BearBull
Global Investments Group

Economic Research

WEEKLY ANALYSIS

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Why the economic recovery in China will be relatively robust

Whatever the magnitude of the shock in Q1, what matters is the strength of the upswing in Q2. Sharp recovery of GDP. Inventory rebuild not to be underestimated. Rise in equities.

Key points

- China did not just halt its economy in February, it also implemented a series of extraordinary stimulus measures
- What can we expect from PMI leading indicators in the next few months?
- First credible signs of a recovery
- Large companies working at 80% of their capacity
- Slower recovery for SMEs, at 60% of their capacity
- Risks of a drop in international demand mitigated by the desire to rebuild inventories
- The world post Covid-19 will want higher inventories
- Foreign reserves and stability of the yuan
- Positive outlook for equities
- Favourable relative valuations

China did not just halt its economy in February, it also implemented a series of extraordinary stimulus measures

While Chinese authorities decided to confine the city of Wuhan first, then Hubei province, before finally adopting extreme confinement measures for the whole country, China's economy slowed drastically to the point of momentarily coming to a halt.

As the epidemic developed, the PBOC and the government continuously implemented measures to support the economy.

These measures took various forms and multiplied as the country became aware of the scope of the epidemic.

Following the approximately -10% drop in Chinese equity prices recorded after the Chinese New Year at the start of February, the PBOC announced some thirty economic support measures, including the injection of 300 billion yuan for loan refinancing and a drop in borrowing rates for the companies most affected by the situation.

A first cut in very short-term refinancing rates of 0.1% was followed by the injection of 1.2 trillion yuan in one day in money markets, while 400 billion yuan were injected into the banking sector.

On 7 February, Chinese authorities announced they would emphasise economic growth over budgetary restraint.

A few days later, local governments gained the right to issue close to 850 billion yuan in bonds in order to fund activities to fight the effects of the coronavirus. Tax cut measures for companies were taken mid-February, which reassured financial markets.

A further key rate cut of 0.1% to 3.15%, its lowest level since 2017, was followed by new injections of 200 billion yuan through one-year loans. The recovery of the equity market helped reconstitute a trillion dollars in market capitalisation, as the yield curve returned to its steepest slope since 2015.

Further rate cuts for companies and individuals preceded an announcement by the authorities highlighting the necessity of adopting a more flexible monetary policy and new tax measures.

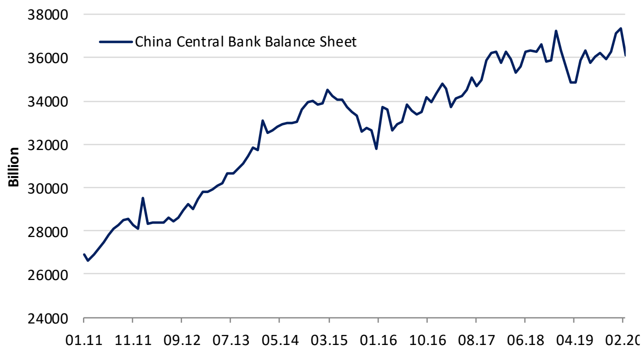
On 25 February, 500 billion yuan were released to refinance commercial banks, SMEs and the agricultural sector at an interest rate reduced by 25 basis points. At the same time, the VAT was cancelled for SMEs in Hubei until May.

At the beginning of March, the PBOC reduced the cash reserve requirements imposed on banks to inject approximately 80 billion dollars into the economy.

Measures to boost consumption and the competitiveness of Chinese products and services were also announced.

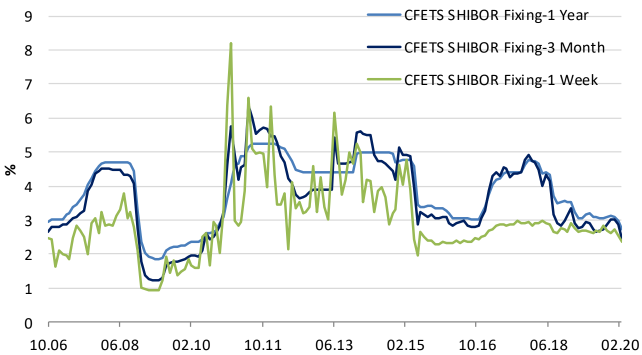
On 20 March, the PBOC decided to keep its base interest rate unchanged for new bank loans, just before the Vice-Governor of the PBOC noted that the economy would soon return to its potential growth rate.

PBOC balance sheet



Sources: Bloomberg, BearBull

Interest rates



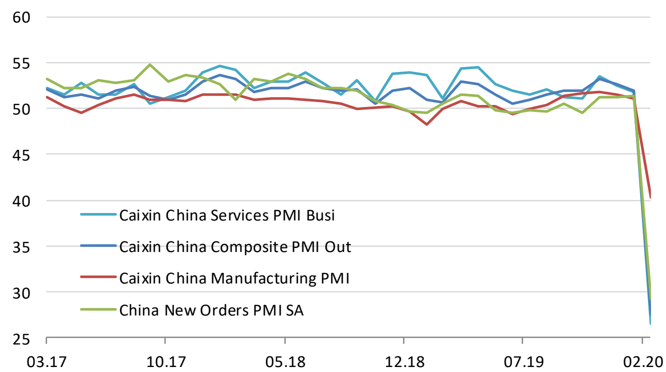
Sources: Bloomberg, BearBull

What can we expect from PMI leading indicators in the next few months?

February leading indicators collapsed in China, reflecting the fundamental change in purchasing managers' sentiment.

The drop in the manufacturing PMI index from 50 to 35.7 (38.8 November 2008) in one month is clearly unsurprising in the context of the confinement measures implemented by the Chinese authorities to fight against the coronavirus epidemic.

Leading indicators – PMI (Caixin)



Sources: Bloomberg, BearBull

The non-manufacturing index reached an even more extreme level, dropping from 54.1 in January to 29.6 in February. Indeed, the confinement measures may have had a heavier impact on services sectors such as restaurants, retail and real estate for example. These levels of concern exceed those observed during the 2008 crisis for the Caixin indices as well, even though the latter are less extreme than the official PMIs. The Caixin Manufacturing PMI declined from 51.1 in January to 40.3 in February (40.9 in November 2008). These leading indicators were not pointing to any contraction in economic activity in January 2020 despite the already visible growth of the epidemic. What then is their predictive capacity in such a troubled context for the next few months?

We believe it will likely soon become clear that these levels were ultimately the lowest in the cycle, as the epidemic appears to be increasingly under control in China. However, these sentiment indicators will hardly be reliable in comparison with other more tangible statistics if they rebound sharply as we expect them to in March already.

First credible signs of a recovery

China's economy will likely close Q1 2020 on barely positive growth despite the extraordinary measures taken to fight the spread of the coronavirus epidemic. A recovery in Q2 could generate growth of +2%. Over the year, the PBOC expects China's real GDP to be up close to +5.4%, which now also seems to be the consensus forecast of China experts.

While these estimates may turn out to be close to reality, it is certainly still difficult at this time to assess the actual impact of the crisis on the performance of China's economy in Q1. Be that as it may, we believe the most crucial element of concern at this time pertains to the long-term reactivation of the world's industrial production facilities rather than to the scope of the "past" crisis.

Official figures in the last weeks show that China's large companies have returned to work and are now operating at 80%-90% of their capacity. Small- and medium-sized enterprises have had more difficulty returning to work and now seem to be operating at close to 60% of their capacity.

Indeed, we noted a few improvements in the situation at the end of Q1 on certain major economic indicators in China. There are signs of a recovery in economic activity especially in the air and sea transport sectors and in China's road network. The wind energy sector already seems to have recovered approximately 60% of its activity and could already be operating at full capacity in April.

The PBOC is convinced that China will be capable of returning in Q2 already to a growth rate compatible with its growth potential according to the Vice-Governor of the Central Bank, Mr. Chen Yulu.

Sources: Bloomberg, BearBull

Risks of a drop in international demand mitigated by the desire to rebuild inventories

The consensus currently seems to be that China's recovery will not be robust and that activity will only resume gradually. One of the main factors underlying this analysis predicting a slow, gradual recovery in activity is based on the fact that international demand will remain weak for a long time and will not be able to shore up Chinese exports.

The health crisis in Europe, the US and now all over the world will have a long-lasting impact on these economies and their external demand. These countries' imports from China will likely diminish further in Q2, which will deprive China's economy of one of its main growth drivers.

We agree that international demand is likely to be lower in the next few weeks and maybe longer still.

However, we believe this factor will be partly mitigated by the fact that the recent crisis has already significantly changed multinationals' perception of risks.

Indeed, the general dependency of economies, companies and value chains on China is now a clearly identified risk. This risk will necessarily be assessed, and diversification solutions will be looked into at the very least.

Moreover, just-in-time production methods limiting stock levels to a minimum will undoubtedly be reviewed as well. If the former risk seems more complex and will probably require significant analyses to modify production chains and supply channels to our minds, we believe that it will be easier to decide to adjust inventory levels to enable better management of any similar crisis in the future.

The health context remains particularly serious as we write these lines. However, the extraordinary support measures that have been adopted urgently by all the central banks and governments that have the capacity to act will undoubtedly reassure multinationals, which will not delay in securing their supply of raw materials or any product or service essential to their production capacity. The world after the Covid-19 pandemic will be different in many ways. With regards to international demand for Chinese products, we believe that investors are underestimating this factor.

Multinationals' desire to secure supplies and rebuild inventory levels above those that prevailed before the pandemic will be a decisive factor in the future growth of international demand for China's output. China's situation thus looks like it is returning to normal, although the country has barely produced anything in the last few months.

Inventories are certainly low, and companies, as well as the government, will certainly want to produce to rebuild inventories and be ready to supply international demand, which will find it hard to make do without Chinese products in 2020 at least.

Chinese exports and imports will quickly rebound

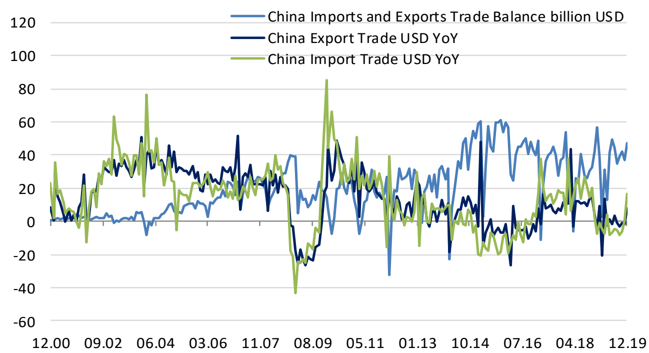
Chinese exports collapsed in January and February due to the shutdown of Chinese factories and their inability to produce export goods. This collapse was not due to a drop in international demand but to a drop in production.

During Q1, Chinese exporters drew from their stocks to export what they could while international demand was still strong. The -17.2% drop in exports YTD in February stands in contrast with the smaller drop of only -4% in imports over the same period.

The biggest drops, in excess of -24%, were recorded in exports to the US, Canada, Japan, the UK and Germany.

The smaller drop in imports is linked with a delay effect, and imports could drop more in March, although they are likely to rebound rapidly in April in volume.

Trade balance, exports & imports (% yoy USD)



Sources: Bloomberg, BearBull

The declining prices of raw materials imported by China overall is a godsend for the Chinese economy, based on processing such materials into finished goods.

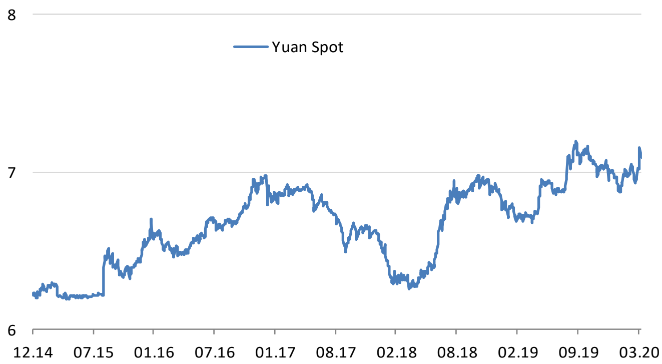
Imports by volume are likely to grow faster than in yuan. The trade deficit in February (-7 billion dollars YTD) is thus once again likely to turn into a surplus in Q2 2020.

Foreign reserves and stability of the yuan

Foreign reserves in China have remained relatively unchanged since 2016, exceeding 3,100 billion dollars in February. The USD/CNY exchange rate has not fluctuated much in the last few months and during the health crisis and the economic shock in China.

The PBOC was quite readily able to control the level of the yuan, which fluctuated by plus or minus 0.15 around 7 yuan to the dollar in 2020. This relative stability in a period of crisis is remarkable.

Exchange rate USD/CNY



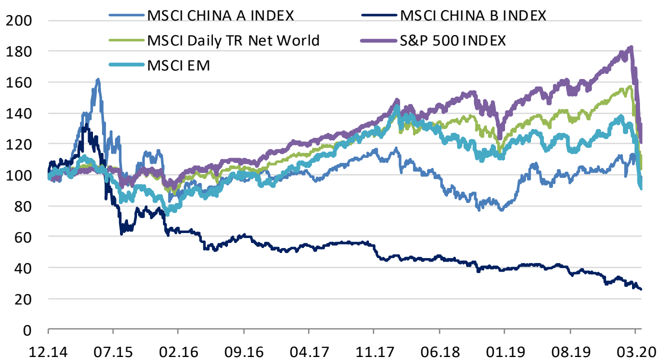
Sources: Bloomberg, BearBull

Positive outlook for equities

Chinese equities are currently trading at 9x 2021 earnings, a particularly favourable ratio in comparison with a 13x valuation for the S&P 500, 10x for Europe and 14x for Japan.

They have withstood the stock market panic of the last few weeks fairly well (-16%) and are likely to benefit from the return of long-term investors.

Chinese equity markets



Sources: Bloomberg, BearBull

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