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ECONOMIC TALKING POINTS

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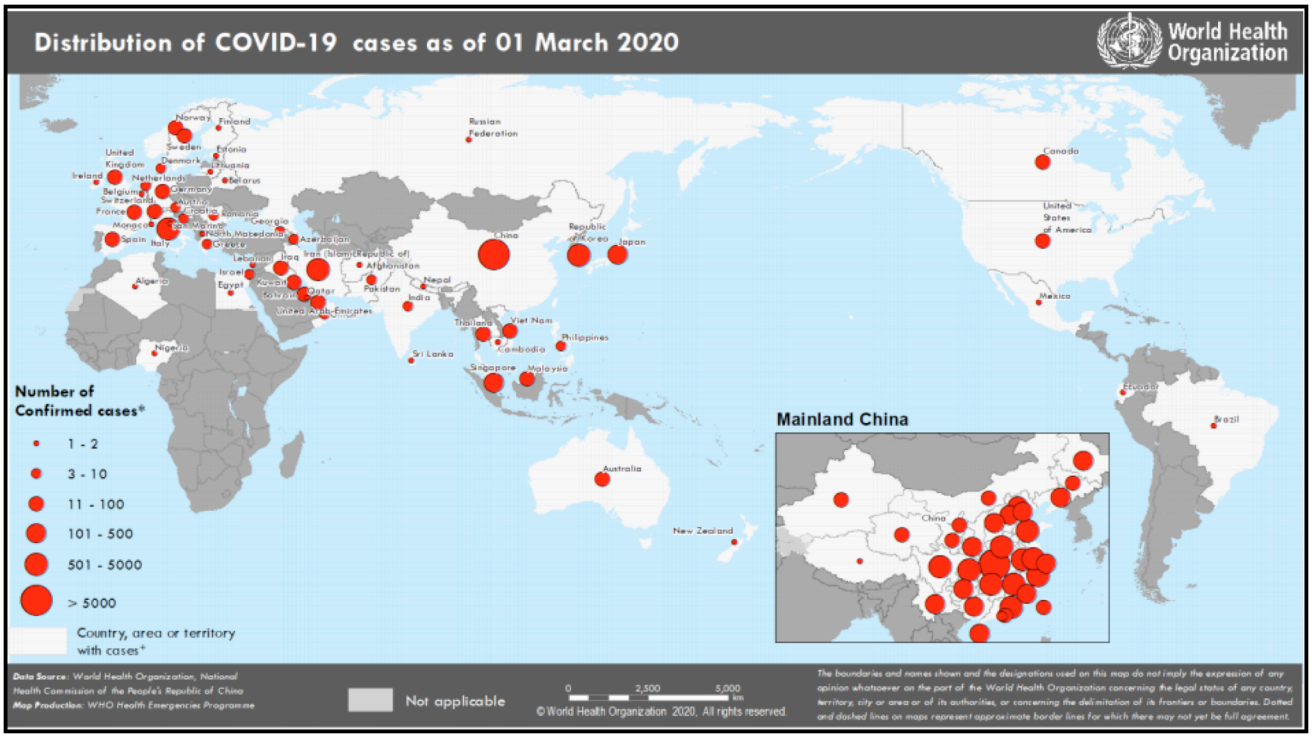
Is a Virus Recession Next for China and the US?

The world has been convulsed by the new coronavirus, officially labeled as COVID-19.

Rarely has the international community been so singularly focused on a pathogen and the threat it poses to human beings and the global economy. It has now been more than three months since this disease surfaced in China's Hubei province — and no yet one has a clue when it will be contained.

Late last week the World Health Organization saw the contagion spreading at such an alarming rate that it raised the global threat to its maximum level, classifying the global risk now as "very high" from "high." Whether it's formally declared or not, we are dealing with a pandemic.

In a little over five weeks (January 25 thru March 1st), the number of countries with confirmed cases of the virus jumped from 9 to more than 60. Those afflicted with the disease spiked from 1,320 to 87,137, and fatalities surged from 41 to 2,977. These numbers are bound to increase exponentially given how quickly it spreads and the fact we're not even close to developing a vaccine.



So where do we go from here?

At this juncture, much is still unknown about its morbidity. No one can say with much confidence how much harm the virus will ultimately do to people or damage to the global economy. Certainly any kind of comparison to the carnage produced by the 1918 – 1919 Spanish flu, which infected one-third of the world's population (500 million people) and killed 50 million people, is without merit given today's sophisticated, hi-tech health care system.

There is at least some history that can serve as guidance on how this virus may play out:

(1) In a humanitarian emergency, the world medical community does have the ability to prioritize the research and development of an essential vaccine. We've seen this before with other deadly diseases, such as yellow fever, measles, smallpox, chicken pox, SARS, Malaria, and Tuberculosis.

(2) No disease in modern history has solely been responsible for precipitating a US recession. Economic downturns here have been caused either by high interest rates (certainly not an issue today), a spike in oil prices due to a supply shortage (again, not a factor given we're now the world's top oil producer), or the result of colossal acts of human folly (such as the reckless lending and borrowing over real estate that triggered the 2008-2009 financial crisis). Given the absence of all three, we see little chance of a two quarter contraction in economic activity in the US.

But other countries may not be so fortunate. For China, South Korea, Japan, Germany and Italy, the coronavirus seriously compounded the economic and

political challenges they faced from trade disputes, supply chain disruptions and domestic political turmoil. The coronavirus outbreak could well bring those economies to their knees.

(3) At some point in the second half of the year this outbreak should fade into history. The coronavirus will then no longer dominate the mindset of consumers and business leaders.

For now, however, there are many troubling questions about this disease and precious few answers. That uncertainty has led investors to dash out of stocks and seek shelter in bonds, gold and cold cash.

To what degree will the coronavirus slow economic growth in China and US? Given how fluid the situation is, we are forced to adjust our GDP forecasts as needed. This is a time for pencils with erasers, not pens.

- **CHINA**

Growth Forecast =
1Q 2020 (Based on government data) = 2.5%, (down from 5.9% prior to virus outbreak.)
1Q 2020 (Forecast by the Economic Outlook Group) = - 8% contraction

2Q 2020 (Based on government data)= 5.0% (vs. 5.8%)
2Q 2020 (Forecast by the Economic Outlook Group) = 3.5%

Full year 2020 (Based on government data) = 5.2% (vs. 5.8%)
Full year 2020 (Forecast by the Economic Outlook Group) = 4.0%

Clearly, the coronavirus has taken a massive toll on China's economy. Regardless of what minimal Q1 GDP growth the government will report in the coming weeks, our assessment is that China's economy will actually contract by as much as 8% in the first three months compared to its year ago level.

This poses an unprecedented challenge for the Communist Party leadership. They have already gone all out to prevent a severe downturn by pumping some $250 billion into the economy and cutting interest rates multiple times. Yet new evidence emerged over the weekend and this morning indicating the country's manufacturing sector has been crippled by the latest epidemic. China reported its Purchasing Managers' Index plunged to a record low of 35.7 in February, a startling collapse from 50 the month before. No one expected such a sharp fall. One component of the PMI series--- manufacturing output --- dropped even more to 29.3, from 51.4 in January.

Even China's service sector has been devastated. The official PMI for non-manufacturing was in free fall last month, tumbling to 29.6 after being in expansion mode of 54.1 in January.

The Caixin/Markit PMI Manufacturing report plummeted to 40.3 last month, the lowest ever for a series that began in 2004. The larger Caixin survey focuses primarily on small and midsize firms, while the government's PMI report polls larger companies and state-owned enterprises.

In a desperate effort to resume economic activity, Chinese policymakers have called on people to return to work. But that effort has been only partially successful. Only 30% of small and medium-sized companies are in full operation, yet this group accounts for 60% of the country's GDP. They are struggling to get back to full operation because workers are either ill, or remain at home for fear of catching the disease.

Moreover, if the disease has not yet been contained and lacking a vaccine, there is the risk that marshaling people back to factories and offices may trigger another upsurge in new patients.

President Xi is also in trouble!

In addition to the country's economic woes, there is also turmoil brewing within the Communist Party. President Xi Jinping is likely to pay a heavy political price for his mediocre handling of the virus outbreak. Public criticism of the government's role has been high, though few citizens dare to post their outrage on social media for fear of government reprisal.

But Xi's reputation has taken a beating all year by the ongoing protests in Hong Kong, sharp slowdown in China's own economy, protracted and tense trade dispute with the US and the international condemnation it received over its maltreatment of Uighur Muslims.

What this suggests is that the Politburo Standing Committee will likely rescind Xi's status as "president for life" within the next 12 months. Needless to say, that could have implications for future trade talks with the US.

As for China's obligation under the recently signed Phase One deal, they will not be able to fully comply with the terms under current circumstances. China agreed to import $32 billion more agricultural products over the next two years ($12.5 billion in 2020 and $19.5 billion in 2021). This is part of the broader $200 billion (above 2017 level) in goods and services they promised to buy through 2021. But the Trump Administration is unlikely to denounce China for failing to meets these goals —— at least until after the November elections.

- **UNITED STATES**

1Q 2020 GDP growth = 1.4% (vs. 1.9% and it includes the impact of the coronavirus and Boeing's shutdown of the 737 MAX.)
2Q 2020 GDP growth = 1.9% (vs. 2.0%)

Full year 2020 = 2.0% (vs. 2.3%)

Up until recently, the US has been largely insulated from the virus. Yet it was only a matter of time before this pathogen found its way here. As of Sunday (March 1st), there were more than 60 confirmed cases of the disease and two deaths in the US. Those numbers are bound to increase in the days ahead and bring new disruptions to travel, commerce and the financial markets.

- **Is there a role for the Federal Reserve in this tense climate?**

The futures market is heavily betting the Fed will cut rates two to four times this year, with perhaps the first being as much as a 50 basis point reduction at the March 18th meeting, if not earlier!

One can easily make an argument why the Fed should not cut rates at this time. It's hard to see how such action will spur more demand for goods and services. After all, if consumers are spooked by the spread of the virus, they will stay away from shopping in public places and lowering interest rates will hardly change that behavior. People are not frequenting malls because the cost of credit is too high! They fear contracting this disease by being in crowded venues.

Then there is another factor to consider. Changes in monetary policy impact the economy with a lag of 12 to 18 months. Thus its effects will not be immediate in any case. But suppose they do slash rates this month. If the coronavirus ceases to be a threat by summer and the emergency is over, then the Fed would prefer to reverse those cuts. But does anyone think they would hike rates in the final months of a contentious presidential campaign?

So what will the Fed do next?

The shockwaves from what is effectively a pandemic has already led to an historic fall in stock prices, with $6 trillion in losses in one week. If the stock market continues plummet this week and the 10-year Treasury note yield tiptoes below 1%, then the FOMC will vote in emergency session to lower the fed funds rate by 50 basis points EVEN BEFORE the March 18th meeting!

Why would they do so? Three reasons.

First, further upheaval in the financial markets and lack of liquidity would not just deeply destabilize the global economy, it would significantly increase the danger of deflation --- which is something the Fed wants to avoid at all costs.

The second reason is simply an image issue. If international organizations, US government agencies, and fiscal policies were all directed to counter the coronavirus threat, it would be awkward for the Fed to simply stand idly by — not to mention the fulminations it would invite from this White House.

Third, there's already fresh data showing consumer confidence is taking a hit. The Bloomberg Consumer Comfort Index fell 2.1 points to 53.1 in the week ending February 23rd. That's the steepest drop in five months. American shoppers have been the bedrock of this economic expansion. Had they not been

hefty spenders in recent years, a recession would certainly have already commenced.

Will consumers still be willing to do the heavy lifting and keep the economy out of trouble?

Our answer is yes! There are two broad questions we ask when projecting consumer spending. Are Americans willing to spend — and do they have the ability to spend?

Household finances are still in good shape. While consumer borrowing increased the most in 13 years last year, servicing that debt has so far been manageable because of low interest rates. At the same time, inflation has and will continue to be subdued (though we will see some spikes in the cost of health care products). Finally, purchasing goods online has become so hassle free, so frictionless that we can expect to see a huge jump in eCommerce for both durable and nondurable (such as groceries) in the weeks ahead.

Ultimately when it comes to the outlook for consumer spending, we go back to the basics. Are people secure in their jobs and income? And are Americans seeing wages and salaries growing faster than inflation? The answers to both are in the affirmative.

Nevertheless, we have to be exceptionally vigilant these days. If consumer sentiment does turn sour, the economic indicators that would first flash such warnings would be the following:

1. A sharp increase in the personal savings rate.
2. Sustained drop in retail sales.
3. Persistent fall in the monthly consumer confidence numbers.
4. Sharp increases in applications for unemployment benefits.

These are the metrics that should now be on everyone's radar screen.

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TABLES TO FOLLOW:

United States

	I 2019	II 2019	III 2019	IV 2019	I 2020	II 2020	III 2020	IV 2020	I 2021	II 2021	III 2021	IV 2021	I 2022	II 2022	III 2022	IV 2022
Real Gross Domestic Product (GDP):																
%	3.1	2.0	2.1	2.1	1.4	1.7	2.2	2.5	2.7	3.3	2.4	2.5	1.5	2.2	2.0	2.1
Personal Consumption Expenditures:																
PCE %	1.1	4.6	3.2	1.7	1.9	2.2	3.1	2.8	1.9	4.1	3.0	2.7	1.1	2.3	1.5	1.7
Inflation, end of period, year-over-year:																
CPI %	1.9	1.6	1.7	2.3	2.1	2.3	2.5	2.6	2.6	2.5	2.6	2.4	2.4	2.5	2.3	2.2
Unemployment Rate (end of period):																
%	3.8	3.7	3.5	3.5	3.6	3.5	3.5	3.4	3.6	3.7	3.9	3.9	3.9	3.9	4.0	4.2
Non-farm Payrolls, monthly avg. thousand:																
	174	152	188	197	175	150	145	140	140	155	155	140	135	120	110	115
Treasury 10-yr Note Yield % (end of period):																
	2.42	2.00	1.65	1.88	1.20	1.25	1.60	1.90	2.10	2.50/td>	2.55	2.80	3.25	3.55	3.85	4.10
Federal funds rate % (end of period):																
	2.38	2.38	1.88	1.63	1.13	1.13	1.13	1.63	1.63	1.88	2.38	2.38	2.38	2.38	2.38	2.13

GDP Growth - Global Economy

Country	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
US	2.6	1.6	2.2	1.8	2.5	2.9	1.6	2.4	2.9	2.3	2.0	2.7	1.9
Eurozone	1.7	1.4	-0.9	-0.3	1.2	1.6	1.7	2.5	1.9	0.9	0.8	1.4	1.2
United Kingdom	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.9	1.3	1.4	0.5	1.7	1.3
Japan	4.6	-0.4	1.6	1.5	-0.1	1.1	1.0	1.9	0.8	0.9	0.7	1.4	0.8
Canada	3.1	3.1	1.7	2.2	2.5	0.9	1.4	3.0	1.9	1.3	0.8	2.3	1.5
India	8.4	8.6	6.7	4.9	7.4	8.0	8.1	7.2	6.8	4.9	5.2	6.1	6.2
China	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.8	6.6	6.1	5.2	5.8	5.6
Brazil	7.5	2.7	0.9	2.3	0.1	-3.5	-3.5	1.1	1.1	1.5	1.2	1.8	1.7
Mexico	5.2	4.0	3.9	1.4	2.3	2.7	2.7	2.4	2.1	-0.1	0.8	1.7	1.2
Australia	2.8	2.6	3.6	2.4	2.6	2.5	2.4	2.4	2.7	1.6	1.2	2.6	2.3
Russia	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.6	2.5	1.3	1.5	1.7	0.9
World	4.2	3.1	2.5	2.6	2.8	2.8	2.6	3.4	3.2	2.8	2.4	3.2	3.0

Economic & Geopolitical Probabilities for 2020 & 2021

PROBABILITY	U.S.
HIGH	Coronavirus and shutdown of Boeing 737 MAX to slow 1Q growth to 1.4% and all 2020 to 2.0%.
Moderate	Federal Reserve to slash rates 50 basis in Q1, with no changes in monetary policy the rest of 2020.
Moderate	Yield on 10 yr.Treasury to climb in 2021 as inflation picks up and investor appetite for US debt wanes.
HIGH	Business CAP EX delayed in 2020 as coronavirus and national elections cloud the economic outlook.
HIGH	New round Keynesian tax cuts to be announced in 2021 regardless of who wins the election.
HIGH	Coronavirus prevents China from carrying out its Phase 1 obligation. Trump withholds criticism until after the election.
	FOREIGN
Moderate	Coronavirus will slow China's 1Q GDP growth to 2.5% (vs. 5.9%), and all 2020 to 5.2% (vs. 5.8%).
HIGH	Venezuela's Maduro regime collapses in 2020; new elections are planned.
HIGH	As public criticism of Xi Jinping's leadership grows, Politburo rescinds his "president for life" status.
HIGH	Foreign adversary launches cyber attack that paralyzes parts of US economy.
Moderate	Iran proceeds to enrich uranium past 20%. Risks increase of a military response by US or Israel.
Moderate	India's legal changes to Kashmir and national citizenship raises risk of new conflict with Pakistan.
HIGH	With UK now out of the EU, talks on their future economic relationship likely to extend beyond 2020.