ClearBridge Investments

Recession Indicators Update: Coronavirus Risk Impacts

March 2, 2020

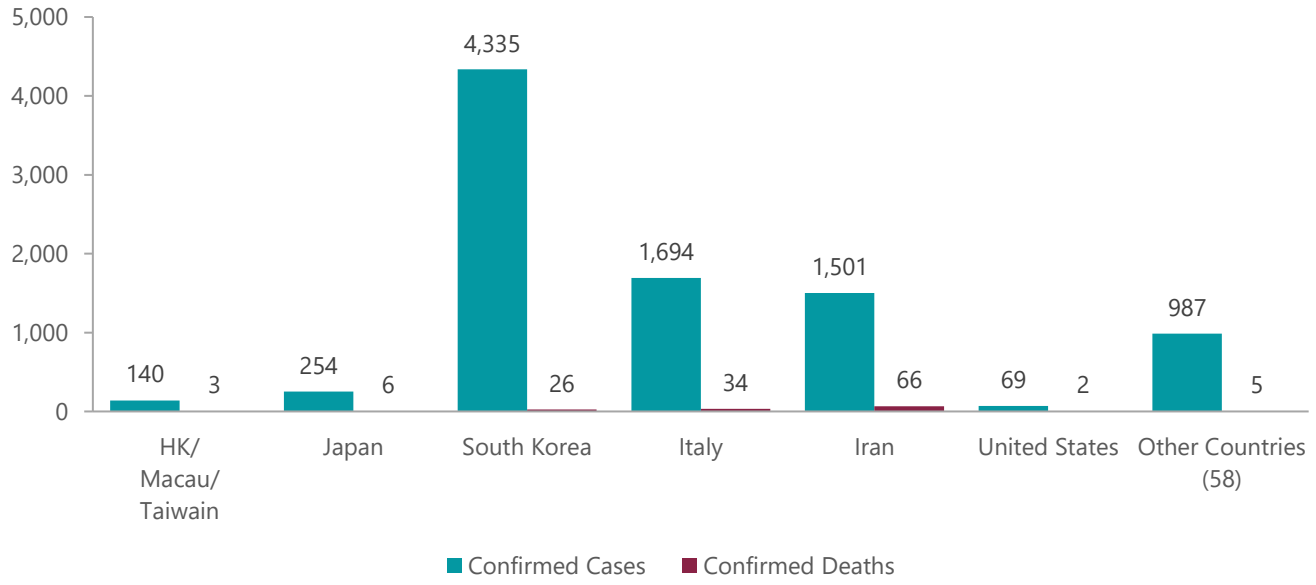
Key Takeaways

- The increased spread of the coronavirus outside of China rattled global equity markets, with U.S. stocks declining over 12% in the past 10 days.
- Prior to the wider outbreak, the ClearBridge Recession Risk Dashboard was improving with Money Supply and Commodities moving to green from yellow. However, Profit Margins changed to red from yellow and Job Sentiment to yellow from green.
- The overall signal remains yellow and is likely to remain so in the near term given the increased risk and uncertainty emanating from the coronavirus outbreak.

Rising Coronavirus Fears Spook Financial Markets

While the coronavirus has been on the radar for many investors prior to the selloff that began in mid-February, initially the disease was largely contained within China (specifically the Hubei province). Equity markets sold off only after the virus began to spread in a more significant fashion outside of China, with meaningful numbers of cases reported more recently in South Korea, Japan, Iran and Italy. As fear of a global outbreak has risen, investors have fled equities in favor of safer assets like fixed income and gold. U.S. and international stocks, as represented by the S&P 500 Index and the MSCI All Country World Ex-U.S. Index, are down 12.7% and 11.8%, respectively, from their recent peaks and 10-year U.S. Treasury yields have plunged to a record low of 1.15%, as of February 28. While the ultimate trajectory of the disease is unknowable, some have begun to question if this could be the straw that breaks the camel's back for the current market run and period of economic expansion.

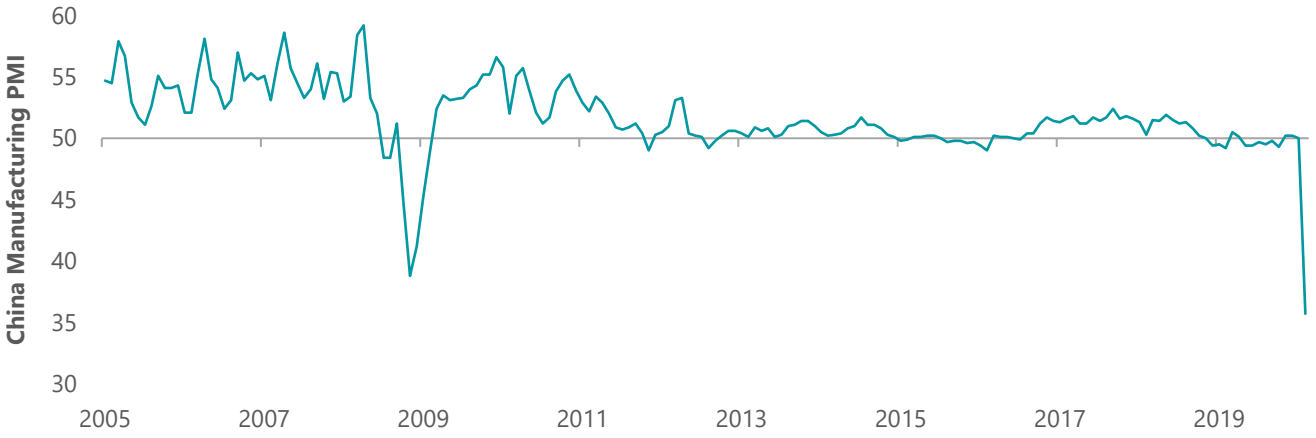
Exhibit 1: Reported Cases Have Increased Outside Mainland China



Data as of March 2, 2020. Source: Bloomberg.

Efforts to contain the spread of coronavirus will curb economic growth in the short term. These include shutting down factories in affected areas, imposing travel restrictions/limits and canceling public events. China's manufacturing PMI for February came in at 35.7, a level worse than what was seen in 2008 (Exhibit 2). Financial markets have become increasingly concerned about the spread of the virus and the potential for associated disruptions to business and consumer activity. For example, the remainder of the Japanese baseball preseason will be played in empty stadiums, as have several Series A soccer games in northern Italy. Beyond sports, the shift by many businesses to more global supply chains and just-in-time inventory management increases the risk of production challenges. Some businesses that are closed or operating at reduced output may come under financial pressure if these limits persist.

Exhibit 2: China Manufacturing Takes a Dive



Data as of Feb. 29, 2020. Source: China Federation of Logistics and Purchasing, Bloomberg.

Consumers around the globe could pull back if they see their hours reduced or even go unpaid, to say nothing of being unable to go out and shop. The economy could also come under pressure if a confidence crisis emerges, a

scenario where actions to limit the coronavirus cause consumers to pull back even if the virus does not impact them directly. The good news is policymakers are well aware of these risks and are taking steps to aid both consumers and businesses during this challenging period.

Most economic models are not designed to capture the impacts of a previously unknown global pandemic and the ClearBridge Recession Risk Dashboard is not unique in this sense. However, we continue to believe the Dashboard and its underlying signals can be illustrative for those seeking to contextualize risks in times like this. Perhaps the most important question for equity investors is if the foundation of the economy is strong enough to withstand the negative growth impulse from the coronavirus.

Exhibit 3: ClearBridge Recession Risk Dashboard

	February 2020	January 2020	December 2019
Yield Curve	✕	✕	✕
Credit Spreads	↑	↑	↑
Money Supply	↑	●	●
Wage Growth	✕	✕	✕
Commodities	↑	●	●
Housing Permits	↑	↑	↑
Jobless Claims	↑	↑	↑
Retail Sales	↑	↑	↑
Job Sentiment	●	↑	↑
ISM New Orders	●	●	✕
Profit Margins	✕	●	●
Truck Shipments	↑	↑	↑
Overall Signal	●	●	●

↑ Expansion ● Caution ✕ Recession

As of Feb. 29, 2020. Source: ClearBridge Investments.

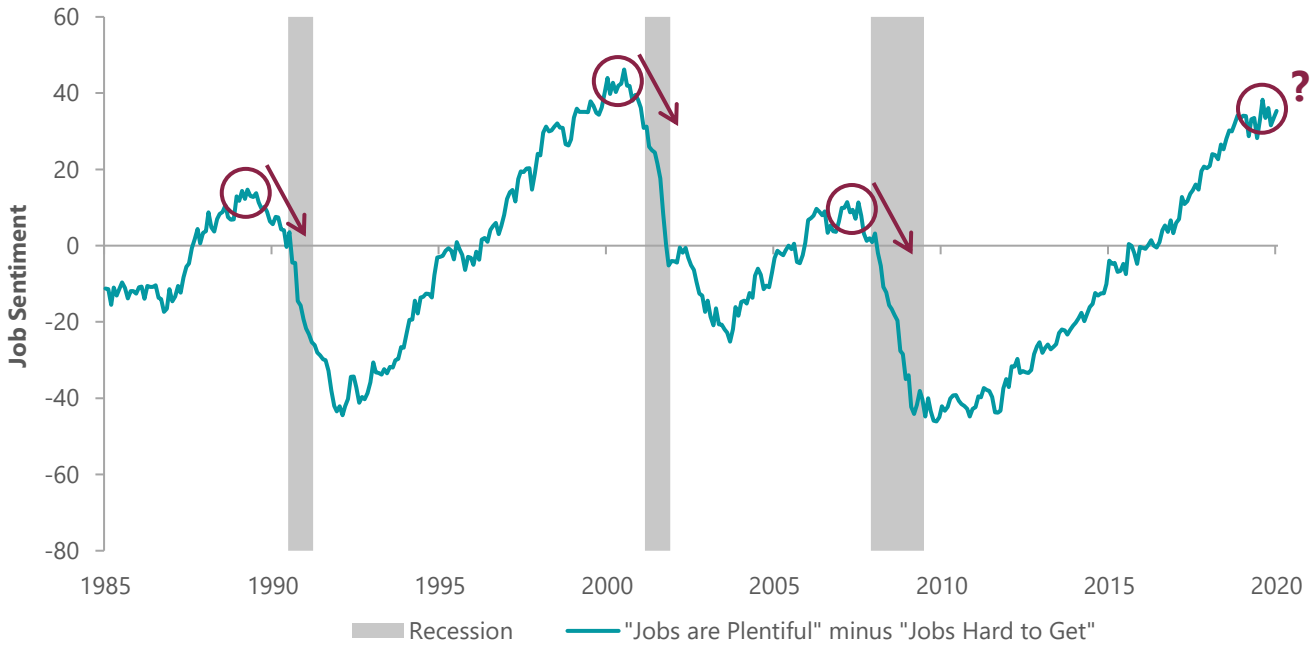
Evaluating Coronavirus Risk Using the ClearBridge Recession Risk Dashboard

The dashboard had been trending healthier over the past several months, and in recent weeks the overall signal was nearing a return to green or expansionary territory. The ISM New Orders signal improved from red to yellow last month on the back of the trade deal, and several variables, such as Wage Growth and Housing Permits, saw improvement but not signal changes. Two signals are also changing from yellow to green this month: Money Supply and Commodities. The expansion of the Fed's balance sheet has been helping to boost Money Supply: the Fed acted in order to stave off issues in the repo market, the effect has been to add liquidity to the financial system, which decreases the risk of recession. Commodities have been helped by falling oil prices as well as positive trends in chemicals and lumber prices, while industrial inputs such as copper and steel remain relatively stable.

However, as the picture regarding the severity of the outbreak has become clearer in recent weeks, the dashboard

has modestly deteriorated and the overall signal remains in yellow cautionary territory. Three indicators worsened but did not change, reflecting increased economic risk from the coronavirus: ISM New Orders, Credit Spreads and the Yield Curve. Despite improvements to Money Supply and Commodities, two non-virus-related signal changes caused the overall signal to remain yellow: Profit Margins and Job Sentiment. Profit Margins have continued to deteriorate and are now red (previously yellow) for the NIPA universe we monitor, and margins worsened for S&P 500 Index companies for the second consecutive earnings season. While improving trends in both wages and commodities should dampen margin pressure over time, corporate profits remain vulnerable at present. Job Sentiment has also worsened, to yellow from green. While the labor market remains healthy, early warning signs of stress are beginning to go off. These include the sharp decline in job openings in the JOLTs report as well as the jobs sentiment data. This month saw a large drop-off in "jobs are plentiful" responses and an uptick in "jobs are hard to get" responses. This measure has clearly stalled, suggesting increased caution is warranted (Exhibit 4).

Exhibit 4: Job Sentiment



As of Feb. 29, 2020. Source: Conference Board, Bloomberg, NBER.

Overall Yellow Signal Likely to Persist Amid Uncertainty

Looking ahead, the macro backdrop remains mixed. While the underlying trend in the pre-coronavirus economy appeared to be improving (absent several one-off items such as the Boeing shutdown), this new unknown has introduced a new set of risks to the global economy. Fed Funds futures have fallen substantially, and that market is now pricing an additional interest rate cut at the upcoming March meeting. While the effectiveness of lower interest rates in dampening the initial, more supply-side impacts of coronavirus may be limited, this could be an important signal to help boost sentiment and stabilize financial markets. In our view, the Fed could achieve a similar result through a combination of other policy tools, such as coordinated liquidity swap lines which were utilized during the global financial crisis. These would allow central bankers to send a message that they are working together to stave off lasting damage from coronavirus by providing sufficient funding to ensure the smooth operations of global markets.

The evolving nature of the spread of the virus makes its demand-side economic impact difficult to forecast with precision, however there is likely to be some drag on U.S. GDP. In the coming months, we believe Credit Spreads,

Retail Sales, ISM New Orders, Commodities and Truck Shipments are the most likely indicators to reflect the impacts of the coronavirus. Additionally, this exogenous event will likely extend the length of the yellow overall dashboard signal, and a “V” shaped economic rebound from the effects of the virus appears increasingly unlikely. Given this, we believe caution is prudent at the current juncture given the potential for heightened volatility such as that experienced by equities in recent weeks.

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