

Economics Group

Special Commentary

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Home Economics

The U.S. economy is entering a major, but hopefully short, recession. Deliberately stopping the economy in order to prevent the spread of a virus and backfilling the hole left by missing private investment with the largest peacetime disbursement of federal dollars is something that's never been done. Without any sort of precedent upon which to base analysis, putting hard numbers into a forecast comes with greater than usual uncertainty. The Federal Reserve opted to drop its Summary of Economic Projections after its latest meeting citing this very uncertainty. Sometime in the middle of March, America went home and shut the door and the way households consume in the world's largest economy changed; maybe not forever, but at least for a while. This special report looks at how consumer spending may change as a result of the outbreak while households are confined to their homes.¹

The way households consume has changed, at least for a while.

Implications of Stay at Home Orders

The world faces an unprecedented challenge trying to contain COVID-19. After the virus originated in China in early January, the first United States case was reported in King County, Washington on January 22. In the two months since, the U.S. case count has shot up to just shy of 400,000 and spans all of the nation's 50 states (Figure 1). That means the world's largest economy has the most cases of any country, comprising more than 25% of total cases to date.

Figure 1

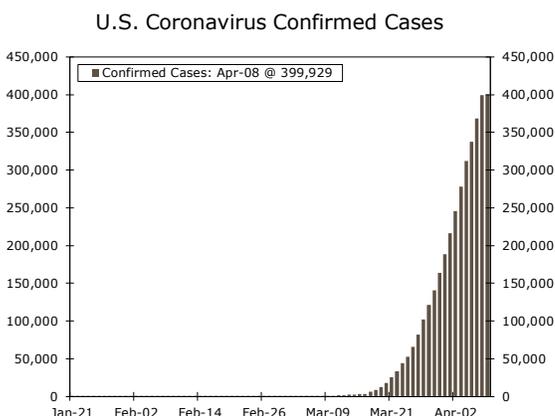
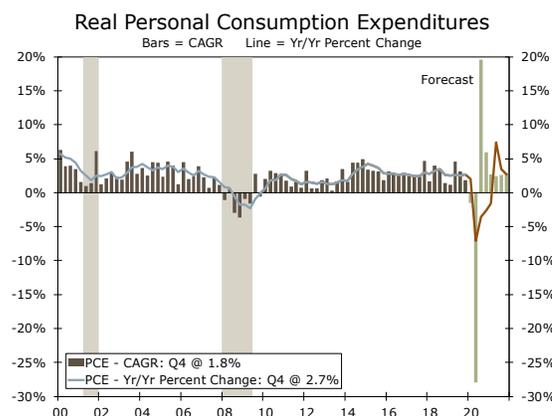


Figure 2



Source: Bloomberg LP, U.S. Department of Commerce and Wells Fargo Securities

State and local governments have made efforts to combat the virus. Forty-three states have issued stay-at-home orders with exceptions for 'critical infrastructure industries', or essential businesses like healthcare, law enforcement and food & agriculture. These guidelines hope to shutter families in their homes to slow the spread of the virus, but in doing so they deliberately bring the U.S.

¹ In a way this exercise is an etymological return trip. The word *economics* itself comes from two ancient Greek words οἶκος, meaning *house* and νόμος, meaning *custom or practice*.



economy to a halt. As a result, ‘non-essential’ businesses are forced to temporarily close their doors as individuals limit daily movement, and particular industries, like airlines and restaurants, have already been disproportionately hit by shelter-in-place restrictions.

The federal government has provided some relief, as its recently passed CARES act will deliver assistance to individuals, through direct payments and a temporary boost to unemployment insurance, and to businesses impacted by containment efforts. Other measures like the 60-day moratorium on foreclosures should provide assistance to many Americans who may have lost their job and cannot meet basic expenditures like mortgage payments. But these federal actions will merely keep individuals afloat. More plainly, it simply may soften the blow to personal consumption by helping individuals meet ‘necessary’ expenditures, such as spending on rent and groceries, but make no mistake consumer spending is set to plunge in the near-term.

How We Got to Our PCE Forecast

Never before has the U.S. deliberately ground the economy to a halt as it has today. Without any sort of precedent upon which to base analysis, putting hard numbers into a forecast comes with greater-than-usual uncertainty. Nonetheless, it is our job, and we had to start somewhere.

We began our analysis by pulling the most detailed breakdown of personal consumption expenditures (PCE) available from the Bureau of Economic Analysis and identified the largest quarter-over-quarter (QoQ) decline per consumption category on record. We doubled each of the worst declines and used that as our starting point for each of the spending components. Then, we went through line-by-line and adjusted categories that were apt to see the consumer behave differently. For example, we lifted some categories on non-durable spending, like food at home, to reflect that people are currently getting more from the grocery story. We of course also cut spending on some of the obvious categories, like new cars to reflect the fact that stay-at-home orders prevent consumers visiting lots and new auto sales typically come under pressure as confidence weakens.

Summing up the various levels of spending in our detailed analysis, we came up with a 27.9% annualized pace of decline in the second quarter (Figure 2). One could reasonably question that approach to different spending categories, but our expectations are not far afield from the preliminary data trickling in. While most economic data to date lags the virus-related effect, some high-frequency public data have already exhibited rapid declines in consumption. At first, the most obvious decline was in the airline industry. Besides press reports of airlines slashing routes in response to international travel restrictions and caution against domestic travel, the number of people passing through TSA airline security is down more than 95% compared to last year (Figure 3). With such a rapid decline in air travel it is of little surprise that hotel occupancy rates have also plummeted. According to STR, hotel occupancy is less than 35%, compared to roughly 70% this time last year (Figure 4). But, the leisure & hospitality sector is set to get hit more broadly.

Forecasts today come with greater-than-usual uncertainty.

Figure 3

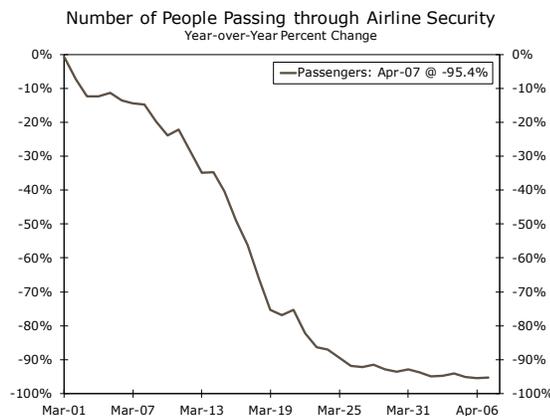
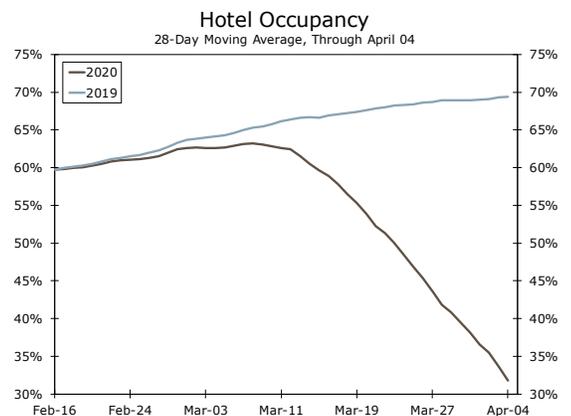


Figure 4



Source: Transportation Security Administration, STR and Wells Fargo Securities

Restaurant reservations, as measured by OpenTable, have fallen off a cliff compared to last year, as many restaurants around the country are closed and those that are open are limited to take-out orders (Figure 5). Consumer outings in general are down almost across the board, evidenced by reports of traffic congestion, and thereby pollution levels, drying up in most major cities. Limited movement will weigh on all sorts of personal consumption. Working from home prevents a commute, which decreases gas consumption and perhaps cuts the visit to the coffee shop or deli for lunch. Malls and movie theaters are closed across the country and cruises have been suspended. All of these things prevent discretionary consumption, and the list goes on.

Figure 5

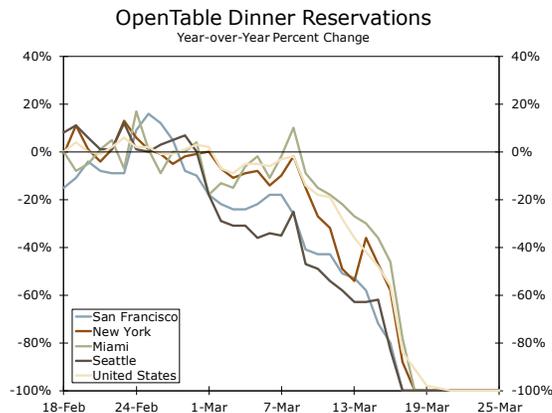
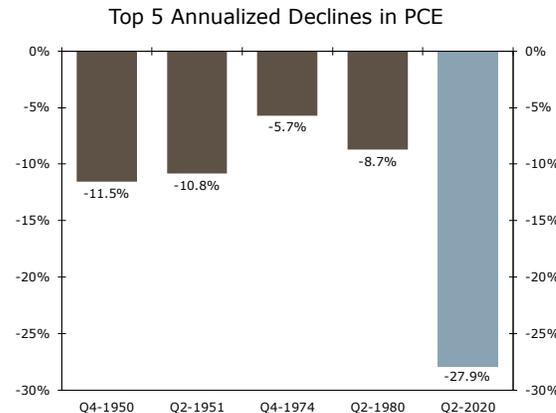


Figure 6



Source: OpenTable, U.S. Department of Commerce and Wells Fargo Securities

But there are also areas of consumption apt to see rapid gains. Widespread media coverage and anecdotal data we hear from customers around the country attest to the increased spending at grocery stores and warehouse clubs. Our colleague who covers economic trends in agriculture and related supply chains observed, “every week is Thanksgiving now at the country’s grocery stores.” Still the surge we expect to see here will not be enough to offset the coming drop in other categories.

Admittedly, there is more uncertainty around our forecast than normal. But, when we are talking about the size of decline we have penciled in for the second quarter, the direction and magnitude are the most important. If realized, the 27.9% rate of decline in PCE would be more than double the largest quarter-over-quarter annualized rate of decline on record (Figure 6). To find the next largest decline you have to go back to the fourth quarter of 1950, when PCE declined 11.5%.

What to Expect from Consumer Confidence and Retail Sales

So far, we only have soft economic data to gauge the consumer reaction to the COVID-19 crisis but even these measures show sharp declines. The fact that consumer confidence “only” fell 12.6 points in March was actually a better outcome than the drop of more than 20 points expected by the consensus (Figure 7). The more-modest decline may have had to do with the fact that the cutoff for responses was March 19, certainly time enough for coronavirus concerns to be reflected, but perhaps not in the more pronounced way many expected. In another widely-followed survey, the University of Michigan’s March consumer sentiment index posted the largest monthly drop since October 2008.

On April 15, the Commerce Department will publish retail sales figures for March, which will be one of the first hard indicators for how the consumer is faring during the pandemic. Obviously, the full scope of the crisis was not yet a front-of-mind consideration for many households in the first half of the month, but by month’s end, everybody was awake to the scope of the crisis.

We expect the March retail sales report to be a mixed bag. Bars and restaurants typically make up a 10-15% share of retail sales, but by the second half of March, and certainly by April, these establishments will have been reduced largely to only take-out and delivery suggesting steep declines in activity.

Q2 may be the worst quarterly decline on record for PCE.

Warehouse clubs and grocery stores stand to see initial gains.

Many other categories will be down but there are bright spots which should get a big boost. Grocery store and warehouse clubs together typically account for a little less than a fifth of all outlays in the retail sales report, but they will likely make up a much larger share in March, though probably not enough to prevent a headline decline. Still, grocery and warehouse stores could see monthly increases that shatter all-time records.

Grocery store spending is typically a steady business with predictable seasonal patterns. If Easter falls in March, it boosts sales, but otherwise it is a seasonally slow time for these retailers. Of the various months of the year for retail, February accounts for the lowest share of sales for both warehouse clubs and grocery stores, and March isn't far behind. March is the third slowest month for warehouse clubs and the fifth slowest month for grocery stores (Figure 8).

Figure 7

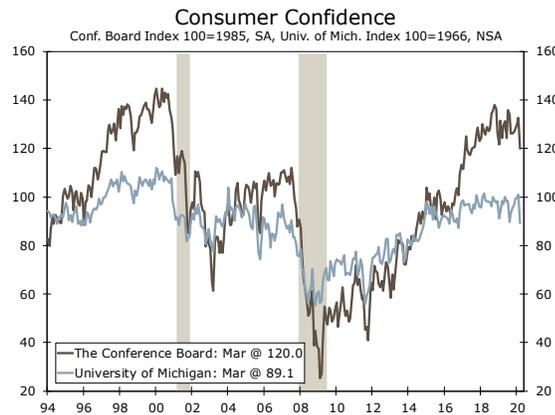
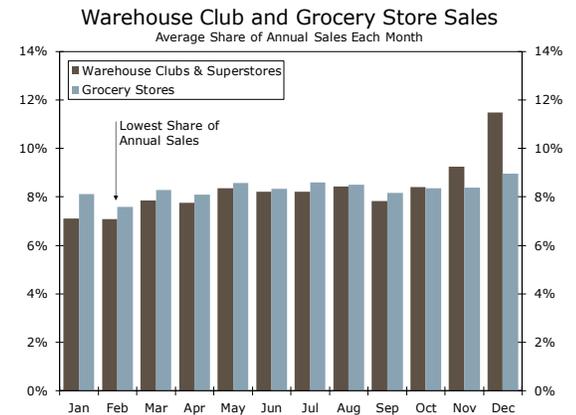


Figure 8



Source: The Conference Board, University of Michigan, U.S. Dept. of Commerce and Wells Fargo Securities

Of course at some point, the panic-buying will abate and practical considerations of household inventory management will overtake the hoarding mentality. More simply: how many times will people freak out and buy all the toilet paper they can fit in their vehicle? So while grocery stores and warehouse clubs may post record month-over-month increases in March, the subsequent months are apt to find a lower gear, though the April-to-July period will likely be much stronger than a typical year just given the lack of other options for people to eat.

Gas stations are likely to see steep declines as well. First, gasoline prices were sharply lower in March compared to February, which will pull nominal sales figures lower even if volumes were steady. With people driving less or not driving at all, however, volumes will be lower as well.

We already know that wholesale auto sales cratered in March. The real question for the retail sales report will be how many auto sales got buttoned up before St. Patrick's Day. Because it is unlikely that buying a new vehicle was at the top of anyone's list as the pandemic consumed the national conversation and stay-at-home orders vary by state in terms of whether or not auto sales can continue. In many states, the service departments are open but the sales are lots temporarily closed. Motor vehicles and parts usually comprise about the same share of spending as grocery and warehouse clubs combined; though that will clearly fall in March.

Building material and gardening stores have announced reduced hours to allow more time for workers to re-stock shelves amid increased demand. These big-box retailers are also deemed "essential" and thus allowed to stay open. Both of the two major players in this space have stepped up delivery and curbside pick-up options amid the outbreak. Now that spring has arrived and people have lots of new-found time on their hands, it stands to reason these retailers could be resilient. It remains to be seen how this increased traffic will offset a potential decline in the typical weekday traffic of contractors amid sharp declines in homebuilding activity.

In terms of retail sales categories, the obvious winner when you cannot go to the store is the "non-store retailers" as they are called in the official report but better known as online shopping. Amazon

But, panic-buying will abate and practical considerations will overtake hoarding mentality.

has made headlines for hiring people in droves in recent weeks even as other service industries shed jobs at record rates. Wait-times for Amazon deliveries, which before the crisis were “same day or tomorrow” for a number of items is now stretched out to several days or longer or simply unavailable for in-demand items like laptops, monitors and (of course) toilet paper.

Electronics and appliance stores are apt to be mixed as well. Building out the home office may help electronic stores, if only for a while, but appliance purchases will likely be put on hold. Elsewhere it gets tougher to make the optimistic argument for other store categories like clothing & shoe stores, sporting goods, department stores, and furniture stores.

The bottom line for retail sales is that despite a few clear winners like online vendors, grocery stores and warehouse clubs and potentially building supply and garden centers, most other stores could see the worst month for sales activity on record; if not in March (since the early weeks were still OK) then in April.

When Cabin Fever Breaks: Pent-Up Demand...Literally

The outbreak threw a wrench into almost every economy on earth, particularly the United States where there are more cases than any other country. When you look at the way it upended ordinary life in America, it forces a realization that anyone who has stepped foot in a grocery store in the past few weeks has confronted. The quietly functioning system upon which our daily lives thoroughly depend, specifically how bread, milk and produce find their way onto our shelves, has been turned upside down.

The ISM Non-Manufacturing Index, a proxy for service sector activity, fell in March, but not nearly as much as many feared. A critical factor was the fact that supplier deliveries soared to a record high. Among the different ISM components, supplier deliveries is the only one that is an inverse indicator. The idea here is that deliveries slow down as the economy improves. More plainly: it's tough to get the stuff you need to run your service sector business when the economy is really humming. That may indeed be the case for online retail, warehouse clubs and grocery stores, but there is a supply factor to be considered here as well. The slow supplier deliveries are occurring amid a drop off in arrivals at the nation's top trading ports and perhaps also reflect supply-chain constraints.

No one knows when we will be out of the woods with this awful virus, estimates vary, and we will be among the first to concede that things could play out differently than what we presently expect. But our forecast is predicated on the notion that the worst of the fallout for the economy will come in the current quarter (Q2). Our dire forecast for PCE is the main driver of the steep 22.3% annualized decline in GDP during the period. But consumer spending is also what will lead us out after the shelter orders are lifted and social distancing is incrementally rolled back.

Pent-up demand will likely result in strong growth once stay-at-home orders begin to rollback.

Economists typically talk about pent-up demand to describe the way households will put off making purchases during recessions, building up excess demand that is unleashed when the first indicators of recovery emerge. Forced sequestration means people will have gone months without any trips to the barber or stylist, without going out to eat or see a movie or a sporting event, or even more critical services like non-life-threatening medical or dental care.

There may never be an “all clear” or sudden and immediate rollback of stay-at-home orders. Still, forcing everyone to stay home necessitates a sharp decline in spending and by the third quarter, after months of suppressed activity, there will be a coiled spring effect which will likely translate into one of the strongest quarters on record for spending even if social distancing becomes a necessary part of life. Even with that surge in the third quarter however, it will not be until the end of 2021 or perhaps not until early 2022 before the level of personal consumption expenditures return to the pre-recession peak.

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