

US: Fighting the fear

Market optimism following the US-China trade deal announcement has given way to fear of what the human and economic cost may be from the coronavirus. Policymakers are understandably reluctant to act right now. If consumer and business respond negatively, they probably won't hesitate. We have trimmed our growth forecast for this year to 1.5% from 1.7%



Shoppers in Fairfax, USA

A "material change"?

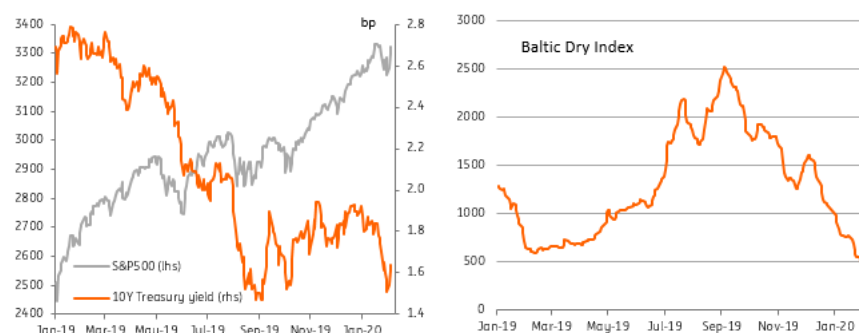
After 2018's tax cut fuelled growth, the US economy was always likely to slow in 2019. Last year's performance was solid, if unspectacular, but it would have been worse had the Federal Reserve not come to the rescue after a market/data wobble in late summer. Fed officials are seemingly of the view that their three 25 basis point rate cuts and liquidity injections, coupled with the phase-one trade deal between the US and China, have stabilised the situation. Only a "material change" in the outlook is going to make them alter their assessment that policy is on hold for the foreseeable future.

Unfortunately, that "material change" could soon be upon us. \$850bn was wiped off the value of S&P 500 stocks and the 10-year Treasury yield plunged back to 1.5% as fear spiked that the coronavirus outbreak could be more severe and have wider consequences than the SARS outbreak

nearly 20 years ago. We have since seen a partial reversal of these moves on potential hope of an eventual vaccine, but markets remain on high alert for bad news.

At the time of writing, there are only 12 confirmed cases in the US with 80 people being tested for the virus. It is entirely possible that the worst is over and that quarantine efforts and swift medical action have contained the situation. However, we can't take anything for granted and in an environment of already subdued global growth, the virus threat amplifies the downside risks to US economic activity. It is certainly not something we can ignore in our forecasts.

Equities remain resilient, but bonds and freight are nervous



Source: Macrobond, ING

Supply chain disruption looks likely

Given the evidently high human and economic cost of the virus in China and other parts of Asia, the most obvious impact is likely to be in US supply chains.

It seems likely that there will be disruption to Chinese factory output and logistics, which means parts and components may increasingly be in short supply for the export market. The availability of consumer goods from the Asian region may also be limited, which means running down US inventories and perhaps marginally weaker import growth. This could be felt acutely in some parts of the US economy given the fact that US imports plunged at an 8.7% annualised rate in 4Q19 so inventories are already starting from low levels for some products.

The disruption in China may also mean that the predicted “export boom” by the US Administration from the phase one trade deal does not come as swiftly or as markedly as initially hoped. This is readily accepted by the White House given the obvious hit to Chinese growth and therefore the likely demand for US-made products. That said, US officials are emphasising that the situation should not be used as an excuse to backtrack from broader commitments pledged as part of the overall trade deal. But the recent Chinese announcement to slash tariffs on \$75 billion US imports offers clear signals that they hold.

Consumers are key

The bigger concern will be what might happen if the virus is not contained and the number of US cases start to rise. We would likely see increased health warnings, which could start to impact both consumer and corporate behaviour. Consumer spending contributes nearly 70% of US GDP, which is greater than other developed market economies, so a shock here would have major ramifications for growth.

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Spending on consumer services would be most vulnerable to such a situation as that is more likely to involve human contact that consumers may become more nervous to experience. For example, travel could be actively discouraged. Hotels and restaurants make up 7% of US consumer spending, transport services (air, rail, bus etc) is 3% and recreational services (cinema, theatre, theme parks, etc) is around 4%. We must then add in the loss of spending from tourism and personal services (such as going to get a haircut). There may be some offset from higher internet sales and perhaps some substitution of spending, but overall we suggest around 18-20% of consumer spending components are vulnerable. If spending was to fall 5% on those components that would knock a full percentage point off consumer spending growth. A ten percent fall in those components would be enough to drag annualised GDP growth in a quarter down to zero.

We have not fully factored this scenario into our forecast as the prognosis for the virus remains so uncertain, but we have certainly made an acknowledgement by trimming our growth forecast for 2020 to 1.5% from 1.7%. The more the virus spreads the greater the chance that we see growth coming in below this. This in turn heightens the probability we see the Federal Reserve respond with lower interest rates and the market becomes more risk averse with lower equity prices and bond yields.

Growth and interest rate risks skewed to the downside

This is especially unfortunate given burgeoning hopes that the improvement in US-China trade relations could provide a platform for stronger US economic numbers in 2020.

The ISM manufacturing index certainly responded positively with the chart below suggesting we could see a sharp recovery in manufacturing output. This though is likely to be a relatively short-term blip with worries about Boeing production cuts providing an offset while the uncertainty the virus generates may further offset the positives. The associated fall in oil prices may also limit the scope for additional well drilling in the United States.

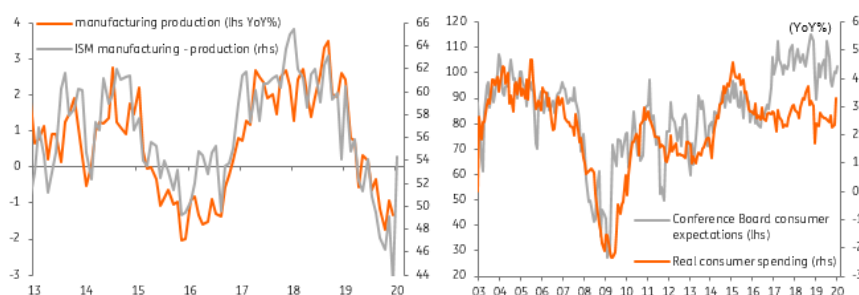
Admittedly, we were slightly less upbeat than many about the implications of the US-China trade deal and didn't see the agreement as transformational. Moreover, with the recent Deloitte's CFO survey showing 97% of respondents thinking the US is either already in a downturn or will be at some point this year, we don't have much confidence that US business leaders are about to start spending in a meaningful way. We are also mindful that presidential elections typically make firms wary of putting money to work given the potential for significant regulatory/taxation changes.

We are also doubtful that strong consumer sentiment readings will translate into a sharp increase in consumer spending given wage growth has dropped back to 2.9% year on year, having flirted with the prospect of breaking above 4% early last year. That said, the housing market is likely to remain a source of strength in the near-term with strong readings for construction and homebuilder sentiment driven by the plunge in mortgage rates through 2019.

Overall, the threat that the coronavirus outbreak poses in an environment of already subdued global growth underlines the potential for medium-term US economic weakness. It is impossible to forecast the path of the virus, but it increases the chances that the Fed will cut rates at least once more to provide some support to the economy.

We suspect 10-year Treasury yields to be anchored around the 1.5% level for most of the first half of 2020.

Signs of hope to be superseded?



Source: Macrobond, ING

Market also exposed to domestic political risk

Looking further ahead (and assuming the virus threat subsides), the second half of the year will be dominated by domestic politics. The long-running presidential impeachment saga has come to an end with President Trump acquitted on a vote split down party lines (Mitt Romney being the only Republican to vote guilty on the abuse of power charge). It does not seem to have done him much harm in the eyes of the electorate with Gallup's latest poll of sentiment towards the president giving him a 49% approval rating – his highest ever!

Amongst Republicans his approval rating is at 90%, for independents, it is at 42% while for Democrat supporters it is just 7%. Meanwhile, the Democrats remain a long way off choosing their candidate to face him and the debacle of the Iowa caucus has not reflected well on the party (Pete Buttigieg and Mike Bloomberg seemingly coming out of it best - and the latter wasn't even on the ballot). It does not seem to be a focus for markets right now, but with a broad range of candidates, the policy mix from the eventual candidate could see equities and the dollar come under pressure depending on whether the party opts for a centrist or progressive.

Despite the latest developments the Democrats still have a strong chance of claiming victory. Given the President is elected on electoral college votes (see [link](#) for a more detailed explanation) the Democrats only need to flip the key swing states of Michigan, Pennsylvania and Wisconsin - assuming they hold onto the ones they currently have. Donald Trump has made much of the strong economy, but these states have underperformed. 3Q GDP growth in Michigan was just 1.3%, Wisconsin was 1.5% and Pennsylvania matched the US average at 2.1%. The labour market contrast is starker. These three states have all seen employment rise by less than half the 4.6% national average experienced since President Trump's inauguration and at one-third of the pace of the national average over the past 12 months.

Should the Democrats play the “it’s the economy, stupid” card at these local levels, this will be an area of weakness for President Trump.

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