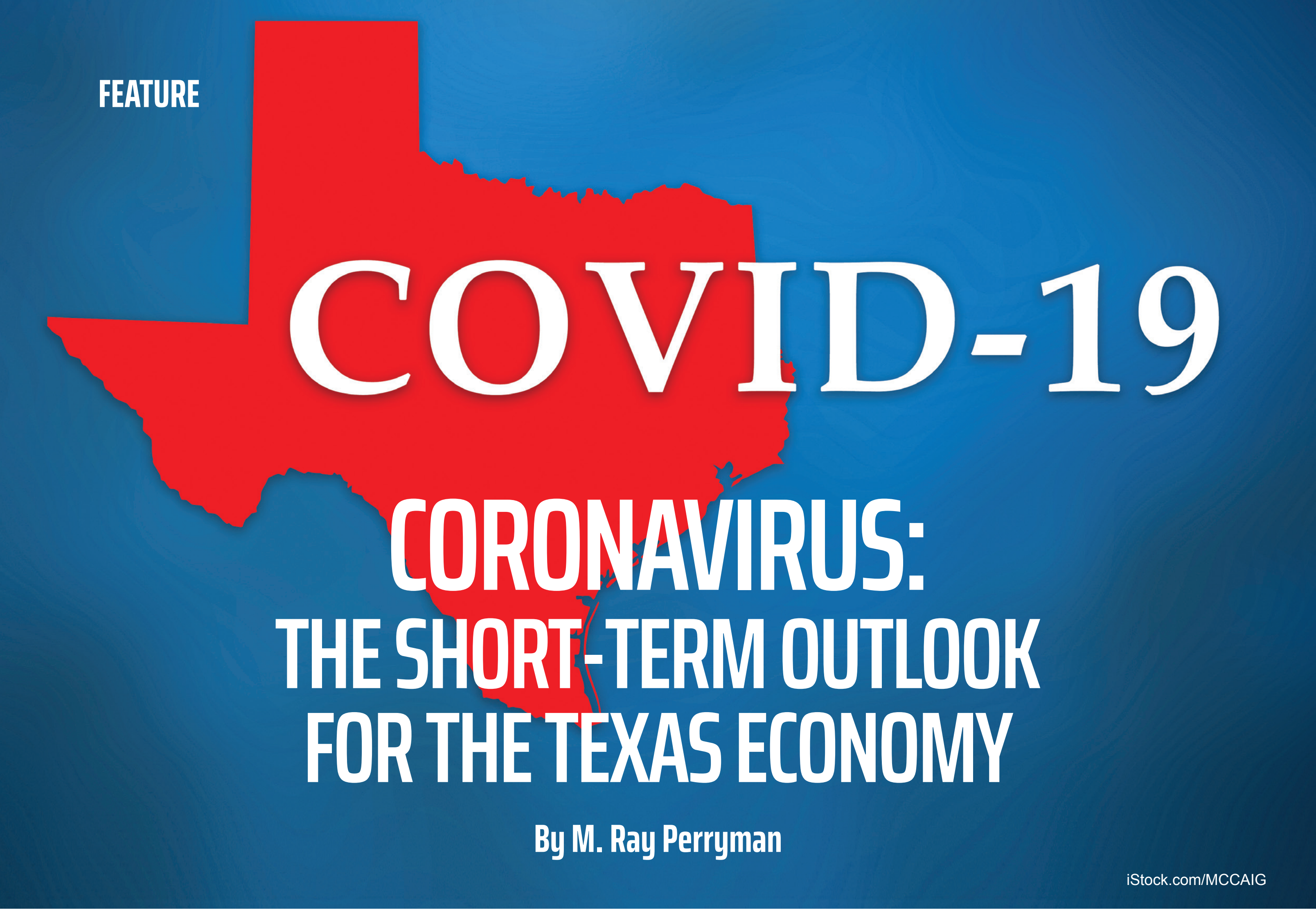


# CORONAVIRUS: THE SHORT-TERM OUTLOOK FOR THE TEXAS ECONOMY

By M. Ray Perryman

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The inevitable result of measures to "flatten the curve" and prevent a major spike in COVID-19 infections has been a strong shock to the economy. Many factors will determine the ultimate effects of the coronavirus on the economy, most of which are highly uncertain at present. The outcomes of reopening the economy and the capacity of businesses to resume normal activities are among myriad phenomena that will play a significant role.

Things are changing quickly and will no doubt be different when you read this article than they are as I write it (mid-June). The discussion below represents what we are seeing at this time.

The Perryman Group's forecast for the Texas economy calls for a significant drop in business activity for 2020, but a return to growth next year and even later this year. Measures taken to slow the spread of COVID-19 have had substantial negative effects, including causing downturns in key export industries such as oil and natural gas.

However, the state is well positioned for recovery and expansion once social distancing requirements can be relaxed and the economy fully reopens (assuming that major spikes in the virus do not necessitate additional business interruptions).

## Economic Recovery from the COVID-19 Pandemic

The massive layoffs and sharp increase in unemployment has led to ubiquitous comparisons to the Great Depression. However, prior to the Great Depression, there were massive structural problems in the economy and policy responses were less well understood. The major harm of the Great Depression was not that joblessness likely spiked above 30%; it was, rather, that it remained there for almost a decade. Unlike the Great Depression, or even the dot-com debacle, the savings and loan mess in the 1980s or the more recent Great Recession, there is not an overarching major structural problem in the economy (such as an overheated market ripe for a crash) that has to be addressed. A combination of unique and unprecedented issues is causing slowing, but as they are dealt with, growth will pick up.

In fact, the May U.S. jobs report brought a gain of 2.5 million jobs and a decrease in the unemployment rate from 14.7% to 13.3%. It was an important positive signal, particularly given that many analysts were anticipating losses of another eight million or more. However, the situation remains challenging and fluid, and the recovery will likely be bumpy.

There are two countervailing forces in the job market. Many companies are continuing to struggle and lay off workers. While initial weekly jobless claims have fallen substantially from peak levels, they remain well above the previous records set during the 2008 recession. Simultaneously, as the economy reopens, some of the most labor-intensive segments (such as retail, bars and restaurants, and personal services) are hiring in large numbers. On balance, there was improvement in overall employment in May.

This pattern is certainly encouraging and consistent with our earlier assessment that, because there were no major structural problems in the economy, it could recover more rapidly than in 2008 (when it took 58 months to restore job losses). It is important, however, to keep things in perspective. The U.S. lost more than 20 million jobs in April and gained about 2.5 million in May, so there remains an enormous gap to bridge.

Much has been made of the fact that May brought the largest monthly gain ever recorded. While this statement is accurate, the increase restores only a fraction of the unprecedented prior loss. Some additional large net gains over the ensuing months may occur given the dynamics of reopening, but this pace will not persist indefinitely.

In addition, subsequent data releases may present a different picture. Job gains are based on a survey of establishments and could be notably revised downward in the next benchmarking if the number of operating locations has dropped. The unemployment rate is based on a survey of households and there may have been some individuals who were classified as employed who were not working due to COVID-19 closures; if these people had instead been counted as unemployed on temporary layoff, the overall unemployment rate would have been several percentage points higher (although the direction of movement should be similar). The Bureau of Labor Statistics has acknowledged this issue.

While The Perryman Group expects economic patterns for the next couple of years to be very different from the firm's projections prior to the outbreak, there is not yet evidence that the long-term outlook for the Texas economy should be modified. Based on current conditions (as of mid-June), it should take about two years to return to prior peak levels even with no major additional disruptions.

## Oil Market Turmoil

In Texas, the oil situation is especially significant to the economy. At the beginning of this year, oil prices were trending in the upper $50s per barrel. As demand dropped in response to COVID-19 restrictions, spot prices fell to a fraction of that level and futures prices actually became negative at times as contracts neared maturity and traders scrambled to avoid having to take delivery of oil at a time when storage capacity would be largely exhausted.

The price decline is due to the combination of (1) plummeting demand as economies and industries around the world shut down due to COVID-19 and (2) rising supply, with threats of even more due to the collapse of talks earlier this year among major global oil producers to try to bring discipline to the market. The subsequent agreement by OPEC+, the U.S., and other nations is not sufficient to rebalance markets due to the unprecedented effects on demand of shutting down huge segments of the world economy, though it is an important step to keep the supply overhang from getting as big as it would otherwise. (As this is being written in June, prices have been restored to the mid- to upper-$30s per barrel.)

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**The industries most likely to see the largest drops in the numbers of jobs include:**

- Accommodations and food services,
- Retail trade,
- Manufacturing, and
- Mining (which is primarily oil and natural gas in Texas).

Although production costs are down sharply in Texas, they are not yet at a level to maintain viability at recent prices. As a result, the situation is leading to significant disruptions in the Permian Basin and the state's other production areas.

The industry has engaged in a rapid shutdown of drilling activity, which ripples through an enormous supply chain and supporting retail and service enterprises in the affected communities and the rest of the state.

Banks that have large energy company loan portfolios are being strained, and mid-stream and downstream investments are being deferred. Adverse effects on oil producing areas are being observed in a dramatic fashion, but the fallout from the situation involves all regions of Texas.

As the economy begins to recover from COVID-19 restrictions and travel prohibitions, oil markets can normalize expeditiously. Prices are already trending toward more normal levels and should recover to sustainable levels for West Texas producers (where costs were falling notably for years before the pandemic) in the next few months.

## This is Not the 1980s

With the oil market in disarray, comparisons are being drawn to the horrific events of the 1980s. While such discussions are both natural and inevitable, they are also both misplaced and incorrect.

One key difference is the sheer speed of the downturn. The prior decline began in early 1982 and did not reach its nadir until a rapid fall in 1986. This time, it unfolded in a matter of weeks.

Moreover, the 1980s debacle occurred amidst a savings and loan and real estate crisis, and ill-conceived reversals in tax policy that led to massive failures throughout the financial system and took years to repair. It was further complicated by the complex geopolitics of the Cold War.

Today, a pandemic arose as the country was enjoying the longest expansion in history with no major structural dislocations. The 1980s downturn came on the heels of the 1970s embargo and energy crisis that brought major cutbacks in energy usage and sluggish demand. By contrast, the current situation arose as a manufacturing boom in emerging countries was driving solid global increases in consumption (and no export ban). Back then, production and known reserves had been declining for decades and the future of the industry was in doubt. "Peak oil" was a common mantra. Presently, we see that:

- Reserves are expanding,
- Technology is evolving rapidly,

- Costs are falling,
- Production is twice its prior peak, and
- There are centuries of supply.

The oil industry in the 1980s was heavily financed by institutional debt, leaving little flexibility to weather setbacks. (A drop of $1 per barrel in 1982 sent the sector reeling.) The recent expansion was fueled by infusions of private equity in the aftermath of the mortgage meltdown and the Great Recession; thus, it is more resilient.

The near-term situation in oil markets is undeniably severe, but it is a temporary aberration stemming from an unprecedented health issue. As the economy reopens, demand for oil will rise and markets will normalize. This is NOT the 1980s.

## Travel Industry Slowdown

Travel has been one of the hardest hit industries during the COVID-19 pandemic. Even as restrictions can be reduced, it will take some time for the industry to recover. Airlines are beginning to add flights in response to increased demand as the economy reopens. While international travel will be somewhat slower to come back, some airlines (such as Southwest) are planning full and even expanding schedules by the end of the year.

American Airlines is expecting to fly about 55% of its domestic capacity in July compared to July 2019. Over time, as conditions become more normal, air travel will likely rebound.

The shift to more remote work and virtual meetings may decrease the need for business travel to some extent, but is unlikely to be a major deterrent to recovery of the travel industry over the long term. Obviously, it is important that the reopening be able to continue in a manner that avoids major spikes in the virus that necessitate additional curtailments.

## Economic Outlook

The Perryman Group's most recent short-term projections for the national economy indicate a decline in real gross product at a -5.47% rate in 2020, representing a loss of more than $1.0 trillion. For 2021, real gross product is forecast to grow by $973.7 billion, a 5.40% rate. Job losses are forecast to total more than 9.818 million on an annualized basis in 2020 (a 6.49% decline), with 5.19% growth expected in 2021.

These job and output losses are reported on an annualized basis. Therefore, many more individuals are likely to be affected for a portion of the year (as an example, an annualized job can be three individuals who are each unemployed for four months) and the annualized loss in gross product will be much larger in the immediate future.

For 2020, The Perryman Group estimates that the Texas economy will experience significant losses due to COVID-19 and the associated disruptions in the oil market. Real gross product is expected to decline by $133.8 billion relative to 2019 levels (a 7.60% loss), while total employment on an annualized basis is likely to drop by almost 861,000 (down 6.48%). Note that job losses are expected to be concentrated in the spring and summer months with some improvement through the year, so reported losses at some points in time will be even higher.

While job losses are currently high and millions of Texans have filed initial claims for unemployment since March, many will return as social distancing requirements are relaxed. In addition, expected economic growth for 2020 has been foregone. When compared to baseline projections before the pandemic, real gross product losses for the year reach $206.3 billion, with more than 1.1 million fewer annualized jobs in Texas relative to pre-COVID-19 expectations.

For 2021, a notable improvement is projected. Gains in real gross product are forecast to be $154.4 billion (a 9.50% increase), while the number of jobs rises by almost 685,000 (up 5.51%). It is expected to take two to five years to return to the level of business activity the state would have otherwise experienced in the absence of COVID-19 and the related measures to prevent a spike in infections.

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## Well Positioned for Growth

Texas is facing COVID-19 issues, as well as a notable contraction in the energy sector. The state economy has been declining steeply at the time of this writing, but is projected to return to growth later this year (although, as noted, the year-over-year numbers are expected to be down considerably).

Because the underlying economy was strong prior to this situation, the decline is likely to be more of a pause than a fundamental change, particularly if safe and effective measures to resume activity are successful. There will definitely be some lasting shifts in both attitudes and actions. Certain behaviors will change and we will forever view the economy through a different lens.

Corporations will likely focus more on the quality of local educational institutions, health care facilities, internet capabilities, equality, and other issues in making investment and location decisions. Greater innovation in health and safety will be a priority.

Diversification of sourcing for inputs may well bring new opportunities for domestic manufacturing and it's likely that interregional competition will be intensified.

Through all of this transformation, however, there is nothing to suggest that the long-term potential of the global economy has been diminished. Texas will clearly face challenges going forward, including providing adequate educational resources and infrastructure development, but remains well positioned for future growth.

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