MORNING BRIEFING
February 11, 2020

China's Chernobyl?

Check out the [audio excerpts](#) and the [collection](#) of the individual charts linked below.

(1) Three Mile Island, Chernobyl, and China's syndromes. (2) The collapse of corrupt regimes. (3) Will Dr. Li's death lead to the China Spring? (4) Autocrats are sickening. (5) Another reason to leave China. (6) The Great Quarantine of China. (7) Signs of life in global PMIs during January, just before the virus made headline news. (8) Eurozone sentiment may have bottomed, though German auto production has not. (9) US productivity growth is moving in the right direction.

Meet Leslie. We have a new employee at YRI. Her name is Leslie, and she will be reading audio excerpts from our *Morning Briefings*. The link to these podcasts is available above. Let us know if you like this new service.

China's Syndromes. "The China Syndrome" is a 1979 movie starring Jane Fonda as reporter Kimberly Wells. She witnesses an accident at a nuclear power plant and is determined to expose it to the public. Her cameraman Richard Adams (played by Michael Douglas) secretly films the panic among the crew at the plant's control room during a near-meltdown of the nuclear reactor. Needless to say, the powers-that-be do everything they can to hide the narrowly averted disaster. The term "China Syndrome" describes a fictional result of a nuclear meltdown, where reactor components melt through their containment structures and into the underlying earth, all the way to China.

In March 1979, a series of mechanical and human errors at the nuclear power plant at Three Mile Island in southcentral Pennsylvania caused the worst commercial nuclear accident in US history, resulting in a partial meltdown that released dangerous radioactive gasses into the atmosphere. The Chernobyl disaster was a nuclear accident that occurred during April 1986, at the No. 4 nuclear reactor in the Chernobyl Nuclear Power Plant, near the city of Pripyat in the north of the Ukrainian SSR. The event was depicted in a 2019 historical drama television miniseries produced by HBO.

Could the coronavirus outbreak do to China anything like the Chernobyl nuclear catastrophe did to the Soviet Union—arguably setting the stage for its rapid collapse by manifesting the consequences of incompetency and corruption in a national government? In my 2018 book *Predicting the Markets*, I wrote:

"One of the most momentous events during my career was the end of the Cold War in 1991. I had seen it coming a few years earlier and wrote a *Topical Study* during August 1989 titled 'The Triumph of Capitalism.' I observed that about one year after Mikhail S. Gorbachev became the General Secretary of the Soviet Communist Party, the nuclear reactor at Chernobyl blew up. The explosion, on April 26, 1986, released at least as much radiation as in the atomic bomb attacks on Hiroshima and Nagasaki. That event and other recent disasters in the Soviet Union were bound to convince Gorbachev of the need to restructure the Soviet economic and political systems, I surmised. Likely, he would conclude that a massive restructuring was essential and urgent because the disasters were 'symptomatic of a disastrous economic system that is no longer just stagnating; rather, it is on the brink of collapse,' I wrote back then. The Berlin Wall was dismantled in late 1989."

China's economy is in much better shape today than was the Soviet Union's economy before it disintegrated. However, the coronavirus outbreak has the potential to cause a social explosion that could set the stage for the meltdown of the Communist regime. Consider the following:

(1) *The death of Dr. Li.* The 2/7 BBC News website reported: "The death of a Chinese doctor who tried to warn about the coronavirus outbreak has sparked widespread public anger and grief in China. Li Wenliang died after contracting the virus while treating patients in Wuhan. Last December he sent a message to fellow medics warning of a virus he thought looked like Sars—another deadly coronavirus. But he was told by police to 'stop making false comments' and was investigated for 'spreading rumours'. … Analysts say it is hard to recall an event in recent years that has triggered as much online grief, rage and mistrust against the Chinese government. News of Dr Li's death became the top trending topic on Chinese social media, garnering an estimated 1.5bn views. His death has also brought demands for action, with 'Wuhan government owes Dr Li Wenliang an apology' and 'We want freedom of speech' among the hashtags trending."

(2) *Autocrats pose a health risk*. In the 1/28 *Morning Briefing*, I observed: "Another potential positive outcome of the outbreak would be if China's autocratic regime is forced by internal political forces to be less autocratic as a result of this health crisis. The Chinese people have

been willing to give up many of their freedoms in exchange for better economic conditions. If health issues become a major source of popular discontent, the government's credibility and supremacy could be sorely tested."

An opinion piece in the 2/6 *Washington Post* was titled "Warning: Chinese authoritarianism is hazardous to your health." It observed: "The Chinese Communist Party has once again proved that authoritarianism is dangerous—not just for human rights but also for public health. Confronted with the Wuhan coronavirus outbreak, the CCP has instinctively reverted to its familiar tool kit: It immediately staged a large-scale lockdown of people and information at the expense of the public good."

The government touted the construction of a hospital in 10 days with 1,000 beds. By some accounts, it resembles a prison. Meanwhile, since it was built, more than 20,000 people have been infected. The author concludes: "Now, with the outbreak spreading from Wuhan to the far reaches of the globe, the regime has again proved itself a danger to civilization. It has succeeded in turning a public health crisis into a human rights catastrophe."

A 2/2 Bloomberg Opinion piece is less alarmist. It is titled "Wuhan Isn't China's Chernobyl." The author observes that Moscow's grip on power was much weaker than Beijing's grip is today. The Soviet economy was a basket case before Chernobyl hit. China's economic growth rate has been slowing, but it is growing. Nevertheless, the article noted: "According to the Lancet, the first known patient developed symptoms as early as Dec. 1. China alerted the World Health Organization by the end of the month. While the first death occurred in early January, full alarm and lockdown didn't ensue until Jan. 23, days before the Lunar New Year holiday. By that point, millions of students, migrant workers and travelers had already left the city."

(3) *Another reason to move supply chains out of China.* Many companies were starting to consider diversifying their supply chains out of China as President Trump escalated his trade war with China during 2018 and 2019. Many companies have been doing just that, and now many more may decide to do so as a result of the disruptions caused by the health crisis in China.

The 2/8 *WSJ* reported: "China extended its new-year holidays three days to Feb. 2, and kept most businesses shut thereafter to combat the outbreak. Many factories are scheduled to reopen Monday, although it is unclear how many can. Many workers can't leave their hometowns, and employers still have to pay them. Factories that do open might have to operate with lower productivity because of labor shortage, new screening requirements and lack of parts. ... Also affected have been shipments via air and water. Since the virus outbreak, more than a dozen countries have stopped flights to and from China, and ships have been held back from calling."

A 2/8 CNBC article titled "'Crisis mode': Coronavirus disrupts the heart of electronics manufacturing in China" reported: "Factories in China, the center of the electronics industry's supply chain, have been closed for an extended Lunar New Year holiday and the outbreak of the deadly coronavirus. Most are expected to reopen on Monday, a week later than scheduled. But quarantines and other measures put in place to stop the spread of the disease in China could continue to disrupt electronics manufacturing well into the 2020 holiday season, even if factories quickly return to full production, manufacturing experts said."

(4) *The Great Quarantine of China.* A week ago, I noted that many countries have banned flights in and out of China. Russia has closed its border with China, which has quarantined Wuhan, where the outbreak began, and other major cities in Hubei province. Foreign governments have been airlifting their citizens out of Wuhan and placing them in isolation for 14 days, which is believed to be how long it takes for the virus' symptoms to show up. Apple shut its 40-plus stores on the Chinese mainland. So did Ikea.

In a 2/7 CNBC interview, our good friend Ed Hyman, the chairman of Evercore ISI, said, "Our team has GDP growth at zero for the first quarter ... China is really slowing and that's worrying people for sure." I agree. In other words, China's mighty economy is likely to come to a standstill during the current quarter.

On 2/4, *The Atlantic* posted a series of photos showing empty streets in China as a result of the coronavirus outbreak: "As authorities and health workers try to halt the spread of the novel coronavirus (2019-nCoV) outbreak in China, travel restrictions and quarantine measures have left many streets, parks, and shopping centers essentially deserted in cities across China." Major cities—such as Wuhan, Shanghai, and Beijing—look like ghost towns.

Global Economy: Before Wuhan. The global economy was starting to show some signs of better growth just before the coronavirus news hit the tape on 1/24. Consider the following:

(1) *Global economy.* The Global C-PMI rose during January to 52.2, up from a recent low of 50.9 during October and the best reading since last March (*Fig. 1*). Leading the way has been the Global NM-PMI. The Global M-PMI has remained slightly above 50.0 for the past three months, after falling below that level from May through October 2019.

(2) *Advanced economies.* January's M-PMI for the advanced economies remained below 50.0 for the ninth consecutive month, but its reading of 49.8 was the index's best since April 2019. The NM-PMI for the advanced economies rose from a recent low of 50.7 during October to 52.8 during January.

(3) *Emerging economies.* The C-PMI, M-PMI, and NM-PMI of the emerging economies have shown more resilience in recent months than those of the advanced economies. That's especially true for the M-PMI, which was 51.0 during January for the former economies but 49.8 for the latter.

(4) *Eurozone sentiment.* Another upbeat economic statistic during January was the Eurozone's Economic Sentiment Indicator. It rose from a recent low of 100.7 during October to 102.8 during January (*Fig. 2*). Admittedly, that's not much of an uptick, but it suggests that the worst is over for the slowdown in the region's real GDP growth since mid-2018.

(5) *German manufacturing.* Also showing a small rebound in recent months has been Germany's IFO Business Confidence Index (*Fig. 3*). This upturn follows a sickening plunge in this index during 2019. Still sickening is the plunge in the 12-month sum of German passenger car registrations from 5.6 million units during summer 2018 to only 4.6 million units at the start of 2020 (*Fig. 4*). During December, German manufacturing orders and production were down 8.7% y/y and 7.6% y/y, respectively (*Fig. 5*).

US Economy: Productivity Rebounding. Before Wuhan hit the fan, the US economy was also showing signs of rebounding in response to the de-escalation of Trump's trade wars, especially with China. The Phase I trade deal between the US and China, which was signed on January 15, promised to boost US exports to China. A significant slowdown in China's economy as a result of the virus outbreak could make that less likely in the near future. In addition, supply-chain disruptions could weigh on US companies as manufacturing firms face shortages of parts and retailers shortages of goods.

The good news in the US is that the labor market remains strong, as evidenced by January's employment report. In addition, productivity growth seems to be making a comeback. Notwithstanding the continuing strength in the monthly employment gains, many companies continue to report shortages of workers. Debbie and I have predicted that they would respond to these shortages by boosting productivity.

Productivity is measured using the output of the nonfarm business (NFB) sector, which has been growing somewhat faster than real GDP since the start of the current economic expansion. So for example, the former was up 2.7% y/y during Q4-2019, while the latter was up 2.3% (*Fig. 6*). Over that same period, NFB hours worked rose just 0.9%, possibly reflecting the slowdown in labor force growth. The result was a 1.8% increase in NFB productivity. For all of 2019, productivity rose 1.7%, the best pace since 2010, accelerating from 2016's 0.3%.

CALENDARS

US: Tues: NFIB Small Business Optimism Index 103.3, Job Openings 6.925m, Quarles, Kashkari. **Wed:** Monthly Budget Statement $6.2b, MBA Mortgage Applications, DOE Oil Inventories, Powell, Harker. (DailyFX estimates)

Global: Tues: UK GDP 0.2%m/m/0.0%q/q/0.8%y/y, UK Industrial Production -0.8%/-1.0% y/y, UK Trade Balance -£350m, Lagarde, Carney, Lane, Schnabel. **Wed:** Eurozone Industrial Production -17%m/m/-1.9%y/y, Japan Machine Tool Orders, Lowe, Lane. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell for two of these three indexes last week. LargeCap's was down for the first time in six weeks from a record high, and SmallCap's was down for the first time in 12 weeks. These indexes began a forward-earnings uptrend during March but stumbled from July to November. LargeCap's forward earnings has risen during 37 of the past 51 weeks, MidCap's 30 of the past 47 weeks, and SmallCap's 28 of the past 45 weeks. While LargeCap's is just 0.3% below its record high, MidCap's and SmallCap's are 2.5% and 4.5% below their October 2018 highs. Index changes for the SMidCaps at the end of 2019 helped MidCap's forward earnings improve from November's 18-month low, while SmallCap's is up from September's 17-month low. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act but began to tumble in October 2018 as y/y comparisons became more difficult. In the latest week, the rate of change in LargeCap's forward earnings dropped to 4.1% y/y from an eight-month high of 4.4%, but is up from a 38-month low of 1.0% in early December. That's down from 23.2% in September 2018, which was the highest since January 2011. MidCap's improved w/w to a five-month high of -0.3% y/y from -0.5%, and compares to -5.5% in mid-November, which was the lowest since December 2009. That also compares to 24.1% in September 2018 (the highest since April 2011). SmallCap's improved w/w to an eight-month high of 1.0% y/y from 0.6%; that's up markedly from -9.6% in mid-September, which was the lowest since December 2009 and compares to an eight-year high of 35.3% in October 2018. Analysts had been expecting double-digit percentage earnings growth for 2019 during late 2018, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2019, 2020, and 2021: LargeCap (0.4%, 8.4%, 11.1%), MidCap (-6.0, 11.7, 10.8), and SmallCap (-0.9, 12.8, 13.5).

S&P 500/400/600 Valuation (*link*): Valuations moved higher last week for these three indexes. LargeCap's forward P/E rose w/w to 18.6 from 18.0. That compares to a five-year low of 13.9 during December 2018 and an 18-year high of 18.7 during mid-January—and of course is well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E rose w/w to 16.9 from 16.5. That's up from 13.0 during December 2018, which was the lowest reading since November 2011. MidCap's P/E is down from a 22-month high of 17.4 in mid-December and the record high of 20.6 in January 2002. However, MidCap's P/E has been at or below LargeCap's P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap's P/E increased w/w to 17.1 from 16.7, but is down from mid-December's 16-month high of 18.1. That's well above its seven-year low of 13.6 during December 2018 and compares to its 15-year high of 20.5 in December 2016, when Energy's earnings were depressed. SmallCap's P/E is back below LargeCap's again. It had been below for four months through the end of August—the first time that has happened since 2003.

S&P 500 Q4 Earnings Season Monitor (*link*): With nearly 65% of S&P 500 companies finished reporting revenues and earnings for Q4-2019, revenues and earnings are beating the consensus forecasts by 0.8% and 5.6%, respectively. That compares to their respective 0.9% and 4.9% beats at the same point in Q3. The percentage of companies showing a positive revenue surprise in Q4 is higher than during Q3, but the percentage of positive earnings surprises is lower. On a positive note, y/y earnings growth is exceeding y/y revenue growth for the first time since Q4-2018. Of the 323 companies in the S&P 500 that have reported through mid-day Monday, 72% exceeded industry analysts' earnings estimates. Collectively, the small sample of reporters has a y/y earnings gain of 3.9%. On the revenue side, 66% of companies beat their Q4 sales estimates so far, with results 3.0% higher than a year earlier. Overall Q4 earnings growth results are positive y/y for 66% of companies, and revenues have risen y/y for 69%. These figures will continue to change as more Q4-2019 results are reported in the coming weeks, but what companies say about their growth and margin prospects for 2020 will be investors' main focus.

GLOBAL ECONOMIC INDICATORS

Global Leading Indicators (*link*): In December, the OECD's composite leading indicators (CLIs)—designed to anticipate turning points in economic activity relative to trend six to nine months ahead—continued to point to stable growth momentum in the OECD area as a whole, though below long-term trends. It climbed to a nine-month high of 99.4 in December, up from its recent bottom of 99.2. The report cautions that "CLIs have been estimated using data collected before the WHO's recent declaration of a public health emergency following the novel coronavirus outbreak in China. It is not yet possible to incorporate the potential negative impact of the coronavirus outbreak on global activity, particularly on supply chains and tourism linkages." With this "caveat in mind," stable growth momentum remained the assessment for Japan (99.3), Canada (99.2), and the overall Eurozone (99.3)—including France (99.5), Italy (99.3), and as of December Germany (99.1). CLIs for both the US (99.2) and the UK (99.6) are tentatively pointing to growth gaining momentum from a below-trend pace. As for the emerging economies, Brazil's CLI (102.7) continues to anticipate growth gaining momentum, while Russia's (99.5) still indicates stable growth momentum and India's (99.1) easing growth momentum. As for China (99.8), the report emphasized that before the coronavirus outbreak, tentative signs of growth gaining momentum were emerging for their industrial sector, but now there is a "high degree of uncertainty about near term developments."

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