Economic Analysis

2Q20 GDP: Worst quarter on record overshadowed by strengthening pandemic headwinds

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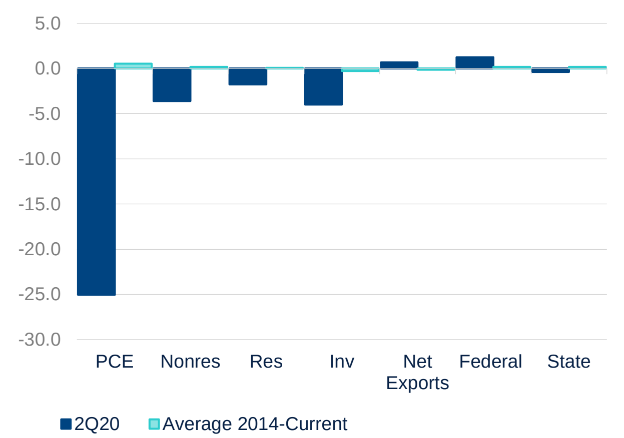
July 30, 2020

In line with our projections for the impact from the pandemic in the second quarter, GDP dropped by 32.9% (BBVA: -32.6%) on an annualized basis, marking the largest drop in official quarterly GDP statistics and likely the steepest decline in over-the-quarter growth since 1937, in the aftermath of the Great Depression. Since 4Q19, real GDP has contracted more than $2tn, implying a drop of 9.5% YoY –the worst since 1946. Outside of positive contributions from the federal government, supported by a 60%QoQa increase in nondefense federal consumption related to the PPP program and other support, there was an across-the-board drop in consumption, investment, exports and state and local government consumption and investment. The massive drop in imports (-59%) also helped to limit the magnitude of the fallout. Given the level of social distancing and mandatory lockdowns implemented during the quarter, the unprecedented drop in GDP was not a surprise. However, the rise in the number of COVID-19 cases since mid-June and high degree of uncertainty have raised doubts around the potential snap back in the third quarter and has lowered the likelihood of the "V-shaped" recovery.

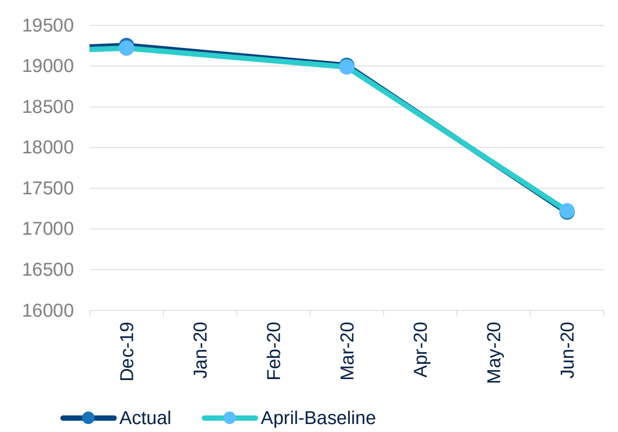
The idiosyncrasies of the Covid-19 pandemic have led to unusual co-movements in consumption. Overall, personal consumption expenditures dropped by 34.6% in the second quarter, with goods declining by 11.3% and services falling by 43.5%. Within goods, consumption of motor vehicles and recreational equipment actually increased whereas purchases of household furnishings fell by 10.6% while consumption of clothing and footwear declined by 48%, pushing it to levels not seen since 2009.

Figure 1. **Contributions to Growth,** (PP)



Source: BBVA Research, BEA & Haver Analytics

Figure 2. **Real GDP: Actual vs. BBVA Forecast** (SAAR, Bn 2012$)

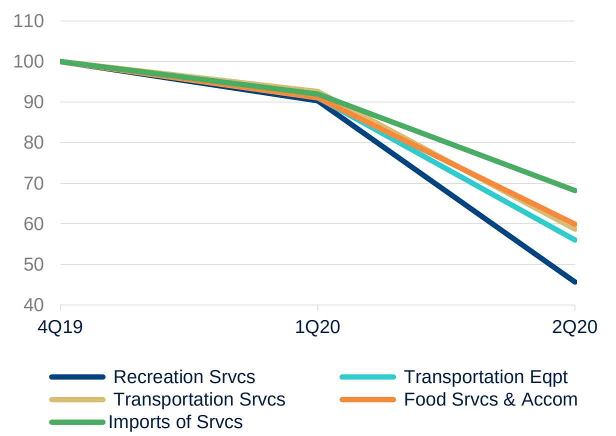


Source: BBVA Research & BEA

Unsurprisingly, while goods consumption was mixed, notwithstanding growth in household utilities and financial services, the service sector plummeted to their lowest level in four years. For example, healthcare services experienced a historic drop for the second straight quarter, as non-essential hospital procedures and other non-hospital related health care services such as dentistry and optometry were shut down or avoided. Likewise, given the degree of voluntary distancing, restrictions on foreign and domestic travel and lockdowns in the beginning of the quarter, transportation services dropped 83.9% while recreational services, which includes concerts, parks, sports centers, theaters and museums dropped by 93.5%, reaching their lowest level since 2002. Similarly, food service and accommodation fell more than 80% on an annualized basis, erasing more than $400bn since the end of 2019.

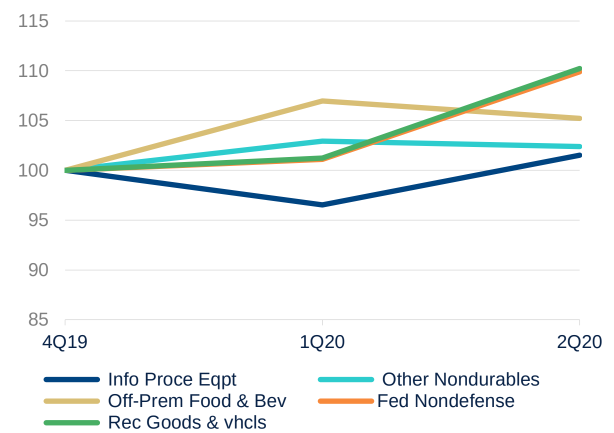
Real private investment also dropped considerably, as firms were unable to anticipate the bottom of the crisis given the significant uncertainty, unprecedented nature of a pandemic and frictions associated with relocating capital to what will be the most productive sectors in the post-pandemic world. The mining sector was also reeling from an unprecedented drop in oil prices, resulting in a 77.9% drop in investment in mining exploration, shafts and wells.

Figure 3. **5 Worst Performing Sectors** (Index 4Q19=100)



Source: BBVA Research, BEA & Haver Analytics

Figure 4 .**5 Best Performing Sectors** (Index 4Q19=100)



Source: BBVA Research, BEA & Haver Analytics

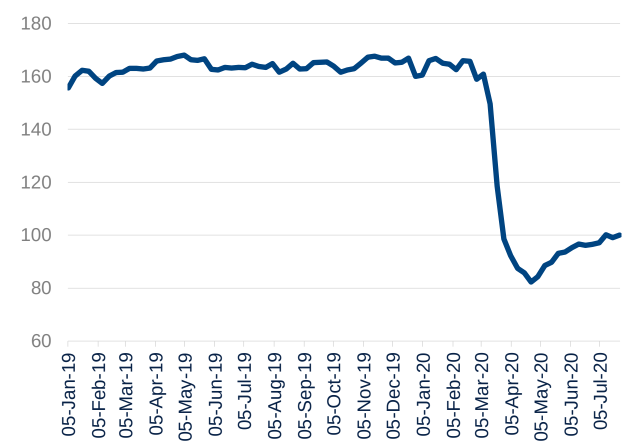
With the likelihood of never returning to the previous norm, investment in transportation equipment and nonresidential structures dropped by 85.7% and 34.9%, respectively. However, with the rapid uptake in video-conferencing and virtual services, contactless purchases and remote working, investment in information and processing equipment surged, growing 22.3%. Meanwhile, residential investment plunged 38%, which is only a fraction of the decline during the housing meltdown in 2006-08.

Significant headwinds also dampened trade, with total trade flows falling $1.1Tn over the quarter on an annualized basis, representing almost 7% of GDP. While more draconian lockdown and distancing measures implemented abroad led to significant drag in exports, net exports contributed 0.7pp to growth, as the drop in exports was more than offset by the drop in imports, which reached their lowest level since 2009.

In total, with the four rounds of fiscal stimulus, nondefense federal spending grew 39.7%, contributing 1PP to growth. While a bulk of the stimulus was represented in either personal consumption or savings, the non-negative contribution helped to counteract the significant headwinds at the state and local level, which is experiencing significant budgetary hardships. Going forward, budgetary shortfalls could require more meaningful transfers from the federal government, if these areas are to avoid a nontrivial pullback in essential services, employment and investment.

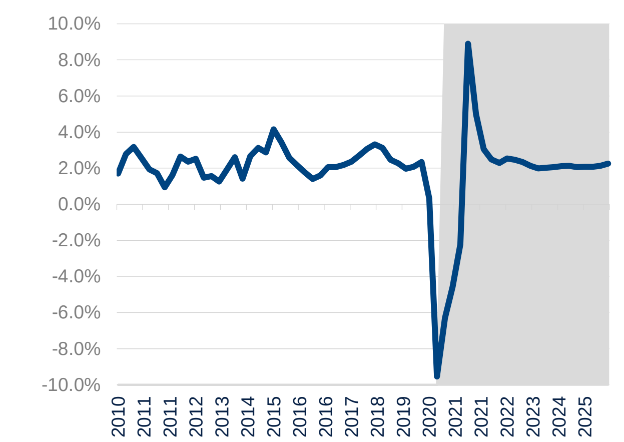
Given that growth for the 1H20 has been exactly in line with our outlook since April, we are maintaining our expectations for growth in 2020 of -5.1%. However, when looking into 2H20, recent spikes in the number of Covid-19 in hotspots around the country and the shift to more cautious behavioral responses, as a result of the surge in case levels, suggests that the risks are firmly tilted to the downside. In fact, our weekly activity index and other high-frequency indicators suggest that the pace of the recovery has slowed since the second half of June.

Figure 5. **BBVA Weekly Activity Index** (Index Jan-90=100)



Source: BBVA Research, BEA & Haver Analytics

Figure 6 .**Real GDP** (YoY%)



Source: BBVA Research

The recent rise in cases, which is seen by most experts as part of the "first wave", has shown that outright containment of the virus prior to a vaccine is unrealistic and thus the probability of subsequent waves is extremely high. The heterogeneous policy response in the U.S., which accounts for 27% of global cases, has led to declining case levels in some areas and surging case levels in others suggesting that the country could also face a whack-a-mole scenario, where cases asynchronously ebb and flow across states and regions. Moreover, research suggests that coronaviruses tend to display a nontrivial degree of seasonality implying that there remains a possibility for a true "second wave" in the fall or winter -when seasonal flu viruses are more common- which has the potential to heavily weigh on growth prospects for the year.

While there remains a high probability of additional monetary accommodation and fiscal support in 2H20, the recent surge in cases, elevated uncertainty, global recession and resulting pullback in activity shows that fiscal and monetary policy will not be enough to avoid more negative economic outcomes if the health crisis persists. For example, new unemployment insurance claims have increased in the past two weeks and remain 4 times higher than the historical average. Ultimately, economic and health outcomes will be interwoven for the foreseeable future, or until there is a widely available and viable vaccine.

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