Prudential
Bring Your Challenges®

Economic Perspective

February 10, 2020

FREQUENTLY ASKED QUESTIONS

by **Robert F. DeLucia, CFA**
Consulting Economist

Summary and Major Conclusions:

Financial markets are focused primarily on world economic growth, rather than the domestic economy. As such, the largest individual stock declines have occurred in US multinationals in the manufacturing sector, many of which derive more than 50% of their earnings outside the US. The cumulative impact on the world economy will be predicated upon the duration of the epidemic and any mutations that might come about. The Chinese economy is most vulnerable to a marked loss in economic momentum, whereas the impact on US GDP should be mild.

- Based upon the experience of previous epidemics, the recent outbreak of the coronavirus in China's Hubei Province will have a short-term economic and financial market impact, but one that should fade after a period of several months, assuming there are no mutations and that effective measures are taken.
- The epidemic will have a disproportionately large impact on the Chinese economy, and should also affect the surrounding countries in Asia, although to a lesser extent. The direct impact on the US economy should be mild.
- The severe reaction of world financial markets reflects the growing importance of China to the world economy and the expected slowdown in world exports. It also reflects significantly overbought equity markets in the US and around the world.
- There are several factors supporting my forecast of faster US GDP growth this year. The most obvious is the easing of trade tensions between China and the US with the recent signing of the "phase one" trade truce.
- Much improved financial conditions should also boost economic growth. Compared with a monetary tightening campaign during 2017 and 2018, the Federal Reserve eased monetary policy considerably over the course of 2019.
- It seems highly unlikely that the Federal Reserve will tighten monetary policy this year. The current strategic objective of monetary policy is to achieve faster economic growth and higher inflation.
- The Fed is also concerned that the core inflation rate has been consistently below its long-term target of 2%, and would like to raise both inflation and inflationary expectations.
- The Federal Reserve is insistent that it has not resumed quantitative easing. The Fed is splitting hairs. Incremental purchases of Treasury securities of any duration have the effect of injecting additional liquidity into the economy, and are therefore expansionary.
- The Treasury yield curve has flattened in recent months but is unlikely to invert on a sustained basis during 2020. In fact, the next major shift in the curve will likely be toward steepening, once the US economy shows clear signs of faster growth.
- The domestic economy is not unresponsive to lower borrowing costs as some believe. The most obvious benefit for the economy is the direct stimulus to housing construction. The plunge in mortgage rates over the past year from nearly 5% to 3.5% has sparked a sharp rise in residential construction.

- Less obvious is the boost to the economy from increased refinance activity. By substituting low-cost for high-cost mortgage debt, households can enhance their purchasing power. Businesses can also improve their finances by paying down high-cost debt and issuing new lower-cost debt.

- The potential danger to the US economy from trillion-dollar deficits is predicated upon time horizon — minimal risk in the short term but the potential for a crisis in the long term.

- The short-term economic impact of a large deficit has been attenuated by record-low borrowing costs. The amount of interest payments by the Treasury on its debt outstanding is an estimated 1.5% of GDP annually, near the lows of the past 50 years.

- In the long term, federal government finances are on an unsustainable path. The combination of growth in the national debt and higher interest rates could lead to a US debt crisis during the upcoming decade.

This week's *Economic Perspective* provides answers to frequently asked questions regarding the economy and financial markets, with a special emphasis on the economic and investment impact of the spreading coronavirus that originated in China several weeks ago.

COULD YOU PROVIDE SOME PERSPECTIVE REGARDING THE SPREADING CORONAVIRUS?

Based upon the experience of previous epidemics, the recent outbreak of the coronavirus in China's Wuhan, the capital city of Hubei Province, will most likely have a worrisome but short-term economic and financial market impact. The cumulative impact on the world economy will be predicated upon the duration of the epidemic and any mutations that might come about. More than two dozen countries have reported cases of the novel virus.

The 2003 SARS epidemic in China caused widespread contagion during the early weeks and months, but peaked once strong countermeasures were implemented. The World Health Organization (WHO) declared an end to the SARS epidemic within four months of its onset. The coronavirus appears to be more infectious but has a much lower fatality rate — 2% versus nearly 10% for SARS. It should be noted that the response of Chinese authorities to this crisis has been far more effective in 2020 compared with 2003.

The most immediate impact has been on financial markets: World equity markets have declined, while market yields on US Treasury securities have plunged to near all-time lows. World oil and commodity prices have also collapsed. The violent reaction of world financial markets can be attributed to the much larger role of China within the world economy, with GDP comprising 15% of world GDP, versus only 4% in 2003. Simply put, economic weakness in China means less stimulus for European, Asian, and other export-oriented economies, all of which are heavily dependent upon Chinese import demand.

Financial markets appear to be focused on world economic growth, rather than just that of the US. As such, *the largest individual stock declines have occurred in US multinationals in the manufacturing sector*, many of which are heavily dependent on world trade and derive more than 50% of their earnings from outside the US. The US equity market had been anticipating a global manufacturing recovery in early 2020, which has obviously been deferred once again. It should also be noted that the S&P 500 Index was overvalued and overbought when the virus was first detected, in anticipation of better economic news.

WHAT ARE THE LIKELY ECONOMIC AND INVESTMENT CONSEQUENCES OF THE EPIDEMIC?

The epidemic will have a disproportionately large impact on the Chinese economy and affect the surrounding countries in Asia, but to a lesser extent. The Chinese economy is most vulnerable to a marked loss in economic momentum. Production and employment will be impacted by factory closings and disruptions to supply chains. Curtailment of transportation services — trains, buses, and airlines — will also reduce spending and output. A decline in consumer confidence should result in weaker private consumption, while leisure and hospitality will take a significant hit.

US manufacturers such as Ford, Apple, and Tesla have temporarily suspended production in China. In addition, Apple, Levi Strauss, McDonald's, and Starbucks have temporarily closed stores. The Great Wall, Disneyland, and movie theaters have all been closed. China's GDP growth rate in the first quarter could fall to as low as 3%, down from a 6% annual rate in the previous quarter, which would be its worst quarter since 1990. I am not lowering my full-year GDP growth estimate of 6% because of an expected strong rebound during the remainder of this year. The impact on US GDP should be mild, but the world economy will likely weaken noticeably in Q1.

Although conditions will likely worsen in coming weeks, I am optimistically assuming that the epidemic will be contained during the next several months and that the Chinese and world economies should rebound in the spring. As is typically the case, world financial markets should anticipate a successful containment effort, implying higher stock prices and bond yields in advance of any positive news on the virus. It should be emphasized, however, that there will be very little confidence in any specific forecast until there is evidence of a peak in the number of infections and deaths.

WHY DOES YOUR FORECAST ASSUME AN ACCELERATION IN US ECONOMIC GROWTH IN 2020?

There are several factors supporting my forecast of faster US GDP growth this year. The most obvious is the easing of trade tensions between China and US with the recent signing of the "phase one" trade truce. In addition, the new trade pact between the US and Canada and Mexico — officially referred to as USMCA — could also add to growth in 2020 and beyond.

Much improved financial conditions should also boost economic growth. Compared with its monetary tightening campaign during 2017 and 2018, the Federal Reserve eased monetary policy considerably over the course of 2019. Changes in monetary policy tend to lead changes in the economy by six to nine months. The Fed cut its policy rate three times last year, starting in July. The favorable impact of increased monetary accommodation should become apparent in incoming economic data.

There are also specific economic sector considerations. Consumer spending, housing construction, and investment in intellectual property and software are likely to remain strong again this year but should be augmented by a rebound in manufacturing and business investment in plant and equipment. An improving trend in business confidence should lift business spending by the middle of this year. Finally, the decline in business inventories during 2019 subtracted from growth. Compared with GDP growth of 2.3%, real final demand increased by 2.7% last year. Rather than subtracting from GDP growth, inventory investment should add to GDP in 2020.

IS THE FEDERAL RESERVE LIKELY TO TIGHTEN MONETARY POLICY THIS YEAR?

It seems highly unlikely that the Federal Reserve will tighten monetary policy this year. The current strategic objective of monetary policy is to achieve faster economic growth and higher inflation. Because of lingering pockets of economic weakness, the Fed appears content to err on the side of excessive stimulus. The Fed is also concerned that the underlying core inflation rate has been consistently below its long-term target of 2%, and would like to raise both inflation and inflationary expectations.

The Fed is also unlikely to cut interest rates during 2020. Trendline GDP is expanding at a 2% annual rate, roughly in line with the economy's long-term growth potential. However, there is one caveat: A Fed rate cut could come about if inflationary expectations weaken further from current already depressed levels. Federal Reserve officials have greater concerns regarding lower, rather than higher, inflation.

DO YOU EXPECT THE US TREASURY YIELD CURVE TO BECOME INVERTED AS WAS THE CASE FOR MUCH OF 2019?

The Treasury yield curve was inverted from May through September of last year, but shifted to its normal upward slope in October. The curve has flattened in recent months but is unlikely to invert on a ***sustained*** basis during 2020. In fact, the next major shift in the curve will likely be toward steepening, once the US economy shows clear signs of faster growth, and possibly a reversal in inflation.

Specifically, as measured by the overnight federal funds rate, short-term rates are likely to remain steady at 1.75%, implying a yield of 1.5% on three-month Treasury bills. At the same time, the market yield on ten-year Treasury bonds could rise from 1.6% to 2% or higher, while the yield on 30-year bonds could rise from 2% to 2.5%. A steepening yield curve is a classic signal of market expectations of a strengthening economy.

MANY ECONOMISTS CLAIM THAT A DECLINE IN BORROWING COSTS HAS A LIMITED ECONOMIC EFFECT. DO YOU AGREE?

I disagree. The most obvious benefit for the domestic economy is a boost to housing construction. There is an extremely tight correlation between government bond yields and mortgage rates. The plunge in mortgage rates over the past year from nearly 5% to 3.5% has provided a powerful boost to the housing market. Single-family housing starts have risen by 30% from their 2019 lows. Household spending in general is responsive to lower borrowing costs, although to a much lesser extent.

Less obvious is the boost to the economy from increased refinance activity. By substituting low-cost for high-cost mortgage debt, households can enhance their purchasing power. Businesses can also improve their finances by refinancing high-cost debt. Finally, the financial burden associated with large and growing budget deficits is lessened by low funding costs for the federal government. As a share of GDP, interest expense has declined to only 1.5% of GDP, down from greater than 3% in 1995.

HOW MUCH DANGER DO TRILLION-DOLLAR FEDERAL BUDGET DEFICITS POSE TO THE US ECONOMY?

The Congressional Budget Office (CBO) is projecting federal budget deficits in excess of $1 trillion each year through 2030. The potential danger to the US economy is predicated upon time horizon — minimal risk in the short term but the potential for a crisis in the long term. As a percentage of GDP, government debt held by the public is expected to exceed 80% this year and approach 100% in 2030, the highest level since 1946. In 2020, the US Treasury will spend $1.28 for every $1 it collects in tax revenues.

The large size of the budget deficit is unprecedented in the following sense: Historically, the deficit and employment have been negatively correlated. For obvious reasons, the deficit surges during periods of recession and high unemployment, and shrinks during periods of prosperity and low unemployment. Simply put, a trillion-dollar deficit is incompatible with an unemployment rate of 3.5%, the lowest in 50 years.

The short-term economic impact of a large deficit has been attenuated by record-low borrowing costs. The amount of interest payments by the Treasury on its debt outstanding is an estimated 1.5% of GDP annually, near the lows of the past 50 years. The result is a smaller deficit than otherwise in an environment of normal borrowing costs.

In the long term, federal government finances are on an unsustainable path. The combination of growth in the national debt and higher interest rates could lead to a US debt crisis during the next decade. The primary catalyst for rising deficits in future years is the projection for continued relentless growth in safety-net programs, mainly Social Security and Medicare. In the end, Congress will have no choice but to adopt legislation that reduces the trajectory of outlays in these programs. History clearly shows that Congress does not respond to such situations until there is a full-blown crisis.

Robert F. DeLucia, CFA, was formerly Senior Economist and Portfolio Manager for Prudential Retirement. Prior to that role, he spent 25 years at CIGNA Investment Management, most recently serving as Chief Economist and Senior Portfolio Manager. He currently serves as the Consulting Economist for Prudential Retirement. Bob has 45 years of investment experience.

Bloomberg Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index: Measures the performance of rules based, market value-weighted inflation protected securities issued by the U.S. Treasury. It is a subset of the Global Inflation-Linked Index (Series-L).

CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

MSCI World Ex US Index: Measures the performance of the large and mid-cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.