FUNDAMENTAL FLASH

China Getting Back to Business

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Prepared by Affin Hwang Asset Management

Emerging from a painful economic shutdown, China is gradually getting back to business and adapting to a new normal since COVID-19 was first detected in the country last year. Is recovery underway for the world's second largest economy? In the following interview, John Lau, Senior Investment Analyst of Affin Hwang AM shares more on China's path to recovery and outlook for the country.

1. China is the first country to reopen its economy after imposing lockdown to contain the outbreak of COVID-19. What has your observation been of its recovery and are activities picking up?

China's new confirmed COVID-19 infected cases have peaked since mid-February which is much earlier than most of the major economies in the world including the US. Work has also started to resume in China since mid-March. Hence in that sense, China is leading in terms of recovery. From data collected as of 31st May 2020, more than 95% of the factories in China have already re-opened nationwide.

Coal consumption is already back to last year's level, while independent oil refineries are currently running at higher rates as compared to 2H'19. Number of passengers traveling in China is 50% lower y-o-y, recovering from -80% y-o-y levels at the beginning of March. International air travellers are still 90% below last year's level.

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We do expect the tourism sector to recover at a slower pace given strict border controls and potential change in traveling behaviours.

With regards to issues surrounding supply chains, the pandemic has indeed sparked some discussions on the seemingly overreliance on China in global production. In the long run, we do see a potential that individual countries will try to relocate some production capacities onshore.

That said, it is not something that can take place in a short period of time. China is no longer a production powerhouse relying solely on cheap labour like a decade ago. In fact, labour cost in China has now already exceeded a few other countries like Vietnam and Cambodia. What China boasts is a complete infrastructure, from raw material procurement, transportation, technological support, etc., that was built over the years. This is not something that other countries can replicate in the near term.

2. China's stimulus package came short of expectations after it was announced last month. Do you think the stimulus is enough to spur back growth?

China held its National People's Congress (NPC) and Chinese People's Political Consultative Conference (CPPCC) last May, where policymakers announced a volley of fiscal stimulus measuers to cushion the economic blow from the COVID-19 pandemic.

There are two interesting points to note: 1) China re-introduced Central Government Special Bonds (last used in 2008); 2) China has set fiscal deficit target of at least 3.5% (official ceiling was 3% previously).

It is true that the total dollar amount has disappointed market’s expectations, given that major economies around the world like the US and EU have announced massive stimulus to support respective economies.

There could be several reasons why the stimulus disappointed:

- Lesson learnt from 2008/09 stimulus: China embarked on a massive stimulus post GFC, and as a result, many inefficient companies (a.k.a. zombie companies) surfaced, overproduction of materials (coal, steel, cement), corruption, etc. , which are problems that took China many years to solve subsequently. This could have caused China to be more careful in pump priming the economy in a large way again.

- Multiple challenges: China is currently facing multiple challenges, both economically and geopolitically. Other than the devastating economic impact caused by the Covid-19 pandemic, China is also facing challenges from the US and Trump administration, which could actually go on for a longer period of time. Given these challenges, China might be reserving some financial muscles, in anticipation of future difficulties that need to be tackled.

- Debt issues: It is right to point out that debt levels have soared in China, with domestic debt reaching 300% of GDP as of 2019. China has tried to deleverage its economy in 2016 and 2018, but both effort have proved to be damaging to its growth, and the country continued to lever up subsequently. This could be somewhat constraining for policy makers.

To sum up, recent economic data shows that China is recovering. We believe that the government will be monitoring the effectiveness of stimulus announced, and is willing and able to do more when needed.

3. Geopolitical tensions between US and China have started to simmer recently. How do you see the relationship dynamics of the two countries evolve as China's economy continues to grow in size?

The conflict between US and China conflict is a structural issue. Besides economic growth, China is also growing its technological capability, military strength and geopolitical influence. As China rises, it will increasingly be viewed as a threat to US's dominant superpower position in the global arena. There is also rising distrust of China among both Democrats and Republicans in the US and a desire to contain China's rise.

While US will like to improve its domestic economy by reducing its import reliance, it is not embarking on an isolationist path. Although US President Donald Trump has used trade tariff against its allies including Canada and European countries, he has only targeted a few industries to modestly bolster the US domestic economy. His trade policies have been modest and benign towards US allies, unlike his response towards China where many industries were hit with higher tariffs.

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