Major Country Risk Developments
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By Byron Shoulton

Overview

The outbreak of the new coronavirus (aka Covid-19) and its negative impact on cross border trade, economic activity, travel, access to vital manufacturing components, raw materials, semi-finished and finished goods - continues to be the major global concern of the day. Fears triggered by the disruption to supply chains, loss of production, weakening sales and the uncertainty as to when a vaccine will be developed, caused sharp declines in global stock markets as volatility continues. The epidemic's impact is also causing disbelief and foreboding among global producers, consumers, financial institutions and policymakers. The upshot: several central banks, beginning with the U.S. Federal Reserve have quickly cut interest rates, while asserting a commitment to do whatever is necessary to prevent economic collapse. Several countries across the globe have downgraded economic growth targets for 2020, report weakening economic activity, loss of markets, an inability to get product to and from China, South Korea and elsewhere. Declining tourism, the lack of adequate workforce due to incubation, travel lockdown, etc. are some of the disruptions which remain in effect and which could grow as the epidemic spreads. Airlines, shipping, retail, hotels & leisure, restaurants and tourism are just a sample of sectors that have been hit globally and remain affected due to the virus.

The Economist Intelligence Unit revised its global growth forecast for 2020 from 2.3% to 2.2%, with growth in the eurozone forecast down from 1.3% to 1.2%. The EIU expects to review these projections further, given continued uncertainty about the future development of the pathogen.

While reports suggest a decline in new cases in China (where the epidemic was first diagnosed), there are daily disclosures of additional infections spreading to more countries. At the time of this writing Covid-19 has spread to more than 80 countries, causing major disruption across several industries. Expert opinion projects this number will continue to grow.

China's ability to isolate Wuhan city (the suspected epicenter) and surrounding provinces, curtail travel and quarantine citizens - appears to be effective in slowing the spread in that country. Some opinions suggest this crisis will be short-term in nature [4-6 months] by which time a vaccine could be discovered to effectively treat Covid-19. However, various scientific assessments suggest that at best, finding a cure within twelve to eighteen months would be considered fortuitous.

Policymakers in advanced countries have now made clear their readiness to pursue an active fiscal and monetary response to the disruption caused by the virus. However, there is a sense that these measures are mostly symbolic gestures to markets. The steps taken have not removed investors' (or public) concerns as more people around the world are getting diagnosed with the virus which has claimed over 3,200 lives as of March 06, 2020. There is only so much that monetary policy and stimulus measures can do, as health authorities are warning that it may be impossible to fully contain the pathogen as infections are spreading within many communities around the world. Meanwhile, steps taken to halt the outbreak have curtailed international and domestic travel and business activity in the epicenters of the disease and beyond. The IMF has proposed $50 billion in financing to countries stricken by the outbreak; while the World Bank pledged $12 billion for countries to improve their health systems to tackle the crisis.

One overriding realization growing out of this crisis is the extent to which so many countries and leading global companies, became overly dependent on China as the supply source for a wide range of products including pharmaceuticals, car parts, smartphones, among others. One certain outcome from this crisis will be a rethinking of current supply chain arrangements. Executives and company boards of directors will face pressure to not allow current practices to continue - given the lessons learned and the exposure of global vulnerabilities affecting numerous sectors. It is true that the trade war [plus years of rising production costs in China] had already triggered some diversification away from manufacturing in China to cheaper locations. However, the global over-reliance on China-based suppliers for a wide variety of components, parts and finished products has starkly exposed this as a strategic mistake. Never again should any one country be allowed to play such a dominant role in the availability of so many products, affecting numerous sectors, manufacturers, retailers and consumers simultaneously - in so many countries.

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Meanwhile, the shock that Covid-19 has wrought on markets around the world coincides with a dangerous financial backdrop marked by spiraling global debt. According to the Institute of International Finance, the ratio of global debt to gross domestic product hit an all-time high of over 322% in the third quarter of 2019, with total debt reaching $253 trillion. The implication, if the virus continues to spread, is that any weakness in the financial system have the potential to trigger a new debt crisis. In the short term the behavior of credit markets will be critical. Despite the decline in bond yields and borrowing costs, financial conditions have tightened for weaker corporate borrowers. Their access to bond markets has become more difficult. After the recent 50 basis point cut, the U.S. Federal Reserve's policy rate of 1%-1.5% is still higher than the 0.8% yield on the policy-sensitive two-year Treasury note.

Much of the debt build-up since the financial crisis of 2007-08 has been in the non-bank corporate sector where current disruption to supply chains and reduced global growth imply lower earnings and greater difficulty in servicing debt. The coronavirus raises the extraordinary prospect of a credit crunch in a world of ultra-low and negative interest rates. Continuing loose monetary policy has brought forward debt financed private spending, thereby lengthening an already protracted cycle in which extraordinary low or negative interest rates appear to be less and less effective in stimulating demand. Since the last financial crisis there has been a big increase in government debt as well as loans to the corporate sector.

The OECD reports that at the end of December 2019 the global outstanding stock of non-financial corporate bonds reached a high of $13.5 trillion, double the level in December 2008. The rise is most striking in the U.S., where the Fed estimates that corporate debt has risen from $3.3 trillion before the financial crisis to $6.5 trillion last year. Much of this debt is concentrated in old economy sectors where many companies are less cash generative than Big Tech firms. Debt servicing is thus more burdensome. The shift to corporate indebtedness is in one sense less risky for the financial system than the earlier surge in subprime mortgage borrowing. However, banks won't be able to escape the consequences of a wider collapse in markets in the event of a continued loss of investor confidence and or a rise in interest rates from today's extraordinary low levels. Such an outcome would lead to increased defaults on banks' loans.

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The OECD notes that compared with previous credit cycles today's stock of corporate bonds has lower overall credit quality, longer maturities, inferior covenant protection and higher payback requirements. In a downturn, some of the large recent issuance of BBB bonds – the lowest investment grade category- could end up being downgraded. In many emerging markets debt levels are also much higher than in 2009. The probability is high for several of those emerging markets (e.g. Argentina, Turkey, Brazil) to fall back into crisis, causing disruption in debt servicing, spending cuts and potentially tipping parts of the world into recession.

China

The Ministry of Industry and Information technology has reported that less than a third of small and medium-sized businesses, which employ 80% of China's workforce, are operating normally. Labor shortage is making efforts to kick-start the Chinese economy futile. Since the Covid-19 epidemic was declared a national emergency in January, provincial authorities have imposed strict limitations on citizens movements. The measures are especially stringent in the countryside, where roadblocks prevent people from visiting even neighboring villages.

While official reports indicate signs of the virus abating on the mainland, with the number of new infections falling to zero in some provinces, rural authorities have been reluctant to ease the lockdown. In some cases, residents must pass through several checkpoints to get to the nearest bus station (many of which remain closed). To travel for work, residents need a certificate from their employer stating the business has reopened as well as a written pledge not to return to their village until the epidemic has ended. These requirements amount to a travel ban for those without a formal job. A recent survey found that less than a third of local adults had traveled outside their hometown for work after the lunar new year. Normally between 80% and 90% of adults travel for work.

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As a consequence, China's Industrial activity has been severely dented as factories desperately seek workers to run assembly lines. The labor shortage pushed February's manufacturing purchasing managers' index to a record low of 35.

GDP growth for 2020 has been revised down to 5.3% and will likely be further revised down in the coming months. The pace of Chinese growth has been slowing for more than two years and that was before the impact of the trade war, tariffs and the Covid-19 outbreak. GDP growth in China below 6% is considered close to being in recession territory.

The retail and services sectors across China have already been hit as a result of the quarantine measures and public concerns about the virus. Swedish furniture retailer IKEA has closed half of its 30 stores in China and fashion retailer H&M has closed 97 of its 580 stores. The impact of weaker foot traffic in stores on export earnings from these and other European consumer goods firms will probably be lessened by stronger online sales as consumers change their shopping patterns.

There is movement by Beijing to apply political pressure on local authorities to begin relaxing controls which would allow migrant workers to return to work. However, local leaders want to wait until the central government has determined that the country has reached the turning point and declares that it is safe to resume normal transportation links. This would mean millions of stranded workers would be able to return to work [and begin earning wages once again]. Optimistic projections suggest that the public health emergency could likely be lifted in China by the end of April. Others assess a 20% probability that the virus will not be contained until mid-2020.

Separately, the ongoing freeze on international travel, plus China's economic slowdown means that thousands of Chinese tourists who had become big spenders, prone to be buyers of luxury goods, are staying home and are spending less. This is causing huge decline in sales of luxury goods around the world. High end retailers, resorts, hotels, airlines and auto manufacturers all report steep declines in sales resulting from the absence of Chinese buyers. This is further evidence that the coronavirus is having an adverse impact on businesses and consumers globally.

Meanwhile, Chinese stocks recently closed at a two-year high, roaring back from a coronavirus-driven sell-off as investors prepared for more relief measures from the central government. Despite widespread disruption to supply chains in China, the stock market index has gained nearly 3 per cent so far in 2020 while most other big global indices languish in the red.

Europe

The European automotive sector is highly exposed to supply chain disruptions from China. A number of car manufacturers have stated that they are only weeks away from having to stop production at European auto plants owing to difficulties sourcing components from Chinese suppliers. They cite the issue of just one missing part being able to stop an entire assembly line as an alternative supplier cannot be sourced in time (carmakers are likely to be looking to Vietnam and Thailand, which have already benefited from supply chain diversification from the U.S.-China trade war). Hyundai has already had to suspend production at its plant in South Korea, and there is a clear risk that several European automotive plants may have to pause production. This would have knock-on effects for parts suppliers in central Europe.

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The effect of factory shutdowns in the auto sector will be mitigated by an 8.2% year-on-year decline in new car sales in China in 2019, meaning that most carmakers serving that market (or located there) have surplus stock, as well as surplus components at their plants. However, European new car sales picked up sharply toward year-end 2019 - with double digit growth in Germany - so many ran out of components earlier.

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Supply chain disruptions will affect other industries as well as automobiles. The Netherlands is most directly exposed, with 19% of its export earnings coming from China, but in reality, this reflects its status as a trade hub for the region. Europe's busiest seaport is Rotterdam in the Netherlands, and over 40% of the country's imports are destined for re-export. For example, disruptions to exports from China to Europe will show up in the Netherlands. The shipping industry reported it has already seen the cancellations of 151,000 containers due to be shipped between Asia and Europe, according to a report by a Danish maritime data provider.

Tourists inflows to the EU from China have risen strongly in recent years – tripling over the past decade- and major destinations are already feeling their absence. That said, Chinese visitors are a small share of the total, 2.4% in France, the top destination (Italy, Germany and the UK are also popular). Chinese tourists typically spend less than Western tourists on accommodations and dining, but more on retail. The luxury goods sector is particularly exposed, with Chinese shoppers making up a third of the global market, according to management consultancy Bain.

For the Eurozone, the main concern is that the efforts to contain Covid-19 will delay the rebound in the industrial sector after its contraction in 2019. Forward-looking indicators had suggested that the downturn might be bottoming out at the end of year 2019, but more recent industrial production data, which show a 2.1% year-on-year fall in eurozone output in December, suggest that the sector is still vulnerable. With manufacturing sentiment now likely to waver again and the slowdown in China dampening global demand more broadly, the expectation is for further contraction in eurozone industrial output in the first quarter of 2020.

The Italian economy has been held back by subdued consumer and business sentiment and by weaker external conditions, as a result of the negative impact of global trade tensions. GDP expanded by just 0.3% in 2019 (down from 0.8% in 2018). A further contraction is expected in the first quarter of 2020 owing to the negative effects on economic activity of the spread of the coronavirus in Italy since February. Italian exports of goods and services did well in 2019, but face headwinds in 2020 given the global economic slowdown.

South Korea

South Korea's Covid-19 caseload rose above 5,300, with the outbreak in the southeastern city of Daegu, and shows little sign of a slowdown. The country unveiled an extra budget $9.8 billion to help fight the virus and mitigate the economic fallout. Unveiling the extra budget, the Finance Ministry said some $4 billion will be allocated to offer more medical equipment, hospital beds and facilities for patient treatment.

About 60% of confirmed cases have been linked to a religious group in Daegu, the country's fourth-largest city, with a population of 2.5 million. However, health authorities have shifted their focus to testing ordinary citizens in Daegu, citing an alarming level of community spread. Other major provinces and cities have also reported infections, including Seoul and Busan. New cases were also reported in several other provinces. Since raising the virus alert level to "red," the highest level, on Feb. 23, health authorities have focused on halting the spread of the virus. Following the report of the first case in South Korea on Jan. 20, the pace of infections had not been alarming until Feb. 18, when a 61-year-old woman in Daegu tested positive for the virus. Since then, the nation has seen an explosion in infections and has accelerated virus tests on potential cases.

There are signs that South Korea's external sector started to suffer from the repercussions of the Covid-19 epidemic in February. Exports to and imports from China – South Korea's biggest export market, and an important supplier to various export-oriented industries- both declined, by 6.6% and 15.6% respectively. Factory shutdowns in China have prompted a series of suspended operations of some automakers in South Korea since January, causing a 16.6% plunge in car exports that month.

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The expectation is that the prospects of South Korea's external sector will deteriorate in the upcoming months. New export orders have already shown a sharp decline in March according to various business surveys. The global spread of Covid-19, amid rising confirmed cases and death tolls in major trading economies and consumer markets, will further dampen external demand. Moreover, the outbreak and spread of the epidemic within South Korea will result in more factory shutdowns in the country, reducing manufacturing output.

Consumer spending declined sharply in February, dragging down the prices of associated services. The cost of dining out increased by only 0.7% - the lowest monthly rise since February 2013. The ongoing epidemic in South Korea will continue to dampen spending on services, with the easing trend in services price growth expected to last for the first half of the year. Meanwhile, the government's package of measures to shore up consumers spending, including a temporary 70% cut in the excise tax levied on new passenger car purchases, will add deflationary pressure on certain consumer goods. The impact of the epidemic will be more acute on non-manufacturing sectors because of the sharp slowdown in consumer spending.

Despite a decision by the South Korean central bank at the end of February to keep interest rates unchanged at a record low 1.25%, it is expected that a rate cut will be coming in the second quarter. This will be aimed at stimulating private consumption and investment amid the fallout from the epidemic.

Brazil

The economy expanded 1.1% last year with expectations that 2020 would see that growth strengthen. Now, there are growing fears about the impact of Covid-19 outbreak on the economic outlook for Latin America's largest economy.

Growth estimates have been cut to 1.5% -2% from 2.3% (just a month ago) amid concerns that the spread of the virus will hit Brazil's crucial export sector. This is occurring at a time when the Brazilian economy is still fragile. According to official data, the economy grew 0.5% in the final quarter of 2019, down from 0.6% in the third quarter. Now the focus is shifting to how the spread of Covid-19 will impact growth in 2020. The country has 5 confirmed cases of the virus so far, with another 400 suspected. No doubt, these numbers will grow. Since reopening on February 26th, following the Carnival public holidays, and reflecting international market trends, Brazil's stock market and currency have come under pressure. The former was down nearly 10%, while the latter by 2% (the currency, the real, has weakened by 11% so far in 2020). In addition, Brazil is exposed to lower commodity prices.

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The impact on Brazil (and the broader region) of the Covid-19 virus will depend on its effect on the global economy and financial markets, as well as the extent to which the virus spreads locally, disrupting domestic economic activity. The external drivers will be several; through weaker global demand for Brazil's commodity exports; disruption in international supply chains; and through international financial markets. If the virus takes hold locally, it will prove a stiff test for the authorities to bring it under control and for the public health system, which is already stretched.

The outbreak comes at a delicate time for Brazil's economy. It has been struggling to recover from steep recession and to pick up from low GDP growth averaging 1.3% in 2017-18. Before the recent sell-off, President Bolsonaro vented his frustration over the pace of economic recovery by appearing to issue an ultimatum to the Economy Minister to deliver GDP growth of at least 2% in 2020. The president has given the Minister a wide leeway to pursue his agenda of fiscal and economic reforms that are underpinning confidence. In return however President Bolsonaro wants the Economy Minister to oversee an upturn that would help his own reelection bid in 2022. Investors are monitoring the Minister's position closely, and some of the President's comments also hurt investor sentiment. On top of this, tensions between the executive and the Congress have flared recently, after legislators demanded greater control over discretionary budget resources. The government is betting heavily on fiscal adjustments as a panacea that will restore confidence, welcome investors and trigger sustained growth. The expectation is that the central bank will follow the U.S. Federal Reserve with an emergency interest rate cut in the near future. That would be one positive development.

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Multibuyer Non-Cancelable* Policy:
$11,000,000 in limits of liability for a key account policy in the international industrial chemicals sector.

Bank's Accounts Receivable Purchase Policy:
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