Will China Lead the Post-Coronavirus Economic Recovery?

Yes, China should be the first economy to improve.

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Will China lead the way out?

Yes, we think so. China was the first country to get hit by the coronavirus and is the first country to bring the outbreak under firm control. So it seems logical that China should also be the first country whose economy starts to improve and where life returns to something more closely resembling normality. China's robust initial policy response to the coronavirus has paid off. It holds out hope of a gradual recovery in the economy from this point onward, together with the return of more normal business and social conditions.

Some schools are reopening in areas deemed at low risk from the coronavirus, though they remain under close supervision. Jiangsu province is aiming for the full opening of all schools and colleges by April 13. In another sign of returning normality, museums in a number of cities, including Shanghai, have reopened, as have a number of national restaurant chains that have been closed since late January. In short, the coronavirus winter in China is beginning to thaw, and signs of spring are appearing with increasing frequency.

The exceptionally weak economic data for January and February revealed that the short-term economic costs of China's lockdown and quarantine measures have been great, which rules out a V-shaped recovery. Moreover, the rapid spread of the coronavirus to other countries has made global recession the new base-case scenario for 2020. Chinese export performance is thus likely to weaken, and it will be domestic demand that must lead China's economic recovery. The rebound in the March official purchasing managers' indexes to above 50 for both manufacturing and services is one bright spot, as it shows that business confidence in China has begun to recover at the margin.

Turning to the latest news on the number of coronavirus cases in China, only three new local cases have been reported since March 24, which is very encouraging. A small number of new imported cases continue to be reported, around 50 daily, as Chinese citizens return from overseas. China's tightened immigration controls

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are fortunately proving effective at screening and detecting these imported coronavirus infections. There have been no community clusters within China arising from imported coronavirus cases. Recognizing the importance of maintaining this, foreigners have been temporarily banned from entering China. In early April, China looks to be over the worst of the coronavirus outbreak. We should be cautious in this view, however, since the appearance of a second wave cannot be ruled out.

Are there lessons for other countries to learn from the way China has handled the coronavirus crisis?

After some initial delay at the local level, the Chinese authorities were quick to take dramatic steps to prevent the outbreak spreading beyond Wuhan and Hubei province. At the time there was tremendous uncertainty over the nature of the new coronavirus, including its method of transmission, contagiousness, and mortality rate. The lack of visibility helped persuade the central government to take the extreme measure of locking down more cities and provinces in addition to Wuhan and Hubei. Travel and quarantine restrictions at their maximum extent covered almost half the total Chinese population.

If we take January 23 as being the start of the lockdown period, then the peak of new cases occurred just 12 days later and within a few weeks, the Chinese authorities had managed to stop the virus spreading further. Should Beijing not have followed their initial draconian approach of lockdown, travel restrictions, and strict quarantine, then the number of coronavirus cases would likely have been many times greater.

In places where the coronavirus is at the early stage of the spread curve, the policy of extensive testing, tracing, and isolation has been effective. That's what Korea, Singapore, Hong Kong, and Taiwan have been doing, which helped those places to bring the outbreak under control.

In Europe and the U.S., where the coronavirus outbreak has crossed the critical point, it's imperative to flatten the curve in order to avoid medical resources being overwhelmed. These areas may have to adopt strict social distancing policies even at a meaningful cost to economy/society. Once the new cases are being brought down to a sufficiently low level, those countries can then gradually restart their economies, while keeping testing/tracing/isolation policies in place.

In large parts of the developing world, how the coronavirus might evolve is still a big unknown. There is hope that the virus may hit them less hard, due to their younger population, higher temperature, etc. However, it's too early to draw this conclusion. The world community would need to support those countries that may have fewer resources to fight the coronavirus.

A second lesson from China is that national lockdowns and similar policies are not possible without hurting the economy a great deal. They are thus not sustainable for prolonged periods. The silver lining here is that the high-frequency data continue to improve gradually. China appears to be successfully rebooting its economy after a forced two-month shutdown, an event for which there is simply no historical precedent. Remarkably, factory restarts and the resumption of economic activity in the production sector have not been accompanied by any secondary resurgence in coronavirus cases.

Are global supply chains in China now coming back online?

It is still early and too soon to determine the severity of the threat to global supply chains given the restrictions that have been introduced by so many other countries besides China. In China's case,

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we will start to get a better indication of the impact on the economy from the initial lockdown once we start to see more hard economic data, including some quarterly numbers. According to official surveys, the production resumption rate of large industrial firms surpassed 95% in early March. The story is different in the small and mid-size enterprise (SME) space where business reopening is estimated to be about 45%.

It is wise to take these official numbers with a grain of salt, as we believe many factories are still likely to be operating below normal capacity. A recent survey released by Peking University suggests that the overall resumption rate for the industrials sector was just over 60% in early March, given the lower-than-normal work volume. Construction activity is another important factor to track, and our company contacts point to this being only about 40%–50% of normal levels.

The main conclusion to be drawn from the surveys and high-frequency daily data, and what matters most to our investment views, is that we believe China is over the worst of the coronavirus crisis and production and business activity at larger enterprises is gradually returning to normal. And in the logistics industry—vital for global supply chains—economic powerhouse Shenzhen reported that conditions were almost back to normal by mid-March.

The two pain points to watch in our view are:

1. China's SMEs. These are still struggling and are an important component of the Chinese economy. This is where we think the stimulus and financial relief measures will be aimed.

2. The spread of the coronavirus globally and the negative impact this is going to have on global demand and Chinese exports.

At the onset of the coronavirus crisis in China, the issue for other countries was seen primarily as one of supply chain disruption. But now the focus of attention has shifted to a major shock to aggregate demand. Demand from the U.S. and Europe is expected to be much lower than initially expected in the coming quarters, triggering a global recession in 2020. A key question now is whether fiscal policies can arrive in time to offset some of the shock from the lockdowns taking place in so many countries and lessen the depth and duration of the recession.

Other than industrial production levels in China, another important indicator for us to follow is the services industry. We believe it will be harder for the services industry to recover quickly, and getting back on track may take longer. Services activity generally involves people gathering together and direct human contact. People are understandably still fearful of the coronavirus and are intent on avoiding crowds. How long before Chinese consumers regain the confidence to shop, meet, and socialize is hard to say. There may be a lingering tail impact on the demand for services.

This is all the bad news, but there may also be a silver lining.

We think that the social distancing and work from home arrangements will accelerate many of the trends that were already playing out, such as the growth of online penetration, e-commerce, food delivery, supermarkets (given people will eat out less), and services associated with working from home such as the cloud. With schools closed, teachers gave online lessons to millions of pupils across China. Some of the country's cutting-edge advances in technology have been employed in the fight against the coronavirus, such as an artificial intelligence algorithm that analyzes CT scans in about 20 seconds, faster than any doctor. In Beijing, autonomous vehicles were used to deliver food and essential supplies to residential units under strict quarantine. All of these trends will be beneficial both to China and to other countries in the longer term.

What is happening to our portfolio?

We found most opportunities in areas where the virus brought short term disruption without impacting medium-team underlying demand. These include IT hardware, home improvement, automotive, sportswear, etc. The stocks pulled back along with the market on near-term earnings risk, but we think that pent-up demand could help drive acceleration for several quarters.

We also spend time thinking about second derivative impacts from the virus that have not been priced in. For example, the virus may drive rapid penetration of point-of-care testing beyond this virus season. Also, in certain product categories, the supply disruption expected in the U.S. and Europe may help accelerate domestic substitution.

We owned less travel-/catering-related stocks than we typically would have, especially those related to international travel. Different from the U.S. and EU, many Chinese stocks in the "coronavirus epicenter" have not fallen as much as their overseas peers. We think those businesses could take longer than many expect to recover fully. We have found better risk/reward opportunities elsewhere within the general market correction.

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