Market Strategy

Two different worlds: Part One

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- While investors are buying the dip and sending US equities to all-time highs, commodities and trade-related data are dropping to multi-year lows.
- Commodity-related trade indices such as the Baltic Dry Index (BDI) is now in freefall, having declined 80% since September 2019, and is on track to hit a new all-time low.
- The third and fourth week of February will be a critical window to watch given that most companies in China will resume operations. Many employees are set to travel over this weekend back to their work places and resume working next week.
- We cannot rule out the possibility that the current outbreak spills over into the broader economy and thereby create a financial shock enough to dent investors' "Buy The Dip" (BTD) mentality.
- Therefore, we maintain our recommendation to minimise risk exposure and hedge with precious metals such as gold and silver, while only buying quality blue-chip companies with healthy balance sheets. We also believe the current outbreak has the potential to lead to structural changes in China's working and learning environment, and may benefit technology companies specialising in e-learning.

A black swan to shock the global economy? Following the assassination of the commander of Iran's Quds Force, which resulted in a bumpy start to the year for the global financial market, we think that the current outbreak of the novel coronavirus (2019-nCoV) has the potential to dent investors' sentiments to buy the dip. The outbreak in China has resulted in temporary regional economic shutdowns but will have far-reaching impact on both the country and the global economy, although to an uncertain extent at the moment.

As of the date this report is published, total infected cases reported are 28,281. The death toll is 565, with the mortality rate at around 2%. Since 23rd January, when Wuhan, which has been the epicenter of the 2019-nCov outbreak was completely quarantined, there were an additional 34 cities being shut, and more cities are expected to take the same quarantine measures.

The current outbreak has several similarities to 2003 SARS, including the pathogen, the onset time, part of the symptoms, and so on. Hence, we will analyse the potential economic and financial impact based on economic performance during 2003 SARS period, even though it will be challenging to justify any quantitative impact at the moment given the uncertainty of how the outbreak will develop.

First, China GDP growth in 2020 could fall below 6%. The 2003 SARS outbreak lasted from November 2002 until July 2003. The peak of reported cases and when the most severe quarantine measures were taken by the authorities was in April 2003. The full year impact was around 0.5% based on annualizing the 2% dip in 2Q03 GDP growth compared to 1Q03.

In 2003, the manufacturing industry accounted for 58% of China's economic output while the service industry's contribution was 39%. We believe that these ratios helped cushion the financial and economic impacts of SARS. This is because in general, the manufacturing sector recovers more quickly than the service sector because the resumption of production is easier driven by the wage demand from labor while consumer spending especially service-related sector requires the return of consumer confidence.

The outbreak of SARS in 2003 was also mostly concentrated in Beijing City (3.7% of China's GDP), Guangdong province (11.7% of China's GDP), and Shanxi province (2.1% of China's GDP).

However, the contagion scale of 2019-nCov is multiple times larger than 2003 SARS. More importantly, there was not a single city that was locked down back then. This is the first time in the history of the PRC that China is locking down cities. Not only were restrictions placed on commuting and production activities in almost the entire Hubei province , but also top tier cities such as Hangzhou, Nanjing, and Wenzhou and the crucial transport city Zhenzhou shut as well.

Meanwhile, the long holiday in China has been extended for another week. Hubei province, the most severely infected area, has extended it until 13th Feb. Accordingly, we can estimate that a significant segment of China's economy is almost shut down for at least two weeks. Based on 2019 China GDP breakdown, the service sector contributed 59%. Without a doubt, retail, F&B, tourism, off-line media, transportation, and hospitality sectors will hit a speed bump during this period. Due to a longer period of recovery expected, 1Q20 and 2Q20 GDP growth are expected to be lower YoY. Therefore, we think that it might be challenging for China to maintain its 6% growth this year.

Figure 1: China GDP growth and breakdown by industries (2003 vs 2019)

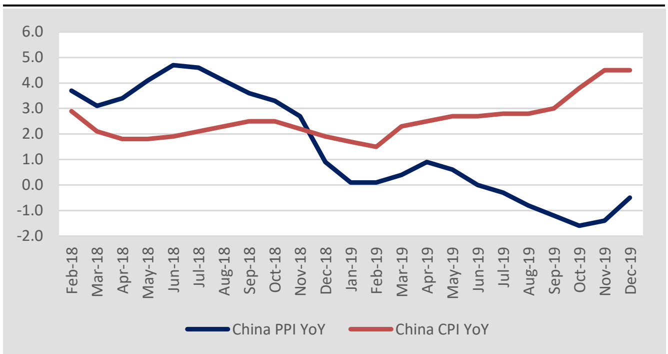
	1Q	2Q	3Q	4Q	Full year
2003	11.1%	9.1%	10%	10%	10%
2019	6.4%	6.2%	6%	6%	6.1%

2003	1Q	2Q	3Q	4Q
Primary industry	1.9%	2.1%	4.8%	3.3%
Secondary industry	52.8%	58.4%	61.3%	59%
Tertiary industry	45.3%	39.5%	33.9%	37.7%
2019				
Primary industry	1.8%	3.4%	4.1%	5.7%
Secondary industry	36.9%	37.3%	34.7%	39.2%
Tertiary industry	61.3%	59.3%	61.2%	55%

Source: NBS, KGI Research

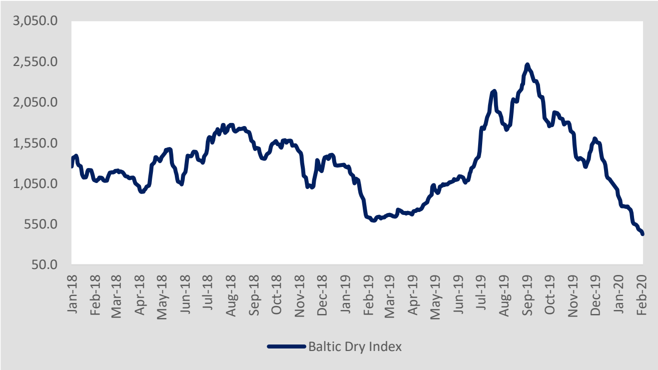
Second, a short-term fall in exports for some export-oriented countries is imminent. Against the backdrop of the Sino-US trade tensions, together with soft domestic PPI and high CPI, China could further reduce its raw material imports, and especially energy related products and end product export. Currently, dozens of cities have restricted traffic and production. Oil prices (Brent) have dropped by 16% since the outbreak was publicly announced in China. Meanwhile, copper has plummeted by 11%; Iron ore sank by 17%; Coffee tanked by 14%; Soy bean prices fell by 7% in that last two weeks. Basically, both hard and soft commodities that China has substantial demand for are under pressure. Counties such as Australia, Brazil, and Mexico will suffer from a short-term decrease in exports. The 2019-nCoV and trade tensions seem to be a double whammy for international trade.

Figure 2: China PPI and CPI



Source: Bloomberg, KGI Research

Figure 3: Baltic Dry Index (BDI) – Reaching all-time lows



Source: Bloomberg, KGI Research

Third, there are new opportunities following this outbreak. In retrospect, one of the reasons China recovered quickly from the 2003 SARS was the tailwind of becoming a member of WTO in late 2001. China was on track to being the world factory since the domestic and overseas demand surged. The quarantine measures during 2003 SARS period hit consumer sectors as well. The crisis back then burgeoned the opportunity of online shopping and logistics. Taobao, the most popular and largest e-commerce platform in China, was launched in 2004. Since then, China has been embracing the golden era of e-commerce.

At the moment, the lockdown has no end date. Students and employees are forced to stay at home and postpone the resumption of school and work. Online education and home office (remote work) are key trends to watch out for in China now. We believe the internet sector in China will enter into wave of structural change soon, as people accept remote study and work.

The implications on financial markets…

For now, the impact on financial markets will be difficult to gauge given the abundant liquidity being injected into the global financial system. **However, the key point to note is the divergence between the weakness in commodities-linked data and the strength in equities market.** At one point, either one has to give in.

Most investors are still preconditioned to BTD, which has worked well over the last 10 years, until such time when the economic data starts to turn down, possibly by as early as February. When a surprise shock coincides with slowing economic growth, sentiments can quickly change.

We will continue this discussion in the second part of a series of reports we will publish on the Wuhan Outbreak. We will discuss the potential domino effect that the current situation can lead to.

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