City National Rochdale®
AN RBC/CITY NATIONAL COMPANY

FEBRUARY 7, 2020

Special Bulletin

CORONAVIRUS

SUMMARY

The Coronavirus outbreak is expected to slow U.S. Q1 growth by as much as 0.4 percentage points to an estimated 1.6%.[1] Despite the U.S. linkage to China, we believe few areas of the U.S. economy should be hard hit by the outbreak outside of travel, hospitality, tourism, and manufacturing. In contrast, we expect a rebound in U.S. economic activity to boost Q2 growth by 0.3 – 0.4 percentage points, limiting the drag to full year growth.[2]

We believe the short term impact on China as a whole will be relatively devastating -retail sales, oil imports, and car sales will sharply decline. Q1 growth is forecasted to fall 1.6 percentage points but a quick rebound in Q2 is expected.[2] China's annual growth outlook will likely be revised downward to the range of 5.5% - 5.8% from the general market consensus of 6%.

Sectors and firms directly exposed are those that rely on revenue from and production in China: airlines, autos, retail, gaming, media, and commodities.

The spread of the Coronavirus is expected to be contained by the end of the first quarter followed by a sharp recovery in Q2. If efforts to contain the outbreak falter, global supply chains will more than likely be disrupted. Companies that operate outside China but depend on inputs from the affected area would face temporary production delays. Permanent economic loss in China will inevitably spillover to the U.S. given that China makes up 24.5% of the U.S. supply chain.

At this time, no major investment changes will be made to our portfolios. Given our current positioning of late-cycle volatility and non-cyclical exposure, our portfolios are well-situated to weather the oncoming short-term disruptions.

The coronavirus outbreak is affecting financial markets in China and beyond. The market consensus is that the majority of impacts will be confined to Q1 2020 with China bearing the brunt of it. In general, the economic effects of the virus are in line with our positioning of late-cycle volatility and non-cyclical exposure. While we estimate a significant impact on company profitability in China, we do not anticipate a material impact on U.S. companies. Therefore, we are not selling any equities in our growth or dividend categories. In addition, a review of our bond holdings has been conducted and we do not foresee any risks to the quality of our bond portfolios and likewise no changes are being made. If the spread and implications of the Coronavirus exceed our current projections, investment positioning across all client portfolios will be updated.

The recent Coronavirus outbreak was initially comparable to the SARs outbreak in 2003 in order to get a sense of its potential economic and financial effect on the global economy. However the composition of the Chinese economy has changed dramatically as consumption is now a much larger factor of economic growth. We believe weaker consumption will pressure China's growth in the short term. The tourism, transportation, and hospitality industries were hit especially hard and the same industries could once again take a significant hit. Nevertheless, in contrast to SARs, the Chinese government's prompt response in conjunction with coordinated international public health actions, are expected to mitigate damages.

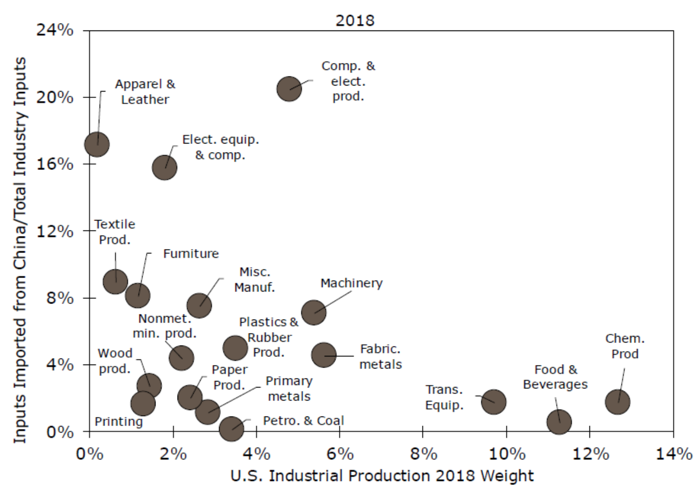
The aggressive government response is expected to quickly slow down the rate of infection and fiscal and monetary policy will likely support the financial markets in the long term. The People's Bank of China has injected 1.7 trillion yuan of liquidity into the banking system and is expected to lower benchmark rates more aggressively if markets continue to deteriorate further. Regulatory relaxation is also anticipated to help offset the damage.

China's growth outlook will likely be revised to an annual growth rate of 5.5-5.8% and Q1 growth is expected to fall around 1.6 percentage points.[1] The longer the Coronavirus outbreak drags on, the greater the effect on employment and permanent loss of output. At this time, minimal permanent damage to the Chinese economy is expected and a quick bounce back in economic activity should help counteract the reverberating disruptions.

Depending on the duration of this global health crisis, we believe the U.S. economy should be able to withstand the near-term effects of a halt in China's economic activity. Research shows that the virus could slow U.S. Q1 growth by 0.4 percentage points, taking the growth forecast from 2% to 1.6%.[1] The Q2 rebound is estimated to increase growth by 0.3 to 0.4 percentage points, which limits the U.S. full year growth drag to 0.05 percentage points.[2] Computer and electronic products industries, which account for 4.8% of U.S. industrial production, are most likely to experience supply chain disruptions given ~20% of their inputs are imported from China.[3] Other industries are also heavily reliant on Chinese imports, such as electrical equipment & components and apparel, but comprise a smaller portion of industrial production. Outside of manufacturing, we expect airlines to face restricted and reduced travel, but U.S. airlines should be able to mitigate adverse impacts through lower Asia Pacific exposure compared to European carriers as well as compressed oil prices. U.S. media and entertainment companies exposed to China's box office revenue will also be affected by the reported closure of thousands of movie theaters in China, but premiere dates will likely be postponed rather than cancelled so that revenue can be deferred (see Figure 1).

FIGURE 1

Inputs Imported from China vs. U.S. IP Weight



Source: U.S. Department of Commerce, Federal Reserve Board and Wells Fargo Securities

While the manufacturing sector is most exposed to supply disruptions, inventory levels have been particularly high across the sub-industries in recent periods, which should be able insulate U.S. production in the near term. Computers & electronic products, however, are the exception as their inventory is near an eight-year low, underscoring their vulnerability to disruptions. For retail, extended disruptions could have a greater effect on sales and consumer spending for the next few months as production and shipment delays wrack the industry with the tightest level of inventory.

If the virus cannot be contained within Q1 as anticipated, we believe the depletion of excess inventory will take an even larger toll on the economy. The potential cascade in the global supply chain will also need to be examined, as the virus' impact on the U.S. economy is influenced beyond just relations between the U.S. and China. For example, China is one of OPEC's largest customers and while it remains to be seen if OPEC will cut output further, Chinese oil purchase cutbacks could reduce global demand enough to cause a supply buildup around the world. Chinese oil demand is already down nearly 20% year-over-year.

1 Winck, Ben. "Goldman Sachs: Coronavirus Fallout Isn't Enough to Slow Global Growth in 2020." Business Insider, 4 Feb. 2020.

2 Mohamed, Theron. "Goldman Sachs Warns Wuhan Coronavirus Will Hit US Economic Growth This Quarter." Business Insider, 31 Jan. 2020.

3 House, S., Quinlan, T., & Seery S. Are U.S. Factories Braced for Supply Disruptions? Wells Fargo Securities, 2020.