AERIAL VIEW

ACCESS A BROADER MARKET PERSPECTIVE

BY JOHN VELIS

BY THE NUMBERS

20.54 MILLION

Number of people receiving regular state unemployment insurance benefits

21.2%

Percentage of unemployed and underemployed in the US

16.16 MILLION

Number of jobs lost since February 2020 in private, service-producing industries

11 MILLION

Number of people receiving pandemic-related unemployment benefits

-6.1%

Year-over-year decline in retail sales in May 2020

SOURCES:

1. US Department of Labor
2. US Bureau of Labor Statistics
3. US Bureau of Labor Statistics
4. US Department of Labor
5. US Census Bureau

INTERRELATED DEMAND AND SUPPLY SHOCKS FROM COVID-19, AS WELL AS THE CHALLENGES OF REALLOCATING WORKERS WITHIN AND BETWEEN SECTORS, WILL COMPLICATE THE RECOVERY OF THE US LABOR MARKET.

BY JOHN VELIS

The economy is facing three kinds of headwinds from COVID-19 simultaneously: a demand shock as spending drops, a supply shock as industries produce fewer goods, and a reallocation shock as workers are laid off and need to be rehired into new sectors.

Both the severity and interplay of these factors will have profound long-term effects on the US labor force. High uncertainty about each, and the policies designed to address them, are also complicating efforts to kick-start the recovery and rendering what would normally be possible, a steep challenge.

Here's why. Turning points in any economic cycle tend to be accompanied by across-the-board slumps in aggregate demand from consumers and businesses and therefore increases in unemployment. Policy responses that are designed to reinvigorate demand usually rely on income benefits supporting household spending and a revival in the job market as an economic expansion takes hold.

That feedback loop cannot be taken for granted here. The efficacy of the current policy reaction to the COVID-19 pandemic may be challenged due to the absence of these second-round effects, for reasons we will go on to explain.

A not-insignificant number of sectors will likely be permanently impaired. Workers are receiving extraordinary unemployment benefits, but their spending alone cannot stimulate the economy into rehiring.

In addition, some workers will not be going back to the jobs they were in. Separately, they may be impeded in their mobility when job hunting by the need to retrain or seek new occupational licenses and qualifications.

Similarly, existing regulations on new business formation and expansions like new factories or rezoning are eroding what would otherwise be important second-round sources of rehiring. This is limiting the success of the policy response so far.

How these regulations and hurdles are affecting different sectors also helps to explain the remarkable dispersion in the performance of the equity markets. Some companies are transforming themselves quickly, without significant challenges as they adapt to the new environment, and others are prevented from doing so.

A TRIPLE THREAT

While the human and societal toll from the global pandemic already have been devastating, in economic terms the effects of COVID-19 are also startling.

Certain industries will likely be substantially reduced in size, and therefore labor demand likely will slow. Some categories of jobs may shrink or be eliminated altogether, while others may increase, requiring a reallocation of workers among and within sectors.

This reallocation of labor demand and supply will likely also happen within industries and regions at the individual firm level. Matching labor demand with those seeking employment will take time, making the

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recovery complicated and protracted.

To unpack this, we look first at the demand side, where the shock has been most evident. As a result of the virus-induced sudden stop in the economy, from which we only now see initial signs of stabilization, declining employment and business closures have reduced current and expected future income in the aggregate economy. Fiscal policy has been crafted to help offset reduced incomes, supply liquidity to affected employers, and bridge the gap in employment for displaced workers. But the long-term effects of this are yet to be fully recognized.

Meanwhile, the supply-side effect has already shown up in supply-chain disruptions (for example, in certain parts of the food-supply chain and transportation, disruptions at plants and factories); rising prices in certain sectors of the economy (elective health care, for example); and higher reopening costs for businesses like restaurants and retail establishments. Uncertainty about the speed of the demand-side recovery, and the reduced revenues of such businesses, may also reduce capital investment and hiring and therefore productive potential, a secondary supply shock.

To complicate matters further, the supply shocks in certain industries may create secondary demand shocks, as reopening in certain sectors and companies requires new services and sources of labor. Short-term supply disruptions that result in layoffs and reduced corporate demand should induce additional demand shocks as suppliers of labor and materials face reduced revenues.

The interactions of these demand and supply forces could create a large reallocation shock, translating into slower long-term growth rates and an impaired recovery.

TIME TO REPAIR

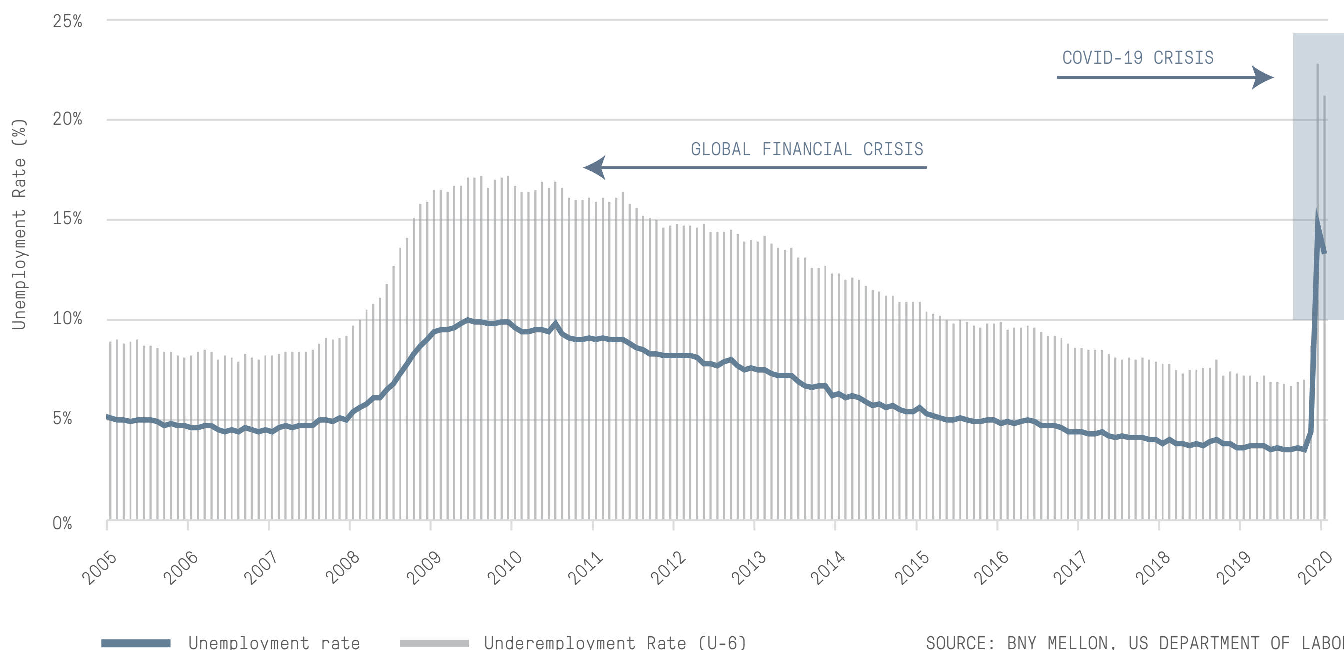
As the economy reopens and slowly recovers, labor and capital will have to go from activities, industries and firms that no longer require it to new areas that will. This is not a frictionless process, and while the reallocation gets underway, there is a risk of deeper and more permanent scarring to the US economy.

A recent paper by Jose Maria Barrero of the Instituto Tecnologico Autonomo de Mexico, Nick Bloom of Stanford University and Steven Davis from the University of Chicago's Booth School of Business discusses the reallocation shock hypothesis and concludes that it commenced in March of this year and is ongoing. They demonstrate this reallocation by combining both hiring intentions from the Federal Reserve Bank of Atlanta's Survey of Business Uncertainty, as well as a cross-sector examination of equity returns.

Reallocation shocks have been discussed before in academic literature.

OUT OF SERVICE

Unemployment levels spiked once the global pandemic took hold, surging to levels not seen since the Great Depression.



A common conclusion is that reallocations take a long time, and labor markets remain under strain for a substantial period. The deep wounds from such reallocation shocks take multiple years to repair while labor markets transition to a true, post-COVID "new normal."

The damage to the labor market already is extensive. Although the May jobs report brought good news – including the hiring of 2.5 million workers and a lower-than-expected unemployment rate – it paints a picture of a labor market that has sustained deep wounds. Some 21 million people remain unemployed, and nearly 15.5 million were classified as having lost their jobs only temporarily and expecting to be rehired within six months.

Had these workers in the latter category been classified as unemployed instead of temporarily laid off, the official unemployment rate would have been above 16% instead of the 13.3% reported.

The broadest measure of labor-market impairment, the so-called U-6, or underemployment rate, is 21.2%, just marginally below the previous month's rate of 22.8%. Therefore, we can say that one fifth of the potential labor force is unemployed or underemployed.

The labor market impairment could last years, while reallocation proceeds and the economy recovers slowly from the COVID-19 shock. Many jobs will not come back, as firms in impacted industries cease operations.

The consensus forecast for 2020 unemployment is 9.5%, not far from the Federal Reserve's most recent projection for the year. Both consensus and the Fed see unemployment falling to around 7.5% in 2021. The uncertainty around the jobs market recovery is very high, however; the Fed's median projection for the unemployment rate is 6.5%, with a very wide range – between 4.5 and 12%.

Consensus (and the Fed's best-case scenarios) are more optimistic than we are; we see unemployment rates above 10% this year and only marginally below that in 2021.

Barrero et al estimated that 42% of the layoffs will turn permanent and reallocation should lag job destruction by at least one year. These estimates are grounded on four potential concerns going forward: unemployment benefits exceeding expected earnings, employer payroll subsidies, licensing restrictions impeding mobility and regulations on business formation.

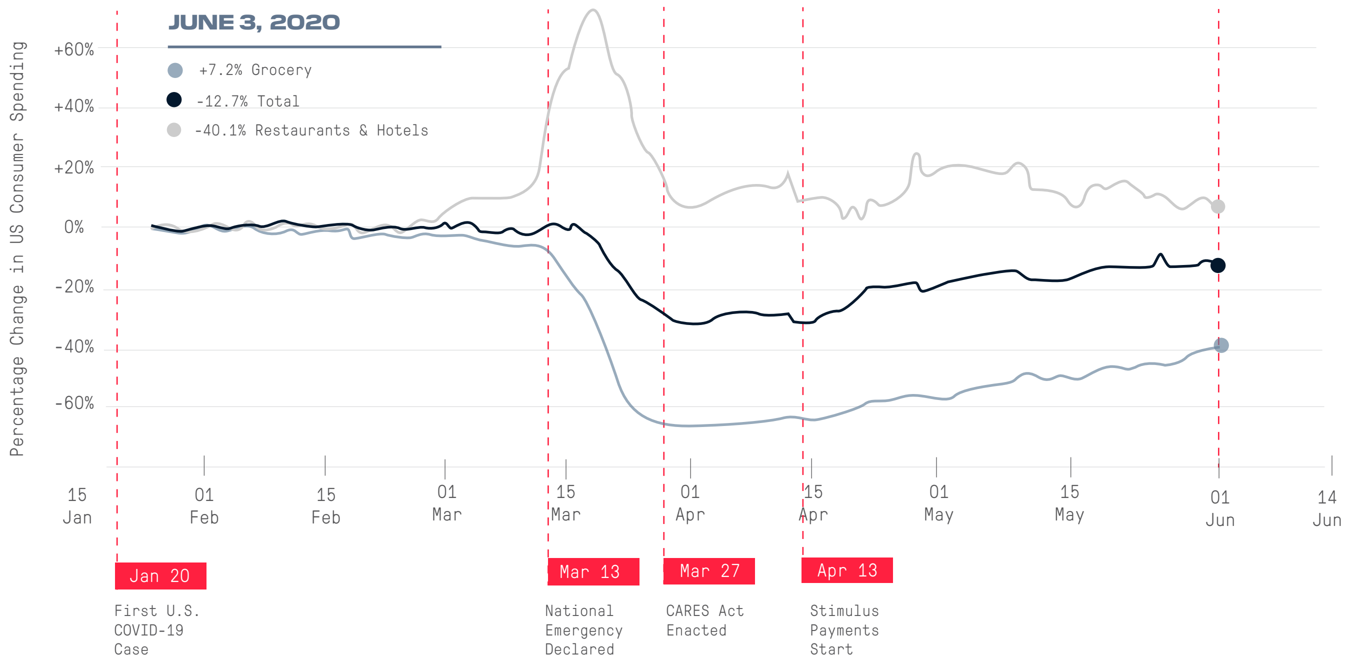
MAPPING THE RECOVERY

For example, we estimate the hardest-hit industries today – which include education, entertainment, travel, and food and accommodation – will not recover to pre-COVID levels of activity by the end of this year and instead will do so slowly during 2021.

Before the economic downturn, those sectors collectively employed

MONEY, MONEY, MONEY

In the United States, as of June 3, 2020, total spending by all consumers decreased by 12.7% compared to January 2020.

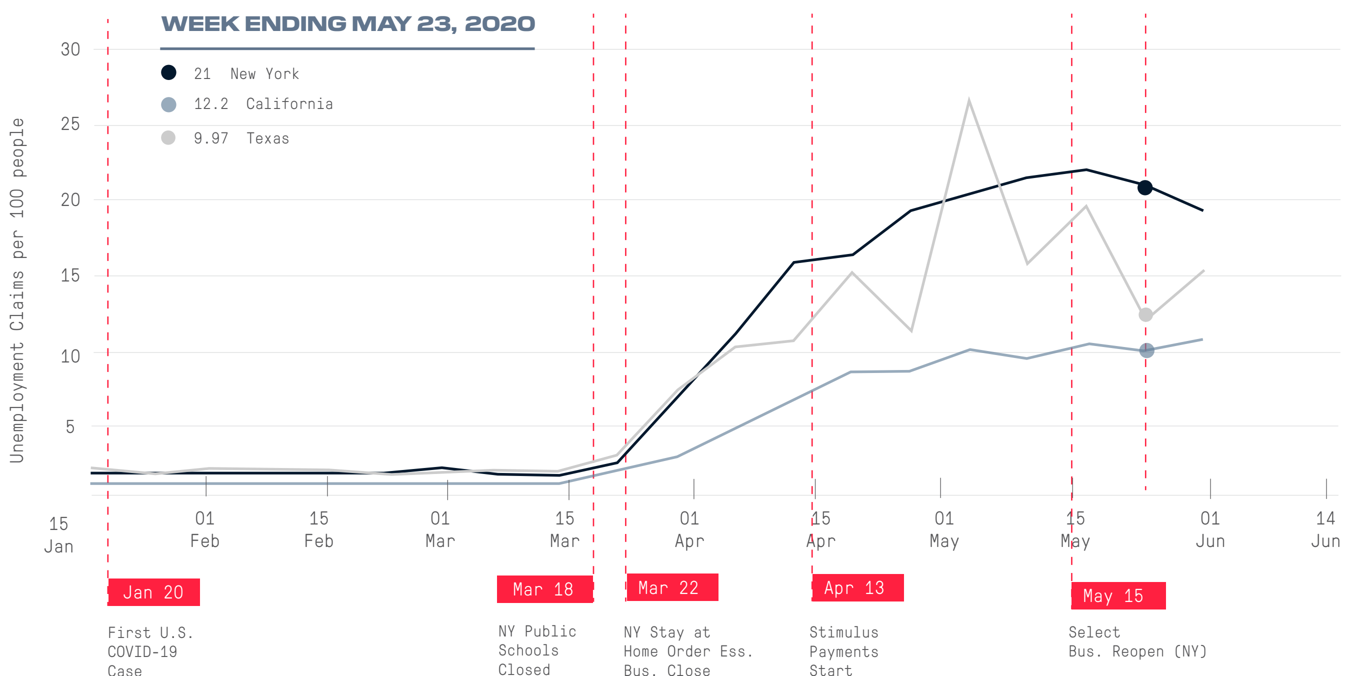


SOURCE: OPPORTUNITY INSIGHTS

* Change in average consumer credit and debit card spending, indexed to January 2020. Data as of June 13, 2020

WORK FOR HIRE

In New York, as of May 23, 2020, there were 21 initial and continued unemployment claims per 100 people in the labor force.



SOURCE: OPPORTUNITY INSIGHTS, US DEPARTMENT OF LABOR

* Number of unemployment benefit claims filed with state unemployment offices per 100 people in labor force. Data as of June 13, 2020

We see unemployment rates above 10% this year and only marginally below that in 2021.

more than 40 million workers, or roughly 25% of the labor force. We estimate that in just those sectors alone, there will be six million fewer jobs in these sectors at the end of 2020 and still four million fewer in 2021. This excess labor supply will have to be absorbed into other industries that will emerge on the other side of the recovery in positions of strength.

Those firms and industries with relatively stronger financial situations and/or better competitive positions in their markets (think video conference software) will be responsible for fewer job losses. Technology, certain subsectors of the retail industry (those businesses which can exploit growing demand for contact-free transactions), commercial services that can reallocate business lines to a post-COVID economy, and new lines of business, will recover faster. But they too have suffered severe short-term losses in demand and therefore employment.

Companies with adequate liquidity and financial positions will be able to weather the crisis better, will have to shed fewer jobs, and may be able to resume hiring sooner than firms facing financial distress or stubbornly muted demand as a result of the structural changes the crisis has created.

In general, however, larger incumbent firms will fare better. However the "matching" of firms that have higher demand for workers with the unemployed will be costly and take time. The economic concept of "hysteresis" will be at work. In other words, it is generally easier and less costly for firms to reduce their numbers of employees at the onset of a recession than it is to rehire them. This means unemployment figures soar in the first instance and then come down slowly. Reallocation makes this process even more drawn out and costly.

Current benefits for unemployed workers under the CARES Act expire at the end of July. As of this writing, progress toward renewing the existing policies or enacting new and additional measures is muted at best.

It's important to emphasize that current policy – and any extension after July – would presumably be designed to help bridge the gap during the crisis. Additional policies to encourage job creation and business formation are longer-term requirements.

In part, reallocation shocks are so painful and enduring because aligning job openings with available workers is costly and time-consuming. Employee skills developed for one type of job in a certain industry that no longer has demand for workers aren't necessarily appropriate for other occupations and industries.

Skills can erode if left unused for a period of time, making the pool of labor unsuited for the new jobs for which demand will eventually increase. Job training and temporary support for the unemployed will be needed. ●

John Velis is an FX and Macro Strategist at BNY Mellon Americas.
Questions or Comments? Write to Daniel.Tenengauzer@bnymellon.com, John.Velis@bnymellon.com or reach out to your usual relationship manager.

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