FOUR STAR
wealth advisors LLC

February 8, 2020- *as published on Forbes.com*

Virus' Total Impact Unknown – But Economic Impacts Are Serious

Robert Barone Contributor
Great Speculations Contributor Group

There were three headlines on Page A6 of the February 6th Wall Street Journal (WSJ):

- "Viral Outbreak Squeezes Manufacturers" with the sub-head: "Airbus, Hyundai among multinationals cutting back because of constraints in China;"
- "Apple Faces Risk In Its Reliance on Chinese Factories;"
- "Cruise Passengers Quarantined on Board."

We have seen similar headlines since, and will continue to see them while the virus rages. As I write (February 7), the coronavirus has infected more than 34,000 in China with 722 deaths (so far, a 2.1% death rate). This virus is much more contagious than the 2003 SARS which only infected a total of 8,096. Whether-or-not it is as deadly remains to be seen. Total deaths from SARS were 774, 9.6% of those infected.

While the virus rages and the full scope of the economic impacts are yet to be seen, for some strange reasons, the equity markets rose the week of February 3rd. As always, when uncertainty is high, equities react, and it is hard to decipher why. Perhaps it was the rumor that Gilead had an effective vaccine. One other theory that piqued my interest revolved around the view that the daily number of new cases would continue to rise for the 14-day incubation period associated with this virus. Since quarantine measures began in Hubei Province in China at the end of January, the theory goes that we would see the peak in daily new infections the week of February 17, after which date, the infection rate would fall. Nice theory, but why markets would rise before seeing the fall in daily new cases is baffling.

At this time, no one knows how long it will take to control the virus or how widespread the epidemic will become. What we do know (see *WSJ* headlines above) is that this will have negative economic repercussions. The recent behavior of the stock market would imply that the economic repercussions will be shallow and short-lived. The bond market, on the other hand, appears to have the opposite view, as bond yields have fallen precipitously since the virus reared its ugly head.

Current State of U.S. GDP

While Q4's GDP came in at 2.1%, once deconstructed, uncertainty prevails. Of the 2.1 percentage points of growth, 1.3 occurred because "net exports" rose. This is normally a good thing, but this time they rose because of a huge deterioration (-8.7%) in imports, normally a sign of consumer weakness. Exports fell too, but, because they did not fall as much, "net exports" were positive. A more realistic measure of a sustainable GDP growth rate, especially now that world trade is in chaos, would remove the 1.3 from the 2.1, leaving only +0.8% growth going into Q1. And if the growth of government spending (clearly on an unsustainable path at the federal level) is removed, Q4's real GDP growth number falls to +0.2% (probably not significantly different from zero).

Virus Disruptions

The virus has now caused:

- The closure of a significant number of businesses in China. While the headlines feature prominent multinational brands like KFC, Starbucks, Apple etc., most Chinese firms added an extra week to the Lunar New Year shut-down (i.e., through February 9th), and many are likely to extend such shut downs;
- Macau has closed-down, and this will significantly impact gaming and leisure companies;
- There are travel restrictions to and from China by most countries; and there are travel restrictions in China itself, especially in Hubei and surrounding provinces;
- There are significant supply chain disruptions as many industries depend in some way on Chinese supply chains.

While the total economic impacts won't be known for many months after the crisis passes, for sure, we know that they will be serious and they will be negative. (So why the rise in equity values?) All travel and leisure industries are already suffering. Who is going to sign up for a cruise during this outbreak? **When companies close offices and/or governments restrict travel and stop or curtail imports and exports, then, not only is consumer demand reduced, but production, too, grinds to a halt for lack of inputs.**

According to the February 7th edition of the *WSJ*, (P. B-12), "The Economic Cost of Coronavirus," the 2015 outbreak of Middle East Respiratory Syndrome (MERS) in So. Korea only infected 186 people, but the "avoidance response" from the population was so strong that, according to Korea's Economic Research Institute, the economic cost was an outsized $8.2 billion. SARS, too, had a huge economic impact on tourism in Asia and in the Pacific region. Again, according to the *WSJ*: "With airlines suspending flight service to China and nerves frayed among travelers elsewhere, the coronavirus impact may be worse [than MERS or SARS]." While this currently is mainly a Chinese problem, the *WSJ* concludes: "If people outside China start engaging in avoidance behavior, the economic damage will get far worse."

World Conditions Prior to the Outbreak

China's growth rate in 2019 was the slowest on record (since 1992), and most observers in the know say that the "official" 6% growth rate is already significantly overstated. It isn't just that travel activity has been curtailed, quarantines set up, and businesses and factories have been closed, but the fear of infection will clearly engender the "avoidance behavior syndrome." Long after this virus is contained (which may be weeks or even months from now), this fear and avoidance behavior will keep many folks at home. When we had the SARS scare in 2003, China's economy represented 9% of world GDP. Today, it represents 19%. Worse, China's consumer today represents a much larger proportion of that economy than she did then.

As I write, the virus, itself, is not spreading among the populations of the developed world. But the economies of the developed world are not starting from strength. India, for example, was already showing a significant economic slowdown prior to the outbreak, i.e., slowest growth rate in 10 years. Q4 GDP growth in the EU was +0.1% (again, likely not significantly different from zero) and Germany just posted a -2.1% M/M fall in its December factory orders and a whopping -3.5% fall in it Industrial Production (IP). France, too, suffered a -2.8% IP plunge in December, and Spain's showed up at -1.4%.

The World Bank and IMF had lowered their world growth forecasts weeks prior to the outbreak. JP Morgan's economists' early estimates of the virus' impact on world growth was -0.3% for Q1, but, less than a week after that pronouncement, they now say the impact is going to be much larger. UBS's economists are much more pessimistic, indicating a -2.5 percentage point reduction in Q1's global growth. Since the World Bank's Q1 GDP growth forecast for the world was only 2.5% total, the UBS view implies 0% worldwide growth. Some would call that a worldwide recession.

U.S. Employment

The January employment report was ballyhooed as another indicator of just how strong the U.S. economy is. The 225k rise in jobs in the Payroll (Establishment) Survey beat expectations of 158k. But, the following were either not mentioned, or were downplayed:

- The U3 unemployment rate ticked up to 3.6% from 3.5%. That's because the concurrent Household Survey, which is the survey used to calculate U3, recorded a loss of -89k jobs, with the all-important 25-54 year age cohort losing -166k jobs! In that survey, full-time employment fell -656k in January while part-time rose 567k. These aren't strong jobs numbers. While the Household Survey is more volatile than the Payroll Survey, **it simply doesn't sit well when the two surveys, taken at the same time, produce such opposite results;**
- Of the 225k rise in the Payroll Survey, 44k were in Construction. Much of this growth was due to the mild winter weather in January, just like the rise in housing starts. The "seasonal factors" expect an "average" winter, and when it is milder, the data is skewed to the high side, and vice-versa. When the weather is mild and construction can proceed, construction planned for spring simply gets pulled forward;

- I have observed over many of these blogs that the Birth/Death model used by BLS to "estimate" the net number of new jobs produced by start-up small businesses was overstating employment in the Payroll Survey in 2019. Every February, BLS does what they call an "Annual Benchmark Revision" of the prior year's payroll data. The revision just released ***removed*** -514k jobs (i.e., nearly -43k/month) from 2019 totals. I am told from a reliable source that most of this was due to downward revisions to the Birth/Death model algorithm;
- To add insult to injury, according to Wall Street Economist David Rosenberg, the Birth/Death model was responsible for +141k of the Payroll Survey's +225k total. So, with the weather related +44k construction payrolls and this +141k, these two questionable sources accounted for +185k of the +225k net new jobs, or 82%;
- +36k of the jobs showed up in the Leisure and Hospitality sector. With travel interrupted by the virus outbreak, we can expect serious layoffs in that sector going forward;
- Job losses in Retail (-8.3k) and Manufacturing (-12k) don't bode well either. Likely the loss in Manufacturing payrolls was the beginning of the domino effect from Boeing's MAX production shut-down in January. Expect more to come. In a recent discussion, Treasury Secretary Mnuchin believes the Boeing impact could cut -.50 percentage points from U.S. GDP growth.

Conclusions

It appears that equity markets are significantly disconnected from economic reality and corporate fundamentals. Even if the coronavirus is short-lived (no evidence of this so far), multinational corporate shutdowns in China, disruption of business and commerce there, broken and suspended transportation and travel schedules, disrupted supply chains, and consumer avoidance behavior is sure to have a significant impact on revenue, profits, and Q1 GDP. And, I suspect these impacts will reach much deeper into 2020 economic results, especially if the virus proves to have staying power. At this time, it is hard to see why equity markets appear so unconcerned especially since the economics are so compelling.

About the Contributor

Robert Barone, Ph.D. is a Georgetown educated economist. He is a financial advisor at Four Star Wealth Advisors: www.fourstarwealth.com. He is nationally known for his writings and Robert's storied career includes his having served as a Professor of Finance, a community bank CEO, and a Director and Chairman of the Federal Home Loan Bank of San Francisco. Robert is currently a Director of CSAA Insurance Company (the AAA brand) where he chairs the Finance and Investment Committee. Robert is the co-portfolio manager of the UVA Unconstrained Medium-Term Fixed Income ETF (FFIU).