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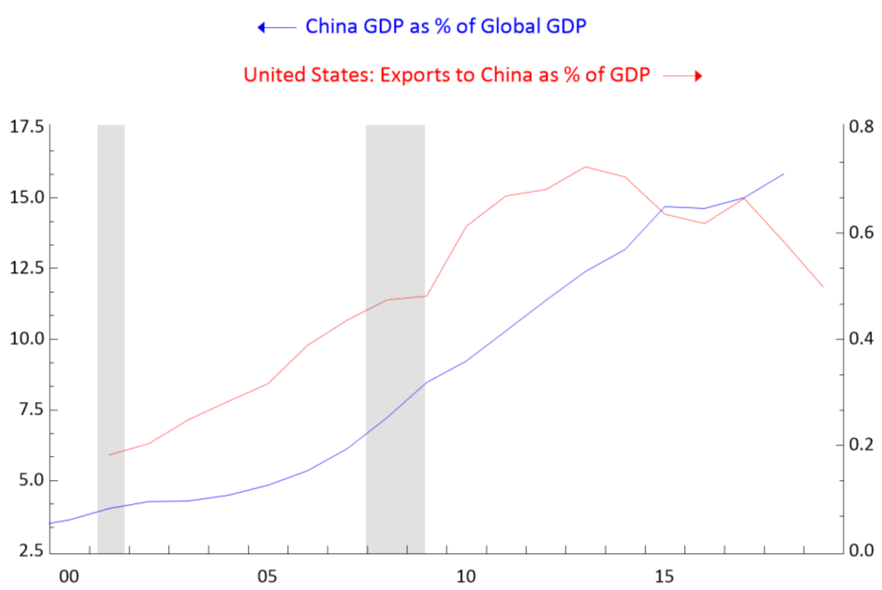
Daily Deck: Coronavirus, China, and supply chains

[*This note corrects an error in the prior version with respect to the USD versus the Euro.*]

One of the stats that gets thrown around a lot as investors try to gauge the economic fallout from coronavirus is the significant increase in China's share of global GDP since the SARS outbreak circa 2003. Yes, China's share of global output has increased markedly to about 16% in 2018 from just above 4% in 2003. Moreover, we are cognizant that there exists the potential for significant supply-chain disruptions (in a just-in-time inventory world) the longer this outbreak drags out. But while China's share of global GDP has surged over the last few decades, US growth exposure to China *vis-a-vis* exports has grown only marginally.

Again, we are not getting into the largely unknown effects of potential supply-chain dislocations. Arriving at something representing a reasonable guess would be almost impossible. But here is at least a framework for starting the conversation. US exports to China accounted for about 0.25% of the GDP pie here back in 2003. In 2009, they were a grand total of 0.5% of US GDP. In other words, if they went from the current $106b to zero, it would shave – all else equal – 0.5% from US growth. Other parts of the world are significantly more linked to China and thus it is not surprising that as the virus has taken hold, the US has looked increasingly like the relative value destination. It is no accident the USD just made another fresh nearby high against the Euro.



Source: Haver Analytics/RBC Capital Markets US Economics

We have written about the isolation of the US economy relative to other developed markets. Many non-US investors tend to cringe when we say things like this, but the historical record is clear on this point. Notice the historical correlations between US growth and other major global economies over the last three decades in the charts below. Yes, economic growth correlations spiked during the 2008/09 financial crisis. But, as we know, the epicenter of this

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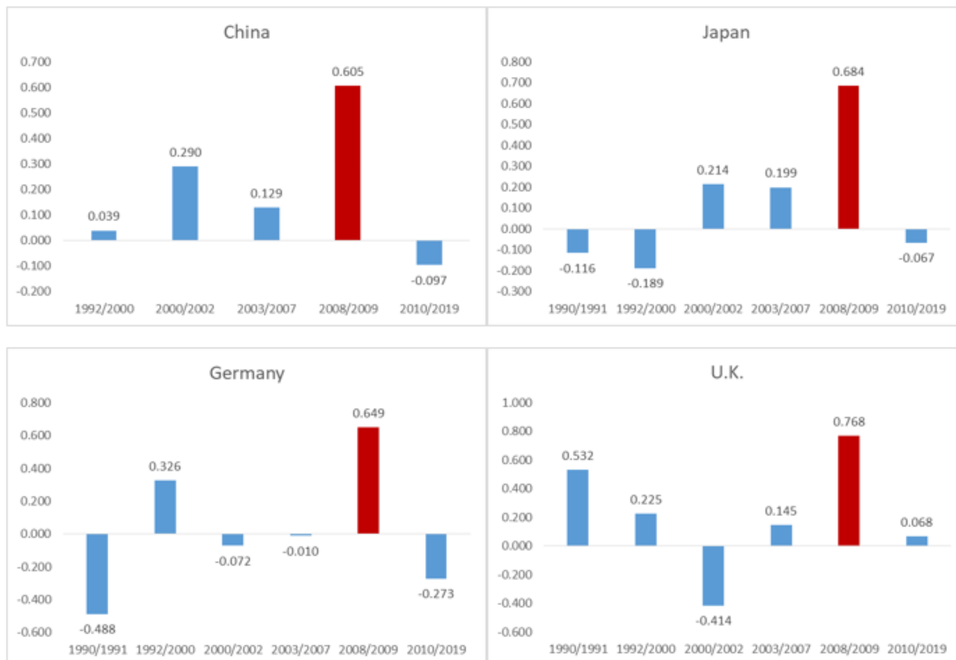
crisis was the United States. So the US caught a cold and the rest of the world was put into the intensive care unit. Excluding that period, US growth correlations with the globe are extremely weak. In large part this is because, despite a secular decline, the fact is that the United States still generates about 75% of its economy-wide corporate profits from domestic sources.

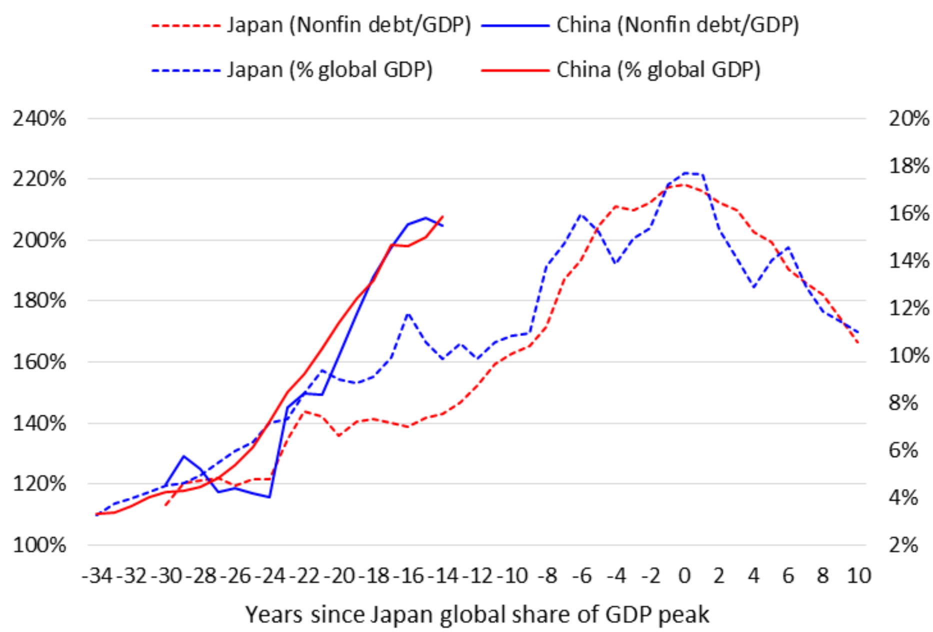
Correlations with US GDP growth



Source: Haver Analytics, RBC Capital Markets US Economics

What is also interesting about China's rise is that it has been increasingly dependent on credit. Those that do not buy into the theory that China will overtake the US in economic dominance at some point over the next few decades typically use as an example the same prognostications that were made about Japan. The evidence suggests they might be on to something here.

Recall that Japan was widely expected to surpass the United States when its share of global growth was on an uptrend back in the 1980s. Japanese growth as a share of the globe eventually peaked out around 18% and subsequently slipped to just over 10% today. Credit expansion was a big part of the story then as it is seemingly now for China. China has achieved a 16% share of global GDP in less than half the time it took Japan to get there. But, notably, their credit expansion – especially in recent years – has also vastly outpaced that of Japan in that same time frame. Notice that as China's economy went from about 6% of the globe to 16%, their nonfinancial debt/GDP ratio exploded from about 120% to over 200%. For Japan, a 220% nonfinancial debt/GDP ratio proved to be the peak. Indeed, as the chart below highlights, China's ascent looks like a compressed version of the Japanese case study. Just some food for thought.



Source: World Bank, BIS, RBC Capital Markets US Economics

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