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Coronavirus Comes to America: Ripples or Shock Waves?

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A casual observer might think that the entire investment community has gone bonkers, lost its collective marbles, flipped out. Two weeks ago, the stock market hit an all-time high and then fell 10% faster than it's ever done before. This week has been even wilder, as stocks have alternated between 1,000-point (3%) gains and losses every day. Meanwhile, bond yields have sunk to their lowest levels ever, as the 10-year Treasury yield slid below 1% and the 30-year Treasury bond scraped 1.5%.

Oh, mercy mercy me: Marvin Gaye had that much right. Investors clamored last week for the Fed to cut short-term interest rates in response to the Covid-19 Coronavirus outbreak, and bid up stocks Monday when Fed Chair Jay Powell hinted he would do so. Yet the very next day, when Mr. Powell actually delivered a 0.5% "emergency" cut, investors ridiculed him by thrashing stock prices again; a rate cut isn't a virus vaccine, after all. In yet another turnabout, investors on Wednesday cheered both Congress's $8 billion commitment to Covid-19 research and the Super Tuesday election results. But Thursday's news of a second quarantined cruise ship, this one just outside San Francisco, sent stock prices swooning once again.

> *Oh, mercy mercy me*
> *Things ain't what they used to be, no, no*
> *Where did all the blue skies go?*
> *Poison is the wind that blows from the east*
> *Oh mercy mercy me*

The market action in the past two weeks suggests that investors have rightly concluded that understanding the expected course of the Covid-19 pandemic is only half the problem. Markets are now also assessing how governments and private-sector firms are responding to the pandemic: To what degree will economies and companies be affected by fiscal, monetary, and corporate public health policies that are now being contemplated?

China provides an important illustration of how the cure can be worse than the disease. The city of Wuhan and the entire province of Hubei were effectively isolated and shut down for several weeks beginning in mid-January. Nearly two months later, workers are only now beginning to return to their jobs, and factory output has only slowly begun to rebound. The city and province are among the most important industrial centers in China, so the shutdown had widespread ramifications across the entire country. The good news in China's draconian action is that the shutdowns may have helped maintain public health across the country, as the number of new Covid-19 cases in China has rapidly shrunk. (The number may rise again as people start going back to work.) But the bad news is that the adverse impact on the economy is huge and ongoing.

Official economic data to be published in the next few weeks will likely be quite ugly. Some economists are now forecasting that China will post negative GDP growth for the first half of 2020, a steep fall from the 6% positive growth the country had previously been expected to sustain. The real-time data is deeply sobering: Shipping containers are piling up in the country's harbors, unable to offload goods; coal consumption has dropped precipitously as factories have closed for weeks at a time; and property sales have almost completely ceased. These are just the most easily tracked daily measures, and they portend ill for the broader data yet to be reported.

We see several vectors through which China's sudden slowdown *could* propagate through the global economy; whether these vectors manifest as ripples or shock waves remains to be seen.

- **Demand shock in China.** The consumer-driven economy has stalled. Idled workers and their families haven't been spending money on movies, restaurants, home furnishings, cars, and more. Imports from other countries have declined sharply. Disney, Starbucks, Apple, and other American companies with a large Chinese presence have reported sharp reductions in their revenue forecasts.

- **Supply shock in China.** As factories and transportation were shut down, domestic and supply chains were snapped. Companies throughout China have had increasing difficulty obtaining Hubei-made materials and components for their own factories. The failure to obtain a single key part from Wuhan could theoretically shut down an entire factory hundreds of miles away.

- **Supply shock outside China.** In an era of integrated global supply chains, the same dynamic applies worldwide. Companies in other countries may discover they can't get key parts from China, and alternative suppliers (if any exist) could become overwhelmed.

- **Direct demand shock outside China.** Asian tourism to the United States and Europe has evaporated, leaving many American and European businesses struggling to meet their revenue targets. Airline seats are flying empty; United Airlines cancelled 20% of its April international flights this week, for example. Hotel rooms normally occupied by Chinese tourists are sitting vacant. Layoffs in these industries may become inevitable, spreading demand weakness deeper into the American and European economies.

- **Indirect demand shock outside China.** Several communities have begun to consider closing public schools and other facilities for extended periods. Doing so could cast a pall on consumer spending.[1] The travel industry has suffered severely, as giant trade shows like a global wireless telecom event in Barcelona were cancelled this year. The wildly popular South by Southwest gathering in Texas may be the next big cancellation, as major sponsors like Apple, Netflix, Amazon, Intel, and TikTok have already pulled out. Losing SXSW for a year would be a devastating blow to the Austin economy.

[1] The notion of closing school systems as a way of protecting children is especially troubling, because – unlike typical flu strains – Covid-19 doesn't seem to affect children. Prolonged school closures may do nothing to protect public health, but they could threaten parents' jobs as they scramble to find alternative supervision for their kids.

It’s simply too early to have any confidence that these vectors may represent mere ripples or huge shock waves as Covid-19 propagates itself across the United States. The course of the illness itself is hard enough to predict, and public health responses could greatly magnify or reduce the economic impact over the next few months. *We just can’t know yet.*

Investors are therefore looking to government for reassurance and support. First to act was the Federal Reserve, which cut overnight interest rates by 0.5% on Monday and which may go further in the coming weeks. Yet as much as investors had demanded this action in last week’s trading (as witness the steep near-term yield curve inversion), the backlash Tuesday was striking: Investors realized that cutting the price of money can’t directly stop the virus and won’t restart supply chains. The rate cut does have merit, however, in that it helps ensure liquidity and smooth functioning of the financial system, and it may also help get consumers out of their homes to buy big-ticket items with cheaper financing.

Other government support has been slower to take shape. Tuesday’s G7 meeting of finance ministers of the world’s largest economies was a dismal failure, as the group could not agree on coordinated action. The picture in the U.S. improved later in the week as first the House and then the Senate approved over $8 billion in spending on vaccine research, medical supplies, and coverage for testing. By Thursday, the International Monetary Fund followed Congress’s lead, committing $50 billion to fight Covid-19.

Will that be enough? Or will fear of quarantines cause more economic harm in the name of protecting public health? For all the money about to be spent on vaccine research and production, there are still likely to be more companies that close some offices or factories for extended periods; Amazon announced that it will shut its Seattle facilities for the rest of this month.

Similarly, the International Air Transport Association recently raised its estimate of lost revenue due to Covid-19 from $29 billion to a minimum of $63 billion for this year – and that figure is likely to be multiplied as airlines cut back on spending, and as their employees likewise tighten their belts. United Airlines offered unpaid furloughs to employees affected by its schedule cutbacks, and those employees won’t be spending as much money at their local Home Depot or AMC cinema next month. These are big numbers that are certain to affect our overall economy.

We think that global GDP growth will be nicked in the March quarter, but take a deeper hit in the June quarter before beginning to recover. For the year, the OECD recently sliced its GDP growth estimate from 2.9% to 2.2%; here in the United States, we think GDP growth is now more likely to be about 1.5% this year, about 0.5% slower than we thought just a month ago. We recognize, alas, that these estimates could be wildly wrong depending on the course of the virus itself and on how people respond to it.

Oh, mercy mercy me. How can we invest our clients’ money successfully when there is so much uncertainty about the course of the epidemic and about the economic impact? We take the long-term view: While we can’t be certain of the severity of the epidemic or its effect on the economy in the next few weeks and months, we do know that the illness is relatively mild and that it, like SARS and MERS and H1N1 and others, will ultimately dissipate.

We are confident in the resilience of the U.S. economy. When Covid-19 ultimately recedes from the headlines as new U.S. cases subside, we expect a steady rebound to growth. We remain fully invested, maintaining our slightly defensive stance in both equity and fixed income portfolios. This posture has served our clients very well through the first two months of the year despite the astonishing volatility we have seen, and we will stick with our discipline as conditions evolve. The ancient philosopher Aesop knew that when all is said and done, more is usually said than done; that's a good moral for investors to remember today.