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How should we react to the novel coronavirus outbreak?

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(1) Impossible to foresee the worst outcome of this problem amid concerns about supply chain interruptions

Infections continue to spread at an increasing speed

The coronavirus outbreak is gaining momentum. In Wuhan, the rate of growth in the number of people infected appears to much higher than the pace in official announcements. Thus far, 565 Japanese residents of Wuhan have returned to Japan on charter flights and eight of these people were infected with the coronavirus. Applying this infection rate of 1.4% to Wuhan's population of 11 million results in an estimated 150,000 people who would have this disease. On February 3, government authorities announced that 17,205 people were infected and 361 had died. But the actual numbers are probably much higher. According to a February 3 article in the Yomiuri Shimbun, a University of Hong Kong research team estimated that more than 75,000 people were infected with the coronavirus as of January 25.

"The infection is spreading in Wuhan at an unimaginable speed," said Prof. Hitoshi Oshitani, a virology authority at Tohoku University. The epidemic also began to spread to other cities in China 2-3 weeks after Wuhan. Going forward, we must keep an eye on whether other cities will face a situation similar to that in Wuhan. Unlike SARS, the coronavirus infection does not seem to spread through contagion. Public health measures aimed at containment will be futile if the infection spreads even during the incubation period. Given the movement of people between Japan and China, it is quite possible that Japan will be the first to spread infection outside of China. It is unlikely that the epidemic will be stamped out by the time of Tokyo Olympics Games this summer" (Nihon Keizai Shimbun, February 3).

Following the WHO's declaration of a global health emergency, the United States immediately started barring entry to foreigners who have been in China during the past 14 days. Furthermore, direct US-China flights have been suspended for about three months. Approximately 60 countries now have restrictions on the entry of Chinese nationals. The Chinese government has responded to the crisis by imposing a lockdown on the city of Wuhan, extending the spring break and taking other actions. Despite these measures, infections have spread to Chongqing, Beijing, Shanghai, Guangzhou, Shenzhen and other cities in China. The government's countermeasures were apparently not quick enough to contain this outbreak. As of February 3, according to a February 3 article in the Nihon Keizai Shimbun, there were 11,177 infections in Hebei province (including 5,142 in Wuhan) and 6,028 infections in other provinces, demonstrating that the outbreak has already grown significantly in locations other than Wuhan. As a result, there may be a need to cut off direct contact with people in even more areas of China for a long time. Taking these actions would have a severe impact on the economy.

(2) No change in the outlook for a global economic recovery

The cost of a China quarantine would not be enough to trigger a global recession

The coronavirus outbreak will probably decline at some point because of extreme measures for blocking direct contact with people in affected areas. Even so, there are likely to be serious ramifications. For example, economic activity in China could be disrupted and demand and manufacturing could drop sharply for at least a few weeks or perhaps a few months. A short-term increase in downward pressure on interest rates and prices is also possible. If this happens, countries worldwide would probably respond with additional monetary easing, which is what the IMF recommends.

There only would be a very small risk of a coronavirus epidemic in the United States, which has closed its border to people coming from China. Consequently, a recession in the United States is unlikely and the global upturn in the economy and stock prices will probably continue.

As Musha Research has stated for some time, there have been mini-cycles within the current extended period of US economic growth that began more than 10 years ago. Naturally, these mini-cycles have affected financial markets. In recent years, there were mini-cycle peaks in the spring of 2015 and spring of 2018 and bottoms in the middle of 2016 and fall of 2019. The mini-cycle downturn that started in the middle of 2018 happened because companies pushed back many investments due to the uncertain outlook caused by the US-China trade war. This coincided with increasing indications of the end of a peak in the smartphone and automobile replacement cycle. But now the cycle for replacement purchases has stopped declining and most of the uncertainty about the trade war has been eliminated. That means we can expect to see the mini-cycle, which reached a bottom in 2019, to start rebounding in 2020. Even if the coronavirus slows down China’s economic growth, there is unlikely to be a downturn in the US economy, where consumption is 70% and the non-manufacturing sector is 90% of the GDP. However, there may be a temporary impact on manufacturing, energy and other so-called traditional industries where China accounts for the largest share of demand in the world.

Investments in 5G and other new technologies have started and companies are making investments to remain competitive in high-tech categories such as leading-edge semiconductors. In China, 5G investments are increasing rapidly as the country plans to be the global leader in this market. An investment competition is about to begin as other countries attempt to keep up with China. Global semiconductor industry investments plummeted after the US-China trade war started in 2018. Limitations on the supply of semiconductors caused by smaller investments may lead to a surprisingly big improvement in the balance between supply and demand. The result could be new highs for US semiconductor stocks, which are very sensitive to changes in the health of the manufacturing sector.

The non-manufacturing sector accounts for 90% of the US economy (value-added production). What factors could cause a recession in this sector? Unlike manufacturing, services have no cycles involving inventories, equipment utilization rates or investments. Changes in the financial environment are the biggest risk concerning the growth of medical care, education, entertainment, tourism, professional services, real estate, retailing, telecommunications and other services. One possibility is monetary tightening and higher interest rates in response to increasing inflation and a weaker currency. Services would also be impacted by a drop in purchasing power linked to the bursting of a price bubble. These points lead to the conclusion that damage to China’s economy would result in monetary easing, which would have a positive influence on financial markets.

Assuming there is no dramatic shift in the outlook for more global economic growth, the long-term increase in stock prices in Japan will probably continue. This includes the assumption that Japan can avoid a coronavirus epidemic and other problems. In February, a golden cross appeared on the Nikkei Average monthly chart as the one-year moving average moved above the two-year moving average. The stage is set for a stock market rally in terms of technical indicators and supply and demand. Since 2010, a golden cross has happened only three times: December 2012, May 2017 and now. The previous two golden crosses marked the beginnings of powerful bull markets. If the outbreak of coronavirus can be suppressed, the recent dip in stock prices may be a springboard for the start of a rally.

(3) Investors increasingly shun China as doubts about the sustainability of its economy grow

The dangers of overreliance on China

The US-China trade war is just one of many risk factors concerning the excessive dependence on China as a supplier of manufactured goods. Risk involving health and safety is also appearing. Today, China accounts for the largest share of global manufacturing output by far. China has a 60% share of cement production and 52% share of steel output. China also makes more than half of the world’s home appliances, smartphones, PCs, solar cells, lithium-ion batteries, drones, 5G equipment and other high-tech products except semiconductors.

Despite this dominant position, many people have doubts about the sustainability of the model for the growth of China’s economy. The use of excessive investments and debt to fuel growth is one source of concern. A profit structure underpinned by government subsidies and other public-sector support is another reason for concern.

Furthermore, there is a widespread perception that stealing and copying intellectual property has contributed to China's ability to manufacture goods. The coronavirus crisis may become an event that reinforces the already strong doubts about China.

The United States has taken several actions to shut out the coronavirus: (1) urging US citizens to avoid travel in China; (2) refusing entry to foreign nationals who live in China; and (3) suspending direct flights to China by three airlines for about three months. Some people believe mistrust of China prompted the United States to select more drastic measures than would have been used otherwise. On January 30, US Commerce Secretary Wilbur Ross said that the coronavirus crisis may return jobs to the United States as companies bring back manufacturing operations currently located in China. There has been criticism of the remarks of Mr. Ross as insensitive at a time when China is dealing with this crisis. However, the coronavirus outbreak will undoubtedly force companies to consider making big changes to supply chains that currently rely on China to a large degree.

The crisis has exposed the government's strong-arm tactics and tendency to conceal information, perhaps reducing central government power

On January 27, the mayor of Wuhan stated on China's national TV network that everyone involved with the coronavirus outbreak is dissatisfied with the disclosure of information. In fact, the authority of the mayor is severely limited by the leaders of the provincial and national government. The mayor admitted that even if he receives useful information, he is unable to make a public announcement without prior consent because he is a local government official. Only a few weeks earlier, people who used the Internet to provide information about the coronavirus outbreak were arrested for distributing "fake news." Subsequently, all information about the crisis has been controlled. Moreover, there are critics who believe the WHO delayed its decision to declare a global health emergency because of improper emphasis on the interests of China.

WHO Director-General Tedros Adhanom Ghebreyesus is from Ethiopia, a country that receives considerable financial aid from China. Prior to announcing an emergency, Dr. Tedros praised China for its extraordinary measures, expressed his appreciation for these actions and said no excessive response was needed. This statement is an indication of the improper pressure that China can exert on multinational organizations.

The coronavirus crisis may very well become an event that marks the starting point of a significant decline in China's stature within the global supply chain.