Principal Global Investors

Economic Insights: **The headwinds just don't stop**

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Just when the evidence shows that the United States and world economies were picking up a bit of steam, another headwind hits the upturn. A new virus that originated in Wuhan, China, novel coronavirus (nCov), is causing sickness and deaths as well as havoc in markets.

But unless its severity is worse than initial reports suggest, the pickup in global growth should be more delayed than derailed.

Vexing virus

There have been many reasons to feel optimistic about global activity over the last few months. But, nCov isn't one of them. It's too early to know how serious the impact of the virus will be. Markets aren't waiting to find out, with big drops in copper and oil prices, stock markets, and long-term interest rates.

The transmission rate of nCov—or, how many people are infected by each contagious person—is estimated at 2.6, with a range of 1.5 and 3.5.[1] That's less than the ordinary winter flu and similar to the SARS epidemic. Fortunately, from early reports, the mortality rate from nCov doesn't yet appear nearly as severe as SARS. With 213 deaths through the end of January from around 10,000 cases, that's a fatality rate of about two per 100. The rate for SARS was about one fatality in 10 cases. For those affected, it's a human tragedy. The risk is that the fatality rate rises over time.

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The economic impact of nCov will be felt most in China, followed by destination countries for Chinese tourists. China's Lunar Holiday has been extended to prevent more contagion. Some factories have shut down temporarily and retail sales will likely plunge this quarter. Chinese growth could be two percentage points lower than past estimates in the first quarter, potentially followed by a sizeable rebound in the second. If that's correct, there may not be too big a hit to growth for 2020.

The key to watch for markets: when the number of new cases actually peaks.

The upturn has arrived

Prior to the nCov outbreak, Chinese economic activity was improving in last year's second half. The turnaround in Chinese activity was one of the main reasons we felt confident in a global growth pick up. Leading indicators bottomed in February. Our own economic momentum indicator, which captures ups and downs in activity more clearly than official data on gross domestic product (GDP), picked up over the year. The official manufacturing survey gained ground in November and the Caixin survey, which measures smaller companies, has been at expansion levels since August. Monthly industrial production was solid in December. New credit issued accelerated throughout 2019.

[1] MRC Centre for Global Infectious Disease Analysis

The upturn will clearly be pushed off course by the nCov. Though the SARS epidemic didn't impact world growth dramatically, China now is the second largest world economy, so the global impact will be much greater. The overall shock is highly uncertain and depends on how long the outbreak lasts. If SARS is any guide, there may be a disruption for several months, or a quarter or two, and then a sharp bounce in activity. In 2003, Chinese GDP growth dropped two percentage points from the first to the second quarter, then rebounded. Retail sales sharply decelerated but recovered. Data is always noisy in January and February with the Chinese New Year holiday. For 2020, China's growth will likely be somewhat less than 6%.

The U.S. economy was steady in the fourth quarter, expanding 2.1%, seasonally adjusted annualized basis. Details of fourth quarter output weren't great, with a slower rate of consumer spending and a fall in investment. Net exports added almost 1.5 percent points to growth as imports dropped sharply and domestic demand was weak. Final sales to domestic purchasers grew only 1.6%.

Consumer spending decelerated. Business fixed asset investment was headwind for the third quarter in a row, although expenses for intellectual property—including software, research, and development—continued strong. Mining exploration contracted at a double-digit pace for a second quarter in row, with the weakness in oil prices. Inventories subtracted more than a percentage point from overall growth, but that bodes well for the first quarter. Wages and salaries accelerated, but real personal disposable income was up only 1.5%. Housing was the bright spot, adding to growth for a second quarter in a row.

U.S. GDP growth is still expected to hover around 2% to 2.5% this year. Boeing's 737 Max production stoppage will be a big drag on first quarter growth, but the weakness in consumer spending should subside. Consumer confidence is in near-record territory and key measures of labor market health are robust. There are tentative signs that business sentiment is picking up: CEO confidence likely hit a trough in the third quarter of last year; capital spending plans have picked up. Architectural billings are expanding nicely. Further, faster wage growth is an incentive to invest in productivity-enhancing equipment. All this bodes well for capital spending. Falling oil prices are a headwind for certain businesses. But low mortgage rates should boost housing activity for some time.

Growth in the Eurozone likely touched bottom in the fourth quarter. Business sentiment indicators have rebounded sharply. European economic confidence has picked up and likely made a low in October. Manufacturing has been lackluster but seems to be improving. The unemployment rate declined in December and is at the lowest level since 2007. Wages are rising and with the strength in the labor market, consumer confidence was steady last year despite the falloff in industrial activity and business confidence. Fourth quarter growth was very slow, only 0.1% over the prior quarter. We expect growth in the Eurozone to modestly rebound, to 1% to 1.5% in 2020. Last year's pickup in Chinese activity should boost the area's exports so long as the nCov epidemic doesn't last terribly long. Structural issues likely weigh on the German auto sector, constraining its bounce.

Japan's economy stumbled raggedly into 2020. Growth likely contracted in the fourth quarter with the impact from a typhoon and the October 1 two-point bump in the value-added tax. While there's a clearly subpar rebound from the tax hike, the economy should recover modestly this quarter. Retail sales plunged 14.2% in October , only revived 4.5% in November, and rose a mere 0.2% in December. The jobless rate stays incredibly low at 2.2%, so consumer confidence rebounded sharply, as have services activity trackers. Manufacturing surveys have improved. However, measures of actual industrial activity and exports remain weak. Growth in Japan could range from 0.5% to 1% in 2020. Fiscal stimulus and the 2020 Tokyo Olympics will provide some lift. A turnaround in global trade flows, if it comes, will also help.

Overall, the wave of revival from the nearly two-year slowdown in world activity had just gotten underway late in the fourth quarter. The virus may disrupt the pickup for a few months, but this is an event, not a trend. In the meantime, central banks stay extremely accommodative and interest rates are very low. Consumers remain confident and resilient. Labor markets are tightening, and wage gains are robust. Trade conflicts have eased. Leading indicators have turned up.

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The upturn in the data should become more evident after the hit from the virus fades, and into the second quarter.

Investment conjectures

Long-term interest rates plunged in response to the uncertainties around the impact of the coronavirus. And why not? Commodity prices fell dramatically, so inflation is likely to stay low. Central banks could become even more accommodative in the face of yet another headwind, and the pickup in growth might be delayed for some time. Lower rates make sense in this environment.

Can they last? Likely not at the low levels of January 31. Yields on 10-year U.S. treasury bonds and 10-year German bunds closed the month at 1.5% and 0.43% respectively. Once investors see the peak in the number of new coronavirus cases, interest rates should gradually rally back to highs of late last year or perhaps a bit beyond.

Central banks surely aren't going to push yields higher. The U.S. Federal Reserve (Fed) won't raise the fed funds rate this year, period. Further, if inflation stays muted, there are some odds that the Fed could cut rates another 0.25%. The Bank of England kept its official rate on hold despite expectations for a cut, likely in response to improved confidence and anticipation of better activity. If that hope isn't fulfilled, a March rate cut will be coming in the United Kingdom.

The collapse in long-term safe-haven yields helped investors in those bonds have excellent January returns. Barclay's index of long-term U.S. treasury bonds returned 6.8% for the month. Our suggestion continues to be high quality, short to intermediate term corporate or emerging market bonds over the next six to nine months. They provide more yield and some safety if yields rise or economic problems develop.

How about the stock market? After an 18.3% melt-up in the S&P 500 Index from last August through mid-January, equity investors gave some back during the last two weeks with a 3.7% drop from the peak on January 17. At that top, with optimism roaring, euphoria building, and valuations at extremes, the market was ripe for a pullback. All it needed was a catalyst. Had the Wuhan flu stayed in the shadows, something else would have derailed the rally. There's likely more downdraft to come to dissipate the excess exuberance.

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The consensus is already telling investors to buy this dip. That may be premature as the number of new cases of the virus in China has only stabilized in the last couple of days and not yet peaked. Once that happens, though, and with world growth likely to improve as the year progresses, there should be some modest upside left in the stock market.

However, the risk-to-reward ratio is rising. From 666 in early March 2009, the S&P 500 Index surged about five times to above 3300 recently, an incredible move in only 11 years. The upside from here is surely limited. Trying to get that last few percent out of a long rally is always risky.

Profit expectations even for 2019 continue to shrink. Early last year, operating earnings estimates for the S&P 500 for 2019 were in the mid-$160s. Now, with three quarters already in, those guesses are $157 and change, up only 3.8% for the year. With wage costs accelerating, the $175 projection for 2020 up 11.2%, is surely overly optimistic. Still, we'd stick with stocks probably through mid-year anyway. An end to nCov worries and improved world growth could bring another run to new highs in the second quarter.

We'd been advising a portfolio balanced between sectors and between U.S. and international for some months. That—plus a large dollop of caution—still seems the right approach.

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