COLUMBIA THREADNEEDLE
INVESTMENTS

Recession risks: Coronavirus + oil shock + what else?

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First, supply was the concern. Now demand is dropping — and recession risks are clearly elevated.

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When the news of the novel coronavirus first began to emerge from China, economic analysis was generally focused on the disruption of supply chains and the effect on companies unable to easily relocate manufacturing. Now that companies and consumers are cutting back on spending, a drop in demand has heightened fears of a sharp slowdown in economic growth. A collapse in oil prices has added to concerns.

The growth outlook dims

Recession risks are now clearly elevated, and we expect that there will be a hit to U.S. growth. It's also clear that the extent of the decline will depend on the severity and the duration of the coronavirus infections. If the outbreak disrupts demand for a prolonged period — beyond the next two months — the impact on growth will be that much more significant. Swift and draconian actions have led to containment in some East Asian countries (China, Singapore), but it's evident from Chinese data (and likely from Italy's data to follow) that these measures also take a severe toll on economic growth.

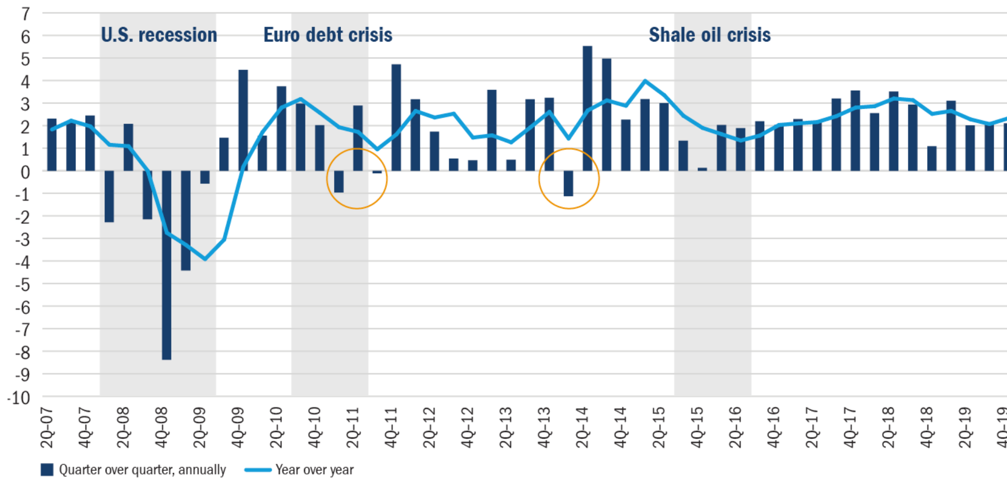
Further headwinds: Falling oil prices and capital expenditure

The experience of 2015-2016 has shown that a decline in oil prices is no longer a net positive for the U.S. economy. It may benefit consumer pocketbooks, but at times of uncertainty, people are likely to save the windfall and reduce their spending. Because of the sharp fall in oil prices, we cannot rule out the risk of credit downgrades and increased defaults among energy companies — which could spill over to other segments of the U.S. economy. Our expectation for capital expenditure (capex), specifically in energy production, is for deep cuts — perhaps to zero in 2020 — which will also be a drag on growth.

Watching for how consumers and businesses react

The current expansion is the longest on record, and there have been three instances of negative quarterly growth. And yet the economy has continued its long upward grind.

United States real GDP growth (%)



Source: Columbia Threadneedle Investments. Data as of 12/31/19.

If containment and mitigation efforts appear successful in the U.S., we expect the coronavirus hit to growth to be short-lived. In addition to public health efforts, a lot depends on how businesses and consumers react. U.S. companies will likely see an impact on earnings, but it's not clear how they will respond. Consumers are also likely to be affected, and we need to understand if they retrench spending sharply or benefit from lower rates and lower oil prices. Leading indicators to help assess these responses include the Institute of Supply Management Purchasing Managers' Index, a widely watched indicator of recent U.S. economic activity, consumer and business sentiment indicators, and monthly payroll data.

Catalysts for improvement

The most significant catalyst for improvement will be limiting the spread of coronavirus, but monetary and fiscal responses will also be important to ensure that companies can continue to borrow if they need to fund operations.

- **Monetary policy**: It's evident that the Federal Reserve Board is prepared to act quickly and decisively, and the Fed's activities and forward guidance can help stabilize market sentiment. Cutting rates is less important than keeping the credit channels open. Maintaining liquidity in the markets will be essential.
- **Fiscal policy**: We also need a well thought out and targeted fiscal response to support demand in the economy. The U.S. administration announced $8.3 billion in emergency funding, and more is likely to come. China is coordinating monetary, fiscal and credit programs.

Bottom line

If the coronavirus disrupts demand for a prolonged period — beyond the next two months — the impact on growth will be far more significant. Ongoing economic reports may continue to fuel volatility as investors digest the data, and it will be important for investors to distinguish between backward-looking reports (e.g., retail sales, payroll) and forward-looking indicators, like sentiment.

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