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LEADING LONG ISLAND

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LIA Monthly Economic Report

A Research Report for Directors and Members of the Long Island Association, Inc.

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This issue of the LIA newsletter examines the potential economic impact of the coronavirus outbreak. Initial fears of a possible pandemic froze economic activity in affected areas and led to sharp declines in the stock market.

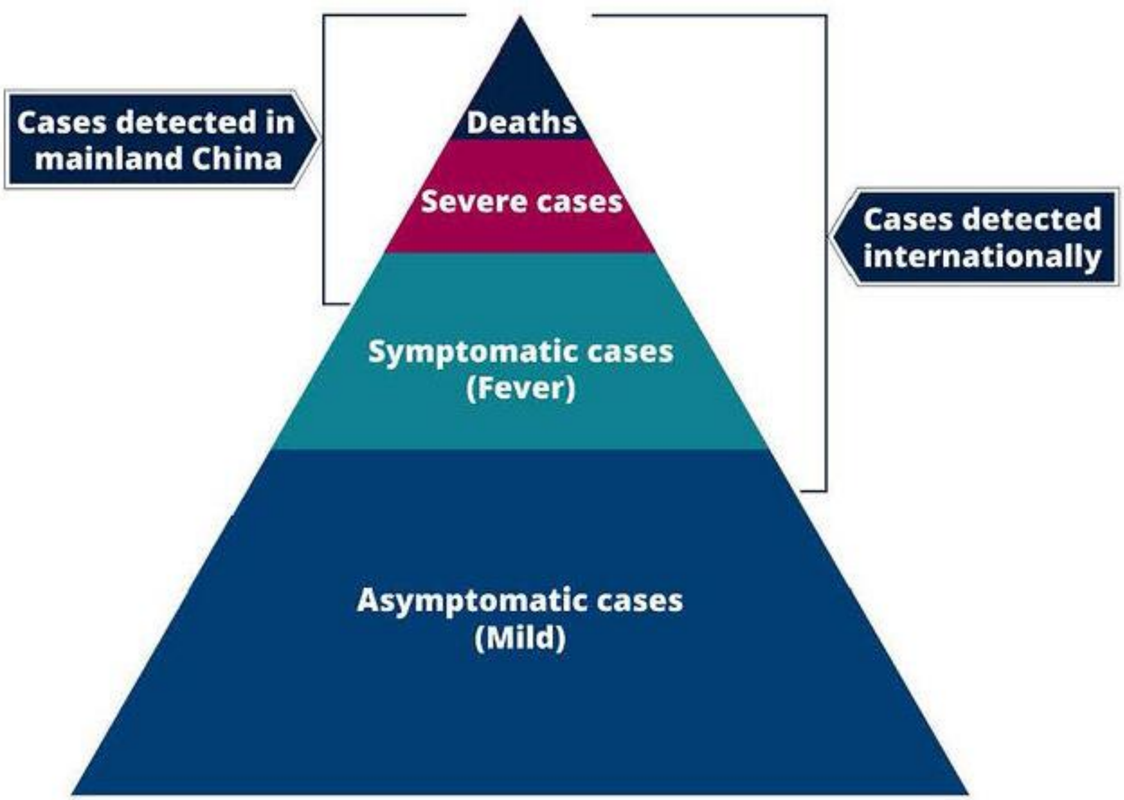
Emerging evidence that the virus is substantially less lethal than initially feared and efforts by the Federal Reserve to provide monetary stimulus, may help alleviate concerns and provide economic stimulus but, the biggest concern may not be the virus itself but public fear of the virus.

HOW SERIOUS IS THE CORONAVIRUS?

Assessing the economic impact of the coronavirus begins with an understanding of how serious this disease really is. There has been a lot of uncertainty about this. Initially, mortality rates were thought to be quite high—initially as high as 15 percent in China, the epicenter of the virus. But this greatly overstated the true mortality rate, because initially only the most serious cases were reported.

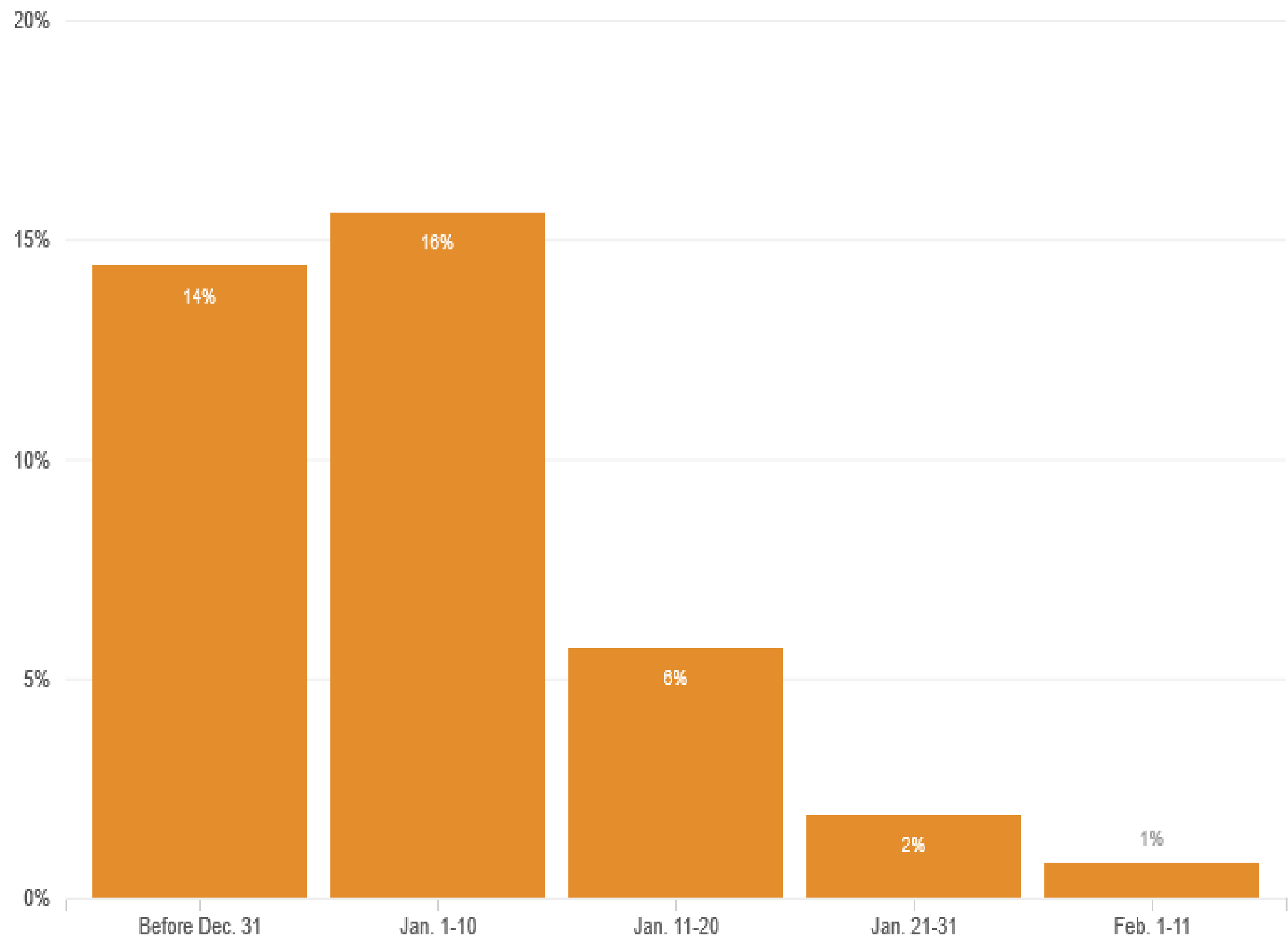
As Figure 1 below indicates, there were many milder, asymptomatic cases of coronavirus that were not included in initial mortality estimates. Over time, as more mild and asymptomatic cases were identified in China, the estimated mortality rate plunged dramatically (see Figure 2). By the first two weeks of February, the mortality rate had declined to 1 percent. More recently, the estimated mortality rate from coronavirus in China has fallen even further, to 0.4 percent. And some experts suggest the rate could be as low as 0.2 percent, which puts it in the range of mortality rates associated with the flu.

Figure 1. Schematic of Coronavirus Cases by Degree of Severity



Source: https://www.bbc.com/news/health-51674743

Figure 2. Estimated Coronavirus Mortality Rates in China over Time



Source: https://www.npr.org/sections/goatsandsoda/2020/03/03/809904660/why-the-death-rate-from-coronavirus-is-plunging-in-china

This year, the mortality rate from the flu in the United States is 1.4 percent. And this rate fluctuates from year to year, with some rates higher and others below this rate. Tens of millions of Americans have contracted the flu virus this year, and some 18,000 people have died from the flu. This far exceeds the number of infections and deaths reported from the coronavirus worldwide. Moreover, transmission rates of the coronavirus are believed to be similar to that of the flu. Based on this evidence, it would seem that the coronavirus is hardly more serious than the flu itself.

REACTION TO THE VIRUS

Measures to contain the virus are critical. This has led to supply chain issues, especially in China, where particularly aggressive measures have been employed to contain the virus. Major events with large crowds and social gatherings have been cancelled as well in an effort to contain the virus.

Such measures are prudent and necessary. They will inevitably have some adverse economic effects. But these effects should be time-delimited. And given an economy that is fundamentally strong, one could anticipate a relatively quick recovery in the U.S. once the virus has been contained.

Perhaps the bigger concern, however, is the potential demand side reaction, resulting from fear of the virus. Despite growing evidence that the coronavirus is far less lethal than initially supposed, the virus has instilled fear around the globe. Airlines and the energy sector have been particularly hard hit, as both business and private consumers are substantially reducing their travel plans. And reduced travel has adverse effects on the other industries, such as hotels, restaurants, entertainment, and retail.

The economist, Austan Goolsbee, has argued eloquently that demand-side contraction could have particularly adverse effects in mature, service-based economies such as the United States. As he notes:

Consider travel. The average American takes three flights a year; the average Chinese person less than half a flight. And the epidemiological disaster of the Diamond Princess has persuaded many people to hold off on cruises. That cruise ship stigma alone potentially affects about 3.5 percent of the United States, which has about 11.5 million passengers each year, compared with only 0.17 percent of China, which has about 2.3 million passengers.

People may stop attending American sporting events. There have even been calls for the N.C.A.A. to play its March Madness college basketball tournament without an audience. But sports is a huge business in the United States. People spend upward of 10 times as much on sporting events as they do in China.

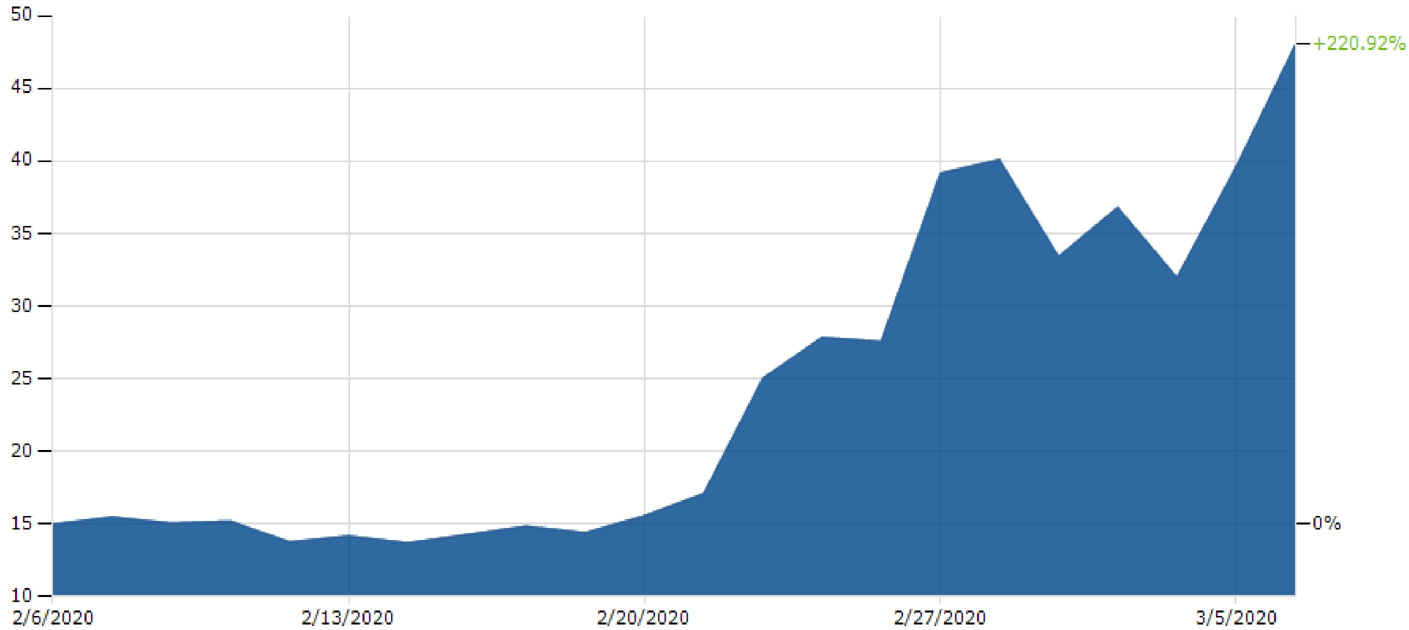
That's just a start. Who wants to go to the dentist or the hospital during an outbreak if a visit isn't necessary? Yet health spending is 17 percent of the U.S. economy — more than triple the proportion spent in China.

TURMOIL IN FINANCIAL MARKETS

Predictably, fear of the coronavirus has roiled the stock market. The Dow Jones Industrial Average has fallen thousands of points from its peak, and daily fluctuations of 1,000 points or more have become common. This volatility is well illustrated by recent spikes in the VIX[1] as indicated in the chart below.

[1] The VIX is the ticker symbol and the popular name for the Chicago Board Options Exchange's CBOE Volatility Index, a popular measure of the stock market's expectation of volatility based on S&P 500 index options.

Figure 3. Trends in the Volatility Index (VIX)



Source: https://markets.businessinsider.com/index/vix

These large fluctuations reflect fear and uncertainty due to the coronavirus. The danger is this fear will spill over into the real economy. This has already begun to happen in certain sectors such as travel and related industries.

And as money has flown out of stocks and into secure instruments like treasuries, interest rates of treasury bills have fallen to historic lows. This situation leaves investors caught between a rock and a hard place. To many, the stock market seems too risky right now. But returns on safe investments like treasury bills are extremely low.

THE OUTLOOK

Initially, economic concerns about the coronavirus centered on supply-side shocks and its impact on the supply chain. But evidence is already emerging that supply chains in China, so critical to many U.S. industries, are getting back on track. Supply shocks alone should not be long-lasting and one can reasonably anticipate a fairly sharp rebound once supply chains stabilize.

But demand-side shocks pose a potentially more serious threat. As one observer has noted, supply chains don't have emotions but consumers do. And if fears of the coronavirus take root in the United States, consumer confidence and spending may suffer. As Professor Goolsbee has noted:

So, for all the talk about the global "supply shock" set off by the coronavirus outbreak and its impact on supply chains, we may have more to fear from an old-fashioned "demand shock" that emerges when everyone simply stays home. A major coronavirus epidemic in the United States might be like a big snowstorm that shuts down most economic activity and social interaction only until the snow is cleared away. But the coronavirus could be a "Snowmaggedon-style storm" that hits the whole country and lasts for months.

Sharp declines in stocks threaten consumer and business confidence. Plummeting oil prices have pummeled energy stocks, as an apparent price war has developed between OPEC and Russia.

Since most countries have not yet conducted large-scale community testing for coronavirus infections, reported death rates have been relatively high. But large declines in mortality rates have been observed with large-sample community-wide testing such as in South Korea, because this includes many milder cases. As such evidence mounts, this should help to alleviate fears about the coronavirus.

The Federal Reserve's move to reduce interest rates will provide some relief, making credit more accessible and stimulating the real estate sector. And there is renewed interest in fiscal stimulus. So, some helpful economic policies appear to be emerging in response to the virus scare. And energy costs should be substantially lower, which is helpful for economic activity generally.

Moreover, the overall strength of the economy in the United States and on Long Island, and the emerging evidence that the coronavirus is far less lethal than initially thought, suggest that a "coronapocalypse" will be avoided. But this hinges critically on how quickly consumers and investors recognize that the coronavirus is not the bogeyman it was initially feared to be. As Governor Cuomo has noted, fear of the virus is more concerning than the virus itself.

EFFECTS ON LONG ISLAND

Some sectors of Long Island's economy may be particularly affected by the coronavirus. Most notably, leisure and tourism may suffer in the near term. While long distance travel, especially airline travel, will decline, staycations may rise, which could help to offset some of the tourism decline. And since summer is the main tourism season on Long Island, the worst may be avoided.

As in many other areas, conferences and other large events will be cancelled, which will also lead to economic losses in the short term. And the manufacturing sector may experience supply chain issues, as imports from China have slowed.

With lower interest rates, construction and real estate sectors may improve, but this will likely not occur until fears of the coronavirus have subsided. Lower energy costs will be favorable for both business and consumers. But again, until panic over the coronavirus subsides, spending and economic growth will be compromised.

Consumption spending depends in part on stock market performance through a wealth effect. That is, when the stock market declines, consumers feel less wealthy and cut back on spending. So, until the stock market recovers, once can anticipate consumption spending to be restrained.

And recovery in the stock market and economic activity generally depend critically on when fear of the coronavirus subsides. Nobel Laureate Robert Shiller has argued that coronavirus panic has not yet peaked. As he notes:

What we have now is really two epidemics. We have an epidemic of the coronavirus, but we also have an epidemic of fear based around a narrative that is not necessarily keeping up with scientific reality. And, this narrative has been quite striking… It's a dangerous time for the stock market.

It will take some time for fear of the coronavirus to subside. But with the flu season abating by April and with economic policies to promote growth in place, it is reasonable to expect meaningful recovery in the third quarter of this year.