China Bulletin: Market View

Coronavirus Epidemic Hits China

The respiratory epidemic has drawn global attention and Chinese authorities have had to take strict actions to contain its transmission. First reported in Wuhan in Dec 2019, the epidemic has spread to all provinces in China and has been identified as a Public Health Emergency of International Concern by the WHO. Measures such as shutting down businesses, discouraging the flow of people and extending the Lunar New Year holiday have been introduced and are being implemented in a very stringent manner.

The outbreak, and the response to it, may delay or derail China's weak recovery from US-China trade tensions and the deleveraging policy-driven credit squeeze. The effect of containment measures on the epidemic is unknown, while economic growth is certainly feeling the pain. Even temporary suppression of consumption and house sales will hit the service sector and property developers. In addition to this, manufacturers are unable to fulfil standing orders as scheduled. Above all these, small and medium enterprises are facing the greatest pressure as their cash flow deteriorates severely under the existing restrictions and will worsen considerably if they prolong.

It is difficult to predict how the epidemic will evolve, but I will try to simplify its further development into three scenarios.

1) In an optimistic scenario, containment measures are lifted in 20Q1 and fiscal policy steps up support to small and medium enterprises as well as spending on infrastructure investment. The shock will largely be confined to 20Q1, and 2020 is likely to see growth around 5.5%.

2) A medium scenario is that the situation lingers into 20Q2, and fiscal policy may only have limited resources to support small and medium enterprises. Growth may be dragged below 5% and a meaningful recovery may have to wait until 2021.

3) Worst case scenario is that the outbreak translates into a protracted event and policy makers must focus on its containment. As a consequence, growth in 2020 may be well below 5% and could potentially trigger an international crisis.

Given currently available information, and that local governments have formulated policies to support small and medium businesses, the most likely outcome lies between the optimistic and medium scenarios, yet the uncertainty remains significant.

China Equity Market Outlook

Outlook towards the Chinese equity market is altered by the uncertainty, going from cautiously optimistic to neutral in the short-term. In the coming weeks or months, the development of this epidemic and its impact on growth will dominate market sentiment and volatility will rise in response. However, the probability of a market collapse is

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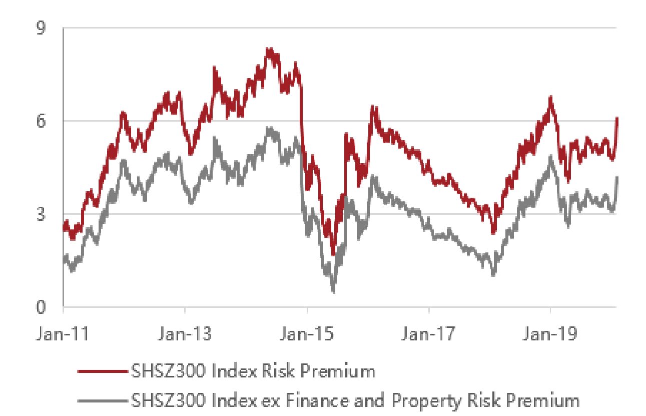
remote after the plunge of mainland equity markets on the first trading day following the Lunar New Year holiday. In the medium-term if my base scenario is realized, equity markets may shake off the shock by mid-2020 and deliver a satisfactory return for 2020. In the long-term, this epidemic or pandemic is unlikely to disrupt the current course of economic growth and the equity markets. The most notable risk to this outlook is the development of the epidemic and a re-escalation of US-China trade disputes.

Figure 1 SHSZ 300 Index Risk Premium

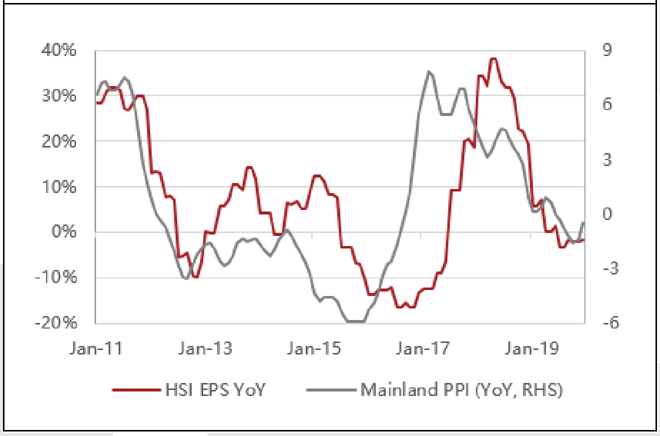


Sector wise, healthcare is an apparent winner as well as large cap names, while consumer services, real estate and construction related sectors are tested. The epidemic and containment shock threatens small and medium enterprises with less reserves, particularly those in consumer service sub-sectors such as restaurants, hotels and travel agencies, leaving market share to the larger survivors. These sub-sectors are packed with small and medium enterprises and employ over 30 million employees. Financial data of listed companies in these sub-sectors shows that a loss of income for 3 months will erode the profits of 3-4 quarters, making it difficult for them to make ends meet given that the loss is not recoverable. Weak real estate developers may suffer losses, or even be driven out of business, as housing sales plummet in response to containment measures, jeopardizing property developers' high turnover strategy that relies on high sales growth. Construction related sectors are being tested due to the prohibition of construction activities and the expected fall of fiscal spending on infrastructure investment.

Hong Kong Equity Market Outlook

The Hang Seng Index saw a correction after the epidemic unfolded and may resume an optimistic trajectory by mid-2020, if the base scenario is realized and the phase one deal is honored. Sentiment remains fragile as the epidemic is ongoing and its impact on the economy is yet to be known. Earnings growth was expected to pick up in 20H1 following the mainland producer price index, and now the recovery may be delayed until 20Q2. However, 20Q3 presents another risk event in the election of the Legislative Council of Hong Kong, which may introduce some pressure on the market. Local names are under stress as uncertainty is rising and continues to erode their profitability. Mainland names, however, are largely immune to the uncertainty, and may benefit from an improved climate in the manufacturing sector and infrastructure spending on certain sectors such as 5G.

Figure 2 HSI EPS vs China Mainland PPI



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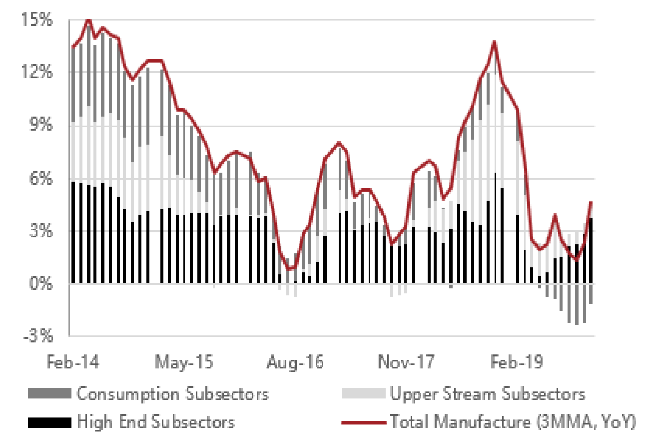
China Economic Outlook

The shock of the epidemic will likely paralyze the economy in 20Q1 and create a friendly environment after it ends. Growth has only showed signs of recovering from domestic structural reforms and external shocks when there are favorable developments on both sides. Policies are set to turn accommodative to support small and medium enterprises and achieve the goal of eliminating poverty, though more details will be unveiled after March. The US-China phase one deal also offers some relief, and hopefully could alleviate the uncertainty and promote manufacturers' confidence.

Fixed asset investment is picking up

December data shows manufacturing fixed asset investment growth is picking up, though housing investment may drop. Fixed asset investment in high end manufacturing sub-sectors makes up 40% of total manufacturing fixed asset investment and was rising with a strong momentum, taking advantage of policy tailwinds and the previous de facto embargo on imported high technology products. The recent epidemic may eat into the market share of Chinese manufacturers as they are prevented from returning to work, accelerating the shift of supply chain away from China. Nondurable consumer goods sub-sectors, contributing 25% of total manufacturing fixed asset investment, are recovering gradually from the hit of trade tension. Upper stream sub-sectors benefited from upbeat housing investment and will probably slow down with it. Housing investment will be tested by the almost certain plunge of house sales in 20Q1 and the resulting drain on developers' already stressed cash flow. To make it worse, the housing sector is less likely to enjoy epidemic spurred supportive policy, and housing investment may see decelerating growth in 20H1 or through 2020.

Figure 3 Manufacturing Investment by Sub-sectors



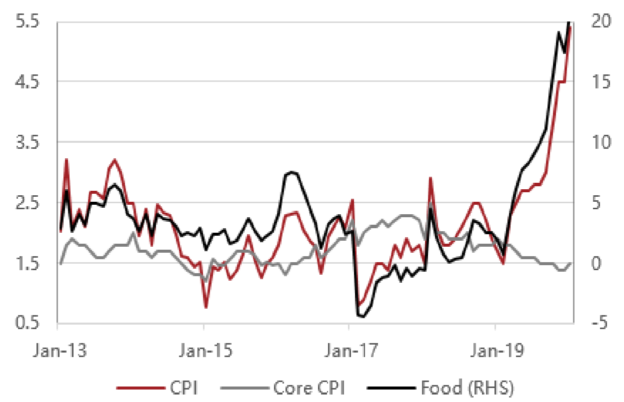
Fiscal Policy is stepping up support to small and medium businesses

As the epidemic is still developing, local authorities have introduced policies to help small and medium businesses and foster employment. Policies focus on exempting businesses from taxes and social security contributions, negotiating a lower rent with landlords, and lowering their interest burden. More nationwide fiscal measures are expected and will wait until the parliament session in early March, which could be delayed.

Inflation gauges are temporarily meaningless

Inflation indices in recent months are distorted, and thus meaningless, when production comes to a standstill and demand for certain products surges. Inflation is an indication of tightness of supply and demand under normal circumstances and implies a policy stance, especially with regards to monetary policy. Now production is halted due to the extension of the public holiday in many sectors, and it is guided by administrative directives instead of market signals in certain sectors where demand surges are driven by panic and anxiety, leading to the conclusion that inflation measures are pointless for the current period. Before the epidemic, rising pork prices pushed consumer inflation to its highest level since the 2011 stimulus-induced peak, while the core series remained close to its historic low, implying sluggish aggregate demand in the last quarters. Producer inflation has been rising to positive territory due to cyclical forces. After the epidemic, all inflation gauges may trend higher before moving lower when producers return to work, but the rise is unlikely to trigger a monetary policy tightening.

Figure 4 China CPI and Components



China Monetary Policy Outlook

PBoC is shifting shifts to deal with the uncertainty by lowering borrowing costs and halting the tightening of financial regulation. Open Market Operations rate was lowered by 10bps on the first trading day after the Lunar New Year holiday, a step up from the previous cut of 5bps. The latest speech of PBoC officials implies a further cut of policy rates and guides down the Loan Prime Rate as well. For existing loans, banks are advised to remit or delay interest charges on borrowers from certain areas and sectors. A lower funding cost does help the economy, but a slower pace of tightening regulation is more effective. Implementing new asset management rules has squeezed non-standard financing to 85% of its its peak level by the end of 2019 and its transition period may be extended for another year from the end of 2020. More structural policies targeting the easing of financing problems of small and private firms can be expected, however large scale monetary stimulus is out of the question as experience of 2015-2016 shows it would only stimulate asset markets.

Figure 5 10Y CDB Rate and Long-term Corporate Loan Growth

China Bond Market Outlook

Accommodative monetary policy and the expected temporary nature of the virus shock imply a lower and steeper curve. It is yet to be seen whether the current 2.8% 10Y rate has fully priced in the cost to growth, which may be short-lived but likely to exceed 0.5%. The 10Y rate traded between 3%-3.4% in 2019, elevated by upbeat expectation in 19Q1, suppressed by credit squeeze and escalation of trade tension in 19Q2, and pushed higher by rising inflation and inflation expectation in 19Q4. The onshore rate curve flattened by almost 20bps after the Lunar New Year, which could see more steepening in the future.

Figure 6 Money Market Rates

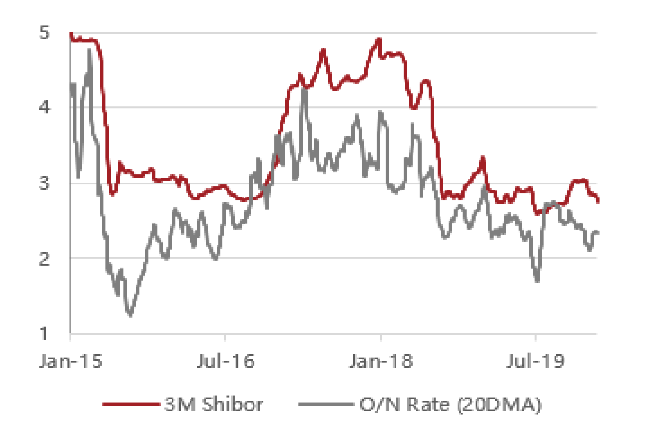


Figure 7 CDB 2Y10Y Spread

Figure 8 5Y Credit Spread AAA vs CDB

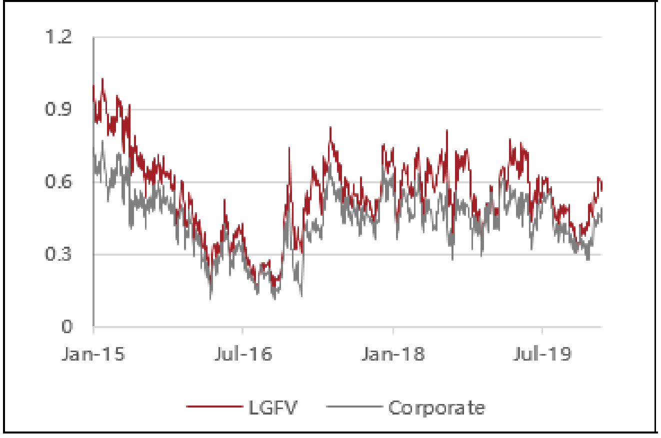
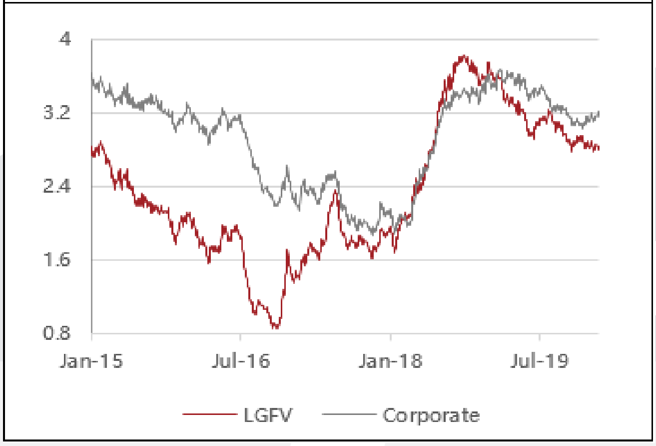


Figure 9 5Y Credit Spread AA- vs CDB



The credit spread of higher rated issuers and LGFVs could tighten further on the shock, while lower rated ones may see a widening spread. Higher rated issuers are mainly SOEs, LGFVs and the largest private corporates, whose credit spread may tighten on the market's speculation of stimulus through SOEs and LGFVs and increasing market concentration ratio. Lower rated issuer credit spread had just tightened after financial conditions improved in mid-2019 and could widen again on deteriorating credit fundamentals and outlook.

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