China Is Leading the Asian Recovery

As COVID-19 fizzles out, China reopens for business.

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KEY INSIGHTS

- Beijing's success in containing the coronavirus is reflected in household and business confidence returning to more normal levels.
- Due to the uncertainty, there is no economic growth target for 2020. But to achieve employment stability, positive growth of 2% to 3% may be required.
- China and north Asia are expected to lead the world in a post-coronavirus economic recovery and are better positioned to cope with a potential second wave.

China experienced an earlier lockdown than other countries in the fight against the coronavirus, followed by an earlier easing of restrictions. Government policies in the initial crisis phase focused on containing the coronavirus via lockdowns, travel and immigration restrictions, and strict quarantine regulations. A second phase began in March as the policy focus shifted to a gradual easing of restrictions and the reopening of China's economy. An important milestone was reached in early April. After 11 weeks, China announced the end of the lockdown in Wuhan, the epicenter of the initial outbreak, allowing stranded travelers and migrant workers to finally return home or to their place of work.

Beijing's successful strategy to contain the coronavirus is being reflected in household and business confidence, which are returning to more normal levels. Property is one relative bright spot, for example. Fears of sharp falls in property prices after transactions plunged during the lockdown period have failed to materialize. Instead, pent-up demand among potential homebuyers has allowed residential sales to recover more quickly than expected. The residential property sector appears to be emerging relatively unscathed from the coronavirus pandemic—one less headwind for the economy in 2020.

Business and Consumer Confidence Are on the Mend

Although there are still many risks and uncertainties, confidence among Chinese entrepreneurs and businessmen is recovering. The Organization for Economic Cooperation and Development's gauge of manufacturing confidence in China rebounded in April to its highest level since October 2018. As we approach midyear, economic and social activity are continuing to normalize across China. While there have been few

setbacks, the pace has remained slower in the services and consumer areas than in the industrial complex. (See Figure 1, which uses high-frequency data to monitor China's reopening.) The rebound in economic activity has also been more concentrated among larger enterprises, and, in many areas, China's smaller and medium-sized enterprises (SMEs) are still struggling. SMEs are an important component of the Chinese economy. Policymakers are well aware of this, and at the National People's Congress (NPC) some of the policy stimulus and financial relief measures aimed at supporting China's SMEs.

China's industrial sector has largely completed the normalization process, according to the National Bureau of Statistics. By April, over 97% of larger industrial enterprises were operational, with over half operating at or above 80% of the normal level. Toward the end of April, Moody's reaffirmed China's A1 sovereign rating in a generally positive report on the country, commenting that China possessed the necessary policy space to combat the coronavirus and promote an economic recovery in the second half of the year.

NPC Confirms Recovery Policies Are on Track

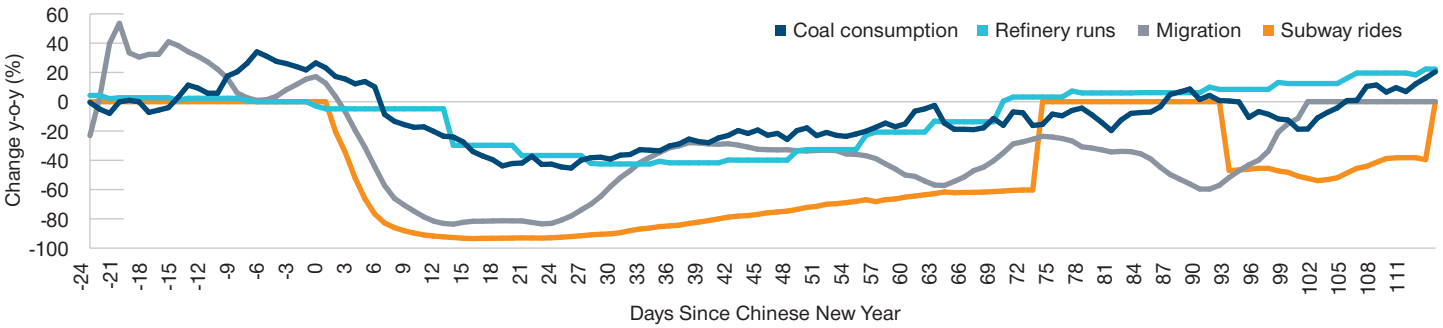
China held its annual parliament, the NPC, in May after a two-month delay. Being able to hold the event in Beijing is testimony to China's success in battling the coronavirus. The traditional economic report by Premier Li Keqiang on the first day of the NPC brought few surprises. This confirms that Beijing believes it has the right policies in place to support recovery. Due to the uncertainty created by the coronavirus, there is no official GDP growth target for 2020, the first omission since targets were introduced in 1994. This is sensible as it provides more flexibility to policymakers during the economy's reopening. They have enough on their hands without worrying about a gross domestic product (GDP) target, a construct that is "man-made" according to Li. The NPC's priority in 2020 is jobs and labor market stabilization together with poverty reduction. The target for urban unemployment is an ambitious one of 6%, implying zero increase from the current level. Private sector forecasts typically show unemployment rising to 10% or higher by December, after allowing for migrant workers who are not fully covered in the official series.

Fiscal Policy in the Spotlight at NPC

As expected, fiscal policy took center stage at the NPC in efforts to reboot the Chinese economy. The central government budget deficit is only earmarked to increase from 2.8% in 2019 to 3.6% this year, a modest increase. A broader measure that includes off-budget

Tracking China's Economic Reopening

(Fig. 1) High-frequency indicators of production and labor mobility



As of May 16, 2020. Migration series discontinued on May 4, 2020.
Source: Sanford C. Bernstein (Hong Kong) Limited. Analysis by T. Rowe Price.
y-o-y = year-over-year. "0" represents Chinese New Year, to the left of "0" represents days prior to the New Year and to the right are days after the New Year.

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spending—notably, special purpose bonds to finance infrastructure—shows the fiscal deficit increasing from 5% of GDP last year to around 8% in 2020. Even on this broader measure, China's fiscal response to the coronavirus appears modest when compared with other countries, and financial markets initially showed some disappointment. However, the shorter lockdown period in China, which coincided with the Chinese New Year holiday, has caused less severe economic damage and, therefore, less need for more extreme policy measures. And as Moody's has commented, China gains support from other channels to assist recovery, such as government-owned banks and state-owned enterprises. This means total government support for the economy in China's case is greater than the direct fiscal costs.

Turning to monetary policy, credit and money supply growth accelerated for a second consecutive month in April. Annual growth in total social financing rose to 12.0% in April from 11.5% in March, with strength in short-term bills and corporate bonds. The central bank's latest quarterly report said the People's Bank of China will introduce "more powerful" policies in response to unprecedented economic challenges. Monetary easing in China will likely stay measured, however, since Beijing is aware of the dangers of further rapid credit creation. The massive unconventional monetary policies hurriedly introduced in the west were necessary amid broken credit transmission channels, a problem that China does not suffer. The problem for China is that credit had spiraled to high levels in the decade after the financial crisis. In recent years, the government switched its focus to moderate credit growth and gradual deleveraging. It knows this policy has to be put aside in the struggle against the coronavirus. But, at the same time, Beijing also does not want to signal that the commitment to better control credit growth has been abandoned.

There is optionality in China's more targeted approach to reflation compared with other countries. It leaves room for further policy support to the economy if required, support domestic investors know can be implemented speedily and effectively, without resorting to unnecessary debt and credit expansion. Looking ahead, external demand is currently the major economic risk for China, as the global recession triggered by the coronavirus has only just begun to make its presence felt. But we think fiscal stimulus via infrastructure investment plus some pent-up consumer and property demand should be enough to offset weaker export demand and prevent an outright contraction in the Chinese economy in 2020.

Stable Bond and Currency Markets Positive for Equities

Stable bond and currency markets help to provide a favorable backdrop for Chinese equities, in our view. China's domestic bond market has strong fundamentals and offers foreign investors diversification benefits and an attractive yield. As a result, inflows into China's central government bonds have stayed positive (USD 7.25 billion in April). Overseas investor demand should continue to firm given a backdrop of monetary easing and falling inflation.

At the NPC, Li committed to keeping China's currency, the renminbi (RMB), stable at a reasonable level. Rising U.S.-China tensions have led the renminbi to weaken recently against the U.S. dollar. But Beijing continues to show no desire to pursue a deliberate weak currency policy, a high-risk option in turbulent markets that runs counter to China's long-term aim of promoting the RMB as an international currency. Since the coronavirus crisis, the RMB has been firmer than the average emerging market currency and on a trade-weighted basis has strengthened year-to-date.

China's Post-coronavirus Investment Outlook Is Bright

Investors need to remain vigilant about the risk of a second wave of coronavirus infections as Chinese people start to reintegrate into their jobs and social activities across the country. There are potential headline risks such as trade tensions and U.S. preelection politics. That said, we advise investors to focus on the medium- and long-term outlook and solid fundamentals of many Chinese companies. Unlike the U.S., Europe, and Japan, China is expected to escape negative growth in 2020, with an annual expected GDP increase in the 2% to 4% range. In turn, that should enable Chinese companies to be among the first to embark on a new earnings growth cycle in 2021.

Our strategic investment focus has been on companies that are positioned to be long-term beneficiaries in the evolving Chinese economy, driven by trends in domestic growth and demand. We believe in taking a holistic approach to investing in China, looking for the best risk/reward opportunities across the full spectrum of listed Chinese companies, regardless of where they are currently listed (onshore, offshore, or as American Depositary Receipts (ADRs)).

Many overseas investors in China focus largely on mainstream, well-researched "mega-cap" stocks. In contrast, our China research and investment process extends beyond the names commonly seen in many foreign investor China portfolios. As a result, our approach favors a high active share[1] that seeks to capture the rapidly evolving structural trends in China's economy and markets.

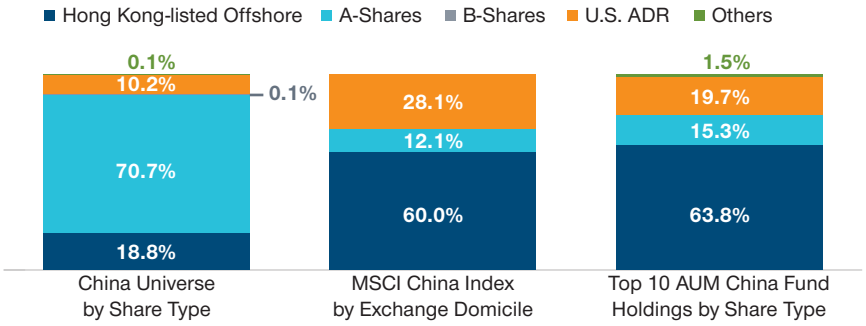
Many Areas of Opportunity for Investors in China

Looking forward, we believe that the social distancing and work-from-home arrangements are likely to accelerate many of the trends in China that are already playing out, including the growth of online penetration, e-commerce, gaming, food delivery, supermarkets, and cloud services associated with working from home. Within the business services sector, we see good potential investment opportunities in property management, an area that is developing rapidly in China, in logistics and in human resources.

We remain positive on secular growth businesses, including business services, such as property management and logistics. We believe the consumption premium trend will resume after temporary disruption from the coronavirus outbreak.

China A-Shares Remain Underrepresented and Under-Owned

(Fig. 2) Market capitalization of China universe, MSCI China Index, and large China funds



As of March 31, 2020.
Sources: MSCI, Goldman Sachs, Morningstar. Please refer to Additional Disclosures for further source information. The top 10 AUM (largest assets under management) China funds are the top 10 funds, by share type, in the Morningstar China Equity Universe.

[1] Active Share is a measure of the percentage of stock holdings in a manager's portfolio that differs from the benchmark index.

> An education dividend that will improve the quality of the labor force and help to drive China up the value chain...

We continue to be impressed with the pace of Chinese companies moving up the technology curve, be it biotech or information technology.

In the near term, we find opportunities in companies that may face a temporary impact from COVID-19, but whose earnings power we expect to be largely intact in one to two years. We also favor businesses that can thrive with self-help, such as strong product cycles or an operational turnaround.

Over the longer term, we remain constructive on China's future, and the coronavirus does nothing to change this view. Over the last decade, the structure of the Chinese economy has been shifting from reliance on infrastructure, residential investment, exports, and low-value-added manufactured goods to the consumer, health care, services, advanced technology, and industrial automation. We expect these powerful trends to continue. At the NPC, President Xi Jinping emphasized that China remained committed to a new development plan in which "domestic circulation [i.e., demand] plays the dominant role." In the future, China would treat domestic demand as the starting point to "accelerate the building of a complete domestic consumption system."

The strength and depth of China's manufacturing response was further confirmed during the coronavirus crisis. For all the negative rhetoric between the U.S. and China caused by COVID-19, the world may find that China remains an integral part of the global supply chain. In our view, China has the most comprehensive/integrated supply chain, from labor-intensive apparel/toys to higher-value-added medical and technology products. This is not about to change. In just a few years' time, we believe China is set to become the largest domestic consumer economy in the world, with a meaningful economy of scale advantage in many products. China continues to cultivate the post-COVID-19 "New Economy" and leverage technology and innovation to drive productivity improvement.

Finally, while everybody knows that China's labor force is likely to shrink gradually in the coming decades, many seem to ignore the positive of China's education dividend. Whereas the number of students entering college stood at around 1 million 20 years ago, today it is over 9 million. In 20 years' time we can expect 30% to 40% of China's population will have a college degree, up sharply from the current 6% to 7%—an education dividend that will improve the quality of the labor force and help to drive China up the value chain through innovation in science, technology, and research and development.

WHAT WE'RE WATCHING NEXT

We will be watching to assess the net impact in the second half of 2020 from the positive boost to China's domestic demand from fiscal and monetary stimulus set against the headwind to China's exports from the global downturn in world trade.

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