



Global Growth, the New Coronavirus and Reactions

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Market developments in the new year have been dominated by the viral outbreak originating in Wuhan, China: panic selling in copper and industrial metals, weakness in commodities and emerging market currencies, developed country sovereign yields back near their August lows, the U.S. yield curve has inverted once more, and stocks are running into resistance.

Managing money is about managing uncertainty. The difficulty in handicapping the new Wuhan coronavirus is that there are more unknowns than knowns. As I write this blog, the official tally of confirmed infections is roughly 17,489 based on tracking information from [John Hopkins University](https://www.jhu.edu/), with various sources claiming these data vastly underreport the real situation. As others have noted, the virus might be worse than the SARS outbreak in 2003 based on the latest data. The current “total deaths/total recovered” ratio of 362/530, divided by the total number of cases (892) implies a “fatality/closed-case” rate of 41%. The equivalent fatality rate for the 8,422 confirmed cases of SARS was 9.6% while the ratio for the 1918 Spanish Influenza pandemic was estimated at 10-20%.

This pessimistic read of the data needs to be qualified by the small number of officially closed cases at this stage of the epidemic—only 892 as mentioned earlier. So simple extrapolations are almost useless for now. In addition, the John Hopkins data shows that most of the fatalities are in Hubei where the virus originated and that the number of infections outside of China has slowed rapidly. It will take a few more weeks for more clarity. Still, the data are a warning.

Perhaps because of this warning, initiatives taken by public health officials in China and around the world—as well as by policymakers and businesses—have become the main threat to what would have otherwise been clear signs of an end to the global recession in manufacturing and trade over the past two years.

- ▣ The World Health Organization declared the epidemic a public health emergency of international concern on January 30. This will reduce the flow of travel and commerce between China and the rest of the world, adding to the number of world airlines that have already suspended service to and from China.
- ▣ Efforts by the Chinese central government to contain the epidemic have become very aggressive. The city of Wuhan, with a population larger than London, is on government-ordered lockdown. Pictures and videos of this city are worth a thousand words in describing the virtual halt to activity. In total, cities with a collective population of 50 million are on lockdown. While only 3% of China’s total, this population group is responsible for a disproportionate share of Chinese gross domestic product (GDP).
- ▣ China’s new year holiday has been extended by another week across a significant part of the country. According to research from Don Straszheim at Evercore ISI, 11 out of a total of 31 provinces representing 58% of China’s GDP and 48% of its population have officially announced no resumption of business operations until at least February 10—February 13 for Hubei, the home province of Wuhan. As of this writing, there were more announcements of extended school closures in Hong Kong.

Reactionary countermeasures are likely to increase until there are signs of containment and/or a halt to the contagion, discovery of a treatment, or increased confidence that the virus is not deadly.

These measures are clearly negative for global growth, world trade, and any incipient upturn in corporate pricing power or inflation. But the focal point of weakness in growth is concentrated in China. Most reported data won’t show this before February. In the meantime, the Shanghai Composite is down roughly 12% while the Hang Seng Index is off about 10%. The knock-on effects to the global economy are evident in capital markets, where the benchmark yield on the 10-year Treasury Note is within a few basis points of the August lows.

China's size and contribution to global growth over the last 10 years has made it the high-beta source of global growth. Any slowdown in this economy will be felt globally. Besides the short-term implications for China's economic growth, longer-term repercussions could be damaging as well. The U.S.-China trade war put pressure on multinationals to relocate their supply chains outside of China. The epidemic could increase this pressure and reinforce the trend decline in China's potential GDP growth, coming from a contraction in the labor force and slower productivity gains.

Will there be countervailing policy stimulus and an eventual V-shaped recovery from this growth slump in China?

- ▣ There is clearly resistance to doing so, but officials are likely to become more desperate the longer the crisis and growth slump drags on.
- ▣ China's leaders don't want to reflate credit growth but they might have to. China's remedial approach to fending off downturns has been to stimulate credit—either through government-sanctioned spending programs, or coopting state-related companies into borrowing and spending. But policymakers have been clear for several years that they don't want to do this anymore.
- ▣ Following the collapse of the U.S. household debt cycle during the Great Financial Crisis, China engineered the first in what have been successive waves of credit inflation aimed at propping up domestic demand and producer prices, in a bid to replace the reduced profile of the American consumer. After 11 years, China's total debt-to-GDP ratio has increased by over 100 percentage points, most of this due to a ratcheting higher in state-related corporate borrowing and spending—the tip of China's fiscal spear. Capital allocation based on administrative guidance into a network of state-sanctioned economic activity instead of based on a rational pricing mechanism has coincided with growing non-performing loans in the banking system and declining marginal efficiency of credit in terms of GDP created. Claims by the People's Bank of China on the commercial banking system are steadily growing, a sign that the misallocation of capital has left the government without much fiscal room-to-manuever and the central bank with the job of monetizing the losses.
- ▣ A pro-growth solution to China's debt problems would be to restructure in a way which permits private companies ready access to capital and an allocation mechanism based on rational pricing and risk. However, the current administration continues to favor a more traditional approach to economic management and wants to retain control of credit by decree.
- ▣ Despite all the reluctance to pull the credit levers once more, the odds are that China's leaders will become more desperate the longer the crisis draws out. At some point in the year the authorities could panic and add a significant amount of stimulus, helping engineer a V-shaped rebound.

As for the U.S. and the Federal Reserve (Fed):

- ▣ Fed Chair Powell used his post-Federal Open Market Committee press ruminations to focus on what happened a month ago without much attention to the implications of the viral outbreak. In his latest appearance, he zeroed in on the Fed's more symmetric approach to its inflation target—a message aimed more at dispelling the notion of a preemptive rate hike if inflation hits 2%, rather than signaling any new stimulus that might be needed to get inflation to that level. Consistent with that message are plans to slow the balance sheet expansion by April. The Fed chair basically ignored the retreat in breakeven inflation rates, the plunge in bond yields, and the inversion in the yield curve.
- ▣ It is noteworthy that the dollar has been soft during some big risk-off days this week. The bulk of fourth quarter GDP was propped up by an unusual spike in net exports, due to a contraction in real imports. The market suspects the Fed may be more proactive than Board members currently expect.

Some Concluding Thoughts

1. Proactive efforts to contain the new virus are anti-growth and will tend to reduce/drag out the scope and scale of any rebound in the global economy this year. The unknown is how long it takes public officials to get ahead of this epidemic and for it to stop expanding. In the interim, it seems probable that these trends will keep global bond yields on their back.
2. China's authorities are likely to swing from resisting added stimulus to moving very quickly and significantly at some point later in the year as things deteriorate.
3. Similarly, the market is beginning to sense the possibility of the Fed acting to reduce rates again sooner

than the Fed is thinking. The probability of a rate cut by June has increased to 60%.

4. No matter the policy outcomes, at some point an intense re-stocking phase will lift global growth.
5. I [wrote a blog in May last year](#) making the case for why the Fed might not raise rates for the next 10 years. Current developments—the stance of the Fed and the outlook for Chinese economic and credit growth—continue to support the conclusion. Related to that is the ability of the U.S. government to finance its budget deficits for the foreseeable future. Prospects seem remote for any significant private sector credit demand from anywhere in the world big enough to compete with this demand. Correspondingly, there is a good case for the global expansion, already 11 years old, to last several more years—assuming this threat from the new virus is overcome.

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