Coronavirus worries hit financial markets and Chinese growth prospects

Highlights

- Fears over the impact and spread of the Coronavirus in late January hit financial markets which had until then enjoyed a largely upbeat start to the year. Brent crude oil prices fell sharply on possible fallout on Chinese and global oil demand.
- US GDP growth was steady at 2.1% in 4Q19, though recent stronger data on housing and manufacturing – virus impact notwithstanding – give some cause for optimism. The Fed has promised to cease its liquidity injections in Q2.
- The ECB left rates on hold notwithstanding the mature stage of the economic cycle is set to limit the potency of any upswing.

Fears over the impact and spread of the Coronavirus in late January hit financial markets, which had until then enjoyed a largely upbeat start to the year on brightening economic prospects helped by the US-China trade deal. The US S&P index for example finished January -0.2% m/m having been up 3% mid-month, while global government bond yields also fell back sharply. While the full implications of the outbreak are still not clear, it is expected to have a large impact on Chinese growth in Q1 just as activity in the world’s second largest economy appeared to be stabilizing. Worries over the impact on Chinese and global oil demand also hammered oil prices, with Brent crude plunging 20% from its January peak.

US growth steady in Q4; Fed leaves rates on hold

Economic growth in the US stood at an annualized 2.1% in 4Q19, unchanged from Q3 and in line with expectations. (Chart 1.) Consumer spending moderated to 1.8% from Q3’s very strong 3.1%, and a slowdown in inventory growth also weighed on activity. These negative factors were offset by stronger government spending (2.7%) and especially a sharp drop in imports (-8.7%) – the latter perhaps due to the unwinding of strong imports in Q3 when firms had looked to beat September’s tariff hikes on Chinese goods. Growth overall in 2019 slowed to 2.3% from 2.9% in 2018 and was the softest since 2016.

Latest high-frequency data suggests that activity may now be picking up, with in particular the housing market recovering (price increases accelerating after a two-year slowdown), the ISM manufacturing index turning positive (50.9) in January for the first time since July and job growth maintaining a strong pace of 225,000 in January. This has eased immediate concerns over a downturn, but uncertainty over trade, the coronavirus and indeed the mature stage of the economic cycle is set to limit the potency of any upswing.

In a relatively low-key January meeting, the Federal Reserve kept policy rates at their current 1.50-1.75% range, citing the strong labor market, moderate consumer spending growth but core inflation – at 1.6% y/y on the PCE measure in December – below the 2% target. Futures markets are pricing in a more than 80% chance of at least one 25 bps cut by year-end. Fed chairman Jay Powell said that the bank could cease pumping extra liquidity into the market – currently at a rate of $60 billion per month – sometime in Q2. The move was originally portrayed as a technical measure to help keep policy interest rates within their target range, and has pushed the Fed’s balance sheet back up to nearly $4.2 trillion from $3.8 trillion last September. But some analysts claim it has been a factor in the strong stock...
market rally and that the Fed will at least have to manage the phasing out of injections carefully to avoid market disruption.

**Eurozone growth slows; UK finally leaves the EU**

Eurozone GDP growth slowed to just 0.1% q/q in 4Q19, below expectations and down from 0.3% in Q3. The decline was driven by falls in output in both France (-0.1%) and Italy (-0.3%) – the former affected by ongoing strike action related to President Macron’s pension reforms. (Chart 2.) Figures for Germany have not yet been released, but growth was negligible in Q3 and recent optimism over a cyclical recovery helped by falling global trade tensions may now be tempered by the impact of the Coronavirus on exports. The Eurozone PMI index edged up in January to a still-modest 51.3, and analysts continue to expect a tentative pick-up in regional growth later this year, with the further decline in unemployment to a 12-year low of 7.4% in December underpinning the outlook for domestic demand.

![Chart 2: Eurozone GDP (% q/q)](chart.png)

The European Central Bank as expected left policy on hold in January, with the deposit rate at -0.5% and quantitative easing of €20 billion per month. It stated that risks to the outlook were now ‘less pronounced’ than before (due to reduced trade tensions) but still ‘tilted to the downside’, though this was before concerns over the Coronavirus outbreak intensified. Inflation ticked up to 1.4% y/y in January from 1.3% in December, but the rise was mostly due to energy prices and core inflation fell back to just 1.1%. Policy is expected to remain on hold going forward and indeed the threshold for a near-term change in policy may now be high as the bank mulls a possible change in the inflation target (currently ‘below or close to 2%’) as part of its recently-launched strategic policy review. Moreover, bank officials have been vocal on the need for fiscal policy to take on a greater role in supporting the regional economy.

Nearly four years after its ‘in-out’ referendum, the UK finally departed the EU at the end of January following 47 years of membership. The UK has now entered an 11-month transition period under which regulations on trade, travel and business with the EU are unchanged, while both sides try to agree a trade deal that will govern the relationship beyond 2020. Although there is a range of possible outcomes, initial signs are that PM Boris Johnson will seek a loose relationship that provides for UK regulatory autonomy even at the expense of fresh trade barriers or potentially a return to basic WTO trading arrangements next year. Largely as expected, the event passed with minimal market impact. The Bank of England kept interest rates on hold at 0.75%, though said it would monitor the impact of improving sentiment on hard data over coming months. It did however revise down its 2020 growth forecast to 0.8% from 1.2% before.

**BoJ upgrades growth outlook**

The Bank of Japan kept monetary policy on hold last month, maintaining its short-term interest rate at -0.1% and its pledge to keep 10-year government bond yields at around 0%. The bank also upgraded its growth outlook for the fiscal year starting in April from 0.7% to 0.9% on the back of planned fiscal stimulus measures amounting to ¥121 billion. Both headline (0.8%) and core (0.9%) inflation rates remain well below the bank’s elusive inflation target of 2%, leaving it ample room to ease monetary policy to support the economy if need be. Meanwhile, both exports and imports continued to fall in December, with exports declining 6.3% y/y (its 12th consecutive month of decline) and imports retreating by 4.9% (albeit an improvement from a 16% drop in November). While the US-China trade deal should offer global trade growth and Japanese exports some support going forward, the economic effects of the rapid spread of the Coronavirus, which has led to the shutdown of various manufacturing plants, may lead to supply-chain disruptions that ultimately hamper global trade growth.

**Chinese economy hit by virus outbreak**

The death toll in China from the Coronavirus outbreak topped 490 by early February with more than 24,000 confirmed cases, much higher than during the 2002-2003 SARS outbreak. This has and will continue to have negative ramifications on the economy, as both local and international authorities take further urgent measures to limit the spread of the virus. The government extended the Lunar New Year holiday and a number of international firms including Starbucks, Apple and Hyundai have halted operations indefinitely.

This will weigh on economic activity in 1Q20, coming soon after data showing that growth stabilized at 6.0% y/y in 4Q19, unchanged from the previous quarter. For 2019 as a whole however, growth slowed to an almost three-decade low of 6.1% in 2019 from 6.6% in 2018, though still within the government’s target of 6-6.5%. (Chart 3.) The slowdown was led by a weaker external sector and as investment and consumer spending came in softer. The official PMI for January showed manufacturing
activity stagnating at 50.0 versus 50.2 in December, but it may not yet be reflecting the full impact of the virus outbreak. Meanwhile, in a bid to provide support to the economy, China’s financial regulators announced $242 billion in liquidity injections and an ease in lending restrictions to help business. The authorities are also reportedly seeking some flexibility on pledges made under the ‘phase one’ trade deal with the US. The stock market fell 7.7% – its largest daily drop in years – the day markets reopened after the extended holiday and the yuan fell back towards RMB7/USD1.

Industry proposes modest reforms to support growth

In its 2020 budget on February 1, the Indian government unveiled a series of modest reforms aimed at boosting spending and investment, in a bid to support a faltering economy. The reforms include a personal income tax cut and proposed amendments to the definition of income tax residency in India, aimed at boosting tax revenues. The Indian government is also planning a $30 billion public asset sale program to help curb the fiscal deficit. Import tariffs were also proposed on certain goods, including furniture and footwear.

The growth rate has been in decline for six consecutive quarters and stood at 4.5% y/y in 3Q19, despite a combined 135 bps of interest rate cuts and considerable corporate tax cuts in 2019. Growth was weighed down by weaker investment, stemming from tighter credit conditions and a banking sector burdened with bad debt, which could impede lending going forward. Private spending has also been relatively weak, despite a modest recovery in 3Q19, and may remain subdued under rising inflationary pressures. However, there are some promising signs: industrial production increased for the first time in four months in November, and the composite PMI hit a seven-year high in January. Looking forward, the consensus view is that growth will pick up to a downwardly-revised 6% in FY20/21, from an estimated 5% in the current fiscal year, an 11-year low.

Oil prices slide on Coronavirus epidemic

The Chinese Coronavirus epidemic has pushed international benchmark Brent crude into bear-market territory as fears grow about the likely impact on Chinese consumption and, by extension, energy demand. As of 5 February, Brent had fallen 20% from its January peak to $55.3 and its lowest in over a year. (Chart 4.) Indeed this is possibly oil’s worst start to a year since 1991, with Chinese oil consumption estimated to have dropped by at least 20% (3 mb/d) – the biggest oil demand shock since the financial crisis – as the country remains in lockdown and international flights suspended.

Oil’s precipitous decline has prompted the OPEC+ group to consider bringing forward its scheduled March meeting to formulate a response to the crisis, perhaps through further production cuts. Talks among an OPEC+ technical panel in early February recommended additional oil production cuts of 600,000 bpd. All indications are that with oil demand weaker, global supply and stock levels are only going to get larger; the Brent forward curve structure has already slipped into contango (where futures prices trade above spot prices) for the first time since last July. Oil’s bearish move has occurred despite the loss of an estimated 1 mb/d of crude from Libya, as forces loyal to General Haftar blockade the country’s ports. Libya’s production is reportedly below 0.3 mb/d, its lowest level since the ousting of Gaddafi in 2011.