INVESTMENTS®

RESEARCH NOTE JUNE 2020

Macro

Measuring the recovery: Reopen for business

Unprecedented times call for a new toolkit. The reopening of the U.S. economy is a momentous undertaking that is changing week by week. To better track this critical time, we introduce high frequency indicators to better gauge how broadly reopening is taking hold—and what it could mean for consumers, businesses and investors.

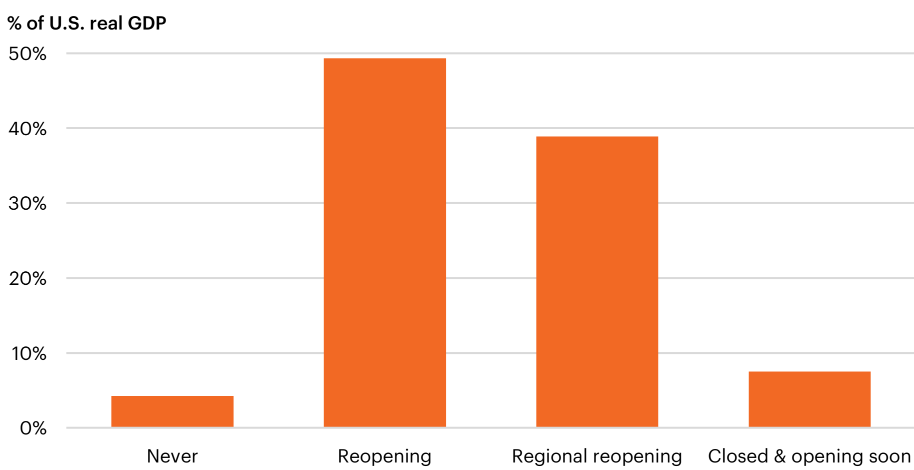
KEY TAKEAWAYS

- The economy is reopening, causing high expectations and rapid changes.
- We enlist a new set of high frequency indicators to track economic activity.
- States that are reopening are growing better than those with more cautious policies, but all states are well below pre-COVID levels of activity.
- "Low-touch" industries have made a strong recovery, while "high-touch" industries have struggled.

The U.S. economy is changing rapidly. In mid-March, as the COVID-19 pandemic crashed upon the U.S. populace, our economy was ostensibly placed in an induced coma, with many businesses shuttered and shelter-in-place orders keeping consumers and workers at home. Even in states where there was never an explicit policy to shelter in place or close businesses, the economy suffered a downturn not seen since the Great Depression. Now, as most states are in some stage of reopening, the green shoots of an economic recovery are taking hold.

Traditional indicators that economists and markets have relied on for decades are released with a significant lag, leaving investors with a feeling of "ancient history" by the time they are released. In the current environment, we need to expand our data toolkit to track the rapidly changing path of consumption, business activity and the economy. Investors will get a more timely and complete picture of our economy by using a combination of these high frequency indicators and the broader, traditional macro indicators that we have tracked through prior business cycles.

STATE LEVEL OF OPENNESS



Source: National Governors Association. Seven states bucketed in "never" did not close or have shelter-in-place policies. "Reopening" are states that reopened entirely at a state level, mostly on May 1. "Regional reopening" includes states that are opening by county or by locality. As of June 1, three states were closed or opening soon.

Reopening: The green shoots of recovery

Reopening is happening, providing a source of optimism that the worst of the economic downturn is behind us. The degree of "openness" is still highly variable between, and even within, states. Some states never closed, though these make up a relatively small share of U.S. GDP. The bulk of states, accounting for approximately half of U.S. GDP, experienced a statewide reopening, mostly around the beginning of May; this group includes the second-largest state in the U.S., Texas. The next group, accounting for 38% of the U.S. economy, is rolling out a more gradual regional reopening where policies vary county by county or city by city. With only three states still closed (or opening soon), this means that 93% of our economy is reopen for business in some form.

The good news is this means that the worst economic news may be behind us. Devastating data including the 22 million jobs lost over March and April seems to have reversed, and we are all hopeful that the unemployment rate hit a high of 14.7% in April. Unemployment dropped to 13.3% in May, still higher than the 10% peak after the Great Recession, but any improvement is good and fuels optimism that the green shoots of recovery are visible and growing.

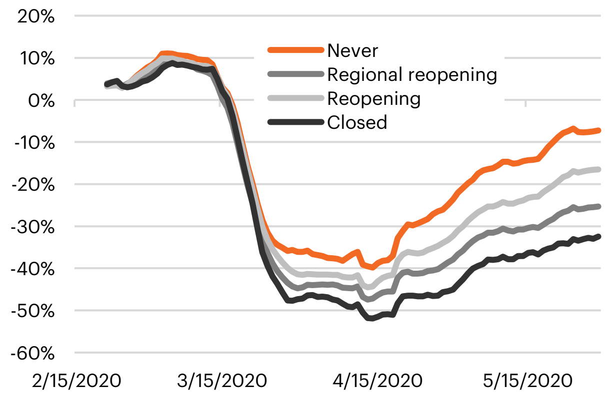
Tracking the recovery's traction

Recently, the May payroll report surprised markets to the upside as 2.5 million jobs were added when a 7.5 million decrease had been expected. This large "miss" by forecasters can, to some degree, be blamed on lack of focus on some of the high frequency indicators that have emerged in the wake of the COVID-19 pandemic.

One data set getting significant attention is compiled by Google and shows human mobility. This data groups movement into categories of workplace, retail and recreation, residential and transport stations.[1] From this data we can confirm that as states reopen, people are emerging from lockdown. States that are relatively more open have seen a greater recovery. However, even states that were never closed still suffered a sharp decline in activity. Similarly, states that are still closed are seeing an increase, albeit smaller, in mobility. In other words, people may choose to do or not do what their state governments are mandating.

1 Google also provides data on grocery and pharmacy, and parks.

RETAIL AND RECREATION

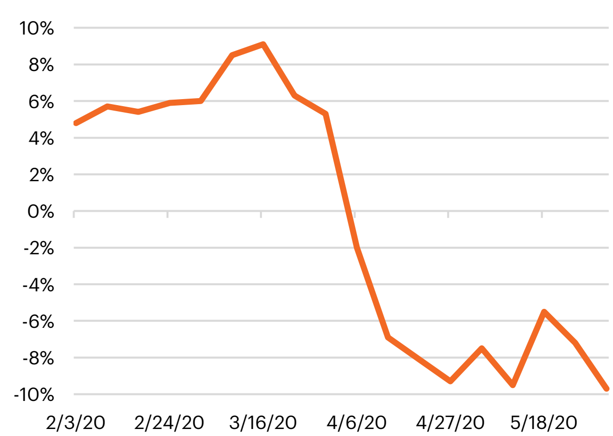


Source: Macrobond, Google, FS Investments, as of June 9, 2020. 7-day moving averages. Values are compared to a baseline (zero value) of January 3, 2020–February 6, 2020.

Retail and recreation will be enormously important to watch over the coming weeks. Consumer spending accounts for about 70% of our economic growth, and the broader economy cannot stage a lasting recovery unless consumer demand returns. This category includes restaurants and cafes as well as shopping centers, and any positive improvement is critical.

Of course, at the end of the day, what will help the economy is for consumers to spend money, not just travel to retail locations. The retail sales data, a comprehensive look at national sales receipts, is reported in the middle of the following month, and will add granular detail about the extent to which traveling to shopping locales has translated into dollars spent. Unfortunately, some other often-watched high frequency indicators, like the weekly

REDBOOK TOTAL RETAIL SALES, % y/y

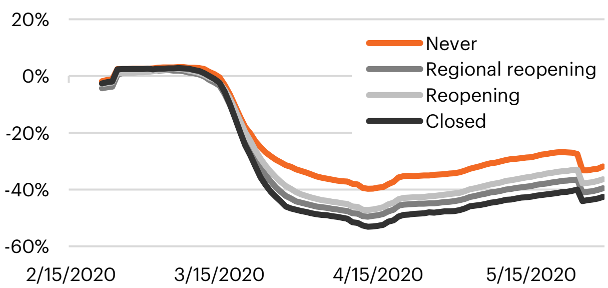


Source: Macrobond, as of June 1, 2020.

Johnson Redbook chain store sales, have not yet shown a corresponding bounce.

Mobility data may shed light on other aspects of the recovery as well, and we are putting time spent at the workplace high on our list. First, this speaks to employment. To be sure, many industries will pivot to working from home and may not see the hours spent at the office return to pre-COVID levels for months, if not years. Yet many jobs, particularly lower-paying service jobs, are not able to be done remotely. Therefore, to some degree time spent at the workplace will help gauge speed of employment.

WORKPLACE



Source: Macrobond, Google, FS Investments, as of June 9, 2020. 7-day moving averages. Values are compared to a baseline (zero value) of January 3, 2020–February 6, 2020.

This series bottomed in mid-April, and the upswing in May is one sign that, despite continued increases in applications for state unemployment benefits, workplace activity is improving. (The dip at the end of May is Memorial Day.) However, questions remain about how many people are actually going to work. There is a difference between being on payrolls and clocking hours. This series can help us with that distinction. The May employment recovery has not been a V-shape by any stretch, a stark reminder that hiring was but a fraction of the jobs lost previously.

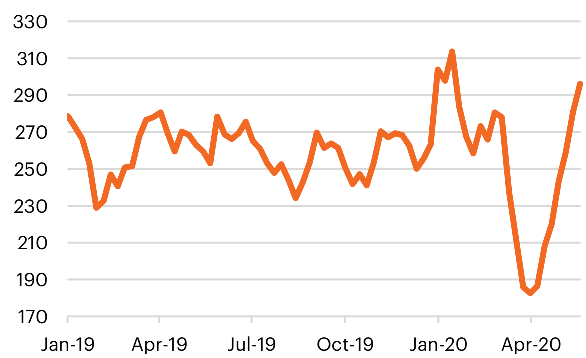
What at the end of the day is the conclusion about this mobility data? Because it is timely, it will be very useful to watch. For example, concern has been raised about business or consumer impact of recent demonstrations that occurred nationwide in the start of June. Mobility data will likely offer a more nuanced look at how consumers, workers and business trends evolve. Are consumers spending, or are they simply feeling housebound? There cannot be a full economic recovery without people being willing to go out in public. The monthly or quarterly national indicators will remain important, but the high frequency data on mobility and movement could be a pivotal leading indicator.

Low touch activities show strong bounce

There are also high frequency indicators specific to industries which tell a story of disparate recovery based on the ability to socially distance. On the surface, this may seem unsurprising. But the magnitude of recovery in some industries that were quickly able to go "virtual" is noteworthy and could highlight a path forward for our recovery.

Mortgage applications, for example, have surged. This has been due in part to record-low interest rates. It is also an important sign of optimism and fully functioning financial markets. In addition, refinancing can be accomplished remotely. Similarly, new business applications have already recovered from the big downturn in April—another optimistic signal for our economy going forward.

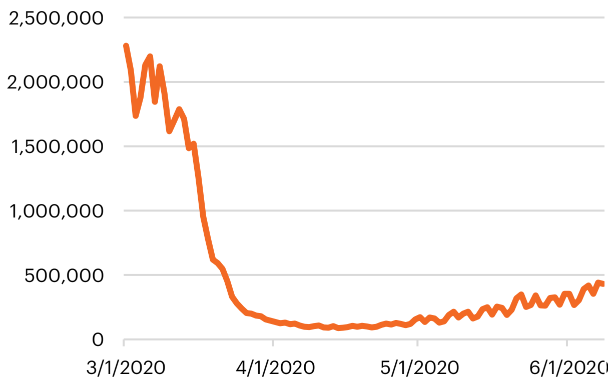
MORTGAGE APPLICATION INDEX



Source: Mortgage Bankers Association, as of May 25, 2020.

Not surprisingly, high frequency indicators confirm that the industries that find it difficult to function while socially distant are lagging in recovery. Airline travel is perhaps the best example of this. Recently, much was made of news that some airlines were adding flights in July in anticipation of a sharp increase in demand. And yet, travel data paints a picture of a sharp decrease in activity that has barely improved. Yes, daily air passengers have risen from a low of about 100,000 per day to around 400,000 per day. But this is less than one-fifth of where air travel was in February. After the September 11 terrorist attacks, it took airline travel almost three years to fully recover passenger volume. A "back to normal" recovery can take years.

AIRLINE PASSENGERS PER DAY

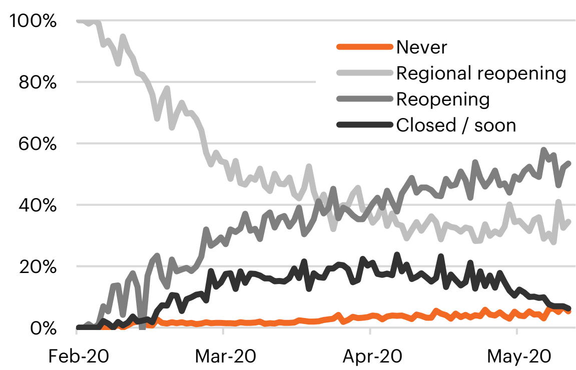


Source: Transportation Security Administration, as of June 8, 2020.

Connecting COVID to the economy

Finally, an important set of high frequency data captures the COVID-19 pandemic that has caused so much economic devastation. The geography of new cases has shifted significantly in the few months that we have been wrestling with this virus. At first, due to the catastrophic outbreak in the New York area, New York City and the five surrounding counties accounted for about a third of all U.S. cases.

SHARE OF NEW COVID-19 CASES



Source: CDC, FS Investments, as of June 9, 2020.

That has changed significantly. Now, about half of new cases are coming from states that have reopened. These states account for about 50% of the population of the U.S. This trend bears close watching. States where a regional reopening strategy is already in place may feel more comfortable with regional closing, should cases flare. Indeed, if new cases boil over, people may choose to shelter at home or reduce consumption, or businesses may send workers home despite what the government is mandating. We witnessed this in February when even states that did not officially mandate shelter-in-place policies saw citizens impose them on themselves.

The path forward

Together, these high frequency indicators point to a slow and steady liftoff—a newborn recovery that is proceeding more slowly in places that are only gradually reopening but still reinforces optimism that the worst may be behind us. What the timeline looks like is still highly uncertain, however. Information on mobility, weekly store sales and initial jobless claims will help us track whether the recovery is crawling or racing toward pre-COVID levels. Mobility data will provide important updates, particularly regarding consumer spending. Whether spending will be commensurate with increased activity remains a critical piece of further information. Over the longer run, workplace mobility will offer insight into both employment activity and changes in work-from-home dynamics.

High frequency indicators show that industries requiring low touch have almost entirely recovered already. This is first and foremost a nod to the optimism which is a critical foundation for a strong recovery in spending and investment. It also shows that the more industries we can push away from high human contact, the better we can support recovery. Clearly this has limits; some industries will be more challenged to create social distance. But flexibility and innovation—most likely from the private sector—will likely help the economy going forward.

In the not-too-distant future, we anticipate challenges to the recovery where we can further enlist high frequency data. There is optimism that consumer demand will return quickly now that many stores are open. And yet there is to some degree a race against time as supplemental unemployment benefits are set to expire in August. Should employment not return, demand may yet become constrained.

Finally, while optimism is important, complacency at this early stage during the recovery would be a mistake. The recession is arguably only three months old, and an average recession lasts 12 months. In other words, lingering unemployment, a recurrence of the health crisis that caused the economic shutdown, or other events that cause uncertainty to ratchet higher could easily derail the high valuations of the financial markets. Uncertainty is just under the surface.

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