KGI CHINA DEVELOPMENT FINANCIAL

Market Strategy

Two different worlds: Part Two

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- A combination of high inflation and weaker economic growth is pushing China into stagflation territory in 1Q20.
- Although there will be temporary supply chain disruptions, the acceleration of manufacturing plants moving out of China as multinational companies realise their over-reliance on the country, will create a more damaging and longer-term impact.
- Meanwhile, Chinese stock markets have rallied to pre-outbreak levels as investors expect a quick end to the outbreak, and as monetary and fiscal stimulus are expected to fully offset the negative impact on economic growth.
- Equity markets may have gone ahead of fundamentals at this point, at least from our point of view, and we recommend being more cautious and not chase rallies. Stick to quality (companies with strong balance sheets and stable dividend yields; see our *Fab 5 Dividend Portfolio*) and *precious metals*. We also recommend accumulating tech-related names in semiconductor and Apple's supply chain (see *KGI Taiwan's Strategy published on 12 Feb*).

China stagflation in 1Q20. On 10th February, China released January's CPI (representing China's inflation rate) which jumped 5.4% YoY, above market consensus of 4.9%. The eight-year-high inflation was due mainly to the 20.6% YoY surge in food prices. Out of which, pork prices soared by 116% and vegetable prices rose by 17.4%, according to the National Bureau of Statistics. This is most likely due to the demand-pull effect given the pre-festival rush to procure goods. Recall that the Spring Festival started early this year on 25th January, which would have resulted in workers travelling back to their hometowns around the second and third week of January, and factories having to rush production within the first two weeks of the year.

Figure 1: China CPI - Food Prices (YoY %)

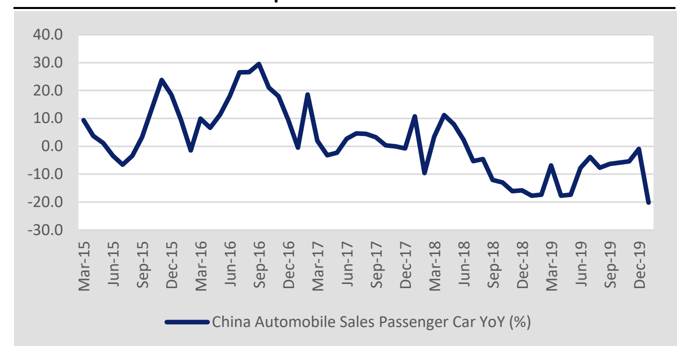
Source: Bloomberg, KGI Research

Short-lived gains of PPI. On the other hand, China's PPI turned positive (0.1% growth YoY) after declining for six consecutive months. The turn was buoyed by the Phase One Trade Deal reached in mid-January. However, given the production shutdowns and lockdown of several cities under strict quarantine orders, the gains could be short-lived.

Slow recovery. Since 10th February, Chinese companies have resumed work amid the ongoing outbreak and lockdown of cities and confinement of communities. We believe that the recovery of production will be slow and will take more than a quarter to return to normalcy. The peak of the spread is expected to be around late February according to the most recent forecasts by China's top epidemiologist Dr. Zhong Nanshan on 11th February.

In our report published last week, we mentioned that based on the current situation of the ongoing shutdown of retail malls, restaurants, tourist attractions, and other public amenities, GDP growth contributed from such segments will be impacted severely. Generally, the first quarter GDP growth is the highest for the year as the country celebrates the Spring Festival, which helps to boost consumption of goods and services. The stall in growth in consumption and the only partial recovery of production could lead to a substantial drawdown in 1Q20 GDP growth (1Q19 GDP growth: 6.4%).

Figure 2: China Passenger Auto Sales (YoY %) declined 20% YoY in January 2020. One of the first set of economic data for January showing a sharp slowdown in China's consumption.



Source: Bloomberg, KGI Research

Recall that one of the ten themes we discussed in our 2020 Outlook was that China could sink into stagflation in 1Q20. CPI could be near to or even higher than GDP growth during the period. Meanwhile, employment will be under more downward pressure as right-sizing is the easiest way for companies to get through the current challenging period. Furthermore, China's Ministry of Education cautioned recent graduates to expect a more challenging job market in 1H20, as the country experiences lower economic growth and confronts the virus outbreak.

Temporary global supply chain disruption in 1Q20; long-term impact of factories increasingly move out of China. According to the World Bank, China's industry value added accounted for more than 28% of the world. Sectors like automobile, electronics, machinery, and textile that have large exposures to China will inevitably face undersupply due to the disruption of materials and parts. Although there is no accurate estimates of the impact, we believe the COVID-19 outbreak would accelerate the trend of plants and factories moving out of China, which has been ongoing over the past two years ever since the start of the trade war. Global manufacturers have since realised the challenges of relying too much on China. Thus, although the current outbreak is widely expected to end before the summer months of July to August, setting up new production lines in regions such as Southeast Asia will be an urgent consideration for companies.

Stock market is supported by monetary and fiscal stimulus. To maintain the stability of financial markets, the PBOC conducted an epic liquidity injection on the same day (3rd February) that the country's stock market reopened after a week's postponement. On 10th February, PBOC started to provide Re-lending Funding of RMB30bn to nine major national banks and other local banks in 10 provinces. The funding is to facilitate the production and businesses related to combating COVID-19. The actual financing rate for companies is estimated to be lower than 1.6% given the up-to-3.15% one-year loan prime rate offered by financial institutions and 50% discount covered by fiscal subsidies.

Meanwhile, on 7th February, China's Ministry of Finance and State Taxation Administration laid out a series of preferential tax policies related to income tax, value-added tax, and individual income tax. The series policies include tax deduction, refund, and exemption during the pandemic period.

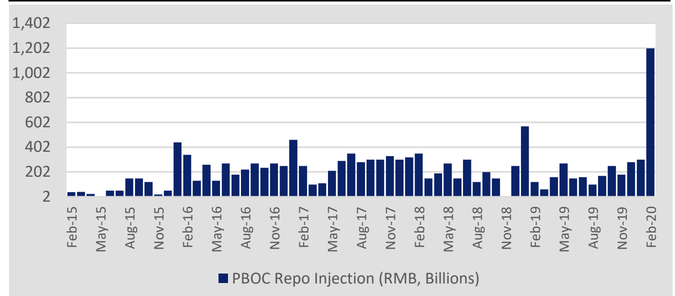
China's immediate combined counter-cyclical stimulus is perhaps the key reason why its stock markets have been recovering from the initial sell-off. As of 12th February, the Shanghai composite index climbed back to the level in early December 2019; and the Shenzhen composite index recovered back to the level before the official announcement of COVID-19 in mid-January. The ChiNext index (proxy of SMEs index) delivered a three-year high, basically shrugging off any impact of the current virus outbreak. The price movements indicate that markets are expecting the outbreak to end soon and for these stimulus measures to fully offset the negative impact on economic growth.

Figure 3: PBOC liquidity injection since the stock market re-opened

Date	Reverse Repo Operation	Amount Expired	Net Injection
3rd Feb	Lower 10bps for 7-day and 14-day repo rate to 2.4% and 2.55% respectively; RMB900bn in 7-day and RMB300bn in 14-day reverse repos	RMB1,050bn	RMB150bn
4th Feb	RMB380bn in 7-day and RMB120bn in 14-day reverse repos	RMB100bn	RMB400bn
9th Feb	RMB700bn in 7-day and 200bn in 14-day reverse repos	RMB 900bn	Nil

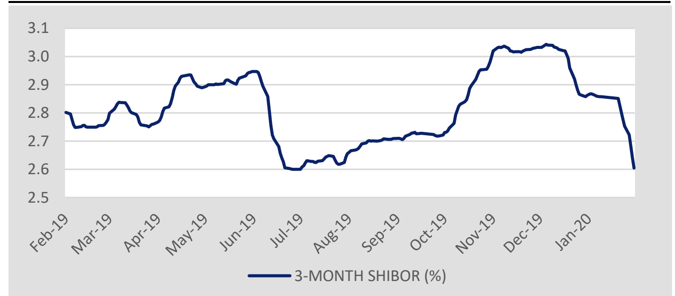
Source: Public sources, KGI Research

Figure 4: PBOC 7-day and 14-day reverse repo transaction



Source: Bloomberg, KGI Research

Figure 5: SHIBOR 3-Months



Source: Bloomberg, KGI Research

The disconnect between the stock market and economic performance could be tested. We are of the view that the stock market is performing far ahead of fundamentals at this time. China's 1Q19 GDP was about RMB21.8tn. Assuming GDP is halved for a month during the outbreak period, the RMB3.6tn output losses is expected to be made up in the remaining 10 months. Before more macro data is released, no one is exactly sure of how large the damage will be. In our view, investors should be more cautious of short-term rebounds and not chase rallies during this period, as investors' sentiment could turn sceptical of the risk-on rally upon the release of more economic data over the coming weeks.

Plan of action: (1) Quality, (2) Precious Metals, and (3) Technology. We would rather stick to quality stocks with strong balance sheets that are able to support their dividend yields (See our *Fab 5 Dividend Portfolio* of blue-chip stocks). Our Taiwan analysts also recommend buying technology-related stocks that are riding on structural long-term trends in: (1) Industrial Automation, (2) Cloud/Data Centre, (3) Semiconductor/OLED, and (4) Apple's supply chain. Among commodities, gold and silver are still holding up well, and are a good hedge in the event inflation returns due to the fiscal and stimulus measures that central banks will roll out in the coming months.

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