

Monthly Economic Update

Damage containment

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7 February 2020



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Coronavirus 'fear factor' is the biggest risk to the economy

The coronavirus has already hit demand in China, as well as supply chains further afield. But if the outbreak becomes more widespread overseas, the major risk is 'fear', and this could begin to take its toll on consumer spending and trade growth among developed economies

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 consumers and business respond negatively, they probably won't hesitate. We have trimmed our growth forecast for this year to -1.5% from 1.7%

Eurozone: Zigzagging towards stronger growth

The eurozone ended 2019 on a soft note, with growth decelerating to 0.1% quarter-on-quarter. While the stars are aligned to see a gradual, though subdued, growth acceleration, the coronavirus might delay the improvement a bit longer, leading us to downgrade our 2020 growth forecast to 0.7%.

UK: Rising optimism tempered by Brexit and virus risks

Despite rising optimism among firms, the risk of an abrupt change in trading relationship with the EU in 2021 means that investment is likely to remain under pressure. For the time being though, we expect interest rates to remain on hold at the next few Bank of England meetings

China's challenge from coronavirus

China is facing more challenges in the middle of the outbreak of the coronavirus, from retail to manufacturing to possible defaults in bank loans and bonds. But the government is going to try to contain the damage to the economy with more fiscal stimulus

Japan: In case of emergency

Japan only has about 25 cases of coronavirus, but if this is just the start of a bigger outbreak, it could see GDP growth slow sharply into full-blown recession

FX: Re-pricing for a shock

FX markets are in the process of adjusting to the coronavirus news – largely seen as a Chinese demand shock. If the virus was to start weighing heavily on activity outside of China – especially in the US – then the dollar might have to re-price lower as well

Rates: Path of least resistance

Market rates are likely to remain relatively low; at about current levels or lower in the coming weeks (and likely months). Structural reversion to higher rates would need evidence that there has been a positive turn of the tide. In the meantime, an information vacuum perception sustains vulnerability. These are strange times, so expect volatility

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Coronavirus 'fear factor' is the biggest risk to the economy

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What's the latest?

The rapid spread of the coronavirus (nCov) throughout China is quickly becoming a major source of uncertainty for the economy. Markets – most notably commodities – have taken a hit as concerns over demand become more widespread.

Comparisons are naturally being made to SARS back in 2003, and the early data suggests that nCov is proving less fatal (the mortality rate is around 2% so far), but importantly it is much more infectious. The number of nCov cases is already far in excess of SARS at the same point in time after the first case was reported.

If there's one glimmer of hope, it's that the rate of change in cases each day has not gone exponential, though these trends can change rapidly.

While this may tentatively hint that the virus has been contained, the reality is we still don't know just how far the virus has spread outside of China. The number of cases confirmed overseas is still limited – especially outside of Asia – but the total is now over 200 and rising. Many of these, however, were visiting Chinese tourists. Cases of community transmission remain low.

Given the virus has a 14-day incubation period, the full spread may only become apparent over coming days. And despite market optimism on potential vaccines, it could be several months before these can come into use.

What's been the impact so far for the global economy?

As Iris Pang notes in this month's economic update, Chinese retail and associated services have felt the immediate brunt of the virus. From shops to restaurants, a lack of footfall is hitting sales, while a sharp fall in inbound tourism will also take its toll.

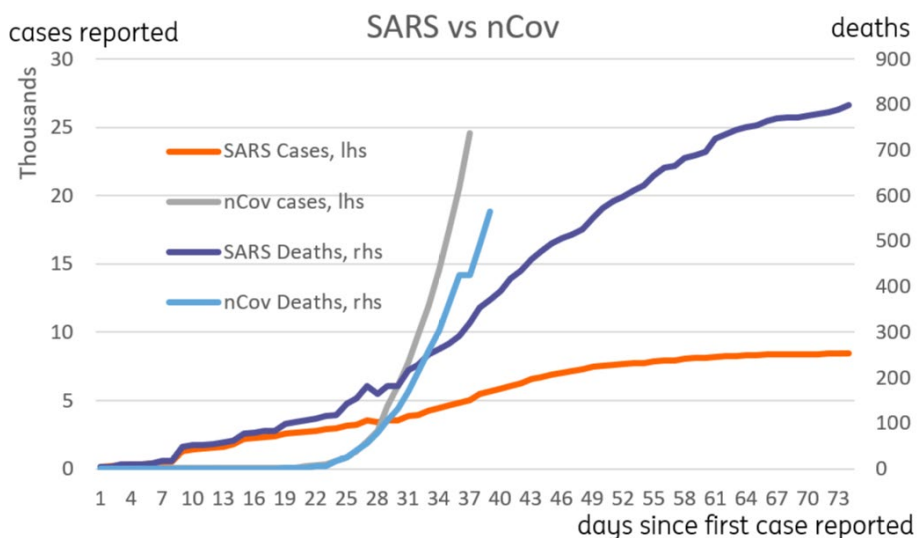
But as time goes on, supply chain disruption will become a bigger concern globally. China is much more integrated into the global economy than it was back in 2003 when the SARS virus hit. A sustained drop in Chinese production of electrical components could

quickly cause knock-on effects elsewhere. Production outages have already forced [carmaker Hyundai](#) to close South Korean factories owing to a lack of Chinese components.

Carsten Brzeski suggests this [could be yet another headache for German industry](#), where the latest data suggests the sector is still experiencing sharp order book deterioration.

World trade growth will inevitably suffer, particularly if marine shipments are cancelled and air freight becomes more restrictive. [Our trade team notes](#) that capacity constraints within global logistics mean the current fall in trade volumes might not be made up quickly later in the year.

Coronavirus cases compared to SARS



Source: WHO

What would a global pandemic mean for global growth?

If the number of cases begins to surge outside of China, one of the principle channels of transmission to the economy will be through “fear”. Fear of catching the virus results in a change in household behaviour that is arguably disproportionate to the chances of either catching the disease, or of dying from it.

That change in behaviour typically manifests through a very substantial decline in consumption of consumer services. Spending on recreation (cinema, theatre), transport (public), eating out and accommodation, could be particularly vulnerable.

Our latest forecasts assume that the epidemic is not contained within China, and there is some ‘community transmission’ in major economies. Taking the US as a guide, we reckon roughly 18-20% of consumer spending is directly exposed to the ‘fear’ factor. A 5% fall in those categories could quickly see around 1% knocked off consumer spending. This is a worry given that consumer spending has been a key growth driver throughout the developed world over recent years, often in the absence of investment and net export growth.

The spread would inevitably hit other sectors, too. Some airlines are already furloughing staff in the region as they cancel flights. And some imports of commodity goods and fuels have been rejected with a force majeure as demand slumps and storage facilities reach capacity.

As always with shocks like this, it's fair to say there is limited scope for policy responses in some countries. Interest rates are low or negative in many advanced economies, while fiscal policy is bound by political constraints (e.g. US), regulatory ones (e.g. EU) or structural (e.g. Japan).

This situation is especially unfortunate since the improvement in US-China trade relations was expected to reduce uncertainty and provide a platform for stronger global growth for 2020. White House officials have acknowledged that the impact on the Chinese economy means that the predicted US "export boom" will be less than hoped, but are keen to emphasise the situation should not be used as an excuse by China to backtrack on commitments made as part of the deal.

What would a widespread pandemic mean for markets?

A generalised shift to risk aversion will likely see equity markets sell off, especially given the fact that the damage to prices has so far been contained. Now, how far they fall may be highly dependent on how stretched their valuations had previously been, so US markets may be more exposed here than some in Europe or Asia. In general, we would expect EM currencies to underperform those of the DM universe which also may hinder the ability of local central banks to respond to weak domestic demand with more accommodative policies. Reliance on commodity exports is another factor that could affect the resilience of an economy, and its asset and FX performance.

Government bond yields will also likely fall further in the short term. In itself, this would create more accommodative financial conditions, but if accompanied by a sell-off in riskier high yield credits that conclusion would be undone, by spreading further pain through the business channels – which are already very weak in many parts.

US: Fighting the fear

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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 consumers and business respond negatively, they probably won't hesitate. We have trimmed our growth forecast for this year to -1.5% from 1.7%



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.

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 raising spending in a meaningful way. We are also cognizant of the fact 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 Donald Trump acquitted on a vote split down party lines (Mitt Romney being the only Republican to vote guilty on the abuse of power charge).

The damage to his ratings, at least so far, has not merely been contained, in fact, Gallup's latest poll of sentiment towards the president gave 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.

Eurozone: Zigzagging towards stronger growth

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The eurozone ended 2019 on a soft note, with growth decelerating to 0.1% quarter-on-quarter. While the stars are aligned to see a gradual, though subdued, growth acceleration, the coronavirus might delay the improvement a bit longer, leading us to downgrade our 2020 growth forecast to 0.7%.



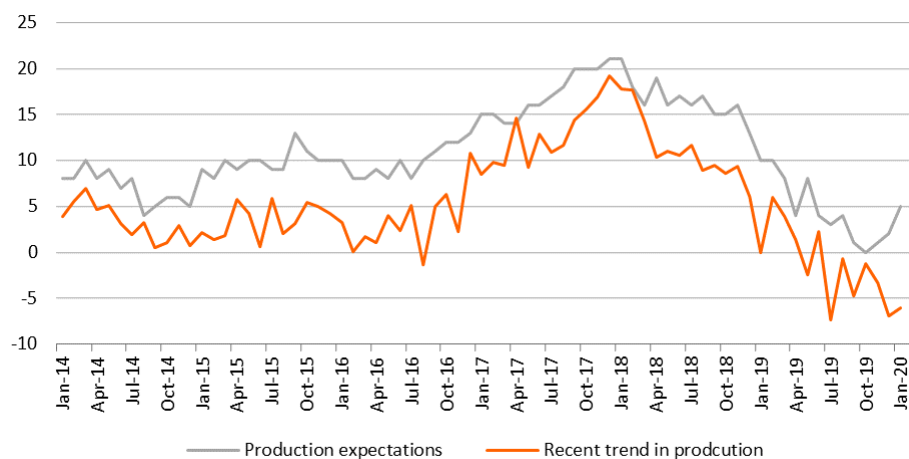
Inventory correction

The 0.1% quarter-on-quarter growth in the last quarter of 2019 was disappointing, with both France and Italy reporting negative GDP growth. In France, the inventory correction shaved 0.4 percentage points off fourth quarter growth, which was probably also a negative factor for Italian growth. And while the GDP figures for Germany are not yet published, the 3.3% drop in retail sales in December shows that industrial weakness might eventually also affect consumption.

The good news is that with companies having cut back inventories in a number of member states, an uptick in demand will result in higher production. The €-coin index, a monthly estimate of the underlying growth pace, rose to 0.25 in January, the highest level since January 2019.

The European Commission's economic sentiment indicator for January increased markedly with production expectations picking up strongly. Confidence in the construction sector also improved, while it stabilised in the services sector. That said, the mood in the retail sector soured a little. However, with the unemployment rate falling to 7.4% in December, the lowest rate in 12 years, and employment plans improving in industry, the backdrop for consumption remains favourable.

Industry is expecting more production



Source: Refinitiv Datastream

Coronavirus will slow the improvement

However, we remain wary of the fact that the improvement is still weak and uneven. Moreover, there are still a number of uncertainties. The coronavirus, while for the time being relatively contained in Europe, is bound to have a dampening effect on growth in the first half of the year, all-be-it only because of lower exports to China. We also expect a significant impact on consumption, which is now only likely to grow by an annualised 0.4% in the first half of this year (0.7ppt lower than our previous estimate), though a limited catch-up effect in the second half could follow.

Political risks have somewhat diminished, although they certainly haven't disappeared entirely. The current Italian government more or less survived the regional elections, while Brexit has now happened (though there is still not much certainty on the future trade relationship). A temporary truce was reached in the trade row between France and the US on the digital tax. That said, President Trump might still fire a few warning shots in order to get a good trade deal with the European Union ahead of the US elections.

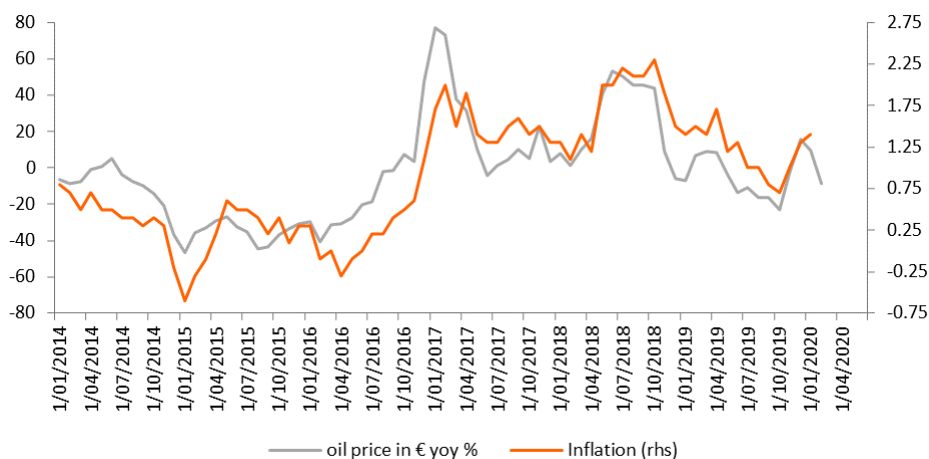
2020 will see slower growth, on average, than 2019

All in all, we don't see much reason to alter our view of some gradual growth improvement over the course of this year, although the first half is now likely to be hurt by the coronavirus fallout. Because of the weak base effect, we also deem it rather unlikely that 2020 will be better than 2019, on average. On the back of the downgrade to the growth profile in the first half of the year, we have lowered our GDP growth forecast for this year to 0.7%, while we pencil in 1.1% for 2021.

Inflation remains low

Eurozone inflation rose further to 1.4% in January. This was largely an oil story due to the fall in oil prices at the beginning of last year. However, this effect is bound to reverse over the coming months. More importantly, underlying inflation has fallen back to 1.1% from 1.3% in December, showing that the upward trend in core inflation remains muted. The fact that the powerful German trade union IG Metall is now proposing wage moderation in exchange for job security shows that an upward push to inflation from wages is not to be expected soon.

Oil prices will push inflation down again



Source: Refinitiv Datastream

ECB: status quo

In these circumstances, not much is to be expected from the European Central Bank. Even the more hawkish President of the Bundesbank, Jens Weidmann, stated in a recent interview that “it is clear that the very low-interest rates cannot be permitted to persist indefinitely. Given the price outlook, though, we need to stay realistic: it will probably take a while for interest rates to pick up again”.

The ECB president, Christine Lagarde has kickstarted the strategy review - the first in 16 years. The ECB expects the review to be concluded by the end of the year and will aim to look at the definition of price stability and the ECB’s toolkit. It will also consider how other factors like financial stability, employment and environmental sustainability could affect monetary policy and its goals.

However, any substantial changes including to the forward guidance, before the end of the strategy review looks unlikely.

UK: Rising optimism tempered by Brexit and virus risks

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Despite rising optimism among firms, the risk of an abrupt change in trading relationship with the EU in 2021 means that investment is likely to remain under pressure. For the time being though, we expect interest rates to remain on hold at the next few Bank of England meetings



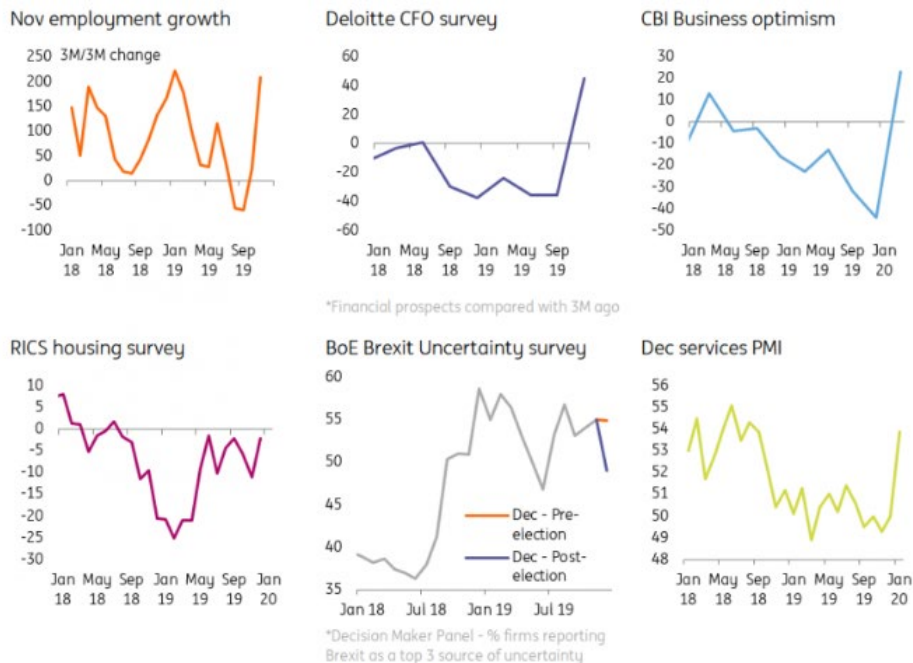
Rising optimism may not translate into faster growth

December's landslide election victory for Boris Johnson's Conservative party, coupled with the avoidance of 'no deal' Brexit at the end of January, has prompted a noticeable rise in sentiment. Virtually every business survey since the turn of the year has rebounded. The latest PMIs point to the fastest rise in 'business expansion' since mid-2018, while fewer business leaders are noting Brexit as a major source of uncertainty according to a recent Bank of England survey.

The key question now is, will this optimism translate into faster economic growth? We think the risk is that it won't, at least not as much as the surveys suggest. And that appeared to be the view taken by the Bank of England at its latest meeting too.

While the Bank noted the improvement in the survey data, its latest forecasts don't point to a sharp revitalisation in quarterly growth rates. Like us, policymakers are projecting 0.2% growth in the first quarter following zero growth in 4Q19.

Survey data has universally rebounded



Source: Macrobond, Bank of England

Coronavirus would hit consumer spending

In the near-term, the obvious downside risk comes from coronavirus. Global manufacturers are already reporting shortages of Chinese-produced components – and a reduction in inbound tourism could also be an issue for the UK. But if the virus were to become more widespread in Europe, then the ‘fear’ factor could begin to take its toll on consumer spending.

In principle, the consumer outlook looks a little brighter this year – falls in household energy costs mean real wages should rise more noticeably. But with restaurants, hotels and recreation making up 20% of UK consumption, these are areas that could feel the squeeze if the virus spreads, and individuals become warier of frequenting busy public spaces.

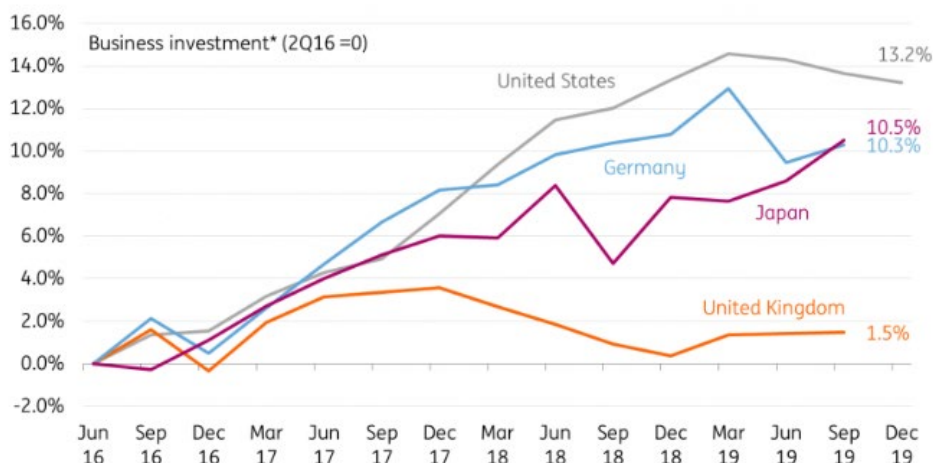
A free-trade agreement doesn't mean frictionless trade

The much bigger risk comes from the potentially abrupt change in the UK-EU trading relationship at the start of 2021. Both sides are aiming to negotiate a free-trade agreement this year, but the key thing to remember is that free trade doesn't equal frictionless trade. Firms will still need to fill in customs documentation, navigating the complicated world of ‘rules of origin’ (the stipulation that a certain percentage of a good should be made in the area it is being exported to), as well as regulatory checks and VAT payments.

A free-trade agreement will also mean greater frictions for services – in particular, those that rely on cross-border market access.

This suggests further risks to investment, which has already underperformed other G7 economies over the past few years. Business investment has risen by only 1.5% since the Brexit vote in 2Q16. The US, Germany and Japan have all seen double-digit growth in business investment since then, according to the most comparable data.

UK investment has significantly underperformed



Source: Macrobond, ING calculations
 Directly comparable data for business investment isn't available. We have used private non-residential investment for US/Japan, non-government investment in machinery/equipment for Germany

Investment likely to remain under pressure

Admittedly, it is still too early to predict exactly how businesses may react to the free-trade agreement. However, the potential for delays at ports in the initial stages (given customs infrastructure may not be fully ready by the start of 2021), means we may see some renewed efforts to stockpile components/finished goods again ahead of the anticipated changes.

Equally, the prospect of greater trade frictions will almost certainly see some onshoring of production over the next couple of years. [The FT reported](#) earlier this week suggesting some carmakers are mulling increasing production for the domestic market. But it's worth remembering that this process would in effect be a cost for businesses, and would divert resources away from other potential investment.

The bottom line is that investment, particularly that with a longer-term horizon, is likely to remain under some pressure. For the time being though, we think the Bank of England is likely to keep interest rates on hold, barring any significant deterioration in the growth numbers.

China's challenge from coronavirus

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China is facing more challenges in the middle of the outbreak of the coronavirus, from retail to manufacturing to possible defaults in bank loans and bonds. But the government is going to try to contain the damage to the economy with more fiscal stimulus



1

The first hit is retail related sector

As readers may know with the outbreak of the coronavirus, Chinese retail shops have had very few consumers. From around a week ago, consumers have worried viruses could be spread by delivery crews who deliver food to their homes, so now, restaurants are in the list of suffering from a very low level of sales. Children's after-school classes have been stopped, eg piano and drawing classes. But they can continue to go online for their python programming classes.

So the service sector has been hit hard, including delivery, retail, restaurants, mass transportation, and inbound tourism. Surely outbound tourism is also affected, which is counted as imports of services, and when it falls it helps GDP to grow, though not in a nice way. Global tourism will be affected by this coronavirus, especially from Chinese lavish spenders.

2

The second hit is the manufacturing sector

The manufacturing sector could also be hard hit by this coronavirus. It is still uncertain how many factory workers will leave their home town to return to work in the factory. Their worry is that once they leave their home town they cannot get in (until the local government relaxes this policy, which seems likely only when the virus is contained), and then they would worry if the factory production will be stable if other workers are not returning to work. On the other hand, the workers cannot easily find a job in their home town. That's why this is uncertainty. We will be clearer on the situation after two weeks from now.

The high chance is that some production lines will be stopped, and therefore will hurt output and exports. The more labour intensive is the factory, the more it will be affected. Not to mention that this will delay investments in production lines even there is such demand.

3

The third hit is the loan and credit sector

We highlight two points for the loan and credit sector under this coronavirus:

- 1) As many companies are hit by the coronavirus, no matter they are hit by sales or by production, they have a chance that they cannot pay back their debts. Non-performing loan ratio should increase from the current 1.86% for 3Q19. We expect this to go up to around 2.5%, a level similar to 4Q08. History tells us that when NPL increases, bank loan growth falls and so does GDP growth.
- 2) There is a usual practice in China that borrowers pledge their stocks as collateral of loans. If the A-share stock market continues to fall then the collateral value will fall, and the borrowers may need to top up their collateral. During the coronavirus, it will be difficult to top up collateral when asset prices should trend downward. Though some news reports claim that the Chinese government could install administrative measures to stop A-share from falling, e.g. buy stocks by the four state-owned asset management companies, this may not prop up every stock that is collateral for loans and credits. Without enough collateral, the borrowers may need to wind down their loan and credit outstanding or risk a default, which will also affect GDP growth.

Fiscal stimulus is the cure for the coronavirus

We expect that the Chinese government will increase fiscal support to stabilise GDP growth. We expected 2 trillion yuan of fiscal stimulus before the outbreak of the coronavirus, we believe that the stimulus will go up to at least 3.5 trillion yuan in 2020, which is 3.5% of nominal GDP for 2020.

Most of the fiscal money will be used in the medical sector to try to combat the virus, to cure patients and to prevent more confirmed cases. These are the indirect effect to support GDP.

There are [two hospitals built for this coronavirus](#), and we expect more to come. With the additional hospitals, there will be a need for more hospital beds and medical equipment and medical vehicles.

Monetary easing policy will calm down market

Apart from the fiscal stimulus, monetary policy will ensure ample liquidity in the market so that there is no squeeze in short term interest rates. Without squeeze in the short term interest rate, the market has a lower chance to enter into a chaotic psychological situation.

We expect one more rate cut of 10 bps and one more RRR cut of 0.5 percentage point in 2Q20 if the coronavirus continues in 2Q.

Low energy price will support real GDP growth

As activities slow down, energy prices have dropped, this has a positive impact when we calculate the real GDP. But again, this is not something nice to have.

Our GDP forecasts for 2020

Summing up all the impact from the virus, and assuming that the coronavirus can be hopefully contained by 2Q20 (without new confirmed cases) we expect economic growth (%YoY) of China in 2020 to be 5.4% revised downward from 5.6% after considering the impact on loan growth.

5.0% 1Q20; 5.2% 2Q20; 5.5% 3Q30; 5.8% 4Q20

What will the recovery look like

We expect no speedy recovery of the economy even there will be no new confirmed cases. Full recovery may take four quarters after no new confirmed cases of the coronavirus.

Consumers will still be cautious and play safe, which will continue to affect both inbound tourism and global tourism. They will avoid crowds, avoid places like the gym room, swimming pools, and cinemas.

Factories should recover faster than consumer sectors that will help loan growth to recover as well.

Our forecasts on USD/CNY for 2020

We keep our USD/CNY forecasts (by end of period) as we see the market is quite calm on the currency:

7.050 1Q20; 7.000 2Q20; 6.950 3Q20; 6.850 4Q20.

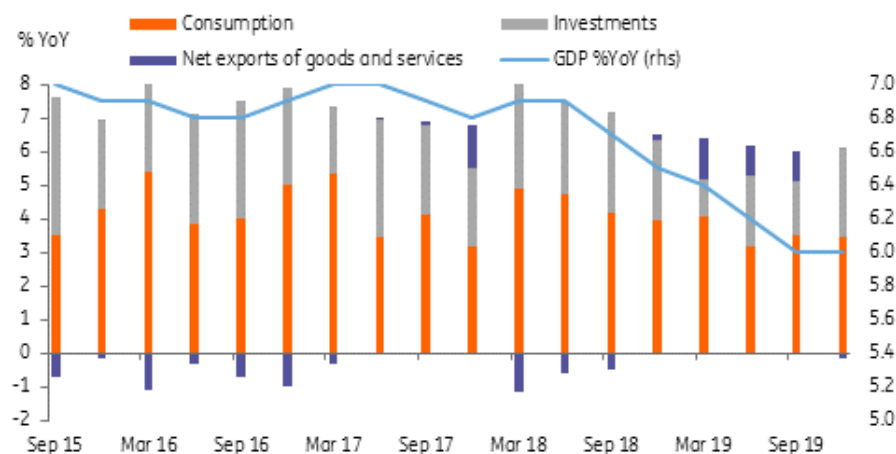
Our range forecast for the USD/CNY in 2020 is 6.5-7.2.

The yuan will weaken to 7.20 in our worst scenario when there is a speedy increase in new confirmed cases and a rise in mortality rate. When the virus is completely under controlled, eg with no new confirmed cases, then the market could rally to 6.5.

Other factors may reappear to be more important in driving the yuan when the virus is contained, eg the technology war and the trade war.

Nowadays, the USD/CNY moves with news and rumours more than with implementation of policies, e.g. RRR cuts and interest rate cuts. So we do not expect the easing monetary policy by PBoC will have much impact on the currency movements.

China GDP by component. Going down to 5.0 in 1Q20?



Source: ING, CEIC

Japan: In case of emergency

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Japan only has about 25 cases of coronavirus, but if this is just the start of a bigger outbreak, it could see GDP growth slow sharply into full-blown recession



How a virus can bring down an economy

We have historical first-hand experience of how a virus can bring down an economy with SARS back in 2003. And while there are many differences between that epidemic and what is happening now, the principal mechanism remains the same.

Where many economic simulations are actually just a form of actuarial arithmetic, for example, the costs of crime, the costs of obesity on the economy and so on, that sort of approach fails with an epidemic like the coronavirus. It may well be that the numbers infected and the total death toll will look insignificant compared to a regular flu outbreak. Such flu epidemics annually affect tens if not hundreds of thousands, and the global death tolls can be very substantial. Yet apart from some of us getting a flu jab, they don't affect our behaviour much.

It may not be proportionate to the individual risk, but the fear generated by an epidemic like the coronavirus, coupled with the official response - quarantines, curfews, lockdowns and travel bans, can have a very substantial impact on economic behaviour, and most of it, negative.

Service sector the hardest hit

When the fear of infection leads to economic retrenchment, by households, certain types of activity are typically shunned. The following, using Japan's household spending and income survey is not an exhaustive list, but shows the sorts of activities curtailed:

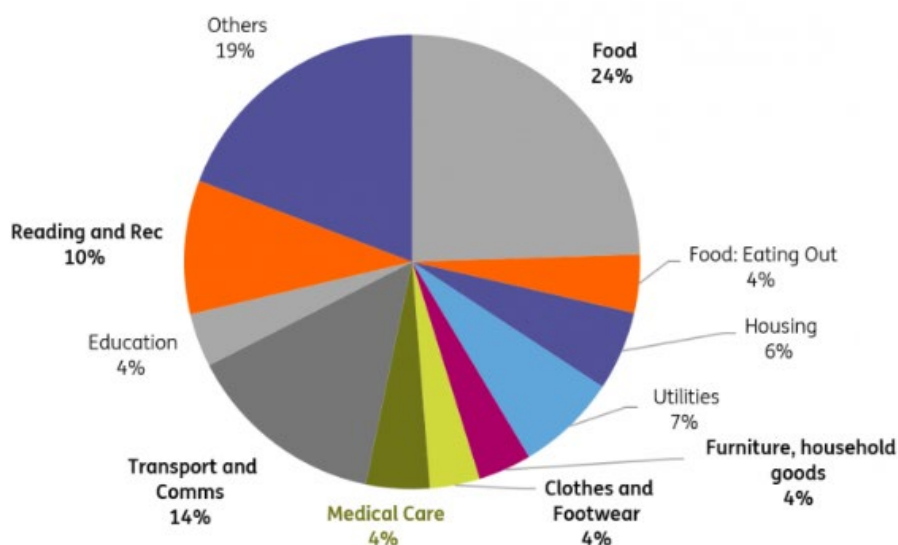
- Eating out (part of the food category - accounts for an average annual expenditure of about JPY152,000, out of the average total household spending of JPY3.3m);
- Recreational activities things like movies, theatre (part of the reading & recreation category - accounts for about two-thirds of the JPY350,000 annual spending of this category);

- Transport and communications - in particular, public transport, which accounts for about one-eighth of the total transport and comms JPY523,000 annual spending.
- Retail sectors such as clothes and footwear and furniture/household goods - together amount to about JPY270,000 annually. Online shopping may make up for some of these losses.

Of course, some other things get a boost. Medical care and medical products: Maybe in such environments, households are quicker to seek professional medical help in the event of sickness even if unrelated to the epidemic. Spending on preventative medicines, vitamins, disinfectant wipes and surgical masks, all may soar if stocks have not run out.

The average annual household spending on medical goods and services in the latest twelve months summed to JPY165,000.

How Japanese households spend their incomes (latest 12M JPY3.5m)



Source: CEIC

Evaluating an epidemic

It is thus a simple job to "shock" the consumer spending part of our GDP forecasts by cutting spending on the consumer services likely to be affected and providing an offsetting boost to medical care spending. In terms of the profile of the "shock", we are in February now, so if there is going to be a sizeable increase in Japanese coronavirus infection, it will probably take most of this month to emerge.

We can only guess the timing of any peak in infection and thereby the most intense impact on household spending, but the onset of the warmer, drier northern hemisphere spring and summer typically makes it harder for such infections to persist. So an April peak followed by some moderation would seem like a reasonable scenario. This leaves both 1Q20 and 2Q20 hit with progressively weaker spending in these areas before the recovery sets in.

But the recovery is unlikely to be "V-shaped", as sometimes is the case in the event of some other natural disasters, like an earthquake. Given the types of expenditure avoided, mainly services, there is unlikely to be much in the way of "pent-up" demand.

For example, you don't take two bus journeys' in May because you didn't take one in April. So the return to normality might be a relatively subdued one. Put another way, some of the expenditure lost, is lost forever.

Outcome of the "shock"

As we said at the outset, only about 25 cases of coronavirus are confirmed in Japan, and most of them were Chinese visitors. What we do not know now, and won't know for some weeks, is whether the virus is now established in the local Japanese population. If it is, it should begin to emerge (individuals will become symptomatic) through "community infection". If that happens, then the sorts of economic impacts we have noted above, plus others, for example, production slowdowns due to logistics interruptions (already affecting some car plants in South Korea), could add considerably to the damage.

Hitting our sensitive spending areas with a 10% decline in 1Q and a further 5% decline in 2Q, but allowing for some greater spending on medical categories, then allowing for a return to pre-epidemic spending levels in 3Q and later, is enough to strip off about 1 percentage point from consumer spending. So relative to the previous forecast for 2020, it knocks off about a half to two-thirds of a percentage point from GDP growth. The effect would have been larger, but the aftermath of the consumption tax had already left household spending depressed so pushing it lower still is somewhat harder than if it had been quite buoyant.

This isn't a "worst-case" scenario but represents a "first-step" forecast given the uncertainty of what may emerge from this corona epidemic, but on the assumption that what we are seeing now is not the peak in infections either for China or for Japan. If we see numbers of infections in Japan rise to thousands, mirroring what is happening in China, then this would almost certainly push Japan to negative growth for the year as a whole, and a full-blown recession of two consecutive quarters of negative growth would be hard to avoid, especially with both monetary and fiscal policy already maxed out.

FX: Re-pricing for a shock

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FX markets are in the process of adjusting to the coronavirus news – largely seen as a Chinese demand shock. If the virus was to start weighing heavily on activity outside of China – especially in the US – then the dollar might have to re-price lower as well



Commodity currencies adjust

The initial reaction in FX markets to the news of the coronavirus has been the sell-off in the commodity currencies. This complex had been well supported since late last year – after the phase-one trade deal. Yet that optimism has now evaporated. Given that China consumes around half of the world's commodities, it has been no surprise that commodity currencies have been dragged lower in line with the 13% fall in key benchmark commodity indices.

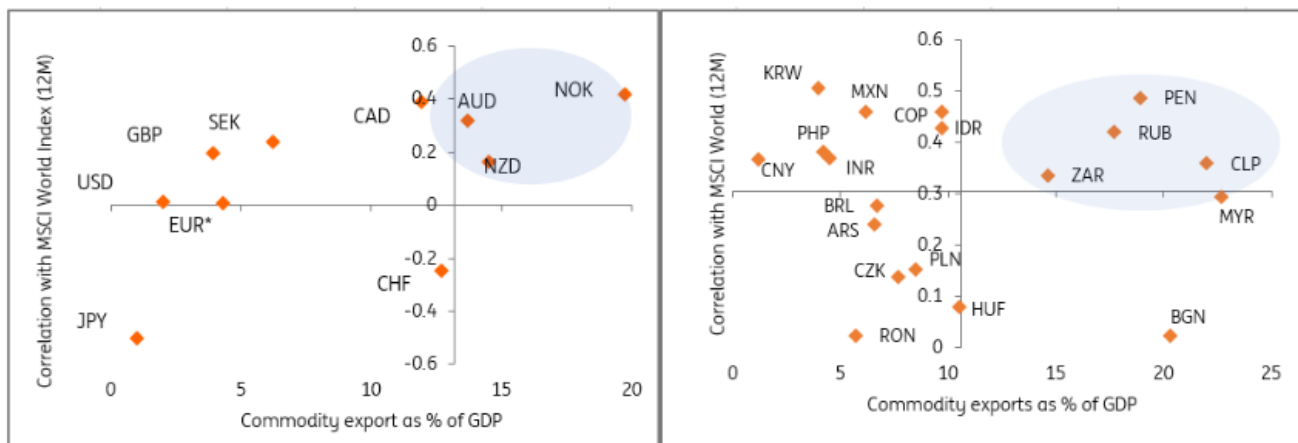
Flattening yield curves around the world have also been representative of declining growth expectations. This has had ramifications for corporate profit expectations and equity markets, prompting those currencies most correlated with equities to underperform as well. Those currencies most exposed to both commodities and equities are thus the most vulnerable to this China demand shock. In the G10 space, this means AUD, NOK and NZD. In the EM space, this means CLP, RUB, PEN and ZAR.

Additionally, those countries most dependent on tourism – especially Chinese tourism – have seen their currencies sell-off. Thailand is vulnerable here. And while not a commodity exporter, South Korea's strong macro links with China means that KRW is in the front line of currency weakness as well.

We suspect all of the above currencies will remain vulnerable through 1Q20 as investors track not only news of the virus, but also the fall-out on consumer and business sentiment and then ultimately the hard data as well. Any hope for a rally in pro-cyclical currencies now looks like it will have to be postponed to 2H20.

Looking at the currencies most exposed to:

i) commodity exports and ii) correlation with equities



Source: ING, Bloomberg

Is the dollar immune?

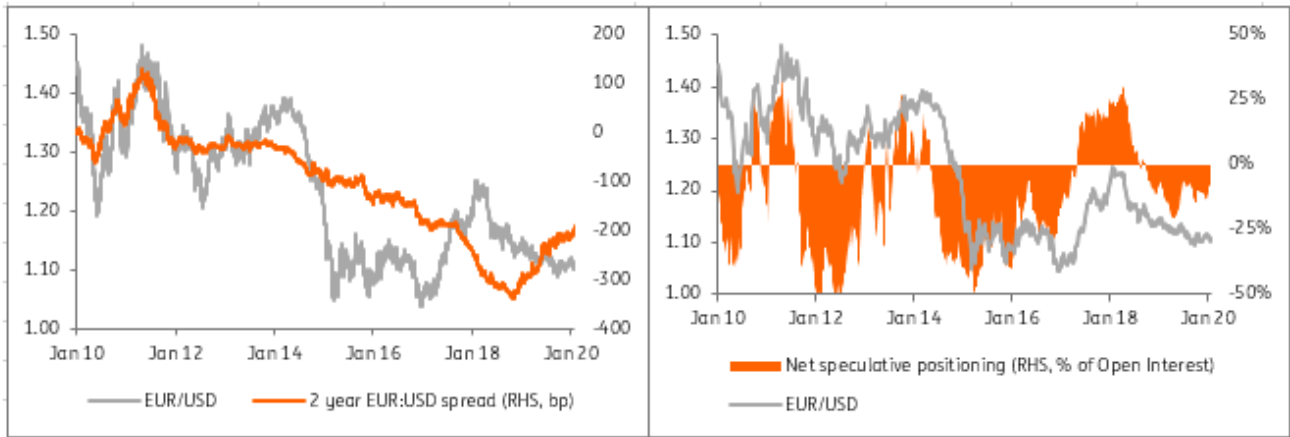
The widely watched Dollar Index, (77% weighted against European currencies), has held up well since the start of the year. This despite the 20bp fall in two-year USD swap rates. Driving this strength has largely been the malaise of European currencies and the fact that the dollar is still an expensive sell. Notably the euro has not been able to make any ground against the dollar which we attribute to the substantial doubts about the European growth profile in 2020.

At the same time, the speculative community has been consistently running short EUR positions since September 2018 and has shown little appetite to scale those down substantially. This despite short term EUR: USD rate spreads having narrowed substantially since last summer. However, it still costs European investors some 2.2% to hedge dollar risk and we suspect these borrowing costs must narrow in another 50-75bp (i.e. the market price 100bp not 50bp of Fed cuts over the next 12 months), before the dollar starts to correct lower. This is especially the case since expected EUR/USD volatility is still plumbing all time lows below 5% (twelve-month EUR/USD volatility).

For the dollar to lose some of its safe haven appeal we will probably need to see some clear US-centric negative news. That could be concerns of the coronavirus hitting US activity and consumption or it could be the US presidential election risk. Equity investors are keeping a wary eye on the Democrat nomination race. Were Bernie Sanders or Elizabeth Warren to start gaining momentum into Super Tuesday in early March, the prospect of their redistributive and regulatory confrontational agenda could start to demand a greater risk premium of US equities and the dollar.

However, that is not our base case, and we still hold that EUR/USD and USD/JPY trade rough 1.10-1.15 and 105-110 ranges respectively this year.

Despite narrowing yield spreads, speculators still run short EUR/USD positions



Source: Bloomberg, ING

Rates: Path of least resistance

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Market rates are likely to remain relatively low; at about current levels or lower in the coming weeks (and likely months). Structural reversion to higher rates would need evidence that there has been a positive turn of the tide. In the meantime, an information vacuum perception sustains vulnerability. These are strange times, so expect volatility



There are numerous nuances to consider as we examine the current circumstances.

First and foremost, rates were already in a stressed mode before the coronavirus narrative hit, and the subsequent move has confirmed the path of least resistance – lower rates.

Second, risk assets have been worried about a catalyst that could take back the outsized gains made in 2019, and this virus event is as good a catalyst as any. That vulnerability can become circular and push core rates even lower. However, let's not get carried away here. It does not mean we need to push our 1.5% target for the 10-year lower. For that to happen, we'd need to see a more definitive turn for the worse. We've not had that yet.

As we progressed towards the end of 2019, there were numerous good reasons for the 10-year US yield to attempt a break back above 2%. But despite elevated US consumer confidence, a tight labour market and an improved trade war narrative, that break higher never really materialised. We saw this from the structure of the curve too, as the 5yr remained very rich to 2s and 10s, which is a classic sign that a preference was there to test the downside rather than the upside. This is why, backed by weak PMIs, our projections pitched a lower rates bias. Fast forward to January 2020 and it has just taken the flu from China to cause a significant move down to the 1.6% area.

That is not to underplay the event, because if there is one thing we do know is we are at the beginning of an event that could easily stretch months. The SARS virus is a go-to template, as there are more similarities than differences. SARS stretched from November 2002 to June 2003 before we got the all-clear, then the thing was in remission.

Remarkably back then, the Federal funds rate was very similar to where it is today (1.75%). It had been cut from 6.5% after the dot.com crash, and ultimately fell to 1% after the SARS virus.

It is not easy to break out precise market reactions, but before the SARS flu had receded, the 10yr yield had fallen from around 4% down to a little under 3.25%. Part of this was the virus, but a large part was also the other background noise. The curve was already steep (c.200 basis points), and only steepened further on the final Fed cut to 1%.

Away from the virus itself, it is interesting to note the difference in the shape of the 2/10yr curve (200bp) and the level of the 10yr yield back then (4%) compared to now where we have a 20bp & sub-2% combo – a good illustration of the excess of demand oversupply that is driving yields today.

From a eurozone perspective, this is the last thing the European Central Bank needs. Europe is already down, with Germany and Italy at the bottom of the spectrum of contemporaneous growth observations while the ECB is practically out of bullets. That said, the Treasury/Bund spread has tightened, which means that the move in US Treasuries has been more significant than for Bund yields. There is already a deep negative discount in the price of eurozone bonds, but with the ECB likely standing pat at -50bp, there is a limit to how bad things can get.

For that to change, again, we'd need to see a clear turn for the worse on the virus impact.

ING global forecasts

	2018					2019F					2020F					2021F				
	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY
United States																				
GDP (% QoQ, ann)	2.6	3.5	2.9	1.1	2.9	3.1	2.0	2.1	2.1	2.3	1.0	0.9	2.0	2.0	1.5	2.0	1.8	1.9	1.9	1.9
CPI headline (% YoY)	2.7	2.7	2.6	2.2	2.4	1.6	1.8	1.8	2.0	1.8	1.9	1.4	1.6	1.6	1.6	2.0	2.2	2.1	2.0	2.1
Federal funds (% eop) ¹	1.50	1.75	2.00	2.25	2.25	2.25	2.25	1.75	1.50	1.50	1.50	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.50	1.50
3-month interest rate (% eop)	2.30	2.35	2.45	2.65	2.65	2.30	2.00	1.70	1.87	1.87	1.60	1.50	1.50	1.50	1.50	1.50	1.50	1.66	1.90	1.90
10-year interest rate (% eop)	3.00	3.00	3.00	2.80	2.80	2.30	2.00	1.70	1.90	1.90	1.50	1.50	1.80	2.00	2.00	2.10	2.40	2.60	2.60	2.60
Fiscal balance (% of GDP)					-4.0										-4.7					-4.7
Fiscal thrust (% of GDP)					1.1					0.4					0.0					0.3
Debt held by public (% of GDP)					76.7					79.0					81.5					84.0
Eurozone																				
GDP (% QoQ, ann)	3.2	1.5	0.8	1.4	1.9	1.8	0.6	1.1	0.5	1.2	0.3	0.6	1.5	1.1	0.7	1.1	1.0	1.0	0.9	1.1
CPI headline (% YoY)	1.3	1.7	2.0	2.0	1.8	1.4	1.3	0.9	1.0	1.2	1.2	1.2	1.1	1.3	1.2	1.2	1.3	1.4	1.4	1.3
Refi minimum bid rate (% eop)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
3-month interest rate (% eop)	-0.33	-0.33	-0.33	-0.33	-0.33	-0.32	-0.32	-0.41	-0.40	-0.40	-0.40	-0.40	-0.38	-0.38	-0.38	-0.38	-0.38	-0.30	-0.30	-0.30
10-year interest rate (% eop)	0.50	0.30	0.40	0.24	0.24	-0.07	-0.31	-0.57	-0.19	-0.19	-0.35	-0.35	-0.20	-0.20	-0.20	-0.15	-0.15	-0.10	-0.05	-0.05
Fiscal balance (% of GDP)					-0.5					-0.7					-0.8					-0.8
Fiscal thrust (% of GDP)					-0.2					0.0					0.1					0.1
Gross public debt/GDP (%)					87.8					87.0					86.3					85.0
Japan																				
GDP (% QoQ, ann)	-0.6	2.2	-2.0	1.5	0.8	2.6	2.0	1.8	-2.4	0.0	1.5	-0.2	1.5	0.3	0.0	0.9	1.8	-0.7	1.3	0.0
CPI headline (% YoY)	1.3	0.6	1.1	0.9	1.0	0.3	0.8	0.3	0.5	0.5	0.9	1.0	1.2	1.0	1.1	1.1	1.0	0.9	0.8	1.0
Excess reserve rate (%)	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
3-month interest rate (% eop)	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.10	-0.05	-0.05	-0.05	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
10-year interest rate (% eop)	0.05	0.05	0.10	0.00	0.00	-0.10	-0.15	-0.25	-0.05	-0.05	-0.10	-0.20	-0.10	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Fiscal balance (% of GDP)					-3.8					-2.6					-2.8					-2.4
Gross public debt/GDP (%)					238.2					224.0					225.6					226.8
China																				
GDP (% YoY)	6.8	6.7	6.5	6.3	6.6	6.4	6.2	6.0	6.3	6.3	5.6	5.4	5.6	5.8	5.6	5.9	6.2	6.5	6.3	6.2
CPI headline (% YoY)	2.2	1.8	2.3	2.5	2.2	1.8	2.6	2.9	4.7	3.0	3.0	2.6	2.5	2.4	2.6	2.5	2.5	2.5	2.5	2.5
PBOC 7-day reverse repo rate (% eop)	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.50	2.50	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.45
10-year T-bond yield (% eop)	3.75	3.50	3.65	3.30	3.30	3.07	3.20	3.14	3.10	3.10	2.95	2.90	2.95	2.98	2.98	2.98	3.00	3.20	3.40	3.40
Fiscal balance (% of GDP)					-2.6					-4.5					-4.0					-4.0
Public debt, inc local govt (% GDP)					88.0					102					103					105
UK																				
GDP (% QoQ, ann)	0.2	1.6	2.8	0.9	1.4	2.5	-0.7	1.7	0.2	1.3	0.4	1.1	1.3	2.0	0.8	1.2	1.3	0.8	0.5	1.3
CPI headline (% YoY)	2.7	2.4	2.5	2.3	2.5	1.9	2.0	1.8	1.4	1.8	1.7	1.2	1.2	1.6	1.4	1.7	1.9	1.9	1.9	1.9
BoE official bank rate (% eop)	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00
BoE Quantitative Easing (£bn)	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445
3-month interest rate (% eop)	0.60	0.80	0.80	0.80	0.80	0.83	0.77	0.77	0.80	0.80	0.80	0.80	0.80	0.90	0.90	0.90	1.10	1.10	1.10	1.10
10-year interest rate (% eop)	1.45	1.48	1.57	1.30	1.30	1.00	0.80	0.50	0.82	0.82	0.50	0.60	0.90	0.90	0.90	0.90	1.00	1.00	1.00	1.00
Fiscal balance (% of GDP)					-1.4					-1.4					-1.2					-1.0
Gross public debt/GDP (%)					86.9					85.7					84.4					83.6
EUR/USD (eop)	1.20	1.17	1.15	1.12	1.12	1.12	1.12	1.09	1.12	1.12	1.10	1.11	1.12	1.13	1.13	1.14	1.15	1.18	1.20	1.20
USD/JPY (eop)	107	110	114	113	113	112	108	108	109	109	108	108	108	108	108	107	106	105	100	100
USD/CNY (eop)	6.28	6.67	6.87	6.88	6.88	6.74	6.90	7.15	7.00	7.00	7.05	7.00	6.95	6.85	6.85	6.80	6.70	6.60	6.50	6.50
EUR/GBP (eop)	0.88	0.88	0.89	0.90	0.90	0.85	0.90	0.89	0.85	0.85	0.85	0.88	0.85	0.82	0.82	0.82	0.82	0.82	0.82	0.82
Brent Crude (US\$/bbl, avg)	67	75	76	69	72	64	68	62	62	64	60	58	62	67	62	64	70	70	68	68

¹Lower level of 25bp range; 3-month interest rate forecast based on interbank rates

Source: ING forecasts

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