Two-front war

Shock from virus and oil lead us to drop GDP estimates, but recession averted.

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BOTTOM LINE

The growing coronavirus pandemic and the 58% first-quarter collapse in crude oil prices will collectively impair both economic and corporate profit growth here and abroad. As a result, Federated Hermes' macroeconomic policy committee met on Wednesday to reduce our GDP estimates for each of the next three quarters, pushing our second-quarter estimate sharply lower from 3% to -1.7%. Importantly, however, as we expected, the Federal Reserve announced a powerful monetary response on Sunday night when it cut its benchmark rate to near zero and launched a new round of quantitative easing. We would expect a similarly strong fiscal policy response from Washington in the days ahead and that, combined with an all-in Fed, these actions will help the U.S. economy skirt recession by orchestrating a V-bottom recovery by the fourth quarter.

To be sure, recent economic metrics suggest that the labor market is healthy, consumer spending and confidence are solid, the housing market has

rebounded in response to lower interest rates, inflation remains benign and manufacturing appears to have bottomed at the end of 2019. But in our view, those are all rear-view mirror statistics, and we expect a significant deterioration in coming months.

While the trajectory of confirmed coronavirus cases in China seems to have plateaued in recent weeks, the U.S. is lagging that trend by at least a month, and our health-care system has done a poor job to date of providing enough testing for at-risk individuals. Consequently, we expect that the situation here will get worse before it gets better through perhaps the end of April, with the hospitality industry particularly hit hard.

In addition, coronavirus has destabilized global energy markets, as slower economic growth has significantly reduced demand for crude oil, particularly in China. But when Saudi Arabia called an emergency OPEC+ meeting in Vienna last week to negotiate a production cut to balance reduced demand, Russia refused to participate.

To force compliance and punish Russia, Saudi Arabia announced last weekend it would instead significantly increase production by 2.6 million barrels per day and offer deep 30% discounts to Russia's oil customers after April 1, when the current agreement expires. As a result, oil prices (WTI) plunged by the most in a decade this week, touching long-term technical support at about $27, a 58% decline from $66 per barrel in early January. While the decline in energy prices is good news for U.S. businesses and consumers, we believe that the damage from sharply reduced oilfield corporate spending and manufacturing will outstrip that gain.

As a result, the S&P 500 has plunged 27% since its all-time record high on Feb. 19—the fastest and sharpest decline in stock prices from a record high since 1931. In addition, the volatility index (VIX) has spiked from 12 to 78 over the

past month, and benchmark 10-year Treasury yields have plummeted from 1.65% a month ago to an all-time low of 0.31% on Monday, before stabilizing at around 0.90% now.

In response, in rare inter-meeting moves ahead of its regular policy-setting meeting this coming Tuesday and Wednesday, the Federal Reserve surprisingly cut interest rates by 50 basis points last week and a full percentage point last night to a range of 0-0.25%. The Fed also pledged to inject $1.5 trillion in liquidity into the banking system and take additional steps to support the overnight funding markets. What we're waiting for, then, is a comprehensive fiscal policy plan from President Trump and House Speaker Pelosi, although we've been deeply disappointed with the lack of leadership emanating from the administration and Congress to date. While we anticipate that a constructive bipartisan proposal will emerge from Washington in coming days, another failed misstep could drive stocks to retest their Christmas Eve 2018 trough at 2,350.

Lowering our GDP growth estimates The equity and fixed-income investment professionals who comprise Federated Hermes' macroeconomic policy committee met on Wednesday to discuss the damage that coronavirus and plunging oil prices will inflict on the U.S. economy:

- The Commerce Department left fourth quarter and full-year 2019 GDP growth unrevised at 2.1% and 2.3%, respectively.
- The first two months of the first quarter were solid and are in the bank, although we expect to begin to see some sharp deterioration in March. As a result, we lowered our first-quarter of 2020 growth estimate from 2% to 1.5%. Blue Chip consensus remained at 1.6% (within a range of 0.7% to 2%), and the Atlanta Fed's GDPNow model is at 3.1%.

- The next few months will bear the brunt of the coronavirus pandemic, as businesses and schools are shut down and non-essential travel comes to a screeching halt. So we gutted our second-quarter of 2020 GDP estimate from 3% to -1.7%, while the Blue Chip has kept its estimate unchanged at 1.9% (within a range of -0.1% to 2.1%).
- While we expect coronavirus infections to finally plateau in the U.S. by the end of the second quarter, it may take a little while to restart the economy. So we slashed our third-quarter of 2020 growth estimate from 2.8% to 0.9%, with Blue Chip's call unchanged at 1.8% (within a range of 0.8% to 2.8%).
- By the end of the third quarter, with Covid-19 likely behind us, we expect economic activity to begin to return to normal, with a sharp snapback in the fourth quarter. So we raised our fourth-quarter of 2020 growth estimate a tick from 2.9% to 3%, while the Blue Chip remains at 1.9% (within a range of 1.6% to 2.6%).
- Due to our reduced estimates during the first three quarters of the year, we lowered our full-year 2020 GDP growth estimate from 2.4% to 1.1%, while the Blue Chip consensus reduced its from 1.9% to 1.7% (within a range of 1.3% to 1.9%).
- We believe that economic life will begin to return to normal in 2021, so our call for full-year 2021 growth estimate is 2.5%, with Blue Chip consensus at 2% (within a range of 1.6% to 2.3%).

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DISCLOSURES

Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

VIX: The ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.

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