U.S. Markets and Economy

After reaching new all-time highs in mid-February, U.S. stocks fell sharply late in the month as coronavirus began to spread around the world. All major indexes fell more than 10%, which is the official Wall Street definition of a correction. Although most of the confirmed cases and deaths are still concentrated in China, where the virus originated, South Korea and Italy have both had significant outbreaks, and a total of 60 countries (including the U.S.) have reported confirmed cases. The rapidity of the fall in equity prices (replicated in many other countries) is a response to the potential economic damage that coronavirus, if it became a true pandemic, could create for the U.S. and the world economy.

The prospective economic damage is basically of two kinds. On the demand side, if consumers cut back on travel, visits to malls, and purchases of major consumer durables, GDP growth will be weaker, seeing as consumption spending accounts for 70% of U.S. GDP. On the supply side, the potential output of the U.S. economy could fall if international supply chains (many of which run through China) are disrupted. At this juncture, it is impossible to gauge the extent of the damage to the U.S. economy, seeing as public health experts cannot yet know 1) how widely the virus will spread, 2) how many of those infected will become seriously ill, and 3) what responses governments will take to contain the virus. The forecast is especially murky because it appears that although the mortality rate for the virus is low, its ability to be spread by human contact appears high. Making it more difficult to gauge is the fact that many can be infected with no symptoms for weeks and most (80%) of the infections appear to be very mild. This uncertainty can be unnerving for markets, which will remain jumpy until the forecast is clearer.

World Markets and Economy

Even though China is the epicenter of the virus, Chinese stocks have held up better than equities in most countries. This partly reflects the government’s draconian attempts to stop the spread of the virus. China essentially quarantined a province of 65 million people, which has seriously disrupted economic activity in all of China. Economic growth will fall sharply in the current quarter, even though the growth in the number of new infections in China has dropped
significantly. Chinese consumers are reducing spending and staying at home, and many workers have not returned to their jobs, which reduces output directly. The Chinese are planning major new government spending and easier monetary policy to restart rapid growth, but it may be months before the full effects of this stimulus are felt.

Japan’s economy was already reeling from the increase in the consumption tax that went into effect in late 2019. Japan’s trade with China has now been disrupted, and Japan has also reported almost 1,000 cases of the coronavirus. Schools have been closed and travel disrupted. Most forecasters expect at least a second quarter of economic decline now, which meets the standard definition of recession. Japanese stocks fell more than 10% from their February peak.

South Korea has the largest number of coronavirus cases outside of China (4,000), and this has of course disrupted economic activity inside the country. Declining trade with China will also reduce Korean economic growth. Korean stocks are now down more than 15% from their January highs.

Europe, especially Italy and Germany, has been hit hard by the coronavirus. Italy has reported well over 1,000 cases, and quarantines and travel restrictions could push the Italian economy back into a recession. Germany was also teetering on the brink of recession, and the temporary loss of export markets in China could also push Germany into recession. This news helped push down European blue-chip stocks, as measured by the EUROSTOXX Index, by 15% in late February.

**Outlook**

The U.S. economy had good momentum going into late February, although further spread of the virus could weaken growth going forward. The Federal Reserve’s monetary policy body, the FOMC, has already stated that if the economy weakens, it will step up with more interest rate cuts. This stance encourages Wall Street, although the effects of monetary policy do take months to percolate through the economy, and they mostly affect the “demand” side of production rather than the “supply” side. Thus, U.S. stock investors may have to tolerate more uncertainty and volatility over the next several months.

If the world can avoid a full-fledged pandemic, the U.S. economy can recover to its 2% growth path and corporate profits can begin to grow again next year. The Federal Reserve will be more accommodative with new interest rate cuts if the data begins to show a significant slowdown in the U.S. Until the economic forecast of virus spread is clearer, stocks could be very volatile.