for each scenario. That's why, for the next several months at least, economists, investors, and analysts will all be looking anxiously at every bit of data they can find to determine which letter the recovery will resemble.

As part of my ongoing efforts to keep you up-to-date on how the coronavirus is affecting your investments, I thought it would be good to briefly cover each scenario. We'll look at why each shape may or may not happen and how each could impact us. Before we begin, though, there's one thing to remember. As long-term investors, the long-term health of the economy plays a role in how we plan for the future. Despite this, we must always remember that the economy and the markets are *not* the same. They are related, but they don't move in lockstep. More often, the markets move *ahead* of the economy. Investors are always looking towards the future, trying to gauge where the economy will go as opposed to where it is now. That's why, despite the spate of bad economic news lately, the markets have been fairly stable. So, even if the economic recovery resembles a specific letter, that doesn't mean the markets will look the same.

With that said, let's begin with the most optimistic of letters:

The V-Shaped Recovery

V for victory, right? In this case, victory over the pandemic's effects on the economy.

Think of a V-shaped recovery like dropping a fully inflated basketball. The fall will be swift and steep – but the ball will bounce back just as quickly. In this case, the ball is the economy. The pandemic caused a brutal drop in employment, stock prices, and GDP, but the recovery will be equally fast. It's probably the most optimistic scenario we can hope for.

The case for a V

There are three basic arguments for a V-shaped recovery. First is that the U.S. economy was fairly strong before the pandemic. Since the current recession was caused by external factors (like a virus) and not structural ones (like a change in fiscal policy or a credit crisis), the thinking is that the recovery will be equally strong.

The second argument is based on history. V-shaped recoveries have happened before, with sharp drops often leading to equally sharp ascents. One example is the recession of 1953. America's soaring post-war economy plummeted to earth thanks to skyrocketing interest rates. Within a year, though, the economy recovered, with the country's GDP returning near pre-recession levels.

The final argument for a V is the stock market. On February 19, the S&P 500 was at 3,386.[1] Roughly a month later, it had dropped over a thousand points to 2,237.[2] That's one of the fastest bear markets in history. But by June, just over three months later, the S&P had *risen* 800 points.[2] It's not quite a V, but it's close. So, if the stock market can do it, why not the overall economy?

The case against a V

Unfortunately, the letter V also stands for "virus." So long as the virus continues to affect our daily lives, so too will it affect the economy. That's why many experts consider a V-shaped recovery to be overly optimistic.

Besides infecting over 1.5 million people[3], let's look at what the coronavirus has done in the United States. Since March, over 38.6 million people have filed unemployment claims.[4] The jobless rate has floated just under 15%, the highest since the Great Depression.[5] Oil prices crashed due to plummeting demand. Entire industries have seen business drop to drastic levels.

These kinds of effects don't just get reversed overnight.

Again, the markets and the economy are not the same. The markets have stabilized largely based on government stimulus, hope for a vaccine, and because all this economic pain has already been priced in. Of these factors, only the first – government intervention – has any effect on the economy *right now.* Most experts believe a widescale vaccine is still at least a year away. And while government stimulus has helped, it's only bandaging the wound, not healing it.

A V-shaped recovery would be wonderful, and it's still a real possibility. In fact, in May, the unemployment rate actually *dropped* to 13.3 percent![6] But even though the U.S. is starting to open back up, returning to normal could still take much longer.

The U-Shaped Recovery

Ah, the letter U. Visually similar to the letter V, but more rounded, less dramatic. That's a perfect way to think of a U-shaped recovery. Think of it like a V, except the recovery takes longer. In this case, the nation's GDP would shrink for 2-3 quarters in a row, and then slowly return to normal. A good example of a U-shaped recovery occurred back in 1973. After contracting sharply, the U.S. economy remained in the doldrums for roughly two years before rebounding to pre-recession levels.

A quick note about GDP

You probably learned about GDP in high school or college, but here's a quick refresher in case you find it helpful. A country's **gross domestic product**, or GDP, is a measure of the total value of all goods and services produced in a specific time period. Consumer spending, government spending, business investment, and national exports are all components of GDP. While it has limitations, GDP is important, because it serves as a useful vital sign of our economy's health. Higher GDP signals both higher wages and more jobs, as businesses need more production to meet growing demand. A declining GDP reflects layoffs, falling revenue, and lower consumer spending.

The case for a U

In a recent survey, nearly 45% of the economists who participated predicted the U.S. recovery would be U-shaped.[7] It makes sense. Remember above, when I said that so long as the virus affects our daily lives, it will affect our economy? The U-shaped recovery reflects that. Back in April, the World Health Organization warned that the coronavirus would likely "be with us for a long time."[8] Some experts think it will only go away once we have a widely available vaccine that helps us achieve herd immunity. So, in this scenario, the recovery will be slow and gradual. Only when we have a vaccine will it accelerate.

The case against a U

Economists and epidemiologists will both be hoping for the same thing here: No major surge of cases, especially in the winter. If social distancing measures and increased testing are enough for businesses to reopen and bring back furloughed workers, a U is likely. But if the country reopens too fast, too soon or if the virus resurges with a vengeance in the winter, there may be no choice but to bring back stricter quarantine measures. If that happens, the single-U recovery will likely devolve into…

The W-Shaped Recovery

The letter W – it looks more like a double-V than a double-U, doesn't it? And there lies the insidious nature of this type of recovery. It's essentially *two* recoveries…for *two* recessions.

Most of my clients probably remember the recession of the early 1980s. In many ways, it was two recessions in one. A weak economy devolved into a bad one. Then, the recovery started – only for the economy to plummet *again.* This is why a W-shaped recovery is also known as a "double-dip recession." What initially looks like a quick turnaround turns into something much longer. Just when you thought it was safe to go back into the water…

The case for a W

It's simple. If we are hit with a second, or even third wave of infections, all our efforts to flatten the curve will be undone. Should that happen, more lockdown measures will likely have to be enacted. The result? More economic pain, as our country rides a rollercoaster of good quarters and bad.

The case against a W

The good news is that W-shaped recoveries are relatively rare. By some estimates, we've only had two in modern history: in the late '30s and early '80s.[9] Both of these cases occurred largely due to internal factors. Careful management of both our economy *and* our epidemiology should hopefully prevent a W from happening.

The L-Shaped Recovery

You have to tilt your head to see the L in this scenario, but in any case, it's the least ideal letter.

In a sense, an L-shaped recovery is no recovery at all. Because here, the economy takes *years*, sometimes even decades, to return to pre-recession levels. Instead, a new normal sets in, and the economy's baseline becomes lower than it used to be. Certain jobs that were lost never come back. Certain spending habits never resume. Business investment is irrevocably altered. In other words, the pandemic's effect on our nation's GDP is enduring, not temporary.

One of the most famous L's in modern history occurred in Japan. This was the so-called "lost decade" of the 1990s – and some economists think it was really *two* decades! Closer to home, the United States experienced an L-shaped recovery of sorts after the financial crisis. While the Great Recession is generally thought to have ended in 2009, it took over six years for the unemployment rate to drop below 5%. (The GDP growth rate, meanwhile, is *still* lower than what it used to be.)

The case for an L

As of this writing, few economists seem to be forecasting an L-shaped recovery. But it's worth noting that a paper released by the National Bureau of Economic Research takes a gloomier view. According to their data, a high unemployment rate is likely to stick around for some time. That's partially because some industries have been hit particularly hard, and likely won't recover until the pandemic has ended. (The travel and hospitality industries are good examples.) Should that happen, the paper estimates that 35% of workers who have been laid off will not be recalled to their jobs.[10] Such a large percentage of permanently unemployed workers would have a big impact on consumer spending, which accounts for roughly 67% of our nation's GDP.[11]

The case against an L

Forecasts for an L-shaped recovery are definitely in the minority right now. It's certainly possible, but it assumes that the coronavirus spreads completely unchecked for years to come, without cure or even containment. Remember, the government and the Federal Reserve have been working hard to shore up the economy. Furthermore, an unprecedented amount of money and brainpower is being poured into the race to find treatments for the virus. Finally, current economic data suggests that, while unemployment is still rising, weekly jobless claims may have peaked. That means the worst would be behind us.

For these reasons, the consensus among economists seems to be that a U-shaped recovery is more likely. Let's keep our fingers crossed!

So, what does all this mean for the markets?

You've probably noticed it already, but each of these letters has something in common: They all start by plunging down.

Right now, our economy is in a recession. Whichever letter the recovery ends up looking like, we're currently on the downward side. That's why, over the last few weeks, many clients have asked me:

"How are the markets going up when unemployment and the economy are so bad?"

"Should I even trust the numbers I'm seeing in the markets right now?"

"What if the markets drop again? Should I start adding funds to my portfolio or should I wait?"

"What should *I be doing as an investor right now?"*

The first question, at least, is fairly easy to answer. I alluded to it earlier, but let's quickly review how the markets work compared to the economy.

The economy moves based on activity, like production, consumption, and trade. The markets, on the other hand, move largely on anticipation. When investors expect something will happen, they make decisions based off that expectation. So, when the markets plummeted in March, it was based on the expectation that unemployment would rise, consumer spending would fall, and the economy would contract. In other words, the markets fell because investors saw the downward slope coming a mile away. Whether the recovery ends up resembling a V, a U, a W, or an L, they knew that economic *pain* would come before economic *gain*.

Well, that pain has happened. So why haven't the markets continued to slide? Because that pain has already been "priced in." The massive swings we saw in March were based on what is happening *right now*. By the same token, the markets have stabilized because of what investors expect in the *future* – that the economy will make like a V or a U and rise again.

Unfortunately, the other questions don't have easy answers. As we've already covered, there are cases to be made for and against each letter. In fact, different industries will experience different letters. Some industries may enjoy V-shaped recoveries. Others may have to endure L's. Accordingly, different sectors of the markets may sink or swim.

As time passes, more economic data will come out. So, at some point, we'll be able to tell the shape of the recovery. But again, what looks like a V could end up really being a W. The letter U could actually be the beginning of a sideways-L. There's really no way to *know* ahead of time.

The economist John Kenneth Galbraith once said that "the only function of economic forecasting is to make astrology look respectable." That's why we *don't make decisions based on economic predictions.* In the end, that's just a type of gambling, and we don't gamble with your money.

With that in mind, let's return to the last – and most important – question my clients have been asking lately:

What should I be doing as an investor right now?

There are three basic things everyone should be doing right now.

First is to remember *why* we invest. We invest because you have long-term goals you want to accomplish. There are things you want to do and places you want to go. There are dreams you want to achieve and people you want to protect. We invest so you will have financial means to live the life you've worked so hard for.

Second is to remember *how* we invest. Because we invest for *your* (as in, nobody else's) long-term goals (as in, the things you care about most) we don't make decisions based on predicting whether we'll have a V recovery or a W or any other letter. Make no mistake, the type of recovery we see *will* have an impact on the markets – and by extension, on your portfolio. So, as your financial advisor, I do track the economy closely, so we can prepare for what the future holds. But *how* we invest – that's based on determining what kind of risk and what kind of return you need to reach your goals. That's why you'll never hear me say, "You should put more money in the markets because I think the economy is going to do better next month." Or, "You should take money *out* of the markets because I think the economy will do worse."

Instead, I make recommendations based on what you *need* to achieve your goals, as well as what level of risk you can afford to take on. That's why some investors should consider adding funds while others just maintain their current portfolio. There's no "one size fits all" approach.

The third thing investors should do, then, is take this opportunity to assess whether their goals and needs have changed. Imagine, for a moment, that you *do* know which type of economic recovery we'll experience. How would a U-type recovery, or a W-type recovery, be likely to affect your income? Your expenses? Your insurance coverage? Your retirement date? Your loved ones? How would a long-term pandemic affect your goals? Will some (like travel) need to be pushed back? Can others (like landscaping your yard or contributing to charity) be moved up as a result?

The answers to these questions go a *long* way to determining whether we should maintain or adjust our current investment strategy. When it comes to your personal finances, factoring the answers into our plan is more important than looking at the markets every day, or predicting what the economy will do.

So, here's what I recommend doing. Take a few minutes to think about everything you just read. Think about your long-term goals and your short-term needs. Has anything changed? Does anything *need* to change? If so, let's talk. We can meet over the phone or online to update your investment strategy or financial plan. We can review your goals, adding and modifying as needed. We can also review your financial *needs*, including your income, risk tolerance, and more. In other words, we can lay out a new plan to make your personal economic recovery look however you want!

In the meantime, I hope you found this information interesting and helpful. Please let me know if there is ever anything my team and I can do for you. Here's to a great recovery!

-STEVE ROBBINS, CFP®

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