Is global recession coming?

by
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In early 2020, global financial markets and investors' somewhat cautious optimism was buoyed by the signing of a phase one trade deal between the US and China, coupled with incipient signs of global growth stabilisation and bottoming out. As recently as in January, the International Monetary Fund (IMF) had dismissed fears that the global economy is on the path of recession, and in fact it projected a global growth rebound in 2020, estimated at 3.3% in 2020 and 3.4% in 2021 from an estimated 2.9% in 2019.

Back in 2019, there were periodic fears that the US economy will likely go into recession in 2020 or in 2021. The US economy faces the prospects of a slowing growth as the tax cuts stimulus had lapsed and also tempered by the damage inflicted by almost a year-long US-China trade spat. Despite a phase one trade deal signed in January 2020, uncertainty still lingers on the stage two trade negotiations, which was put on a back burner as Trump is being preoccupied with the presidential election campaign. There remain valid concerns that the re-election of President Trump in November would be dangerous to China as he would step up more pressure to get a fair trade.

The US Federal Reserve had slashed interest rates three times in 2019 by a cumulative 75 basis points to 1.5%-1.75% to provide insurance against ongoing risks, which was meant to stave off the risk of recession. About a year ago, the US yield curve inverted (short-term interest rates rise above long-term rates) for the first time in March 2019 and lasted for much of the rest of the year through mid-October. The yield curve inversion signals danger ahead, and is a reliable predictive power of future recessions, and going by past episodes of recessions, it would likely to happen in about a year or so.

Spread of Covid-19

The highly contagious Covid-19 outbreak, which had erupted from China, the epicentre, is now spreading fast to major trading countries such as Japan and Korea and also starting to take its toll on the US and Europe. The odds of the US recession have increased to at least 70%.

It is generally perceived that Covid-19's economic impact will be short-lived and more damaging in China, at least in 1H20. It will bounce back quickly with the support of massive fiscal and monetary stimulus as consumers resume demand and firms continue production to clear order backlogs and demand as well as re-stock inventories.

The highly contagious Covid-19 outbreak had first erupted from China

With the World Health Organisation declaring the coronavirus outbreak as a global pandemic, it would certainly significantly temper global sentiment and change all earlier assessments that the virus impact can be manageable. While there are positive developments that new infected cases in China are expected to somewhat stabilise and be contained going into early second quarter, there is heightened fear that news cases are only starting to rise in countries outside China, and the outbreak may go beyond 2H20.

It is now becoming increasingly clear and worrisome that the Covid-19 outbreak has done more economic damage than anticipated. China's factory output and trade numbers have plummeted more than expected in January and February 2020. Tourism and related services, aviation, transportation and manufacturing (such as smartphone, electrical and electronics, and automobile manufacturers), commodities, and oil and gas industries are badly affected. The global supply chain disruptions have undermined output everywhere, making China's major trading partners more vulnerable.

Facing recessionary risk

Recessionary risk is real. Covid-19's inflicted economic consequences are likely to be compounded by unfavourable conditions in most advanced economies and emerging economies, including China, which have already been in a slowing growth trajectory since 2H18. These economies' vulnerabilities have risen and are now less able to absorb shocks, especially when hit by an exogenous shock. The IMF is looking at more dire scenarios where the spread of the virus continues for longer

Global growth scenarios in 2020

SCENARIO		PROBABILITY	PROJECTED GLOBAL GDP GROWTH
Upside	• Global growth stabilisation and recovery • Monetary and fiscal stimulus are working	25%	2.7%
Base case	• Global stabilisation and moderate recovery in 2H20 • A prolonged Covid-19 outbreak, disrupted supply chains, financial turbulence, geopolitical shocks	25%	2.5%
Downside	• Recessionary risk • Deepening impact from a prolonged Covid-19 outbreak • Failure of monetary and fiscal policy stimulus • Sharp correction in global equities	50%	-1% to 1.5%

and more globally, and the growth consequences are more protracted.

The US economy has started to feel the rippling effects of the Covid-19-induced supply chain disruptions and demand shocks with the Fed's Beige Book reporting the first negative impact of the coronavirus on economic activities. There is a real risk that US consumers' fundamentals, a strong pillar underpinning the economy, will be hurt if the coronavirus spread worsens.

Japan's economy, which had declined by an annualised rate of 6.3% in the fourth quarter of 2019 – a decline that was blamed on a 10% consumption-tax hike from 8% previously and the global trade slowdown – is likely to suffer a technical recession in 1H20.

Growth in the eurozone is slowing or somewhat stagnating to the point of recession. The European manufacturing and trade sectors are more deeply connected to China through the supply chains web than that with the US.

Selloff in stock market

The next stop on the road to recession is a substantial selloff as well as a wide swing in the stock market as investors worry that the coronavirus would hit the economy badly and cause a knock-down impact on corporate earnings and profits of the companies they are investing in. If the virus impact prolongs and worsens, the declining profits or large losses would affect companies' cash flows to service their debt. As the debt grows faster than the economy, it becomes unsustainable. Typically, stock prices fall by about 30%-40% before a severe economic downturn.

The benchmark 10-year Treasury yields saw sharp declines after the Fed announced an unexpected 50-basis-point cut in its benchmark interest rate to 1%-1.25%, the first time such an emergency move was made since the 2008-09 global financial crisis (GFC). The Fed swept into action again, slashing its benchmark interest rate to near zero and promising to boost its bond holdings by at least U$700 bil. The 10-year Treasury yield tumbled below 1% for the first time ever as investors continued to seek safer assets amid fears that the coronavirus will disrupt global supply chains and tip the economy into a recession. Markets are implicitly expecting a long and deep recession.

Central banks and governments worldwide have cut interest rates and opened up the fiscal spigots to fight the worldwide spread of the coronavirus outbreak. More than US$45 bil of budget support has already been pledged or is under consideration to counter the virus impact, encompassing a mix of cash handouts, tax breaks, healthcare prevention, expenditure programmes, and projects and transfers.

Global central banks are coming into this economic shock with far less ammunition globally. With global interest rates generally staying low, and some at negative levels, this means some central banks may not have room to take interest rates much lower. For those that still do, any rate cut may not be effective in lifting economic activity.

The overextended state of central banks' balance sheets with the combined asset of the Federal Reserve, European Central Bank and Bank of Japan (BOJ) collectively standing at US$14.5 tril in November 2019, down slightly from the peak of around US$15 tril in early 2018 and more than 3.5 times the pre-crisis level of US$4 tril, means that more balance-sheet expansion or quantitative easing (QE) down the road may not guarantee a sustained economic revival.

While it is widely acknowledged that the QE was successful in putting a floor under collapsing markets and containing the depths of the 2008/09 GFC, it failed to achieve traction in sparking vigorous economic recovery and sustainable expansion post GFC, partly due to the lack of meaningful economic and growth reforms. Despite BOJ having negative interest rates and repeatedly purchasing massive amounts of both stocks and bonds, it is now in its fifth recession since 2008. FocusM