US: Hope for the best, prepare for the worst

Coronavirus concerns are gripping the nation as an initial supply shock morphs into a financial shock and now a demand shock. The Federal Reserve has leapt to action, but we are still in the early phase and the economic disruption will likely intensify in the coming weeks

A reversal of fortunes

The US economy appeared to have started 2020 on a strong footing with consumer confidence close to record highs, business surveys bouncing back as trade tensions eased and residential investment a key source of strength. However, it is increasingly apparent that the US faces a major economic drag from the rapidly spreading coronavirus. There was already a (relatively modest) supply shock as supply chains faced disruption due to factory closures in China and other parts of Asia, but over the past couple of weeks, this has turned into a financial shock as bond yields and equities plunged. So far there is little sign of distress in high yield and the leveraged loan markets, but this is something the Federal Reserve is closely watching.

We have revised our full-year 2020 GDP growth forecast *downwards to 1.2%.*

On top of this, there is growing concern that the fear factor surrounding Covid-19 will change corporate and consumer behaviour and lead to a demand shock as well. This is most likely through the service sector of the economy with travel, hotel accommodation, restaurants and leisure-related sectors looking vulnerable. Together, these components make up nearly a fifth of consumer spending or a little over 10% of GDP. If they do indeed experience a sharp contraction, a negative second-quarter GDP print will be hard to avoid, especially with exports likely to soften and investment spending weakening as companies become more cautious.

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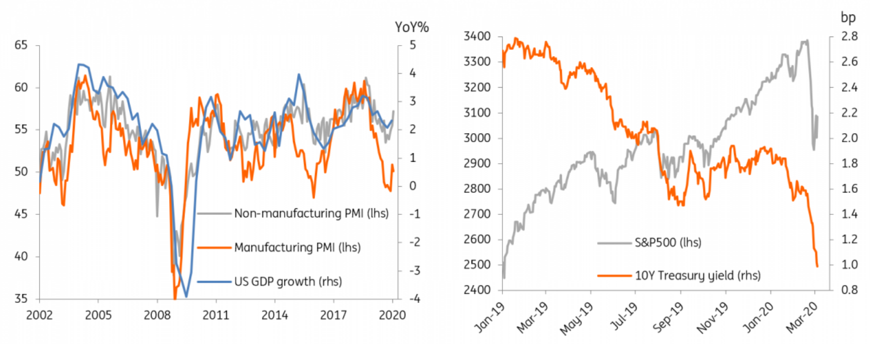
Business surveys had turned the corner, but market plunge points to a reversal



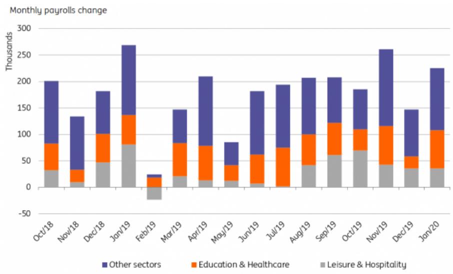
Source: ING, Bloomberg

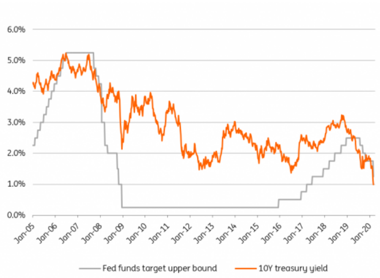
Inflation risks to the downside

We have to be cognizant of the potential for weaker jobs numbers too. Leisure and hospitality, which is heavily exposed to the fear factor of Covid-19, has been responsible for nearly 20% of all the US jobs created over the past 18 months. Education and healthcare has been an even bigger contributor to employment growth so if we start to see schools close this component will be impacted, but we could see stronger health and social assistance hiring in its place. Either way, we see a diminished prospect of a substantial acceleration in wage growth in coming months even if labour supply is impacted through illness and worker absenteeism.

Inflation pressures are likely to soften more broadly. Oil and other commodity prices have plunged and this should contribute to a rapid decline in headline inflation while weaker economic demand is likely to offset the supply shock, thereby keeping core inflation contained. For example, retailers and restaurants may end up having to offer significant discounts to entice customers out of their homes.

US jobs growth composition and US interest rates





Source: ING, Bloomberg

The rapid response team...

The Federal Reserve responded with an emergency 50 basis point rate cut on 3rd March. We doubt it will trigger a meaningful boost to aggregate demand, but implementing rate cuts should help to mitigate some of the strains in the financial system, particularly if it is accompanied by additional liquidity/credit measures in coming months. We are pencilling in two further 25bp rates cuts for 2Q providing a total of 100bp of easing, but the risks are going to be skewed towards the Fed taking more aggressive action. The 10-year yield has already breached 1%, but we suspect it has further to fall. We target 0.75% in coming weeks.

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There has been notional talk about fiscal loosening to support the economy, but we doubt anything meaningful will happen given the fraught Democrat-Republican relationship that was exacerbated by the impeachment process brought against President Donald Trump. The Republicans would likely push for tax cuts that the Democrats would likely oppose in favour of higher spending.

Instead, we should be looking for the release of emergency funding in the tens of billions rather than hundreds of billions. This would likely be focused on testing kits, protective equipment and boosting staffing at healthcentres. The Federal government may also offer support to states through larger Medicaid contributions while temporarily loosening the conditions required to qualify for welfare benefits – you often have to be available (and looking) for work to qualify, but that may not possible given Covid-19. We may also see support to heavily disrupted businesses such as being able to delay or defer some tax payments plus the potential for business grants or lending facilities to help tide small firms over until the crisis fades.

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Our best guess as a team is that the peak economic effect of Covid-19 will be in 2Q20 and that pressures may then start to ease, but this is a massive unknown. Assuming this view is correct we expect to see a gradual improvement in economic activity in 2H20, but with Presidential, House and Senate election campaigning reaching a peak at that time, businesses and households may remain cautious.

The race for the White House is becoming clearer

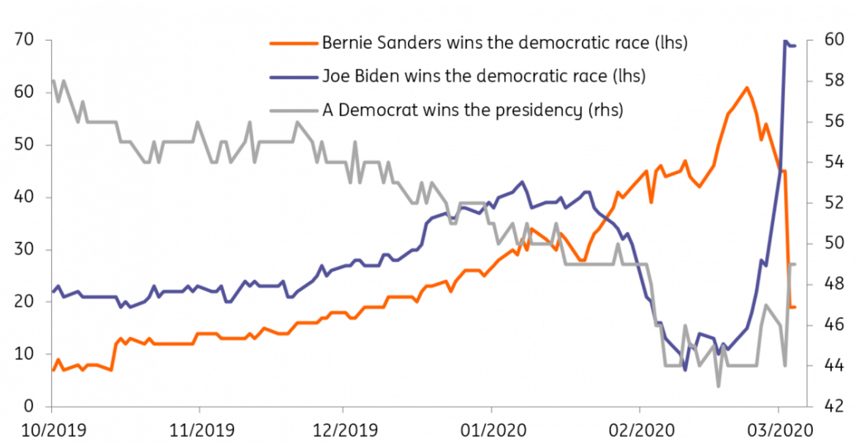
That said, it is looking a little clearer as to who President Trump will face in the battle for the presidency.

In recent days we have seen Pete Buttigieg, Amy Klobuchar, Elizabeth Warren and Mike Bloomberg all pull out of the race for the Democrat party nomination. Former Vice President Joe Biden has made a remarkable comeback with sweeping victories on Super Tuesday where 14 states and a third of the delegates were up for grabs in the battle for the candidacy. It appears to be a run-off between the centrist Biden and the self-declared “democratic socialist”, Bernie Sanders. With Biden receiving the backing of Buttigieg, Bloomberg and Klobuchar the momentum seems to have shifted dramatically in his favour as the chart below suggests.

Sanders is very much a progressive and has been emphasising policies that would benefit the poorer segments of the population such as a massive increase in healthcare spending, funded by tax rises for the wealthiest individuals and companies. Biden would be less revolutionary in this regard, but both candidates are certainly pushing for tougher regulatory and environmental standards than US companies currently face. One of the biggest differences is on trade policy with Joe Biden widely regarded as being in favour of deals and deepening trade relationships while Bernie Sanders has taken pride in opposing NAFTA, its USMCA replacement and TTIP.

Implied probability of victory based on PredictIt website quotes

www.predictit.org



Source: ING, Bloomberg

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