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SKODONNELL/GETTY IMAGES

Having largely ignored Covid-19 as it spread across China, global financial markets reacted strongly last week when the virus spread to Europe and the Middle East, stoking fears of a global pandemic. Since then, Covid-19 risks have been priced so aggressively across various asset classes that some fear a recession in the global economy may be a foregone conclusion.

In our conversations, business leaders are asking whether the market drawdown truly signals a recession, how bad a Covid-19 recession would be, what the scenarios are for growth and recovery, and whether there will be any lasting structural impact from the unfolding crisis.

In truth, projections and indices won't answer these questions. Hardly reliable in the calmest of times, a GDP forecast is dubious when the virus trajectory is unknowable, as are the effectiveness of containment efforts, and consumers' and firms' reactions. There is no single number that credibly captures or foresees Covid-19's economic impact.

Instead, we must take a careful look at market signals across asset classes, recession and recovery patterns, as well as the history of epidemics and shocks, to glean insights into the path ahead.

What Markets are Telling Us

Last week's brutal drawdown in global financial markets might seem to indicate that the world economy is on a path to recession. Valuations of safe assets have spiked sharply, with the term premium on long-dated U.S. government bonds falling to near record lows at negative 116 basis points — that's how much investors are willing to pay for the safe harbor of U.S. government debt. As a result, mechanical models of recession risk have ticked higher.

Yet, a closer look reveals that a recession should not be seen as a foregone conclusion.

First, take valuations of risk assets, where the impact of Covid-19 has not been uniform. On the benign end, credit spreads have risen remarkably little, suggesting that credit markets do not yet foresee funding and financing problems. Equity valuations have conspicuously fallen from recent highs, but it should be noted that they are still elevated relative to their longer-term history. On the opposite end of the spectrum, volatility has signaled the greatest strain, intermittently putting implied next-month volatility on par with any of the major dislocations of the past 30 years, outside of the global financial crisis.

Second, while financial markets are a relevant recession indicator (not least because they can also cause them), history shows that bear markets and recessions should not be automatically conflated. In reality, the overlap is only about two out of every three U.S. bear markets — in other words, one out of every three bear markets is non-recessionary. Over the last 100 years, we counted seven such instances where bear markets did not coincide with recessions.

There is no doubt that financial markets now ascribe significant disruptive potential to Covid-19, and those risks are real. But the variations in asset valuations underline the significant uncertainty surrounding this epidemic, and history cautions us against drawing a straight line between financial market sell-offs and the real economy.

What Would a Covid-19-Induced Recession Look Like?

Though market sentiment can be misleading, recessionary risk is real. The vulnerability of major economies, including the U.S. economy, has risen as growth has slowed and the expansions of various countries are now less able to absorb shocks. In fact, an exogenous shock hitting the U.S. economy at a time of vulnerability has been the most plausible recessionary scenario for some time.

Recessions typically fall into one of three categories:

- *Real recession.* Classically, this is a CapEx boom cycle that turns to bust and derails the expansion. But severe exogenous demand and supply shocks — such as wars, disasters, or other disruptions — can also push the real economy into a contraction. It’s here that Covid-19 has the greatest chance to infect its host.
- *Policy recession.* When central banks leave policy rates too high relative to the economy’s “neutral” rate, they tighten financial conditions and credit intermediation, and, with a lag, choke off the expansion. This risk remains modest — outside of the U.S. rates are already rock bottom or even negative, while the Federal Reserve has delivered a surprise cut of 50 basis points. Outside of the monetary policy response, the G7 finance ministers have also pledged fiscal support.
- *Financial crisis.* Financial imbalances tend to build up slowly and over long periods of time, before rapidly unwinding, disrupting financial intermediation and then the real economy. There are some marked differences globally, yet in the critical U.S. economy, financial crisis risks are difficult to point to. Some commentators point to the bubble in corporate credit, as seen in significant issuance and tight spreads. Yet, we struggle with the subprime analogy of the last recession, as corporate credit neither funds a real economy boom (as subprime did with housing), nor is the debt held on banks’ balance sheets. Both factors limit the systemic risk of a potential shakeout in credit, though this risk can’t be dismissed entirely. It’s difficult to see Covid-19 contributing to financial imbalances, but stress could arise from cash flow strains, particular in small and medium enterprises (SMEs).

Looking at this taxonomy, and again at history, there is some good news in the “real economy” classification. Though idiosyncratic, real recessions tend to be more benign than either policy recessions or those induced by financial crisis, as they represent potentially severe but essentially transient demand (or supply) shocks. Policy recessions, by contrast, can be, depending on the size of the error, severe. In fact, the Great Depression was induced by perhaps the largest policy error ever. And financial crises are the most pernicious kind, since they introduce structural problems into the economy that can take a long time to be corrected.

What is the Likely Recovery Path?

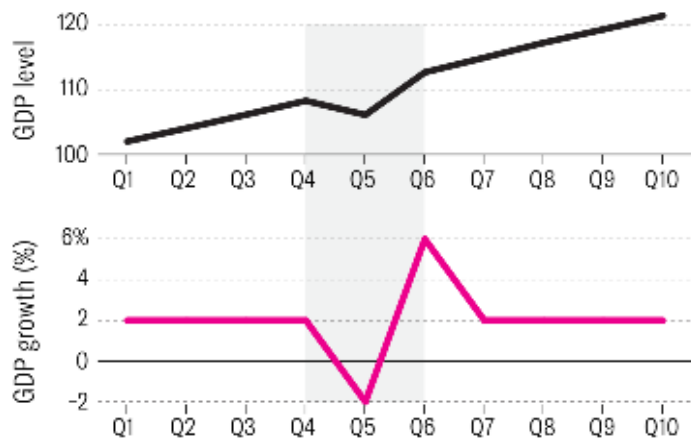
Whether economies can avoid the recession or not, the path back to growth under Covid-19 will depend on a range of drivers, such as the degree to which demand will be delayed or foregone, whether the shock is truly a spike or lasts, or whether there is structural damage, among other factors. It’s reasonable to sketch three broad scenarios, which we described as V-U-L.

- *V-shaped*: This scenario describes the “classic” real economy shock, a displacement of output, but growth eventually rebounds. In this scenario, annual growth rates could fully absorb the shock. Though it may seem optimistic amid today’s gloom, we think it is plausible.
- *U-shaped*: This scenario is the ugly sibling of V – the shock persists, and while the initial growth path is resumed, there is some permanent loss of output. Is this plausible for Covid-19? Absolutely, but we’d want to see more evidence of the virus’ actual damage to make this the base case.
- *L-shaped*: This scenario is the very ugly and poor relation of V and U. For this to materialize, you’d have to believe in Covid-19’s ability to do significant structural damage, i.e. breaking something on the economy’s supply side – the labor market, capital formation, or the productivity function. This is difficult to imagine even with pessimistic assumptions. At some point we will be on the other side of this epidemic.

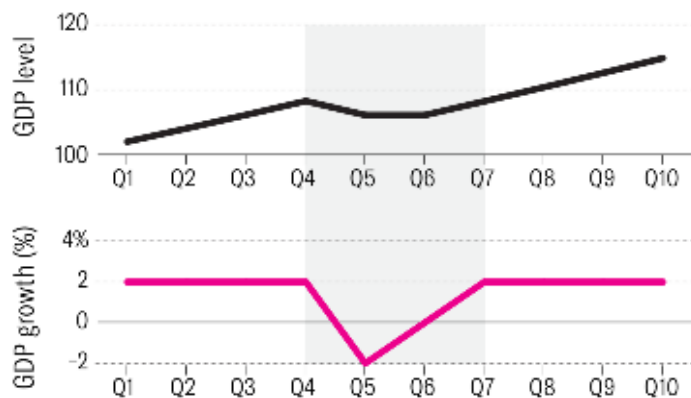
Economic Shock: 3 Scenarios

A V-shaped scenario depicts a classic economic shock, where growth eventually rebounds. In a U-shaped scenario, there is some permanent loss of output after the initial shock. An L-shaped scenario signals real structural damage, with a significant impact on growth.

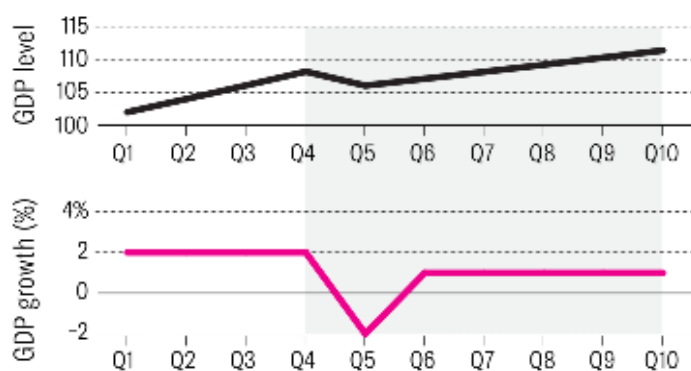
“V” scenario (likely)



“U” scenario (plausible)



“L” scenario (unlikely)



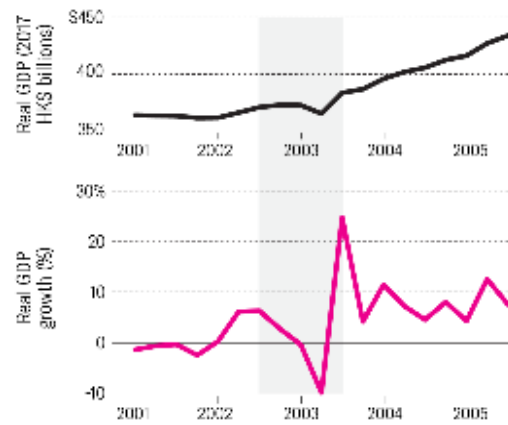
Source: BCG Center for Macroeconomic analysis



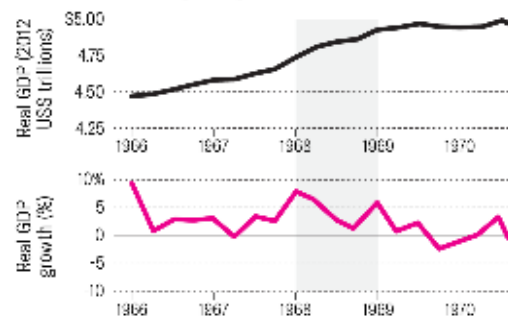
Again, it's worth looking back at history to place the potential impact path of Covid-19 empirically. In fact, V-shapes monopolize the empirical landscape of prior shocks, including epidemics such as SARS, the 1968 H3N2 ("Hong Kong") flu, 1958 H2N2 ("Asian") flu, and 1918 Spanish flu.

Prior Epidemics Were All V-Shaped

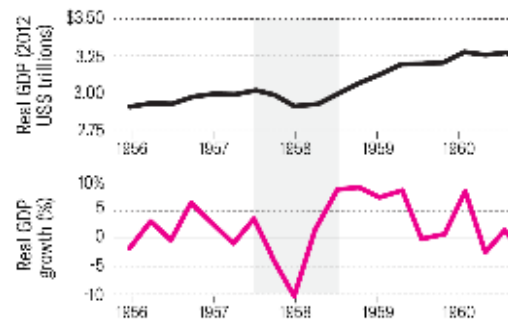
2002 Hong Kong SARS – 288 global deaths



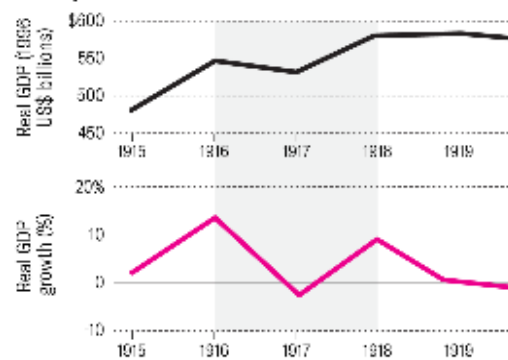
1968 H3N2 ("Hong Kong") flu – 100,000 U.S. deaths



1958 H2N2 ("Asian") flu – 116,000 U.S. deaths



1918 Spanish flu – 675,000 U.S. deaths



Note: Real GDP growth is quarterly except for 1918 when it is yearly.
 Source: U.S. Census Bureau, FRED, (2020) Census and Statistics Department (Hong Kong), FRED (Center for Macroeconomic Analysis) | HBR

Will There be Any Lasting Economic Consequences of Covid-19?

To understand this, we need to examine the transmission mechanism through which the health crisis infects the economy.

If the taxonomy of recessions tells us *where* the virus likely attacks the economy, transmission channels tell us *how* the virus takes control of its host. This is important since it implies different impacts and remedies. There are three plausible transmission channels:

- *Indirect hit to confidence (wealth effect)*: A classic transmission of exogenous shocks to the real economy is via financial markets (and more broadly financial conditions) — they become part of the problem. As markets fall and household wealth contracts, household savings rates move up and thus consumption must fall. This effect can be powerful, particularly in advanced economies where household exposure to the equity asset class is high, such as the U.S. That said, it would take both a steep (more bear market than correction) and sustained decline.
- *Direct hit to consumer confidence*: While financial market performance and consumer confidence correlate strongly, long-run data also shows that consumer confidence can drop even when markets are up. Covid-19 appears to be a potentially potent direct hit on confidence, keeping consumers at home, weary of discretionary spending, and perhaps pessimistic about the longer term.
- *Supply-side shock*: The above two channels are demand shocks, but there is additional transmission risk via [supply disruption](#). As the virus shuts down production and disables critical components of supply chains, gaps turn into problems, production could halt, furloughs and layoffs could occur. There will be huge variability across economies and industries, but taking the U.S. economy as an example, we think it would take quite a prolonged crisis for this to feed through in a significant way. Relative to the demand impact, we see this as secondary.

Recessions are predominantly cyclical, not structural, events. And yet the boundary can be blurred. To illustrate, the global financial crisis was a (very bad) cyclical event in the U.S., but it had a structural overhang. The economy rebounded, yet household deleveraging is an ongoing secular phenomenon — household willingness (and ability) to borrow is structurally impaired, and the collateral damage, structurally, is that policy makers find it much harder to push the cycle just by managing short-term interest rates today.

Could Covid-19 create its own structural legacy? History suggests that the global economy after a major crisis like Covid-19 will likely be different in a number of significant ways.

- *Microeconomic legacy*: Crises, including epidemics, can spur the adoption of new technologies and business models. The SARS outbreak of 2003 is often credited with the adoption of online shopping among Chinese consumers, accelerating Alibaba's rise. As schools have closed in Japan and could plausibly close in the U.S. and other markets, could e-learning and e-delivery of education see a breakthrough? Further, have digital efforts in Wuhan to contain the crisis via smart-phone trackers effectively demonstrated a powerful new public health tool?

- *Macroeconomic legacy*: Already it looks like the virus will hasten the progress to more decentralized global value chains — essentially the virus adds a biological dimension to the political and institutional forces that have pushed the pre-2016 value chain model into a more fragmented direction.
- *Political legacy*: Political ramifications are not to be ruled out, globally, as the virus puts to the test various political systems' ability to effectively protect their populations. Brittle institutions could be exposed, and political shifts triggered. Depending on its duration and severity, Covid-19 could even shape the U.S. presidential election. At the multilateral level, the crisis could be read as a call to more cooperation or conversely push the bipolar centers of geopolitical power further apart.

What Should Leaders Do in Relation to Economic Risks?

The insights from financial markets and the history of analogous shocks can be operationalized as follows:

- Don't become dependent on projections. Financial markets are currently reflecting great uncertainty. A wide range of scenarios remain plausible and should be explored by companies.
- Don't allow financial markets gyrations to cloud judgement about the business you lead.
- Focus on consumer confidence signals, trust your own instincts, and know how to leverage your company's data in calibrating such insights. The impact will not be uniform, and the conclusions will be specific to your industry.
- Plan for the best and prepare for the worst trajectories. Keep in mind that a V-shaped recovery is the plausible scenario conceptually and empirically, but don't let that insight make you complacent.
- Begin to look past the crisis. What micro or macroeconomic or legacy will Covid-19 have? What opportunities or challenges will arise?
- Consider how you will address the post-crisis world. Can you be part of faster adoption of new technologies, new processes, etc? Can you eventually find advantage in adversity for your company, clients and society?

(Editor's Note, March 6): *This piece has been updated to reflect the subtypes of the historic flu outbreaks.)*

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