Six Key Questions on U.S. Policy and the Economic Outlook

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Looking ahead to the U.S. economy gradually reopening as policymakers inject record stimulus – all of this in an election year – Libby Cantrill, PIMCO's head of public policy, and Tiffany Wilding, North America economist, assess the key questions and risks.

1) Recently, Congress passed the largest amount of fiscal stimulus in the history of the U.S. What happened, and what is next?

Over the past eight weeks, Congress passed four separate spending bills that amount to nearly $2.9 trillion dollars – more than two times the recovery efforts passed after the 2008 financial crisis. The stimulus includes approximately $720 billion of funding for small businesses, $500 billion for individuals, nearly $300 billion in unemployment insurance, more than $250 billion for healthcare and $150 billion for states and municipalities. Taken together, the response has equaled nearly 14% of U.S. GDP. While these spending bills will be exclusively deficit-financed – we estimate the deficit will exceed $4 trillion this calendar year – U.S. interest rates have barely moved. This is partly because of the Federal Reserve's asset purchases (see PIMCO's recent blog post for details) in addition to the robust demand for U.S. Treasuries from investors seeking a perceived safe-haven asset.

Despite these extraordinary fiscal measures, Congress is discussing a next phase of economic relief ("Phase 4"). While we expect the process for Phase 4 to be more partisan, especially around the contentious issue of state funding, we believe another spending bill is a question of when, not if – and perhaps as soon as June.

Phase 4 could include additional money for states and municipalities, more assistance for the oversubscribed small business program (the Paycheck Protection Program), and likely another round of stimulus checks to individuals. Altogether, though we expect Phase 4 to be smaller than its Phase 3 cousin (which was $2.2 trillion), it could be in the range of $1 trillion to $1.5 trillion.

2) What is the outlook for the U.S. economy for the rest of this year?

As the growth rate of new COVID-19 cases in the U.S. has slowed, the political focus has shifted toward the process of reopening the economy. Reinforcing the desire to end social distancing mandates, economic data has confirmed the staggering and widespread collapse in activity since mid-March, when many of the stay-at-home orders were put in place. States that have had relatively fewer virus cases have still faced a surge in jobless claims and a collapse in high frequency indicators of activity. In April, the U.S. unemployment rate spiked above 14%, according to the Bureau of Labor Statistics.

However, many parts of the U.S. haven't yet secured adequate hospital supplies or surge capacity, nor is there a nationwide testing and tracing system. Therefore, many state and local governments are slowly reopening their economies with social distancing measures still in place: They seek to balance the risk of longer-term economic damage from prolonged business closures with the risk of another severe virus outbreak. But lifting mandates may not change consumer behavior in the absence of vaccines and other therapeutic treatments. And in any case, threading this needle is going to be increasingly difficult for many firms, especially small and midsized enterprises (SMEs) that have been hit particularly hard by this crisis. According to a 2019 Fed survey, one in five *healthy* SMEs would be forced to close if it faced two months of lost revenue.

Overall, we expect U.S. economic activity to accelerate in the second half of May when the majority of states' stay-at-home orders expire. But growth is unlikely to snap back to pre-crisis levels right away. Instead, the path to recovery will likely be gradual and uneven across sectors and regions. Small and midsized businesses, which entered this period with falling profits and rising leverage, appear particularly vulnerable. And while Congress has moved at an unprecedented speed, more fiscal measures are likely needed to ensure a relatively quick recovery.

3) What are risks to that outlook?

The path of the pandemic and timing of reopening remain the largest risks to our outlook. As businesses are allowed to reopen over the next several weeks, it will be critical to monitor the extent to which activity and hiring rebound and the extent to which new virus cases accelerate. A prolonged period of paltry activity that results in widespread business failures or a quicker start that contributes to another outbreak both pose political and economic risks that policymakers must weigh.

4) How do we expect COVID-19 and its economic ramifications to affect November's presidential election?

While a rash of recent polling shows Vice President Biden leading President Trump, national polling this early in the election cycle is seldom reliable. With little clarity about the trajectory of the virus – and the extent to which voters may hold President Trump responsible for the economic fallout – it is too soon to draw any real conclusions, except that like in 2016, it most likely will be another close election.

While national polls garner significant attention, the presidency will be determined – once again – by a handful of swing states. Most important in this election cycle are Arizona, Florida, Pennsylvania, Michigan, and Wisconsin. It is notable that two of these states – Michigan and Pennsylvania – have disproportionately shouldered the economic burden of the pandemic fallout, seeing nearly one in every four individuals of its labor force file for unemployment. Nevertheless, Trump's approval ratings across all five states have held up for now, but his popularity and the economic metrics in these states are worth monitoring.

5) What else should investors pay attention to in the next few months?

Investors should expect more saber-rattling on China in the coming months. Not only are there legitimate questions about China's handling of the coronavirus outbreak, but President Trump – perhaps rightly – sees the issue as a political winner for his reelection: Recent polling suggests that the majority of Americans have a more negative view of China than at any time in recent history. It is too early to say whether the tough talk turns into more punitive action against China, although we would expect the U.S. to pursue other actions – such as export controls, visa and travel restrictions, and sanctioning of individuals – before increasing tariffs given the potential harm to the economy and because the U.S. has already implemented tariffs on $360 billion of goods from China. We also cannot rule out President Trump pulling out of the Phase 1 trade deal and escalating the trade war once again, though this is not our base case.

6) What is the outlook for congressional elections in November?

Given how important a cooperative Congress is to advancing a president's economic agenda, the composition of Congress could be just as important for financial markets as who sits in the White House in 2021. At this point, the House of Representatives looks likely to stay in Democratic control given the large majority Democrats have going into the election along with recent trends: Democrats have gained House seats in five of the six previous general elections.

The Senate, on the other hand, could be up for grabs. Republicans currently control the Senate 53-47 and are defending 23 of the 35 Senate seats up for reelection. Of those 23, three seats appear very vulnerable (Arizona, Colorado, and Maine), while several others are competitive. At the same time, only one seat seems very vulnerable for Democrats (Alabama) and one is competitive (Michigan). Given the overlap of the competitive Senate races and the swing states for the presidential election, it seems that Senate control could very well go in the same direction as the White House. But whichever party ultimately wins control of the Senate, we expect it will only be by a seat or two – or we may even see a 50-50 split (and in that case, the vice president – and hence the White House – casts the tiebreaking Senate vote).

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