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Economic Update

How will the Coronavirus affect the US bond yield?

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Some downside pressure on China and the world due to the coronavirus is unavoidable in the near-term. Our base case for China is that growth will weaken 1 ppt to 5.0% YoY in 1Q20F and by 0.4 ppt to 5.7% in 2020F. If containment of the virus takes longer than expected (i.e. beyond 1Q) growth could ease to 4.0% in 1Q and 5.4% in 2020F. Developments so far suggest our base case is the more likely outcome.

Global economic impact will be relatively mild and short-lived, with travel and manufacturing supply chain the main impacted areas, reducing global growth by 0.3 ppt in 1Q20F and 0.1 ppt in 2020F. We expect the global manufacturing recovery to be delayed but not derailed, even though the auto sector may experience some disruption in the near-term due to delayed factory operations in Hubei.

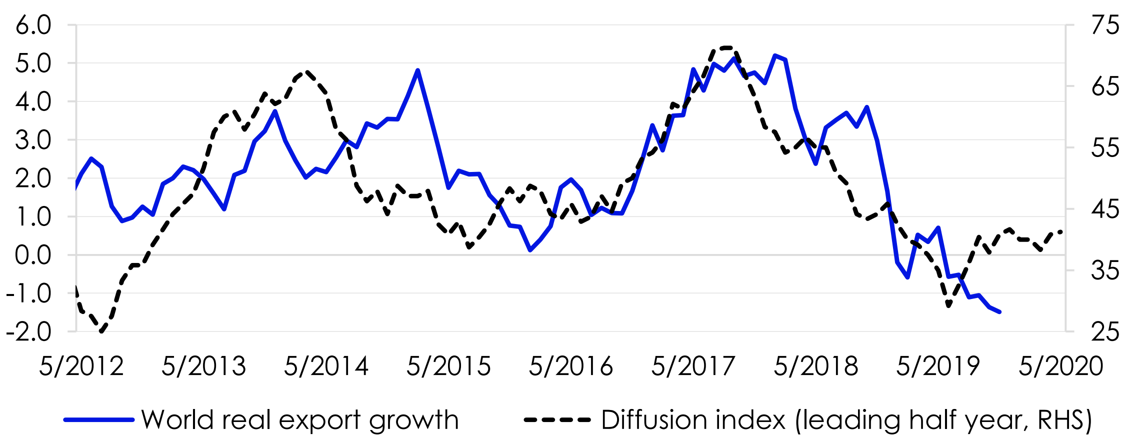
We do not expect the Fed to cut rates due to the virus. It is rare for epidemics to affect Fed monetary policy decisions unless their spread has direct bearing on the economy. The impact of the coronavirus on US growth will be comparatively smaller than the rest of the world.

We expect the 10-year UST in 1Q20F to hover around 1.5-1.8% due in part to concerns about the virus' spread. Once the outbreak is contained, we would expect the rate market to focus on fundamentals that support a modest recovery in the manufacturing sector and a slight pickup in inflation. We lower our average 10-year UST yield forecast for 1Q20F to 1.8% from 2.0%, but continue to expect a gradual rise in rates throughout the remainder of the year. Please refer to Table 1 (page 5) for detailed forecasts.

Economic development early in the year was largely in-line with our forecasts: global manufacturing and trade picked up since 4Q19 led by the auto and IT sectors. Although the latest PMI reports from across the world and our global trade leading indicator mainly reflect data prior to the virus outbreak, they point to further improvement in global trade and manufacturing sentiment in coming months (Fig 1).

The spread of the coronavirus has heightened near-term downside risk to the global economy. Our base case for China is that growth will weaken 1 ppt to 5.0% YoY in 1Q20F and by 0.4 ppt to 5.7% in 2020F. Developments so far continue to support this relatively optimistic view. However, we remain wary of the possibility of a prolonged outbreak, with the number of new cases peaking in early 2Q20 instead of in 1Q20 as in our base case. In the event of a prolonged outbreak, we estimate growth in China would decelerate to 4.5% YoY in 1Q20F before beginning a slow recovery to around 5.0% in 2Q20, which would drag full-year growth down to 5.4%.

Fig 1: Global leading indicator suggests trade recovery is on track



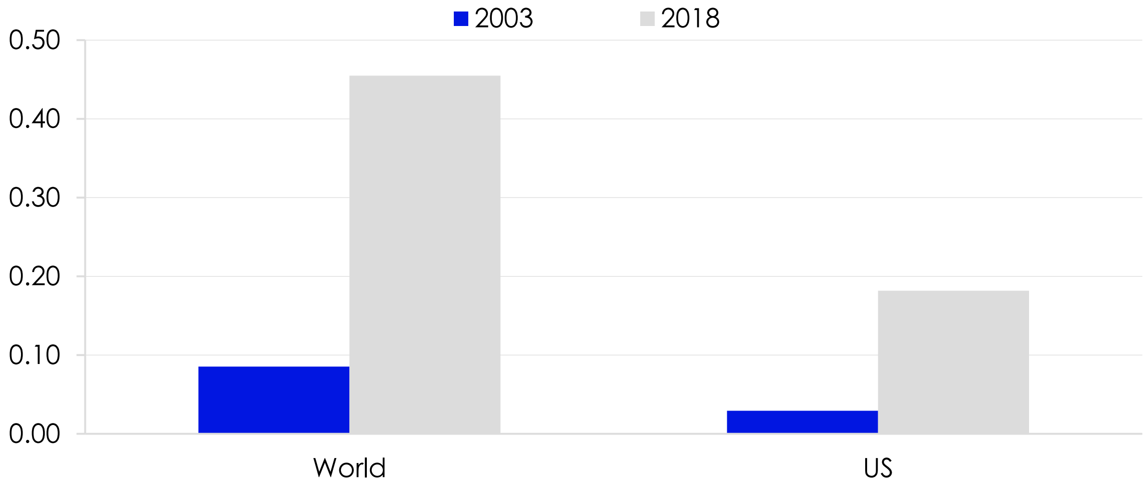
Source: CPB, CEIC, CCBIS

Global travel feels the brunt

The two main implications of the coronavirus for the world economy are a sharp decline in global travel and tourism, a delayed recovery in the manufacturing sector which could lead to disruptions in global supply chains, especially in the case of Chinese-made components, which may not be easily substituted in the short-term. We examine these implications in turn.

- **Effect of the virus on transport and travel services is significant.** China's transport and travel services imports from the rest of the world account for 0.45% of global GDP, five times higher than during the SARS outbreak. US services exports to China also increased significantly since 2003, with US transport and travel services to China together representing nearly 0.2% of US GDP (Fig 2). In the wake of the coronavirus outbreak, cancelled flights and broad-scale travel bans will likely lead to a dramatic reduction in global travel flows in 1Q. Considering Chinese international travels might nosedive in Feb and start to recover somewhat in Mar, we estimate a 50% decline in Chinese travel on its own will reduce global and US growth by 0.2 ppt and 0.1 ppt, respectively, in 1Q20F, but would have a more moderate impact on annual growth were travel to recover in subsequent quarters.

Fig 2: Global and US transportation and travel services exports to China, % of GDP



Source: CEIC, IMF, CCBIS

- **Manufacturing sector will see a delayed but not derailed recovery.** Reduced working days and difficulties returning to work is causing partial suspension of manufacturing and construction activities in China. Under our baseline scenario, a timely containment of the coronavirus will see economic activity bounce back as early as Mar. The progress of production recovery after the Lantern Festival will be critical. Anecdotal evidence suggests major high tech firms and capital-intensive sectors have been able to weather the supply disruptions so far while maintaining production of key parts and components.[1] The auto sector (for which Hubei is a key production center), may suffer more from disruptions to production, even under our baseline scenario, but it is not expected derail the recovery.

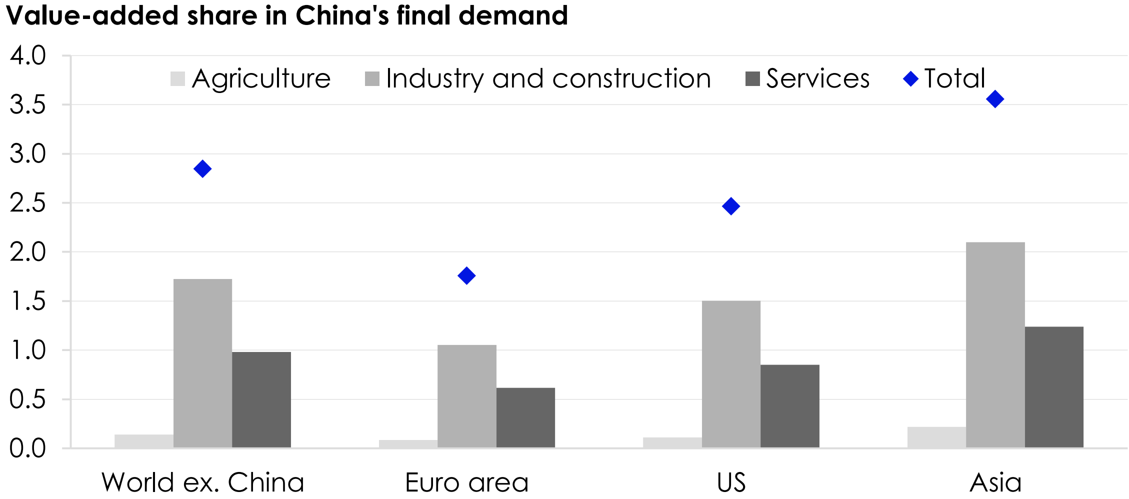
  We also expect the rest of the world to refrain from imposing large-scale trade restrictions on China in addition to the travel bans already in place[2]. Thus, the impact on merchandise trade is likely to be confined to 1Q20F.

On net, small global impact on a full-year basis. We estimate a 1 ppt decline in growth for China in 1Q20F and a 0.3 ppt decline in 2020F would chip 0.3 ppt away from global growth in 1Q20F and 0.1 ppt in 2020F. We estimate the impact on US growth would be smaller, at 0.2 ppt in 1Q20F and less than 0.1 ppt for the full year due to the US' relatively low exposure to China final demand (Fig 3). The just-signed phase-one trade deal should also mitigate the negative impact on growth for the full-year.

1 Most smartphone producers are based outside of Hubei

2 Macro Weekly: Chinese production to gradually resume after the Lantern Festival (9 Feb 2020)

Fig 3: Sector breakdown of value-added exposure to China



Source: OECD TiVA, CCBIS

Global rates expected to climb back up as Fed remains calm

Latest US data indicates solid domestic consumption and healthy job picture. ISM indexes and most regional surveys point to a strong rebound in sentiment surrounding the manufacturing sector in Jan. For example, the Manufacturing ISM New Order Index recently recorded its strongest reading since mid-2019, indicating solid domestic demand. Meanwhile, job market data remained buoyant in Jan, supporting private consumption and moderate wage expansion and inflation. In short, the US economy is well positioned for forthcoming downside shocks from the coronavirus should they arise.

We do not expect the Fed to cut the rate this year. At the end of Jan, market risk aversion pushed up policy rate cut expectations in the rates futures market. Based on previous experience, an epidemic or other health scare rarely directly affects Fed actions unless the risks had spread to the US economy. For instance, though the H1N1 flu of 2009 had a much more severe impact on the US population than has the coronavirus, the Fed at the time nevertheless held rates unchanged. During the SARS epidemic the Fed cut rates in Jun 2003 when the virus was already petering out, and the Fed did so because of domestic low inflation, not because of SARS.

Fundamentals support yields to increase again. Fear has played a major role in the recent decline in rates, evident in the fact that long-term yields mirrored the movements in overnight rate futures. We expect the Fed to stay on hold this year, but the rate market to keep a rate cut pricing until the outbreak is under control. We would expect the rate market to turn its focus back to the fundamentals once the outbreak is contained. A modest recovery in the manufacturing sector and a slight pickup in inflation will lend supports to an increase of bond yields throughout the rest of the year.

Table 1: US economic assumptions and forecasts

	3Q19	4Q19	1Q20F	2Q20F	3Q20F	4Q20F
US Fed fund target range (EOP %)	1.75-2.00	1.50-1.75	1.50-1.75	1.50-1.75	1.50-1.75	1.50-1.75
US 10-year bond yield (avg %)	1.7	1.8	1.8	1.9	2.0	2.1

Source: Bloomberg, CEIC, CCBIS estimates

Rating definitions:

Outperform (O) – expected return > 10% over the next twelve months
Neutral (N) – expected return between -10% and 10% over the next twelve months
Underperform (U) – expected return < -10% over the next twelve months

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