Sunday Wrap

Happy Sunday – if that's the right term today,

This past week, the UK Home Office proudly announced that the new blue British passport will be rolled out from the beginning of March to replace the existing (EU) red one – which seems to be the latest in their much-loved symbolic acts of "taking back control" to restore proper British sovereignty. For the occasion, PM Boris Johnson was photographed waving one of those new blue ones to the media, while Home Secretary Priti Patel (the daughter of immigrants now pulling up the drawbridge) said she can't wait to get one herself. The irony, of course, is that this new British passport will be made by a French-Dutch firm at a factory in Poland – and, as members of the government, Johnson and Patel will both keep their (red) diplomatic passports!

Okay, let's move on to more serious matters:

The coronavirus continues to spread outside China, and this past week provided the first clear signs of the impact on the global economy: And it's not pretty!

Fixed income and FX markets have – finally – begun to reflect some of the likely (significant) effects on global growth, while equity markets have remained mostly immune. That's very unlikely to last.

Among people trying to justify equity markets at these levels, there seems to be some confusion about supply versus demand shocks and about the effectiveness of stimulus. So far, the world is suffering the beginning of primarily a (likely substantial) supply shock, with increasing evidence of a demand shock (particularly in China) on top of that.

But importantly, policy stimulus can partly address demand shocks, but it is much more complicated, if at all possible, to offset supply shocks. Think of it this way: China has closed a reported 70,000 movie theatres because of the virus. That's a supply shock, and no amount of income (demand) stimulus will boost ticket sales. Of course, people may increase the number of downloads of films and games to play at home, as we have seen, but this is nothing more than drops in the ocean in terms of the overall economy.

It's now a virtual given that global GDP will take a major hit in Q1, but it could just as well be a longer-lasting effect, and the uncertainty, let alone the actual hit to growth and profits, is not reflected in equity markets.

Rather, markets continue to trade mostly as if this is just a short-term story with an early rebound, e.g. ala SARS in 2003. Hopefully it is, but there is no evidence to support such an outlook. Uncertainty will continue to dominate until the infection rate and/or death ratio starts to come down on a sustained basis, and such uncertainty is still not priced in.

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And for now, while new cases in China are reported to have come down, the spreading of the virus across the world continues, latest in Northern Italy. In Italy, closure of selected businesses and public office in the most affected areas just south of Milan are now being implemented. I won't take your time running through the numbers of infections and deaths in the various countries around the world, but if you haven't seen it, this website from Johns Hopkins does an amazing job: Coronavirus COVID-19 Global Cases by Johns Hopkins CSSE

Here's what you'll find below, very much the product of a lot of work by several of my team members, including our chief international economist, Daniel Vernazza, and our co-heads of strategy research, Luca Cazzulani and Elia Lattuga:

- **I'll recap the evidence we have from these past few days of this major supply shock beginning to roam the global economy.**
- **I'll discuss why there is no effective policy response to such supply shocks, and I'll discuss what it's likely to mean for global Q1 GDP.**
- **I'll contrast what ought to be the market response to supply shocks with what markets have shown so far.**

1. The first indications of what promises to be a major supply shock to the global economy.

This week saw the first real evidence of the global economic fallout of the coronavirus outbreak. It suggests that the global economy is facing a significant external supply shock from the virus, which promises to be much larger than the experience of SARS in 2003. The key difference compared to 17 years ago is the much greater importance of China for the global economy now, including China's integration in global supply chains as well as Chinese overseas (and relatively high-spending) travel.

So, this past week we learned that in the epicenter (mainland China) passenger car sales dropped a stunning 92% yoy during the first two weeks of February as the Lunar New Year holiday was extended to mid-February. As I understand it, most non-essential businesses were told to stay closed to contain the spread of the virus, but even where showrooms were open, the Chinese Passenger Car Association reported a significant drop in the number of visiting potential buyers, due to the virus. This week, China was meant to return to work but reports and anecdotal evidence suggest streets, restaurants and production lines throughout China are eerily quiet. Research firm China Beige Book found that as of Thursday, of 1,000 firms surveyed one-third remain closed and another third were working remotely.

We also learned this past week – via the February Flash PMIs - of the first clear disruptions around the world. The Asia-Pacific region is in the front-line, of course. In Japan (which was already reeling from the sales tax hike), the composite PMI fell to 47.0 from 51.1, while in Australia it eased slightly further below the 50-level to 48.3.

In Europe, the composite PMIs held up well thanks to resilience from domestic demand and a technical oddity. Looking through that, trouble is brewing. Hence, in Europe there was a huge rise in suppliers' delivery times for manufacturers – a measure of lead times for firms to get the supplies they need for production. Such a rise in delivery times boosts the PMI reading because it's normally associated with strong demand and pressure on capacity, but firms reported in February that the virus outbreak had disrupted supply chains, particularly from

Asia. To get an idea of how big this move is, one can compare the current situation with past supply shocks. In the UK, this week's change in suppliers' delivery times was the largest since the survey began in 1992, i.e. larger than the September 2000 fuel strikes. That UK fuel strike lasted only one week, but it caused major disruption to supply chains and panic buying. Daniel Vernazza has estimated that it subtracted a whopping 1.6 pp (annualized) from UK GDP growth in the third quarter of that year.

Meanwhile, in the US (where the economy remains much more vulnerable than in Europe because of its one-legged growth story, i.e. private consumption, than most people seem to appreciate), the composite PMI, released Friday afternoon, fell abruptly to 49.6 from 53.3 in January. That's the lowest level since October 2013, which was when the US government shut down.

In both the US and in Europe, firms reported weakness in the services sector, partly due to a sharp drop in visitors from China. To put this in perspective, in recent years global GDP has been boosted by no less than 1/3 of a percentage point by Chinese travel abroad. Were such Chinese foreign travel to drop back to, e.g., the pre-2008 level (when it contributed just 5bp to global GDP), let alone stop completely, that alone – before any shock to manufacturing etc. has been included - would push the global economy into a recession broadly similar to the 2001 recession (in global growth terms).

To be sure, this latest US PMI number may overstate the present US weakness, but IHS Markit, which produces the PMI surveys, said that US firms reported increased caution regarding spending amid concern about a general slowdown of the US economy and political uncertainty. This rhymes with pwc's recent global CEO survey, conducted shortly before the virus outbreak. I discussed it in this note on February 2, and as you may recall, a record 63% of the surveyed North American CEOs expected slower global growth this year than last year's weak 3.0%, and only 10% expected stronger growth.

As we argued when the US Q4 GDP number was released, the otherwise decent headline number disguises a pretty troublesome underlying picture because of a huge one-off contribution from a big fall in imports, driven by the trade war. Now add the effect of the virus and recall that the US economy is more exposed to global supply chains from China than Europe, particularly in the tech sector.

The tech sector is typically one of the first to be hit, due to its complex supply chains, "just in time" production, and few alternative suppliers. On Monday, Apple sounded the alarm, saying it was cutting sales expectations amid supply disruptions at its Chinese factories, as well as a fall in Chinese demand for its products as consumers stay at home. Foxconn Technology Group, which makes the majority of Apple's iPhones in China, also issued a warning on revenue forecasts, due to supply-chain disruptions.

Supply bottlenecks reduce the economy's productive capacity, and in the extreme can bring production to a halt. Hyundai shut its car plants in South Korea due to a shortage of parts from mainland China, Nissan has temporarily shut down production at one plant in Japan, and Fiat-Chrysler warned it may have to halt production at one of its European factories. If an alternative supplier is available, typically it's an inferior product and/or higher price, otherwise it would have been chosen in the first place. And once bottlenecks in supply chains begin to emerge, they are usually made worse by consumers and firms trying to stockpile goods to guarantee supplies, thereby aggravating shortages.

2. Why there are few effective policy responses available to counter supply shocks. The outlook for bleak global growth in Q1 – and probably Q2.

When a supply shock hits, e.g. because of disruptions to input and closure of shops, it reduces what firms can pay their staff (and the number of staff they employ), which weighs on spending, and may cause firms to go out of business. Supply-disruptions also reduce firms' return from investing, lowering investment, which will be heightened by uncertainty over the evolution of the virus.

Large negative supply shocks are rare, particularly in advanced economies (the oil shock of 1973, and again later in the 1970s, are well-known examples). Importantly, there is little monetary or fiscal policy can do to offset supply shocks; both fundamentally work by affecting demand, not supply. In the 1970s, when oil prices spiked and output fell, some central banks sought to stimulate demand but ended up creating high inflation, eroding real income and thereby deepening the downturn. That said, by 1975, fiscal and monetary stimulus help the economy recover and adjust to the new world of higher oil prices. Today, inflation is subdued, but that does not make the complexity of policy instruments any easier to navigate. There is a real issue of short-term vs longer-term effects here; subject for another day.

The Chinese authorities have announced measures to help firms with funding, and the PBoC provided additional liquidity at lower rates, with the particular aim of preventing potentially massive job losses. But these measures will not get people back to work and can only last so long before bad loans build up. Given the corporate debt ratios in China, these policy measures could turn into a serious concern over the next couple of years.

So, with clear signs of a significant supply shock, some demand issues on top of that and no real chance of effective stimulus, there is virtually no doubt that the virus will weigh significantly on Chinese and global growth in the first quarter of this year - and almost certainly into the second quarter as well. Whether the effect rolls into the second half of the year will largely depend on whether new cases peak soon, and not really on whether the Fed cuts rates or not. That said, we do think they try to stimulate – by four cuts this year for a total of 100bp (as I have discussed before), although asset purchases might prove more effective in holding up markets and hence limiting the tightening in financial conditions.

Tentatively, we think China's growth rate in Q1 is likely to roughly halve to around 3% yoy from 6% at the end of last year (which would equate to a contraction of a little more than 5% annualized in Q1). The 2003 SARS outbreak subtracted around 2pp from yoy GDP growth in Q2 of 2003 (with annualized growth falling from 12% in the first quarter of 2003 to 3% in Q2 of 2003), but the spread of the coronavirus and containment measures are on a significantly larger scale.

With China accounting for almost 20% of global GDP (in PPP terms), the direct impact of such a slowdown in China alone will subtract 1pp from annualized global GDP growth in Q1 of this year. However, since China has been contributing around +1.2pp to global GDP growth in recent times, we'll be looking at a swing of over 2pp in terms of negative contribution to global growth. On top of that, the already pretty clear drag on growth in the rest of the world will push global GDP growth down still further.

And this comes following an already weak end to 2019 around the world. Of G7 economies, only the US recorded positive growth, and even that was held up by one-off factors, as I noted above. The UK and Germany stagnated in Q4, and Japan, Italy and France all contracted. (Canada has yet to release their Q4 figures.)

How severely this all spills over into Q2 remains to be seen, but a global recession in the first half of 2020 is suddenly looking like a distinct possibility.

3. Financial markets with still a lot of confusion….

How "should" markets react in such an environment of a major negative supply shock and renewed uncertainty about future growth?

Well, since a negative supply shock lowers output and raises prices, you should have expected a decline in equity prices, lower real bond yields and higher break-even inflation. Now add to that the further uncertainty about the outlook and hence a good dose of additional risk aversion, and you should – also – expect higher credit spreads, and a flight to safe-haven currencies.

With this in mind, markets seem to have reacted in a rather casual, and inconsistent, way, partly, of course, because of central bank purchases and generally ample liquidity, but also – it seems – because of an (unsubstantiated) belief that this is just a brief passing issue ala SARS-2003, as well as an apparent confusion about the nature of demand vs supply shocks and the (limited) effectiveness of policy stimulus in these circumstances.

So, here we stand, and what I think you should expect:

In fixed income markets, yields have come down significantly as the (rather predictable, if I may say) signs of the economic impact began to materialize in recent weeks. US 30-year yield hit an all-time low as it broke through 1.9% on Friday. In real yield-land, 2-year UST yields have also dropped sharply since the beginning of February, while the 2-year break-even has climbed back to the highs around the turn of the year. This is all "right direction stuff" for a negative supply shock and increase in risk aversion. But, as I have argued above, the overwhelming probability is that we have seen only the beginning of the economic effects, so our guess is that we'll see further extension of real (and nominal) yields in the direction we have seen these past few weeks.

In FX, the big "beneficiary" (if that's the right word) has clearly been the US dollar, sending EUR/USD considerably lower. But is this due to safe-haven considerations, or does it simply reflect the better US macro data (relative to expectations; in other words, the surprise story), relative to Europe? On the one hand, other traditional safe-haven currencies, particularly the yen and CHF haven't "benefitted" much, but maybe the Japanese macro story, and rate differentials have played the key role here? On the other hand, gold has moved higher. On balance, we, in my team, think the lower EUR/USD has been driven more by relative economic data surprises so far than by safe-haven considerations, which means that – assuming we are about right about the relative strength of the two economies – that there may not be a whole lot of further downside to EUR/USD. My colleague, FX strategist Roberto Mialich, argues that it'll take quite a lot for EUR/USD to break 1.06. Of course, already at these levels, the folks at the ECB will be quite pleased – while President Trump will have to figure out whether the stronger dollar is due to trust in him, or whether it's caused by some global conspiracy against the US. We all stand ready with our twitter accounts open …

Credit markets seem more confused. Credit spreads should have widened on the back of the increase in uncertainty and hence risk aversion. We've seen a bit of that in the US market (particularly for the energy sector as some of the key commodities traded poorly), while European credit spreads have actually tightened a bit, reflecting the ECB's continued presence in the market for investment grade credits, ample liquidity and relatively modest supply. That said, I rather doubt this will hold.

But, of course, the market that still thinks it can walk on water in defiance of macro fundamentals is equities, and particularly US equities. Following recent years' outperformance (relative to Europe) which was not supported by better (relative) earnings, US valuations are now at the top of the past couple of decades. Add to this the low or even negative earnings growth and (by most reliable measures) overbought equity markets, and you have what my colleague Christian Stocker calls “the ingredients for a perfect storm”. I have written about this before, so I’ll just repeat our view that US equities are at high risk of a correction – maybe on the order of 15% +/-. And, needless to say, if (when) that happens, even the more reasonably priced European equities will take a beating as well. That’s life…

In summary, here’s the most important take-away: The world is being hit by a serious virus outbreak, which has already caused tragedy to thousands of families around the world – and to fear of the unknown to hundreds of millions more. The economic impact is now showing up via measurable supply disruptions, and some degree of demand shock – and this is hitting the global economy as it already had started to weaken measurably towards the end of last year. The scope of offsetting policy stimulus is limited, and immensely complicated. Add to this the inevitable increase in uncertainty – about the spreading and death rates of the virus and about the public and private reactions to the fear and to the reality – and you have a very worrisome outlook for the global economy and for financial markets, at least in the near term. I don’t see this properly reflected in markets, particularly the equity market.

If you want to discuss any of this, please do reach out to me, or to anyone else in my team. We are all working full speed thinking about - and analyzing – these developments and their likely effects.

Best

Erik

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