Economic Insights: **Viral headwinds surge across borders**

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The body blows to world growth just keep coming.

New cases of coronavirus in China have fallen by 80-90% from early February, and manufacturers there are resuming operations. But the surge in new cases outside China suggest the global economy will struggle through mid-year.

Stock markets tanked the last week of February, taking only four days to plunge more than 10%--the shortest time in history. Stocks are more attractive now than in mid-February, but a sustained rally is unlikely until new cases peak outside of China.

Economic summary

After gaining momentum through January, revival from last year's world slump has been interrupted. The recent uptick in coronavirus cases outside China has investors fearing the worst. But it will be some time before we'll know how far the virus spreads. Disruptions are already evident in Italy, Japan, the Middle East, and South Korea. New cases with unknown origin are rising in the U.S. In the worst case, sizeable, lengthy closures would augur against a sharp rebound next quarter, as lost wages can't be recovered. Small businesses with delayed revenue streams may close, causing defaults and credit stress. On the plus side, central banks are accommodative and will become even more so.

If the virus can be contained, there should be enough pent-up demand to supercharge a revival as the virus subsides. Then, the pickup in world growth that was apparent before the outbreak will be delayed, not derailed. This is a downside shock, a large negative event, but, probably, not a long-lasting trend.

In the coronavirus aftermath, a long-term trend for global companies may be a new awareness of the hazards of far-flung manufacturing supply chains. When Mother Hubbard opens her cupboard and finds no goods to sell, producers will reimagine their supply sources. Plant closures in China may accentuate the move to shift production closer to the center of final demand. With labor markets tightening in most developed countries, this would give some impetus to inflation in both the short- and long-term.

Chinese businesses resuming activity

The Chinese Lunar New Year began January 25. The holiday ran from January 24-30, then extended to February 2 after the explosion of coronavirus cases. In Hubei province, location of Wuhan and the center of the epidemic, businesses closed until at least February 13, according to National Bureau of Statistics (NBS) surveys. The manufacturing gauge collapsed from 50.0 last month, exactly break-even, to a dismal 35.7, showing significant contraction. For service businesses, the plunge was to 29.6 from 54.1. Both are record lows.

The good news is that new confirmed coronavirus cases in China numbered 427 on February 28, down from nearly 4,000 daily a few weeks ago. As total active confirmed cases trend lower, quarantines are lifting and businesses are resuming operations. According to Cornerstone Macro, Volkswagen and GM restarted a portion of production; Airbus will reopen its Tianjin plant; and Caterpillar will have most plants in China running. Starbucks has reportedly reopened about 85% of its outlets. The NBS noted that at medium- and large-scale manufacturing enterprises, the resumption rate as of February 25 was 85.6%, rising to an expected 94.7% at the end of March.

Large businesses are restarting much faster than small ones, the latter being more vulnerable to cash-flow problems. Standard Charter's survey on small- to medium-sized businesses showed the worst reading ever, with data history going back to 2014. According to the *Wall Street Journal*, citing survey researchers from Tsinghua and Peking universities, one third of small businesses had only a month or less of cash on hand. Beijing officials are aware of the problems and will make credit available. Interest rates have already been lowered. Plans for more infrastructure spending are ramping up. China has allowed banks to delay recognition of bad loans from small businesses. The size of China's stimulus may rival the surge of 2016.

Real gross domestic product (GDP) in China will surely contract in the first quarter, given several weeks of closures. It's likely, though, that official data will show more optimism. There's little question the economy is now improving from a depressing February. According to Bloomberg, passenger traffic is up to the highest level since the New Year's holiday started. Car sales, truck traffic, and coal usage are all up, but from very low levels. More than half of China's migrant workers are back on the job. Pollution levels are rising, an unfortunate indication of a recovering economy. There will likely be a sharp rebound in activity next quarter assuming some normalcy returns.

Meanwhile, outside China …

Manufacturing may finally have turned the corner in the United States, as output (ex aircraft) picked up nicely in January and regional Fed business surveys are clearly better. Housing activity has been vigorous, with building permits at the highest level since 2007. New home sales soared in January. Consumer confidence stays high as job growth and income gains have been robust.

But cracks are showing beneath the surface. Retail sales decelerated in recent months, despite labor market strength and lofty confidence. A key survey of service businesses weakened in February, driven by falloffs in tourism and other travel-related industries associated with coronavirus.

If the virus doesn't spread meaningfully, there could still be problems with supply chain issues, plus travel and trade from countries harder hit by the virus. For example, a *Forbes* article noted that auto companies have only from 2-12 weeks supply of parts on hand. If the virus is contained, those impacts may remain muted; if not, the risk is serious disruption. Last week's stock market collapse could hit consumer confidence and spending. If the U.S. experiences anything like the closures in China, a mild recession could easily result.

In the Eurozone, tepid fourth quarter GDP led to improving data early this year. Business surveys upgraded further in February from the lows of late last year, even in Germany. Most measures of economic confidence rose, too. That strength will be needed as the coronavirus starts to take a toll.

The virus outbreak in Italy penetrated the industrial heartland. Italy's economy was already vulnerable after the fourth quarter contraction in GDP. Business closures in Lombardy likely mean a first quarter contraction, too. Germany, a key part of global supply chains, is also at serious risk, as trade is a large share of their GDP. The *Wall Street Journal*, citing International Monetary Fund statistics, showed that products from Germany may be significantly harder to replace in supply chains than those from China.

Japan is still struggling after a sizeable fourth quarter GDP contraction and is extremely vulnerable to another downdraft. Early business surveys fell in February, with a sharp drop in the services sector. Japan is a hub for Chinese tourism; about 27% of visitors to Japan come from China, and those sojourners are staying home. The second largest tourist source is South Korea, at 24%; they're also not touring. Japan closed its schools for a month, disrupting life for working families. Japan also has large trade exposures to China and South Korea, as about 20% of exports go to China and 8% to South Korea. If the virus spreads much further, the risk is that the Summer Olympics in Japan could be cancelled.

Investment conjectures

The 12.8%, seven-day rout from the mid-February all-time high on the S&P 500 Index was ugly, agonizing, and swift. But markets had become complacent and valuations pricey after the huge returns last year and the straight-up rally since October from record high to record high. Some downdraft was likely, whatever the cause.

For investors, the situation is extremely fluid. If the virus can be contained, the news flow could quickly turn positive and a sharp stock market rally would ensue. Long-term interest rates would also jump. Or: the news could turn even more negative if new cases spike further and fear of recession spreads. That would accelerate the collapse that took 11.5% off the S&P 500 Index the last week of February. The velocity of risk keeps getting faster.

Central banks will do what they can. The Federal Reserve (Fed) will surely cut the fed funds rate in March by 0.25% to 0.5%. The People's Bank of China will likely lower official interest rates further and drop banks' reserve requirements to pour more credit into the system. A boost in fiscal stimulus is surely going to happen in the Eurozone, the United Kingdom, and Japan. It's already been announced in Malaysia and is expanding in China.

What to do? Our confidence, while shaky, as well as our financial market projections, are undergirded by the view that the worst-case scenario of a moderate U.S. recession will probably not occur, and that China will see a significant economic rebound starting late in the second quarter. This suggests that the growth revival that was underway in January may return in the second half of the year. If that happens, there should be some upside for stock prices and long-term interest rates later this year.

In the meantime, though, a further downdraft in stock prices is likely. No equity rally can be sustained until there's a peak in the number of new virus cases. That's not yet apparent with the big jump in new cases in Italy and Iran. That will also keep long-term interest rates under pressure and likely widen the spread between U.S. treasury yields and those on similar maturity corporate bonds. Those spreads widened dramatically in the final days of February.

The appropriate attitude is to hope for the best but prepare for the worst.

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