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Wall Street Is (Finally) Waking Up to the Damage Coronavirus Could Do

The financial world is realizing how different this is from a trade war or other recent economic hiccups.

By Neil Irwin

For weeks, there has been a strange divergence among those trying to predict what coronavirus might mean for financial markets and the world economy.

People in the trenches of global commerce — supply chain managers, travel industry experts, employers large and small — warned of substantial disruptions to their businesses. And public health authorities feared that the disease could spread far beyond Wuhan in China.

Yet financial markets and most economic forecasters projected the virus outbreak wouldn't do much harm to the economy and corporate profits — at the least, nothing that an interest-rate cut or two from the Federal Reserve couldn't fix. The S&P 500 hit a new high less than a week ago, last Wednesday.

Something had to give, and on Monday it did. After reports of people infected with the virus in the major economies of South Korea and Italy, the more pessimistic view began to prevail across major world markets.

There remains huge uncertainty about how widely the virus will spread and how much damage it will do. But the financial world is realizing just how much is at stake — and how different this is from other recent hiccups in the global economy, notably last year's trade war between the United States and China.

"It's one thing if Wuhan is on lockdown, another if all of China is on lockdown, another if all of Asia is on lockdown, and another if the whole world is on lockdown," said Patrick Chovanec, an adviser for Silvercrest Asset Management and an expert on the Chinese economy. "That's why sentiment has shifted — because it's very different to have one country on lockdown for a couple of weeks versus rolling lockdowns throughout the global economy."

Since the end of the global financial crisis more than a decade ago, investors who have been the most alarmist about various risks have had a tendency to lose money. Global asset prices have been on a steady march upward despite the eurozone crisis, the end of the Federal Reserve's quantitative easing, the trade war and every other problem that has occupied financial headlines.

So it is understandable if investors were quick to assume that coronavirus would follow a similar pattern — a temporary blip that reduced China's growth for a quarter or two but had little lasting impact.

"The portfolio managers thought this would be temporary," said Megan Greene, a senior fellow at Harvard Kennedy School. "They figured this is a flash-in-the-pan virus, that it will finish as soon as the winter does, and that even if that assumption isn't right, that central bankers will step in and fix this mess."

Markets accustomed to optimism may be all the more vulnerable if the virus becomes a global pandemic that causes meaningful pullback of commerce across major economies. Even after Monday's sell-off — a 3.4 percent drop in the S&P, the steepest single-day retrenchment in two years — financial markets remain richly valued. The U.S. stock market remained above its level of Feb. 7.

The trade war, in which the United States and China placed tariffs on specific imported goods, caused a significant slump in manufacturing last year. But the coronavirus is hurting service industries as well. If the authorities in major world economies start shutting down any facility where large numbers of people congregate — a list that includes factories, shopping malls and airports — the damage could prove broad and lasting.

When a hotel or airplane sits empty for weeks because people are afraid to travel, that is a loss that cannot be recovered once business returns.

That's particularly relevant for the United States, where service industries account for the majority of economic activity. This means that even companies that made it through the trade wars unscathed might be exposed to lost revenue or business shutdowns because of the virus outbreak.

Moreover, while tariffs might put sand in the gears of global commerce, that has different implications than gears that stop entirely. Companies had many options for dealing with the trade war, whether sourcing goods from elsewhere or simply paying more for them.

The longer the shutdowns of Chinese production, and the more widely other countries are forced to take similar measures, the more the spread of the virus could affect the ability of global companies to do business.

Moreover, while the Fed and other central banks may well take action to try to insulate the world economy from those shocks, their tools are ill-suited to the task in many ways. The economic effects of coronavirus would act as a "supply shock," reducing the productive potential of affected nations for reasons unrelated to the forces that more traditionally shape economic results like monetary policy or fiscal policy.

Put differently: Lower interest rates won't make a sick person well, or give public health authorities confidence that businesses can reopen. All they can do is lower borrowing costs and help encourage businesses and consumers to spend and push financial market prices higher.

"We would rather have a vaccine than a rate cut and fully recognize that monetary policy is not optimized for addressing this type of shock," said Krishna Guha with Evercore ISI, in a research note. "But it does not follow from this that the appropriate path of policy under the shock is unchanged."

Neither economists nor portfolio managers make particularly good epidemiologists. But what has become more clear in the last few days is that it is the science of epidemics — and the policy choices that nations make to try to address it — that will shape the economy for the near future, and maybe quite some time to come.