FIRST QUADRANT

MARKET INSIGHT

The Coronavirus and the PMI

March 2020

Over the past couple years, trade disruptions have created significant headwinds for the global economy, contributing to (if not causing) a concerning global slowdown. The manufacturing sector has been particularly hard-hit, reflected by a troubling decline in the Purchasing Managers' Index (PMI). The deterioration was notable in China, where the steady onslaught of tariffs has significantly slowed down production.

The tide appeared to be turning as the year started, with the US and China finally making concrete progress toward a long-term trade deal. Within a month, however, the outbreak of the coronavirus presented a new threat to the health of the Chinese – and potentially global – economy. Bullish sentiment reversed dramatically as the coronavirus crisis accelerated.

The mid-February release of PMI data assuaged some concern, since many interpreted the increase as a sign that global PMIs had "bottomed out," perhaps signaling that things are improving despite the coronavirus outbreak. Unfortunately, this may be misleading for several reasons.

First, the improvement in global PMIs is partially attributable to longer delivery times. The index construction interprets longer delivery times positively, because longer delivery times are often an indication of increased demand. We believe, however, that in this case, the longer delivery times are attributable to reduced supply associated with the coronavirus, as well as bottlenecks in the global production network.

Second, even in the US, the PMIs were already in weak territory. The Markit Global PMI is an important component in our overall view of the market state, identified through our proprietary Market Risk Indicator (MRI)[1]. Based on this gauge, we have been identifying a global manufacturing recession for over a year, well before the onset of the coronavirus outbreak. Further bottlenecks will likely only be negative for the already weak manufacturing sector.

Finally, the PMI is a survey. As such, it reflects the hopes and fears of purchasing managers rather than hard numbers. Business managers, like most people, tend to stick with an optimistic view until things break. Most interpretations of the PMI state that when it drops below 50, manufacturing is undergoing a recession. Our research has confirmed that the actual threshold is a higher number than 50, confirming a positive bias in the survey. Purchasing managers have been optimistic up to this point in the crisis. We therefore believe that the impact of the virus, which includes plant closings and closed retail businesses throughout the Far East, is likely severely understated.

The PMI has been an excellent indicator of the health of local and global manufacturing, but it is too soon to say that the slowdown has bottomed. In fact, we think it is more likely that we will have bad news ahead. Regardless, we believe that protracted uncertainty is here to stay, and that the best path forward is a well-diversified portfolio.

Endnotes

[1]The FQ Market Risk Indicator ("MRI") is designed to indicate the current phase of the market cycle and the level of macro uncertainty, from resilience (MRI=0.00) to high fragility (MRI=1.00) in increments of 0.25 for a total of five levels.

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