

# Darkest Before the Dawn

A Publication of BMO Capital Markets Economic Research · Douglas Porter, CFA, Chief Economist, BMO Financial Group

This week brought the **first full-fledged detail of the heavy economic toll** in North America from the pandemic, at the same time as the virus spread more aggressively, and the expected shutdown timeline lengthened. Even in the face of this generally tough news on the economic and health fronts, financial markets took it mostly in stride, weakening moderately with volatility climbing off the mountain top. The one true surprise of the week was a series of hints, including Presidential tweets, that there may be a **partial détente in the devastated oil market**. As a result, the biggest move was a near-30% rebound in oil prices, taking WTI above \$27, stabilizing the Canadian dollar just below 71 cents (\$1.415), and helping the TSX to a small gain on the week. But that gain was an outlier, and the good news ended there.

On the economic front, the turn of the calendar brought the first wave of March monthly data, which gave the initial read on the impact of the shutdowns. Given that the closures arrived in a stages through the month, analyzing the results almost became an exercise in dividing figures into before and after. **U.S. employment figures** were the main act, with the staggering rise in initial jobless claims last week of 6.65 million the most devastating news. The fact that seasonal adjustment factors alone added 825,000 folks to the latest claims tally dulled the blow from the reported 701,000 decline in March payrolls the next day. Much less noted was that the companion household survey reported a massive 3 million job loss for last month, easily the largest drop ever. Suffice it to say, these figures will all deteriorate much further in April, even if they were already much worse than expected last month.

While the job market is taking the immediate and obvious hit from the economic deep freeze, other indicators were mixed. **U.S. consumer confidence** stepped back by roughly 10% last month to 120 according to the Conference Board, but the index is still miles above the 2009 low of just 25.3. **Auto sales** crumbled 35% y/y to 11.4 million units, as strong first-half activity fell to almost nothing in late-March. Notably, the drop in Canadian auto sales was even heavier at down 47%, and consumer sentiment fell much further, reflecting a slightly earlier economic shutdown. Meanwhile, sentiment among U.S. firms last month softened only modestly for both **manufacturers and services**—the factory ISM dipped to 49.1 (admittedly held up by supplier delivery delays, so the “real” number was closer to 45), while the non-manufacturing index shocked with a still-solid 52.5 reading (also finding artificial support from supplier delays).

**Look for a widening split between manufacturing and services in coming months**, with the latter likely to take a heavier hit. That’s a clear theme we have seen play out across other economies dealing with the physical distancing. And, it’s the **exact opposite trend normally seen in a “typical” economic downturn**. In more normal times, it’s manufacturing that takes it on the chin, while services hold up relatively well. But the unique nature of this episode, and the mandated closures of many

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service sectors, has totally turned the tables. For example, the U.K. services PMI tanked to 34.5 in March, while manufacturing was 47.8; the Euro area figures were even starker at 26.4 for services and 44.5 for factories. That's the kind of split we are likely to see in April in North America as well.

**Just as the nature of this recession is so unusual** (services versus factories), **the shape of the recovery is also likely to be quite different.** No question, the conventional wisdom on the timing and strength of the recovery took a turn for the worse in recent days, amid the tougher news on the path of the virus. And, ultimately, the **depth** and the **duration** of the downturn will be **dictated by the virus.** But, the recovery may well be more forceful and somewhat faster than generally expected when it arrives, because of this unusual split between sectors. There will be no inventories to work down in services; when they can open for business again, they will be in a position to ramp up quickly. No doubt, many industries will be facing a long workout period based on behavioural changes alone (think travel, entertainment), but the dramatic swell in fiscal measures should support spending in other areas.

Looking ahead to next week, it's a lighter data calendar for the U.S., although jobless claims are expected to post yet another massive reading of just under 6 million. But as so vividly seen this week, financial markets have long since built in very ugly employment assumptions—the **bigger question is how long** the shutdowns linger, not how deep they cut. The much more secondary issue of falling inflation will be addressed by Friday's CPI read, and it's expected to show a sharp drop to around 1.5% y/y from 2.3%. It won't stop there on the way down. In Canada, the focal point will be the March employment data, due on Thursday (ahead of Good Friday). With the survey taken a week later than the U.S. jobs report, it is likely to sustain a relatively deeper hit than the weaker-than-expected stateside data. We have pencilled in a 600,000 decline in jobs, or five times the worst month ever for the LFS (a 124,800 drop in January 2009). Again, we suspect the markets are now essentially numb and/or fully prepared for such news.

On the forecast front, for the first time in weeks, we have no significant changes to report. For oil, we had been assuming that eventually OPEC or Russia would buckle, and had stuck with a call of \$35 WTI for this year. That may still prove optimistic if a solid agreement on large output cuts (at least 10 million bpd) can't be reached at the emergency virtual OPEC+ meeting. Elsewhere, the lack of a forecast change does not necessarily mark the end of revisions. In fact, with the timeline on shutdowns apparently poised to get pushed out further, and potentially much further, the growth estimates will necessarily need to reflect this as more information arrives. The offset is that fiscal policy appears poised and prepared to ramp up as needed to counter the deepening drag on incomes from the shutdowns, and presumably support a comeback in spending later this year.

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Another big adjustment this week was the **budget deficit estimates in Canada.** We noted that last Friday's sudden announcement of a 75% wage subsidy was going to carry a very large price tag, potentially doubling the deficit estimate in a stroke. And so it did. The 12-week program is expected to cost \$71 billion, lifting new direct fiscal support to \$105 billion, according to Finance Minister Morneau. That comes on top of an

underlying deficit of \$28 billion before any of this began, as well as the surge in costs and slump in revenues naturally flowing from the economic blow. We believe it's far too early to try to put a pin in precisely how big the deficit will be, but let's just say that the **modern day record of 8% of GDP** (which translates to about \$180 billion) is **clearly at risk**. If anything, that looks light.

To those who are deeply, and understandably, quite concerned about this sudden and dramatic turn in the deficit—from 1% of GDP to over 8%—I would say four things:

1. What choice do we really have, given the mandated shutdown of the economy?
2. It's much better that Ottawa shoulders the burden of almost all new spending than a hodge-podge effort by the provinces, especially in light of lower borrowing costs for the federal government.
3. On that point, Ottawa can now borrow at all terms of 10 years or less for under 0.7%. So, the annual interest cost of an additional \$200 billion may be less than \$1.5 billion.
4. Finally, the Bank of Canada is essentially financing the net new borrowing, at least for now, by buying "*at least*" \$5 billion of GoCs per week. That QE could build to nearly \$200 billion by the end of 2020.

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