Fear Factor

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Looks like we picked the wrong year to be even modestly bullish on global growth prospects. Markets took another step on the ladder of concern on the **coronavirus**, as the economic impact broadened, and the World Health Organization declared it an international emergency. And, perhaps more importantly, fear of the virus broadened, with mask shortages abounding, and large plastic bottles over one's head now apparently a new fashion statement in some trendier locales.

While some are talking about twists and turns in the novel coronavirus, it actually seems to be progressing in a relatively straightforward pattern—geometrically upward. It's the market reaction to the news that has been topsy-turvy. And, even then, markets have not been entirely consistent in the response. Copper prices have been on a one-way trip south for the past two weeks amid softening global growth prospects, falling 12% over that stretch and reversing all of last fall's gains. Oil has mostly followed suit, with a bit more volatility, and is now off 18% from the early January high—which had been driven by the tensions with Iran (seems so long ago). Bonds, of course, are feasting in an environment of dimming global growth prospects, falling energy prices, and a flight to safety on top. The benchmark 10-year Treasury yield has now stepped down 40 bps in little more than a month to just above 1.5%.

In contrast, it's the equity market that is quite clearly struggling to determine how to respond to this new and sudden risk to global growth. Recall that the S&P 500 stood at a record high as recently as two weeks ago today. News of some U.S. cases of the virus and widening response measures by global companies (e.g. Starbucks shutting down half its stores in China) prompted a two-day 2.5% drop in the index. A run of solid Q4 earnings seemed to stem the tide, but stocks are on track to end lower for a second week on another big step down today.

To try to suss out some likely economic impacts of the virus, we will turn to Nobel prize winner **Robert Shiller** and his latest book *Narrative Economics*. Shiller, of course, rose to extreme fame with the uncanny timing of his book, *Irrational Exuberance* in 2000, which pretty much caught the height of the tech bubble and foretold of its demise. Next, he consistently warned of a U.S. housing bubble from 2005 to 2007, and was eventually proved absolutely correct. Just for an aside, he called bitcoin the biggest financial bubble of all time in 2017, just as it was reaching a frenzied peak. So, while he's not always right on the mark, it's worth listening when he weighs in. Turning to his latest book, he says:

"I have been arguing that it is important for economists to appreciate the popular economic narratives that go viral, that come and go according to epidemiological patterns. Just as a disease, an economic narrative, a story that is connected to things that matter in the economy, rises like an epidemic to influence a large fraction of the population. The epidemic alters their economic actions and their voting. It then

influences government economic policy, and also drives economic fluctuations. During the growth phase of the narrative epidemic, the contagion rate has to be above the forgetting rates, allowing the narrative to grow in influence. Eventually the narrative fades away, after the contagion rate falls below the forgetting rate. Then the narrative may mutate, as viruses do, and another epidemic may return again, and again."

Now, keep in mind that the book and these comments pre-date any word about the coronavirus. Essentially, the point of the book is that new narratives, or story lines, can develop and catch on so quickly—much like an epidemic—that they can actually have an economic impact in themselves. The man is apparently so prescient that even his metaphor examples become reality! The point in current circumstances is that the ultimate economic impact of the novel virus will flow more from the narrative around it (i.e., concerned responses) than its direct impact. And, the response so far is very real, including the lockdown of nearly 50 million people, travel restrictions, cancelled flight routes, and store closures.

In economic terms, the biggest hit will—for now—**land on China**. In an obviously fluid situation, we are cutting our GDP growth estimate there to 4.5% y/y in Q1 and 5.5% for all of 2020 (from 5.9% previously for both). That call implies essentially no growth in Q1 from the prior quarter, but some rebound in Q2 as the tough measures taken there should front-load the growth hit. Elsewhere, we are just trimming around some of the bullish edges we had on our prior calls, including a snip to Q1 in **Canada** (to 2.0% from 2.5%), which shaves a tenth from 2020 (to 1.7% from 1.8%). Recall that SARS also cut Canadian growth for 2003 by an estimated one-tenth, although this virus is quite different. Less affected by the commodity channel, we suspect the **U.S.** economy will also be less dented, though we have slightly clipped our H1 estimate of growth—more to take out some earlier upside potential we had assumed following the Phase One deal. Our annual U.S. call remains at 1.8% for 2020, a shade below potential.

The slightly dimmer growth prospects for Canada raise the odds of a Bank of Canada response, especially given their overt dovish stance in last week's MPR. **We are not quite prepared to fully throw in the towel and call for a rate cut**, given that the Bank will have plenty of time to assess the economic impact of the virus in the months ahead. But the market is not waiting around for the details, and has more than one rate cut fully priced in for the year. Notably, markets are even slightly more aggressive in their expectations of a Fed rate cut later this year. While that's certainly a possibility, we believe that **it is the Bank that's much closer to the edge of moving than the Fed**, due to a) the deep drag on commodity prices; and, b) the Bank's public easing bias.

The deep slowdown in China, even if only temporary, and spreading concerns about the virus look to chill growth more broadly. It's little help that many major economies had already ended last year in a mild funk, with France, Italy and Mexico posting small declines in Q4 GDP. With the virus piling on, we now look for **global growth** to edge down to 2.7% in 2020 from an already sluggish 2.8% last year. While that may not sound big, note that just last week the BoC called for 3.1% global growth this year, bolstered by the U.S./China trade truce, clarity on the USMCA (at last!), and much stronger financial conditions from a year ago. To again paraphrase the legendary Lloyd Bridges, looks like they picked the wrong year to stop being cautious.

Ending on something a little less dour (*more circuses!*), this year's **Super Bowl** may be one of the toughest to predict. After last year's slight miss, I wouldn't dare make another call—but will point out that in the past four election-year games, when the NFC team has triumphed, the Democrats have won, while the Republicans won in the two other years that the AFC team won. Given where things may be headed in November, I'm liking the Chiefs' odds; let's say 31-28.

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