Weekly Market Insights

January 27, 2020

Coronavirus, the shifting fortunes in the primaries and Happy Birthday Mozart

Equity markets fell during the past week and appear to be starting the new week on the down-side.

The DJIA fell 1.22%, the S&P 500 was down 1.03% and the NASDAQ dropped 0.79%, all this with positive economic signs from both Europe and the United States.

Positive News

Economic growth in Europe has been a source of concern since the Great Recession. It started late with monetary stimulus and has yet to embark on a fiscal stimulus package. There are still serious questions about the E.U. recovery with Germany and Brexit, nevertheless there are positive signs. The U.S., Canada and Mexico appear to have come to terms with trade, and the apparent thawing of the trade war between the United States and China are behind the International Monetary Fund's more upbeat forecast for 2020.

Although earnings have been somewhat subdued, they remain positive and encouraging.

What is the problem?

First, the market has been on a long positive run and investors are looking for something of a correction. Having said that, there is normally some sort of stimulus that gets the ball rolling. In this case, we think it is obvious. China!

We have written quite a bit about China, and we have pointed out many of the problems she faces. Now there is one that stands out above the others. The investing world fears a pandemic. We have all read about the Coronavirus that has struck China, and now isolated cases are being found around the world. It is by no means a pandemic yet, but it is a great worry, and the market is forecasting the virus to spread. This is not unique. The markets have made this prediction almost every time a new virus starts to spread. We don't say this in an attempt to downplay its seriousness, but only to remind investors we have been through this before.

Alas, this is not the only problem that China faces. We can start with demographics. Chairman Mao, in his infinite wisdom, instituted a one child per family policy, and it was very successful—so successful that China is now facing a population problem of not too many but too few births. It is not always the best advice to invest in demographic changes. It takes a very long time for these changes to affect a country's economy. Since it takes such a long time, many changes can occur that may alter that demographic path. But, it does appear to be a problem.

There are other more immediate problems facing China. Of course, the trade war is obvious, but in some ways the trade problems are just making China's other more serious problems more noticeable.

China's economic growth has been slowing for years. For quite some time, analysts were not aware of it because of the questionable accuracy of Chinese government releases. China now admits to a slowing economy, but it remains in question just how slow. The government admits to GDP growth of about 6.0-6.2%. Independent analysts have estimated growth as low as 3%.

In the past, China encouraged an enormous explosion of debt to stimulate economic growth. Much of this debt is now in default. These defaults have hit smaller banks the hardest, with some going bankrupt and others borrowing heavily from the government in order to stay solvent. As we have often written, China has still not come to terms with the problem of State Owned Enterprises (SOE).

Finally, perhaps the most damaging of China's problems is the remarkable change in direction of leadership. Ever since President Xi took power, there has been a shocking reversion to the ruling style of Chairman Mao. Again, we have written ad infinitum about this, and readers can find more by going to our web page. But, this change is one of the principal reasons for China's difficulties. We give you, HONG KONG!

The Primaries

As a point of interest, Bernie Sanders is doing quite well in the early stages of the Democratic primaries. Clearly, it is too early to make any predictions, but Senators Sanders and Warren would not fill the hearts of most Wall Streeters with cheer.

In our continuing effort to add substance to economic releases, this week we will discuss Gross Domestic Product.

Gross Domestic Product (GDP)

The Bureau of Economic Analysis (BEA) releases its GDP estimate four weeks after quarter-end, and it is often used as a way for Americans and those around the world to gauge the health of the U.S. economy. GDP is the value of all goods and services produced, and the United States leads the world with a total over 21.5 trillion dollars.[1] This release, however, is more commonly referred to in percentage terms, or the growth in output, and clocked in at 2.1% in the 3rd quarter.

GDP is calculated in one of three ways—the output approach, the income approach, and the expenditure approach. Those who have taken an introductory macroeconomics class are likely familiar with the latter and will remember that GDP = Consumption + Investment + Government Spending + Net Exports. As we have mentioned in prior readings, the consumption piece is the largest and most important in the United States, accounting for more than two-thirds of total GDP. While they are smaller contributors, investment and government spending are still imperative to the health of the U.S. economy. Private investment is critical for increases in productive capacity and employment, while government spending is crucial during slowing or contractionary periods when consumption and investment are lacking. Net exports is the smallest component of GDP, often contributing or detracting only modestly from growth, as trade deficits have become more common in the United States.[2]

So, why is GDP such an attention-grabbing release? For one, the White House and Congress use this reading to help develop their spending and tax policies, while the Federal Reserve relies on GDP to adjust its monetary policy. Historically, more stimulative monetary and fiscal policy has been enacted in response to lackluster GDP numbers (think tax cuts, ramped-up government spending, and interest rate cuts), while more restrictive measures are put in place when the economy is thought to be overheating. Businesses recognize the importance of GDP in the formation of U.S. economic policy and will use this data to make decisions for the future. Investors recognize this as well and will be more inclined to invest in U.S. stocks knowing there are better prospects of earnings growth and business expansion going forward.

The BEA releases quarterly and yearly GDP growth numbers, often with several revisions in the months that follow. Look at annual growth for insights into long-term trends and quarterly estimates for impacts of more recent or short-term events. Pay attention to the seasonally adjusted number, as it removes the effects of seasonal impacts like weather and ensures that movements in GDP better reflect actual changes in economic activity.[3] Do not get caught up in the absolute number, but rather, the changes from prior periods or variations from consensus estimates. Any immediate market swing following the release would likely be due to a growth miss from consensus. The first of three GDP estimates for fourth-quarter 2019 will be released on Thursday with an expected 2.2% annual growth.

- Michael Olin Clark
moclark@1919ic.com

[1]U.S. Bureau of Economic Analysis, Gross Domestic Product [GDP], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/GDP, January 24, 2020.
[2]U.S. Bureau of Economic Analysis, Net Exports of Goods and Services [NETEXP], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/NETEXP, January 24, 2020.
[3]U.S. Bureau of Economic Analysis, Gross Domestic Product; retrieved from BEA.gov, https://www.bea.gov/resources/learning-center/what-to-know-gdp.

Please click **here** for the updated **Economic Release Calendar - January 2020**.

The views expressed are subject to change. Any data cited have been obtained from sources believed to be reliable. The accuracy and completeness of data cannot be guaranteed. Past performance is no guarantee of future results.