Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

WEEKLY CLIENT COMMENTARY May 14, 2020

3 Reasons This Recession Won't Be Worse than the Great Depression

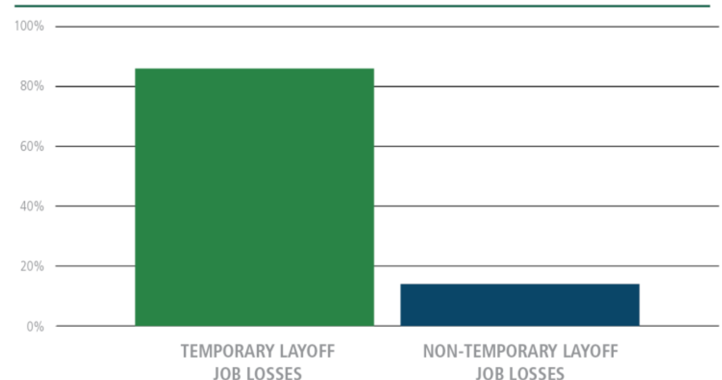
Many readers have probably seen the headlines and stories claiming this recession could be as bad – or worse – than the Great Depression. To that I say, don't take the bait.

The Great Depression was a slow, long, grinding downturn for the U.S. economy. From 1929 to 1933, the economy shrank for *43 consecutive months*, with unemployment hovering around 25% for years. Even as the jobs picture improved over the course of the decade, unemployment remained over 10%.

In the coming month, it looks like U.S. unemployment could push past 20% (it stood at 14.7% in April data).[1] It's this piece of data that is drawing the biggest comparison to the Great Depression, but I think the argument is misguided and incomplete. I don't see this recession coming close to the Great Depression in terms of severity or duration, and I'll give you three reasons why.

1. **Unemployment Figures Do Not Paint a Complete Picture**

The U.S. economy is losing millions of jobs – there is no sugar coating this fact. But if we take a very close look at the job losses across the economy, we find that a large percentage are furloughs (temporary layoffs) as opposed to permanently shrinking the workforce (data below):



Source: Zacks Investment Research[2]

In the current environment, employers appear to be keeping employees close by, in anticipation of the economy's reopening. A recent survey

conducted by Morning Consult found that two-thirds of workers believed that they would return to work for their current employer, which could help restart business much more quickly than if the employer had to rehire.[3] When employees are asked to return to work, there's no need for training, recruitment, job search, background checks, 'onboarding,' etc., all of which are costly and time-consuming. Workers can return to their jobs and immediately be productive.

Additionally, more than half of job losses have come from hospitality, accommodation, food services, retail trade and other service-sector jobs. Those who can work remotely – typically in high-skilled, higher-income jobs in tech, finance, management, professional services – saw a much smaller change to payrolls in March and April. The implication here, in my view, is that the majority of layoffs come from industries that could resume operations immediately when lockdowns and restrictions are lifted – which is beginning to happen now.

Jobs disappeared during the Great Depression because there was no demand, no capital, no functioning Federal Reserve or financial system. Companies had to permanently restructure – or declare bankruptcy – in droves. There was no safety net during the Great Depression.

Today, businesses are struggling in major ways, but they are also receiving financial support from the government with payroll loans that are in many cases forgivable, and workers across many industries are seeing close to full replacement of income from unemployment insurance under the CARES Act.[4] This is not a Depression-like outcome.

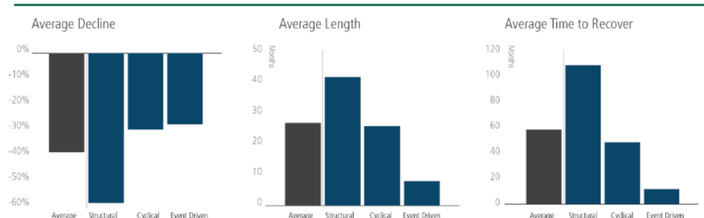
2. **Event-Driven Shock Versus a Structural/Financial Crisis**

The collapse of the financial system was one of the major causes of the Great Depression. Today, banks are very well capitalized and the credit markets remain stable. Comparing the financial system during the Great Depression to the financial system today is essentially comparing night to day.

Because the causes of the Great Depression were structural, industrial production fell by more than half during the entirety of the 1930's. Back then, industrial production was a critical component of the economy. Production trickled higher over a four-year stretch during the mid-1930's, only to plummet sharply again in 1937-1938.[5] Again, the Great Depression was a long, grinding decline. The current lapse in production and services is expected to last a few quarters – not years.

Historically, "event-driven" bear markets (which is how I would characterize the current downturn) have been shorter, less severe, and take less time to recover from than structural or cyclical downturns. I do not believe this time will be different.

Bear Markets & Recoveries
1800s to Current



Source: Goldman Sachs[6]

3. **Policy Mistakes Drove the Great Depression Deeper**

Governments and central banks failed miserably in their response to the Great Depression, doing basically the opposite of what needed to be done.

In the midst of the 1930's downturn, central banks tightened monetary policy in order to maintain the gold standard, resulting in severe deflation which raised the cost of debt and lowered real incomes. The U.S. government equally fumbled the response by putting austerity measures in place (cutting spending) just as the economy needed it most. The government also passed the Smoot-Hawley

Tariff Act in 1930 in an effort to help domestic producers, but it only resulted in more pain due to the loss of global demand.

The policy response in the current crisis has drawn from lessons learned during the Great Depression, and the government and central bank are essentially doing the opposite of what they did during the Depression. The U.S. government has spent some $2.9 trillion in stimulus to boost the economy, and the Federal Reserve slashed rates to the zero bound in addition to offering basically unlimited liquidity to the capital markets.[7] The difference in responses is night and day.

Bottom Line for Investors

I strongly believe the current recession will be shorter, less painful, and will inflict far less damage on households and businesses than the Great Depression. But that's not to say it will be an easy and painless downturn. All recessions hurt the economy and society at-large, and it will take time to rebuild.

In my view, however, getting the economy back to a strong position may require about 15-18 months, versus the 10+ years that were needed to recover from the Depression. There's no comparison, in my view.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] The Wall Street Journal, May 10, 2020. https://www.wsj.com/articles/coronavirus-slump-is-worst-since-great-depression-will-it-be-as-painful-11589115601

[2] Zacks Investment Research

[3] Morning Consult, May 6, 2020. https://morningconsult.com/2020/05/06/analysis-coronavirus-jobs-april/

[4] The Wall Street Journal, May 10, 2020. https://www.wsj.com/articles/coronavirus-slump-is-worst-since-great-depression-will-it-be-as-painful-11589115601

[5] The Wall Street Journal, May 10, 2020. https://www.wsj.com/articles/coronavirus-slump-is-worst-since-great-depression-will-it-be-as-painful-11589115601

[6] Goldman Sachs, Bear Essentials: a guide to navigating a bear market. March 9, 2020.

[7] The Wall Street Journal, May 10, 2020. https://www.wsj.com/articles/coronavirus-slump-is-worst-since-great-depression-will-it-be-as-painful-11589115601

IN FOCUS THIS WEEK

- What could the US economic recovery look like?
- Inside the harsh reality for US manufacturers
- Could lower consumer and business expectations be a good thing?

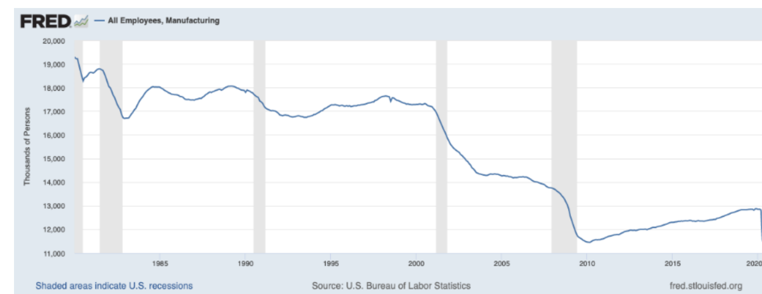
The Nike-Swoosh-Shaped Economic Recovery?

Market-watchers and economists have been eyeing China's economic recovery. Since China was the first country to run through the cycle of the pandemic (shutdowns, restriction on movement, gradual reopening), economic data from China can be useful for projecting how a gradual recovery may look in the U.S. and elsewhere. The takeaways are mixed, but not dire: Chinese factory profits fell by -36.7% in Q1 and the economy suffered its worst quarterly decline in decades, but the sharp drop-off was followed by a sharp bounce-back to pre-virus factory activity.[1] The main issue was that China's economy returned to a world where demand had collapsed, such that even a resurgence in economic activity did not result in a snapback of sales, deliveries, and trade. Because the entire world is riding the same wave and demand is only likely to creep higher over the next several months, we might reasonably expect that the economic recovery looks more like a Nike "Swoosh" than a "V." The good news, in our view, is that we have likely already reached the lowest point of economic activity for the crisis, so the gradual climb upwards is arguably underway. The question is, what will the rate of recovery be?

A Harsh Reality for U.S. Manufacturers

Stories are starting to emerge around the country of factories shifting from furloughs to outright closures. It's difficult news to digest, particularly for those whose jobs are being eliminated and may not return. The factory closures are adding up from a dishware maker in North Carolina to a cutting board maker in Michigan, a Polaris jet ski manufacturer in Indiana, and a factory that produces furniture foam in Oregon. The harsh reality for many of these manufacturers, however, is that the Covid-19 pandemic may simply be accelerating an event that would have occurred anyway in a matter of time. Since the late 1960s, the United States has been losing manufacturing jobs in a steady decline. The globalization of supply chains has been a major factor, but the US economy has also been evolving from an industrial economy into a services, consumption, and technology/information-based economy over the same period.[2] Many companies are using the tragic moment to speed up strategic shifts that may have been inevitable.

U.S. Manufacturing Employment Has Been in Steady Decline



Source: Federal Reserve Bank of St. Louis[3]

Expectations are Falling, and That May Be a Good Thing

US consumers and small businesses are lowering their expectations for a strong economic rebound. In April, Americans' views on the job market and personal finances declined dramatically. More Americans than ever were worried about losing their job, while a record number also had low expectations for future earnings, income, and spending. Similarly, the small business optimism index recorded its biggest two-month decline in the index's history, with a majority of small businesses around the country not expecting a rebound for at least six months.[4] *All this pessimism may be a good thing.* When it comes to equity markets, one of the major drivers of future returns is whether the actual economic outcome exceeds expectations. As expectations fall, the bar is lower for the economy to surprise to the upside, which can help push stocks higher. In this sense, investors should root for dire sentiment, as it builds the "wall of worry" stocks historically love to climb.

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[1] The Wall Street Journal, May 11, 2020. https://www.wsj.com/articles/why-the-economic-recovery-will-be-more-of-a-swoosh-than-v-shaped-11589203608

[2] The Wall Street Journal, May 10, 2020. https://www.wsj.com/articles/factories-close-for-good-as-coronavirus-cuts-demand-11589122800

[3] U.S. Bureau of Labor Statistics, All Employees, Manufacturing [MANEMP], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MANEMP, May 14, 2020.

[4] The Wall Street Journal, May 11, 2020. https://www.wsj.com/articles/new-york-fed-finds-big-deterioration-in-consumer-views-in-april-11589209825

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