GLOBAL MACRO, ECONOMICS & RATES STRATEGY RESEARCH

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Daily Deck: Our COVID-19 base case

We will know a lot about the seasonal pattern of COVID-19 in the coming weeks. If it follows a typical seasonal flu/cold pattern and, indeed, the pattern that emerged from SARS-CoV-1, we should begin to see a significant tapering in infections starting in early April and accelerating sharply through the end of May. While testing has been an issue – especially in the United States – there is enough time between now and early April that we should still be able to put in the peak in infections by then. Again, if the seasonal pattern holds. We would highlight that many medical professionals (including CDC President Dr. Nancy Messionnier) still think it is premature to believe this summer taper will occur. But as we get deep into March and April, a pattern (one way or the other) should begin to emerge.

Summary of base case

Our base case scenario is that COVID-19 follows a seasonal pattern and that warm summer temperatures in the Northern Hemisphere stop the outbreak. We would note that SARS-CoV-1 emerged in late-November 2003, peaked in early-April 2003 and tapered off almost completely by late-May 2003. According to the CDC, there have not been any known cases of SARS-CoV-1 reported anywhere in the world since 2004. This seems like a plausible scenario for how COVID-19 could evolve.

In this scenario the real risk is we "overstimulate." There are a number of fiscal programs being discussed such as a payroll tax holiday. If the President gets his way and we get some form of tax cuts, it probably won't be "turned off" on the first signs the disease is contained. Indeed, Trump just recently suggested a full payroll tax holiday through the election. We would hasten to add that while we think this has low odds of happening, the numbers are enormous. It was unclear whether this would apply to both businesses and individuals, but if we include all payroll taxes (for Social Security and Health programs), we are talking about $1.2 trillion in annual tax revenues. This would be a major stimulus but would also put a huge hole in the budget. A compromise on this front could be something similar to 2011/12 when Social Security taxes for individuals were cut from 6.2% to 4.2% (this would be worth about $200b over one year).

You also have to consider that we are in the midst of a refi wave. In many ways this represents a form of permanent stimulus. A refi wave that sees every mortgage get refi'd (not a stretch when you think about the 2003 wave where about 2/3 of mortgages were refinanced) would add close to $100b over one year (assuming about a 100bps reduction in the outstanding rate).

Finally, all of this is wrapped in an environment where rates are likely to stay low as the Fed is unlikely to raise rates until well after the election. Overstimulated indeed.

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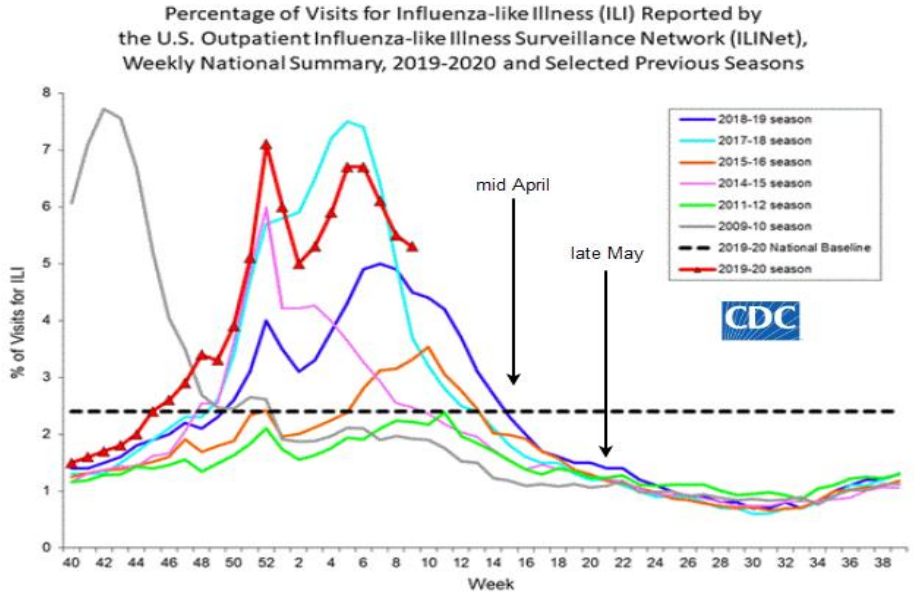
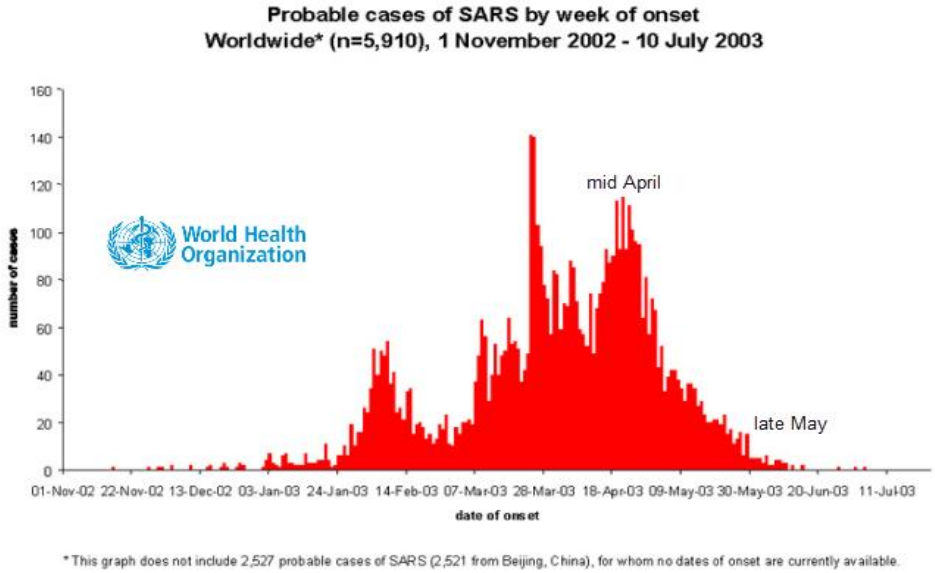


Source: CDC



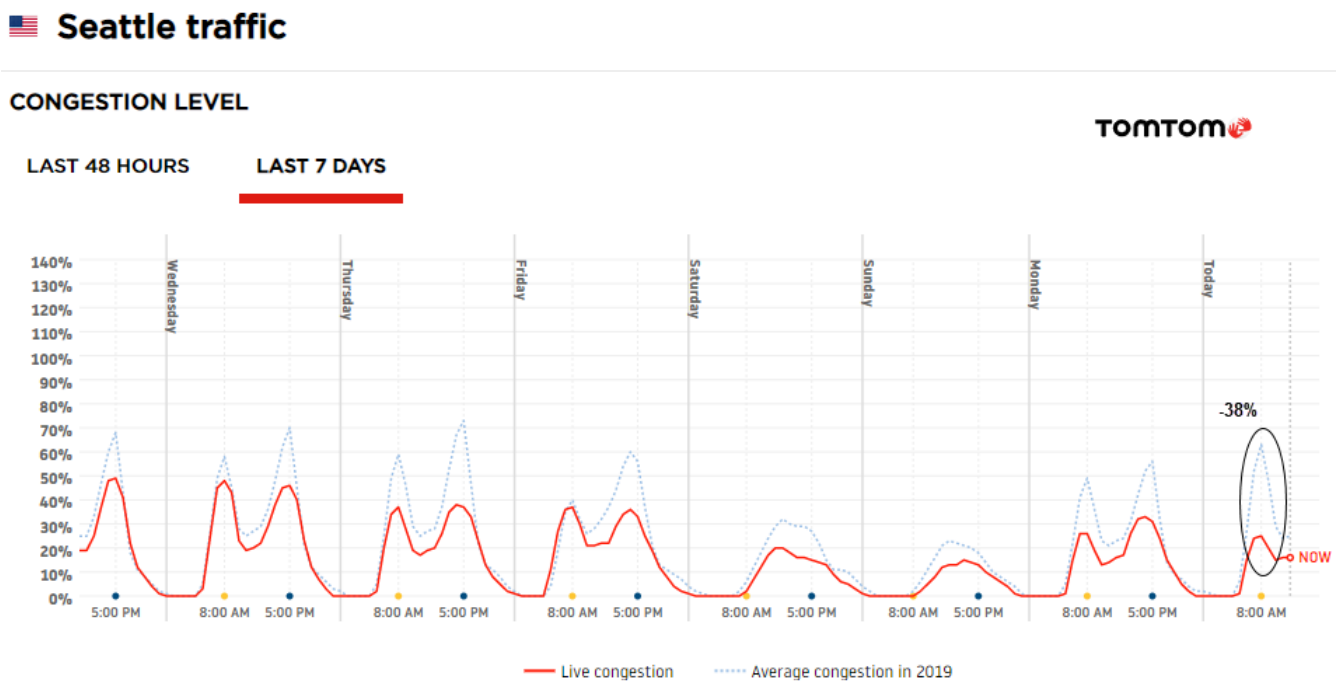
Source: World Health Organization

Some details around the base case

While uncertainty abounds, if we are forced to hang our proverbial hat on any of the potential outcomes, our base case is that COVID-19 does indeed prove to be seasonal.

In this baseline COVID-19 scenario, any drop-off in services spending would likely start at the tail end of March and continue through mid-May. Social distancing looked very modest through the first week of March per the ultra-high-frequency data we track – New York City MTA swipes, thus far, show no shift in subway activity from 2019 and traffic congestion only recently began to show signs of tapering off (New York was running -15% on March 10th but was in line with 2019 activity in the prior week). Seattle recently showed about a -40% drop-off as the city accelerated containment efforts ahead of other cities (closed schools, etc.). These containment efforts are

beginning in earnest in other major cities and thus social separation should accelerate from here. But the hit to 1Q overall should still look very modest given the timing. Perversely, we could actually see firmer consumer spending on the back of heavy "prepper" activity as people emptied shelves ahead of a potential hunkering down.



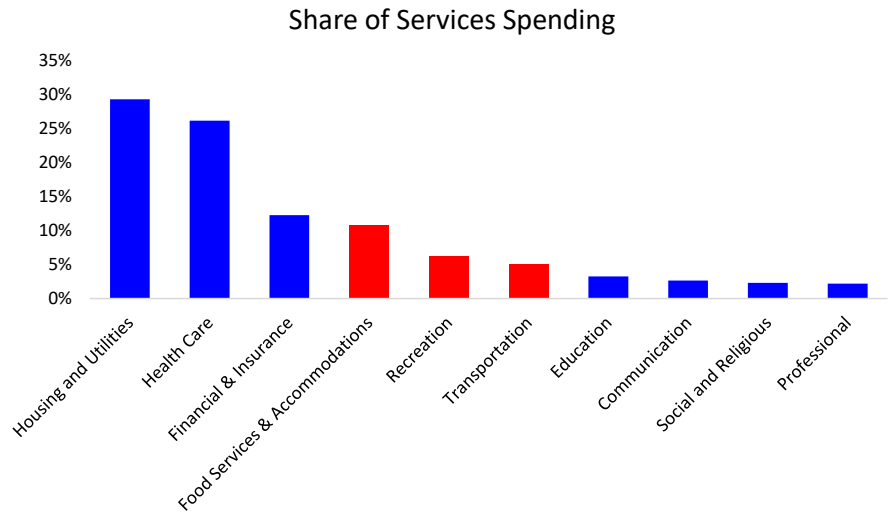
Source: TomTom

Consumer spending looks to be holding up for now but a quasi-quarantine of major US cities should have a material impact on social activity. Note that the top 25 cities in the United States account for about 12% of the total population (and much more if we include immediate surrounding areas). As noted above, traffic data is already flagging a potential social distancing trend. If we assume proportionate hits to socially sensitive consumption (restaurants, recreation activities, travel), we can assume large sequential declines in these components of spending.

This would be offset by the large cohorts of services spending like housing and health care. The fact that a quasi-quarantine would see many folks hunkering down at home should drive utilities and household operation expenses up at least somewhat. Meanwhile, the fact that this is a health event means that sector should see firmer activity. Housing and health account for more than 50% of services spending. Transportation, restaurants and recreation account for a bit more than 20%.

Overall though, the hit to social activities probably overtakes the stabilizer effects of stronger housing and health care spending and we would still expect overall services

to decline about -0.5% real in 2Q. Note that during the depths of the financial crisis, this space slipped -1.4% at the worst. So don't take this drop lightly. It would go down as the fourth worst print of the last 35 years.



Source: BEA, RBC Capital Markets US Economics

Housing activity probably remains firm. House hunting will likely be viewed as relatively low risk – with some caveats – and low rates make ownership extremely attractive. Affordability, if 30yr mortgage rates drop to about 2.75% (which would represent a still-elevated spread to 10yr Treasuries) would be near all-time highs (at about 33% of per capita disposable income) – it was only better during 2011/12 when housing was relapsing after the homebuyer tax credits juiced activity in 2009/10. Back then, home prices were about -40% below where they are today. It will be a push and pull between this and exposure risk to COVID-19. For starters, open houses that can attract crowds are likely to go away near term (perhaps they resurface in summer if COVID-19 shows signs of dissipating). Also, sellers in occupied homes may not want to risk exposure from potential buyers visiting their homes – and vice versa.

In terms of other compoentns of GDP, net exports slip as imports are dinged by softer global activity. But while this adds to growth, this should be offset by a sharp negative swing in inventory investment as supply chains are disrupted.

Capex activity might be a lost cause for now as cash flow management becomes primary and this is one of the easier conduits to tap for relief. We plugged in a -10% annualized drop in 2Q. It could be larger, but fiscal stabilizers should help here too.

So all in, this suggests we see growth slow to about -1.0% in 2Q before rebounding slightly in 3Q and more forcefully in 4Q (once the supply chain/inventory dislocations are dealt with). But we would caution, while we think this is the most probable scenario, there is significant uncertainty with this view. We are assuming the pattern

of this virus maps to previous experience. There are infinite scenarios we can draw out (both more positive and negative) and no list can ever be exhaustive when dealing with a novel virus (mutations alone make for dramatic scenarios in both directions).

What if we are wrong?

There are literally countless other outcomes we could see emerge. We could see a COVID-19 "double dip" where a summer lull gives way to a resurgence later in the year when winter is upon us. There are BIG caveats here. First, we will probably know the kill rate. If it is closer to flu-like in the end, this virus will simply get lumped into the bucket of typical seasonal diseases. If not, and the kill rate remains relatively elevated, say >1%, economic activity picks up similar to our base case, but then headlines emerge of a resurgence in COVID-19 and we get a significant relapse.

The social separation measures now well established likely kick in much sooner. The hit to growth is likely deeper than the first wave if the emergence of a second wave follows seasonal flu patterns of emerging in November and not peaking until April. The hit to 1H growth in 2021 could be substantial. This will be a race between the spread of the disease and development of a vaccine (which is reportedly about 18 months away currently. Even if a bit faster, it would still be too late to stave off economic pain early next year).

And what if the virus does not slow heading into the summer as we expect? The problem here is that from a consumer spending perspective, social activities tend to ramp in the summer months, meaning we would have a serious "seasonal factor" problem. In other words, if seasonal factors in economic data are anticipating a ramp-up in those activities and the ramp never comes, then it will only serve to depress the seasonally adjusted economic data. At that point recession is here.

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