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Contagion: The Coronavirus Impact

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The global economy entered 2020 with a tailwind of more than 70 rate cuts by nearly 50 central banks, led by the Federal Reserve. The stock market surged, consumers became a little more buoyant and a phase one trade deal with China alleviated fears of a full-blown trade war. Even the manufacturing sector, which slipped into a recession in 2019, showed signs of life at the start of 2020. The Institute for Supply Management (ISM)'s manufacturing index moved above 50, the threshold for expansion, for the first time in six months in January.

Then, the coronavirus hit. Initially, China delayed releasing its findings to the public; that allowed the virus to spread. Many patients were sent home before being diagnosed. One of the first doctors to sound the alarm on the virus is now among the casualties. Fatality rates appear to be lower than those for SARS, another form of the coronavirus, but there are gaps in China's data. The uncertainty surrounding the economic fallout of the outbreak roiled financial markets, at least initially.

Hopes are high that epidemiologists will find an effective treatment or a vaccine, but that will not stem upfront disruptions to economic activity. China and Asia more broadly will be hit the hardest. The spillover for Europe and North America will be less severe, but much depends upon the length of time China remains quarantined.

One factor blunting the initial effects on inventories and supply chains was timing. The outbreak occurred when much of the country was already off work due to the Lunar New Year celebrations. There was a blow to tourism but not production as many plants were already idled.

Coronavirus Takes Toll on First Quarter

Real GDP growth came in at a 2.1% annualized rate in the fourth quarter, matching the pace of the third quarter. Underlying growth, however, was much weaker than it appeared. Consumer spending slowed to 1.8%, half the pace of the third quarter. Business investment contracted for the third consecutive quarter while inventories plummeted. Firms bought ahead of feared tariff increases, then liquidated inventories as concerns about tariffs abated. The bright spots were government spending, the housing market and trade. Imports fell more rapidly than exports.

Prospects for the first quarter are not as good. Consumer spending is expected to bounce back while housing is expected to post additional gains. Disruptions created by the coronavirus are expected to take a toll on business investment and delay the rebuilding of inventories. The weakness in imports tied to the coronavirus will partially offset those losses. Government spending is expected to act as a drag on growth. Real GDP is forecast to rise by 1.7% in the first quarter, 0.4% behind the pace of the fourth quarter.

Growth is expected to rebound in the second quarter and in the second half. Much of that rebound is predicated on a V-shaped recovery in China and the return of the 737 Max. Growth could be weaker for longer if the virus does not crest quickly. The SARS epidemic hit in waves and crested during the first quarter of 2003, which allowed China to rebound.

The length of time plants are idled will determine the magnitude of disruptions. We are assuming that much of China's retail, tourism and production capacity will be shuttered through mid-March. The only silver lining is that China has a lot of excess capacity with underutilized labor that can be put to work rapidly to recoup losses after the worst of the infection has abated.

The only benchmark we have is the SARS epidemic of 2003. Growth decelerated in China from an 11.1% pace in the first quarter to 9.1% during the height of the outbreak in the second quarter and then rebounded in the third quarter. Upfront costs will be greater this time around. China was a smaller economy with fewer linkages to the rest of the world in 2003. It was also ramping up instead of combating a slowdown. High debt loads are undermining China's ability to stimulate. China asked banks to lower interest rates and extend repayment plans for their worst affected customers.

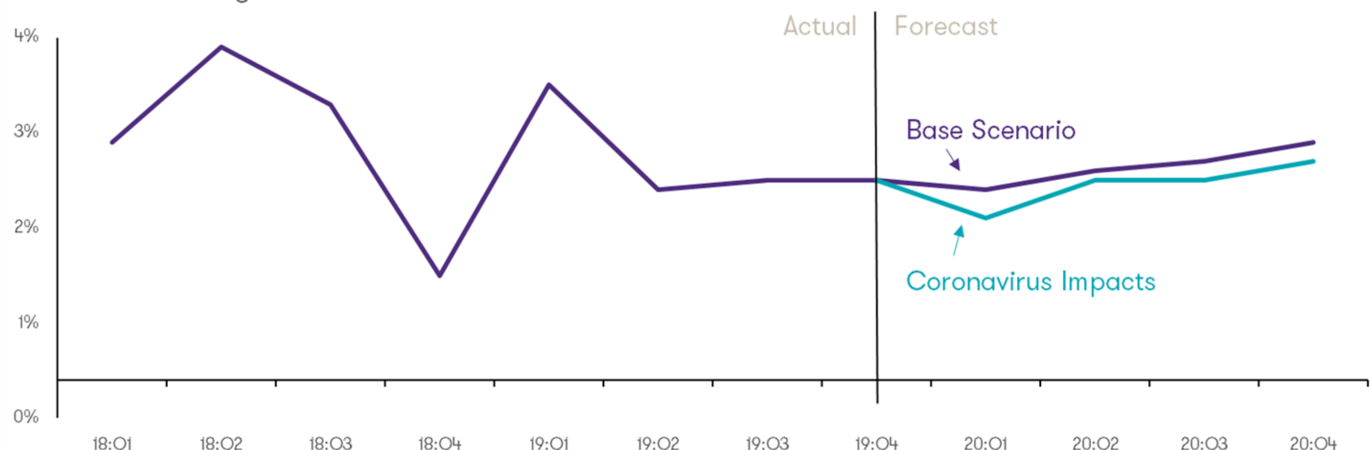
This edition of *Economic Currents* examines the likely impact of the coronavirus on the U.S. economy, by sector. The blow to growth will be small and largely offset as long as the outbreak is short-lived and quickly contained. A longer quarantine, with sequential waves of contagion, would be much more detrimental to the U.S. and the global economy. The contagion rate slowed in the days leading up to the writing of this report but the World Health Organization (WHO) cautioned that the figures "could go up again." Singapore has reported cases with no links to travel to China.

The IMF forecast for 2019 before the outbreak of the coronavirus was for a "**tentative stabilization.**" Global growth was forecast to move up from 2.9% in 2019, the weakest since 2009, to 3.3% in 2020. Gains would have been stronger if not for a large downdraft in growth in India. Fires in Australia were another headwind at the start of the year. The losses due to the coronavirus in China could easily push growth down to 3% in 2020. (See chart on next page.) China, the Philippines and Japan have already committed to stimulate their economies to blunt the expected blows. A longer quarantine of China would require more countries to stimulate and could shave even more from global growth, making 2020 the weakest year since 2009.

This is in addition to the fear triggered by the virus. Xenophobia has surged since the outbreak, which will only add to the rise in nationalism and backlash to trade and immigration that we are already seeing. The uncertainty we had hoped would abate in the wake of the phase one deal with China has just escalated again.

A Modest Slowdown

The chart below shows the forecast for U.S. growth in 2020. Annual growth is expected to slow from 2.3% in 2019 to 2.0% in 2020. The disruptions triggered by the coronavirus are short-lived and largely concentrated in the first half of the year. A return of production of Boeing's 737 Max will ostensibly provide an extra lift to growth later in the year. Risks are to the downside.



Source: Bureau of Economic Analysis, Grant Thornton LLP

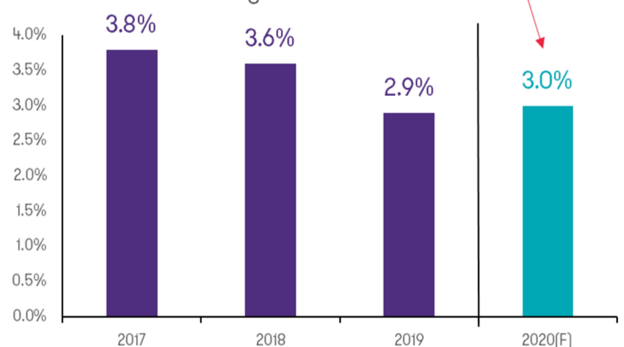
The assumption is that many countries will be forced to stimulate, should a broader slowdown appear imminent. Synchronous use of monetary and fiscal levers are more powerful than stimulus in isolation. The heads of both the Federal Reserve and the European Central Bank have voiced concern over the limits of monetary policy alone.

Consumer Spending Slows

Consumer spending is expected to moderate a bit in 2020. Employment growth should slow after a weather-induced surge in January, while wage gains stay in the 3% range. Job openings actually fell at the end of 2019, while average hourly earnings hovered at 3% at the start of 2020. Gains were uneven. The largest swing in wage growth over the year was in the information sector, which includes Silicon Valley. They slowed to a 3.1% annual pace in January from a red-hot 7.2% gain a year ago.

The weakness associated with the coronavirus will be concentrated in travel, tourism and luxury retail. Chinese tourists play a critical role in spurring business at retailers from Fifth Avenue to Rodeo Drive.

The recent surge in mortgage refinancing and drop in oil prices could provide some offset to that weakness. Spending on remodeling and repairs has picked up. OPEC has been attempting to cut production to stem the decline in oil prices but Russia has balked.



Source: International Monetary Fund, Grant Thornton LLP

Housing Picks Up

Home buying and building is expected to eke out modest gains for 2020. Pending home sales have picked up significantly in recent months in the wake of a surge in mortgage applications. Tight inventories of entry-level houses are the largest constraint on sales. Prices are expected to accelerate, which will cut into the improved affordability due to lower mortgage rates.

Multifamily construction is expected to pick up slightly in 2020. The problem is the composition of growth. Builders have overbuilt luxury apartments, which is exacerbating the shortage of affordable rentals. Sadly, homelessness has risen, despite falling unemployment.

Fears of another epidemic could spur an exodus from China to major cities in the U.S. That could further strain housing supply and exacerbate price pressures.

Business Investment Remains Lackluster

The greatest casualty of the coronavirus is business investment, which has already suffered from weak growth abroad and trade wars. Business investment is expected to contract for the fourth consecutive quarter in the first quarter of 2020, then rebound modestly during the remainder of the year.

The coronavirus is dealing a direct blow to supply chains, which are much more dependent on China than they were in the past. Hyundai in Korea has already had to idle plants because of disruptions to production in China. Large vehicle producers in the U.S. rely on more North American content but are not immune to the disruptions. Many middle-market suppliers to the vehicle industry rely directly on China for their components.

The reality of pandemics will accelerate the move of U.S. firms out of China and into other emerging markets; Vietnam and Mexico are expected to be the largest beneficiaries. Production is not likely to return to the U.S., especially given the strength of the dollar.

Separately, falling oil prices will hurt the shale industry, which has already seen a jump in bankruptcies. Larger oil companies are expected to continue to dominate the sector.

Inventories Bounce Back with a Delay

A large restocking of inventories was hoped to boost growth in 2020. Disruptions to production due to the coronavirus will hinder that rebuilding. Efforts to find alternative suppliers will fall short. Contracts in place and the specialized nature of our imports from China make supply chain diversions more difficult.

Government Spending Lags

Government spending drags on overall growth in 2020. The federal budget for fiscal year 2019, which was approved in December, maintains but does not increase discretionary spending much; the fiscal 2017 and 2018 increases were larger.

Barring a full-blown epidemic, the coronavirus is not expected to affect government spending. There is growing concern, however, about whether previous cuts to the Centers for Disease Control and Prevention (CDC) budget are compromising our ability to respond to such threats.

The Drag from Trade Dissipates

Quarantines of entire cities, cancelled flights into, within and out of China will hamper both imports and exports. Imports to the U.S. are expected to slow more than exports given the lopsided nature of our relationship with China. We import more than we export to China; as those figures plummet, the trade deficit widens at a slower pace.

Risks. The global economy is poised to rebound fairly quickly from the disruptions associated with the coronavirus, but losses could compound if quarantines are extended. The result would hit global growth even harder than expected, which would take a toll on exports.

Inflation Remains Subdued

The core personal consumption and expenditures (PCE) deflator is expected to move up from the lows we hit in 2019 but remain below the Federal Reserve's 2% target in 2020. Easier year-on-year comparisons and an acceleration in home prices are the main reasons. We could see shortages emerge as production in China is hit, but much of the rise in prices related to shortages will be offset by a depreciation in the yuan.

> "The blow to growth will be small and largely offset as long as the outbreak is short-lived and quickly contained."

Risks: Weaker economic growth could cause lower inflation.

An Accommodative Fed

Below-target inflation and cooler-than-desired wage gains are expected to prompt the Federal Reserve to cut rates at least once in 2020. Downside risks associated with the spillover from the coronavirus may force the Fed to act even more aggressively. The Fed is starting to realize that it has more tools to sustain the expansion than to right the ship once it capsizes.

Further complicating Fed actions in 2020 is a desire to stem recent balance sheet purchases to stabilize overnight lending operations. The risk is that those moves could be interpreted as a form of quantitative tightening, despite efforts by the Fed to counter those views.

Risks: The Fed is walking a tightrope, wanting to sustain the expansion without stoking more asset price bubbles. The result will leave financial markets more vulnerable to shifts in monetary policy.

Treasury Yields Edge Higher

The 10-year Treasury yield dropped as investors fled to the safety of U.S. government debt in response to the initial reports of the coronavirus. The yield curve - the difference between 3-month and 10-year Treasury yields - inverted temporarily as the virus spread. Those shifts are expected to unwind as the economic drag from the coronavirus plays out.

Risks. The risks are that the coronavirus persists longer and that the flight to safety intensifies. Yield curve inversions could become more common, but lessons from Japan have taught us they may not represent the same kind of warning flag for a recession as they once did; yield curve inversions are more common when interest rates are already so close to zero.

Stock Market Volatility Picks Up

The S&P 500 surged by nearly 30% in 2019. A modest slowdown at home coupled with a blow to growth in Asia is expected to take a fairly large toll on profits in 2020. A larger percentage of what is sold by U.S. multinationals in China is produced there. The S&P 500 should move up only marginally in the months to come - less than 2%. (So far, Wall Street hasn't received the memo.) Volatility should rise as the hit to profits is realized; the longer quarantines last, the larger the blow.

Risks: Downside risks to growth combined with efforts to stem Treasury bill purchases by the Fed could roil markets. It may be a good time to hold a little more cash. (I am not putting any in the mattress yet.)

Bottom Line

The expansion has proven to be remarkably resilient with the help of the Federal Reserve. We have effectively fought off: surging oil prices, downgrades to U.S. debt during a showdown over raising the debt ceiling, a sovereign debt crisis in Europe, the taper tantrum following the Fed's push to slow the pace of QE, trade wars, a sharp slowdown in global growth and crippling partisanship. That is reassuring as we encounter yet another potential setback.

The U.S. economy appears poised to weather the incoming storm. The Fed can cut more, but not by much. We are only six quarter-point cuts away from zero. I remain cautiously optimistic, but have learned that hubris can be dangerous this late in an economic cycle.

Economic forecast — February 2020

	2019 (E)	2020	2021	2019:4 (A)	2020:1	2020:2	2020:3	2020:4	2021:1	2021:2	2021:3	2021:4
National Outlook												
Chain-Weight GDP[1]	2.3	2.0	1.9	2.1	1.7	2.1	2.1	2.3	1.8	1.6	1.7	1.7
Personal Consumption	2.6	2.5	2.3	1.8	2.4	2.4	2.3	2.3	2.4	2.3	2.3	2.3
Business Fixed Investment	2.1	0.6	3.9	-1.5	-0.5	1.8	5.2	6.3	3.2	3.1	3.2	3.1
Residential Investment	-1.5	2.5	-1.8	5.8	5.6	0.2	-3.1	-0.4	-0.9	-3.2	-3.3	-1.3
Inventory Investment	65	32	50	7	20	28	43	37	40	48	54	56
Net Exports (bil $ '12)	-954	-972	-1062	-902	-935	-965	-989	-998	-1025	-1054	-1077	-1091
Exports	0.0	1.4	4.1	1.4	0.2	0.4	6.6	7.5	3.2	2.6	3.0	3.5
Imports	1.0	1.5	5.5	-8.7	4.1	3.9	7.6	6.4	5.4	5.1	4.7	4.1
Government Expenditures	2.3	2.0	0.7	2.7	1.1	3.4	0.2	0.5	0.8	0.6	0.4	0.2
Federal	3.5	3.3	0.2	3.6	1.5	7.0	1.0	-0.6	-0.2	-0.4	-0.5	-0.7
State and Local	1.6	1.1	1.0	2.2	0.8	1.2	-0.3	1.2	1.4	1.2	1.0	0.8
Final Sales	2.2	2.2	1.8	3.2	1.5	2.0	1.8	2.4	1.7	1.5	1.6	2.0
Inflation												
GDP Deflator	1.8	1.8	2.1	1.4	1.7	2.0	1.7	2.0	2.3	2.0	2.6	2.3
CPI	1.8	1.8	1.7	2.5	1.2	1.9	1.4	0.6	1.7	1.8	2.5	2.7
Core CPI	2.2	2.2	2.2	2.1	2.0	2.3	2.1	1.9	2.2	2.2	2.2	2.2
Special Indicators												
Corporate Profits[2]	-1.6	2.6	4.4	-1.6	1.3	-2.5	-0.6	2.6	4.7	5.8	5.1	4.4
Disposable Personal Income	3.0	2.3	2.2	1.5	2.7	2.5	2.0	2.3	2.5	2.0	1.9	1.8
Housing Starts (mil.)	1.30	1.36	1.31	1.44	1.38	1.36	1.35	1.35	1.34	1.31	1.30	1.29
Civilian Unemployment Rate	3.7	3.5	3.5	3.5	3.5	3.5	3.4	3.4	3.4	3.5	3.5	3.6
Total Nonfarm Payrolls (thous.)[3]	1695	1172	755	441	356	286	230	300	254	209	163	129
Vehicle Sales												
Automobile Sales (mil.)	4.9	4.3	4.1	4.5	4.5	4.4	4.2	4.2	4.2	4.1	4.1	4.1
Domestic	3.5	3.2	3.0	3.3	3.3	3.2	3.1	3.1	3.1	3.0	3.0	3.0
Imports	1.4	1.1	1.1	1.2	1.2	1.2	1.1	1.1	1.1	1.1	1.1	1.1
Lt. Trucks (mil.)	12.1	12.4	12.1	12.3	12.5	12.5	12.3	12.2	12.2	12.2	12.0	11.9
Domestic	9.7	9.8	9.6	9.7	9.9	9.9	9.8	9.7	9.7	9.7	9.6	9.5
Imports	2.4	2.6	2.5	2.6	2.6	2.6	2.5	2.5	2.5	2.5	2.4	2.4
Combined Auto/Lt.Truck	17.0	16.7	16.2	16.8	17.0	16.9	16.5	16.4	16.4	16.3	16.1	16.0
Heavy Truck Sales	0.5	0.5	0.5	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.4
Total Vehicles (mil.)	17.5	17.2	16.7	17.4	17.5	17.4	17.0	16.9	16.9	16.8	16.5	16.4
Interest Rate/Yields												
Federal Funds	2.2	1.5	1.4	1.6	1.6	1.6	1.4	1.4	1.4	1.4	1.4	1.4
10-Year Treasury Note	2.1	1.9	2.5	1.8	1.7	1.8	2.0	2.1	2.3	2.5	2.7	2.6
Corporate Bond BAA	4.4	4.0	4.4	3.9	3.9	4.0	4.0	4.1	4.2	4.4	4.5	4.4
Exchange Rates												
Dollar/Euro	1.12	1.10	1.11	1.11	1.11	1.09	1.09	1.09	1.09	1.10	1.11	1.12
Yen/Dollar	109.0	107.8	107.0	108.7	108.5	108.0	107.5	107.0	107.0	107.0	107.0	107.0

1. In 2019, GDP was $1907.2 billion in chain-weighted 2012 dollars.
2. Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.
3. Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

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