ASIA MACRO STRATEGY

Update on China's Economy and Fed's Backstop

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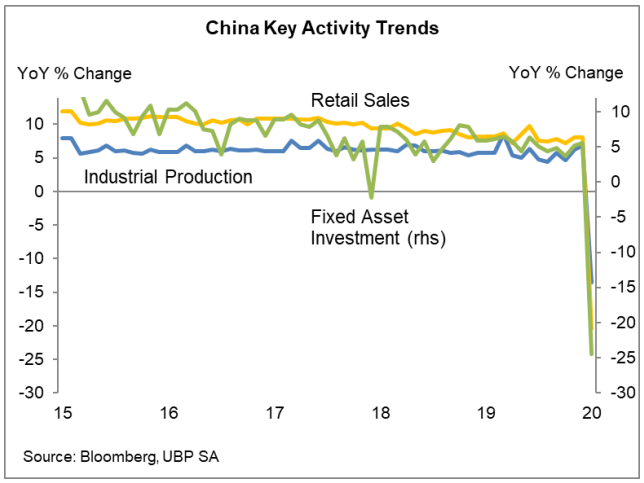
Production Resumption Post Big Slump

China's economic contraction caused by COVID-19 and the city's lockdowns was far more severe than market expectations with the release of January-February (combined) economic data this week for key activities.

In short, industrial production contracted 13.5% year-on-year, fixed asset investment dropped 24.5% and retail sales were down 20.5% – all far worse than consensus estimates of around 3-5% yoy decline.



Like most market forecasts, we have to slash China's GDP forecast given the additional colour, at least for the first quarter (Q1) and second quarter (Q2). We now think that 1Q20 GDP should contract by 2% to 4% (vs. our initial worse case of +2% to +3%), and Q2 may rebound to around -1% to 1% depending on progress on production resumption and global virus containment.

Although today's far-worse-than-expected data releases met with raised eyebrows, the economic slump was a known fact and pretty well-priced. Most evidence suggests that March saw a more noticeable production resumption compared to February, but the pace of recovery is definitely slower than anticipated by policymakers.

Roughly speaking, the Chinese economy may be operating at around 60-70% of normal capacity, but we start to see pockets of activity resuming especially in road traffic and (surprisingly) home sales in major cities (outside of Hubei province).

The concern around manufacturing exports is that even though most factories along the coastal region may have capacity/return of workers reviving to about 70-90%, the collapse in demand from Europe and US may loop back into China's exports even with capacity normalisation. Foreign buyers may also demand substantial price-cutting from the Chinese producers which will impact revenues and profits along the supply chain.

The China Template Works

The better news is that China (and, to a certain extent, Asia except South Korea and the Philippines) is ahead in this COVID-19's infection-containment-economic collapse cycle while many western countries are now starting to confront similar issues faced by the region earlier.

Policy responses in this region – led by China – are ahead in the stimulus phase with further room in monetary and fiscal coordination to continue to fight the headwind ahead.

China, in particular, has shown progress in virus containment and has moved beyond the liquidity injection,

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and emergency spending phase (i.e. medical spending, tax/fee reliefs, deferment of payments, debt forgiveness, cheap loans/subsidies to hit sectors and household).

Obviously, the need for central bank backstop to ensure liquidity supply remains key but China is now focusing more on demand recovery and productivity-enhancing measures to reinvigorate growth once domestic virus concern further fades.

Specifically, local government financing vehicle's financing has relaxed and special bond issues have upped the scale (to RMB950bn or $136bn in the first two months) to embark on a renewed round of infrastructure investment. Also, policy measures to support real estate market and auto purchase have expanded and the take-up rate of new home sales have slowly revived.

Deep Valuations, Needing Patience

The current severe market drawdown has created deep values in Asia/China equities but it is important to see reduced market volatility in order to build positions on dip-buying opportunity.

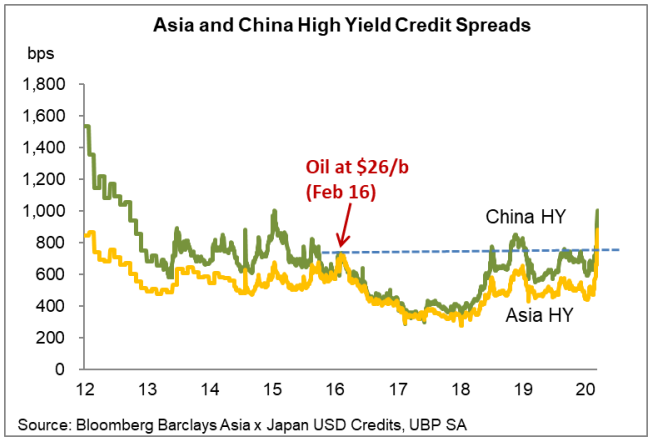
MSCI Asia forward multiple is now at 11.5x (below 10-year mean of 12.6x) as most individual Asian market's PE valuations are now below mean and approaching -1.0 standard deviation level (except India and China). Hong Kong's Hang Seng Index's multiple is at a bottom 9.0x which has exceeded levels during the global financial crisis and many other past major economic/political crises. The MSCI China index fell to 10.8x (at about mean at 11x) but the slight market premium may be justified by virus containment and continued policy stimulus.

However, Asia USD credit market is trickier as USD funding pressure and concern over the high yield (HY) market on collapsing global crude oil prices have continued to dry up liquidity and market functioning.

It will require a much expanded liquidity programme by the Fed to backstop the credit market beyond the 150 basis points (bps) cumulative rate cuts and the broadening of asset purchase in government bonds and into mortgage-backed securities (MBS) by establishing a standing repo facility, expanding USD swap lines with major central banks or even intervene into the HY market directly. Fiscal policy is crucial here to fill the holes to restart demand beyond emergency relief measures.

Asia and China HY credit spreads have widened significantly to the current 880bps and 1,000bps which are beyond the wides during the US HY crisis when crude oil collapsed to $26/b in early 2016.

But patience is needed to see signs of easing in USD funding pressure as a guidepost to entry. We expect policymakers will continue to expand policy options until the market deems sufficient to calm investors' fear and anxiety.



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