Market Strategy

Collateral damage: Japan and South Korea

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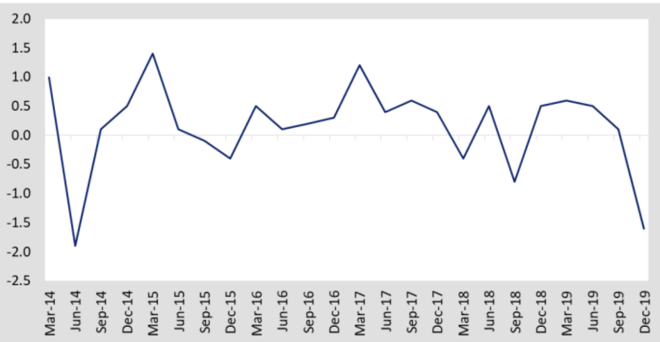
- Japan and South Korea are China's third and fourth largest trading partners. Both countries are heavily reliant on China as an export destination and as a source of imports.
- A key risk we highlight in this report is the rising number of infection cases in both countries that would have the potential to further disrupt the global supply chain in the automobile (Japan's largest export) and electronics-related sectors (South Korea's largest export).
- Furthermore, as Asia's second and fourth largest economies, an economic slowdown in their countries would have a ripple effect on the rest of the world.
- Financial markets have largely shrugged off the impact from the coronavirus. However, we are not out of the woods yet. As the impact starts to become evident in upcoming economic data, the disconnection between risk-assets and the economy will be tested.
- We maintain our recommendations to be cautious and not chase rallies. Stick to quality companies (companies with strong balance sheets and stable dividend yields; see our *Fab 5 Dividend Portfolio*). We reiterate to buy gold and silver, with a target price of US$1,700/oz and US$25/oz, respectively.

Japan – a ticking time bomb. On 17-Feb, Japan released 4Q19 GDP growth figure which fell to -1.6% YoY, more than the market consensus of -0.9%. The weaker-than-expected economic performance was mainly due to subdued private consumption that dropped 2.9% YoY as a result of the sales tax hike in October 2019. Furthermore, business spending during the period plunged by 3.7% YoY, the biggest fall since 3Q18. Government spending grew by 0.2% and public investment increased by 1.1%, with both figures missing expectations. January exports dipped less than expected, by 2.6% YoY, while imports dropped by 3.6% YoY.

Figure 1: Japan quarterly GDP growth (YoY %)



Source: CEIC, KGI Research

4Q19 macro data implies a higher risk of entering a technical recession. Based on the past five-years, private consumption contributes over 50% of total output, and foreign trade accounts for around 35% of Japan's GDP. Yet entering 1Q20, consumption tax continues to plague the sector, while foreign trade is expected to decline due to the slowdown in China as the coronavirus outbreak continues to disrupt supply chains.

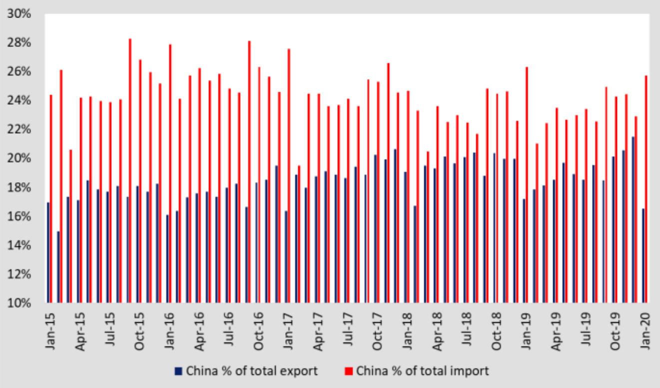
Against the backdrop of the ongoing outbreak of COVID-19 in China that has likely yet to peak, the infection rate in Japan is potentially just starting its exponential climb. As of 20-Feb, there were a total of 634 infected cases in the country, out of which, 542 were from the Diamond Princess Cruise ship, while the rest were domestic. So far, there has only been one death reported.

Warning - Speed bumps ahead. We mentioned in our previous reports that the global supply chain is temporarily disrupted due to China's partial shutdown of its economy. Just after the US, China is Japan's second largest trading partner, accounting for a five-year average of 18% and 24% of the total value of imports and exports, respectively. Trade value growth (both imports and exports) between China and Japan have been trending downwards, and we believe this is closely associated with the softening demand of automobile sales in China, especially since Japanese-branded auto sales takes up a sizable 17.8% of market share in China. In addition, several domestic best-selling auto manufacturers still install engines that are made in Japan.

According to the latest news reports, Toyota's factories in Guangzhou city and Changchun city had resumed operations on 17-Feb, and in Tianjin city on 18-Feb, but are only running at half-capacity. Its remaining factory in Chengdu city is scheduled to resume on 24-Feb. Honda's factory in Guangzhou (one of two plants) have also resumed operations but three plants in Wuhan are still shut until at least 10th March. Following the resumption of production at Nissan's Guangzhou factory on 17-Feb, the rest of its factories in Dalian, will resume on 21-Feb, and in Xiangyang and Zhenzhou on 24-Feb.

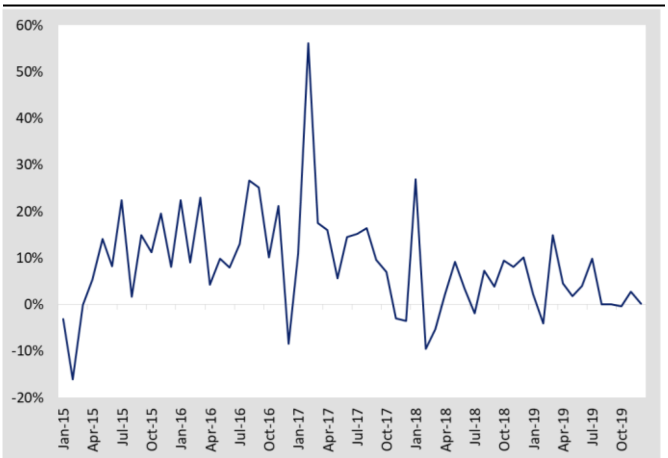
According to the China Passenger Car Association, auto sales in the first half of February 2020 plunged 92% YoY and is expected to drop 70% for the full month. Consequently, we foresee that this will have a substantial drag on the auto components trade between China and Japan.

Figure 2: China and Japan trade value growth trending downward



Source: CEIC, KGI Research

Figure 3: Japanese brand auto sales growth in China

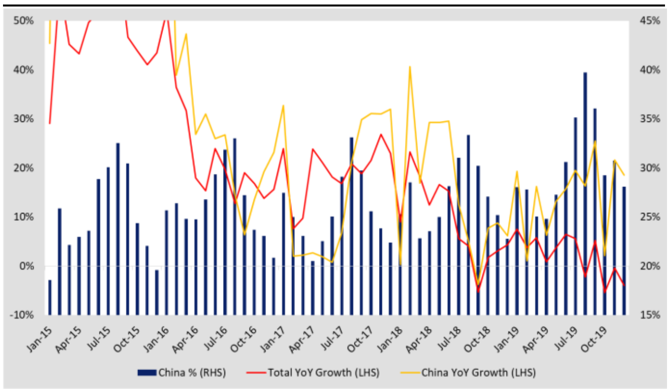


Source: CEIC, KGI Research

Tourism to take a holiday. Tourism contributed more than 7% of Japan's GDP in recent years. Over the past two years, visitors from China have become the main driver of Japan's tourism industry, given that the visitors from China have outpaced overall tourism growth.

However, due to the COVID-19 outbreak, not only have China's tourists been confined domestically, but there are increasing concerns from global tourists on the rising cases of infections in Japan. As a result, we expect the decrease in China's visitors to potentially impact Japan's GDP by 0.4% to 0.5% this year.

Figure 4: China visitors are main drivers of Japan's tourism



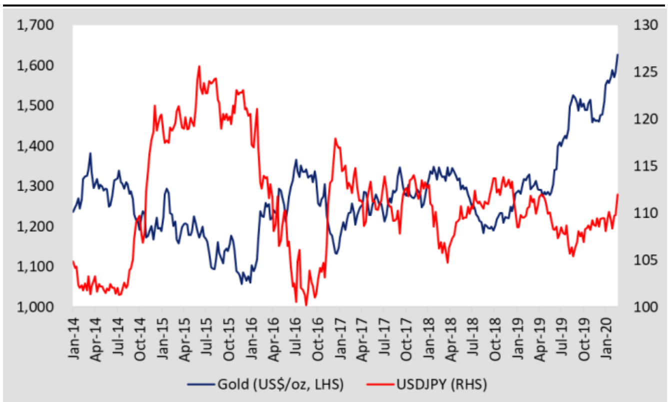
Source: CEIC, KGI Research

Stealth outbreak. The infected cases in Japan have been increasing, and authorities have not completely mapped out cluster tracing of those infected. While the Japanese passengers who have already disembarked from the Diamond Princess Cruise ship have been tested to be virus-free, the accuracy of such tests are not fool-proof. Cases in China have shown that patients who had initially tested negative eventually turned out positive for the virus after a much longer incubation period. Hence, there is still significant uncertainty surrounding those who disembarked - potentially as silent spreaders.

What is sure at this point though, is the shrinking confidence in authorities who think the situation is under control, similar to what China's authorities claimed during the early stages of the outbreak in Wuhan.

Follow the FX. FX markets are reflecting the pessimistic sentiments on Japan's economic prospects. Traditionally, JPY has been traded as a safe haven asset, almost equivalent to gold. However, since Japan raised its sales tax in Oct-19, the synchrony has been broken, indicating expectations of ensuing weakness in Japan's economy, as already evident from the 6.3% annualised decline in 4Q19. From 19-Feb to 20-Feb, JPY depreciated by 2.7% as more negative news surfaced. As a result, we believe that it is highly likely for Japan to enter into a technical recession with 4Q19 and 1Q20 GDP declining consecutively.

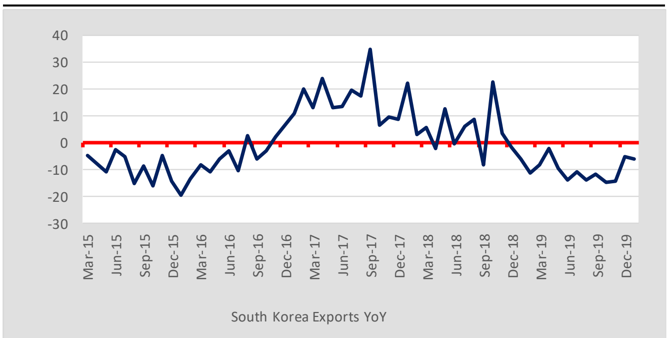
Figure 5: JPY weakens comparing to gold



Source: Bloomberg, KGI Research

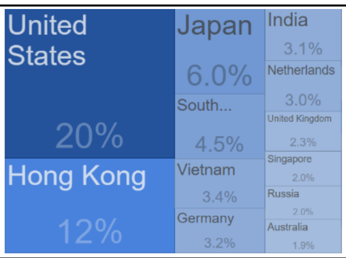
South Korea – barely out of the woods in 2019, and now this. In addition to Japan, it is worth looking at South Korea given that the country is the 4th largest economy in Asia and the 12th largest in the world. In 2019, South Korea's economy was battered by declining exports (-10% YoY in 2019) due to the US-China trade tensions, China's slowdown and a cyclical downturn in the memory chip market. With exports accounting for 24% of South Korea's GDP, prolonged disruption to China's supply chain will eventually have a knock-on effect on the rest of the economy. This is even before taking into account the potential outbreak in the country, which would further disrupt its internal supply chain and have a significant impact on the global technology manufacturing sector that relies heavily on the country's semiconductor exports.

Figure 6: South Korea Exports (YoY %)



Source: Bloomberg, KGI Research

Figure 7: China's top trading partners (% of total exports in 2018)

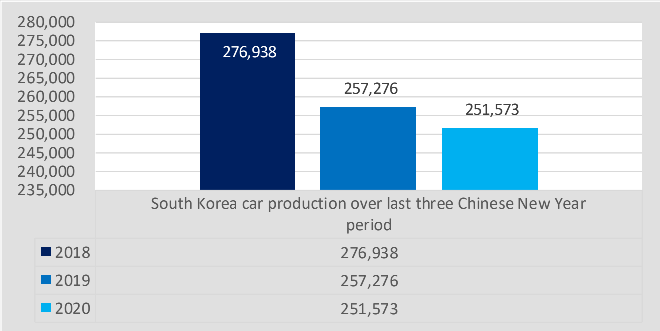


Source: Trading Economics

Early indicators are flashing warning signals. An early set of economic data released for the month of January is already pointing to the impact from the coronavirus outbreak on South Korea's economy. China is the largest export destination for South Korea, accounting for 25% of total exports, and exports are heavily made up of technology-related products. On the other hand, South Korea is the fourth largest export market for China, and accounted for almost 5% of China's total exports. Around a third of China's exports to South Korea are intermediate goods, and hence a critical piece of the economy.

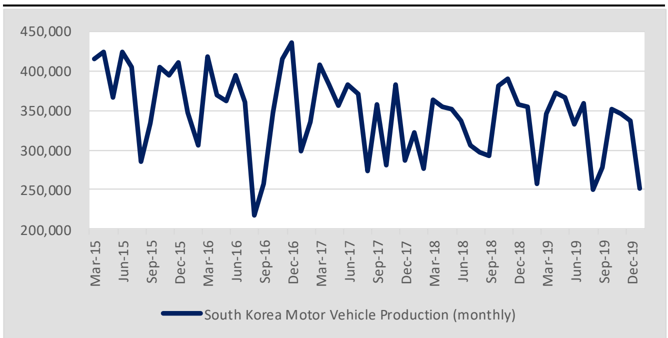
The most significant news so far in South Korea's auto sector, is where key car manufacturers such as Kia and Hyundai have had to temporarily halt production due to parts shortages from China. This was the first time that both car makers had to suspend all of its domestic plants since the Asian Financial Crisis in 1997. From a macro perspective, South Korea's car production in 2020's Chinese New Year period (January) is down 2% from 2019 and 9% lower than 2018.

Figure 8: South Korea car production over the last three Chinese New Year periods (2018 to 2020)



Source: Bloomberg, KGI Research
**Chinese New Year: Feb 2018, Feb 2019, Jan 2020*

Figure 9: South Korea motor vehicle production (monthly). Latest month data is for January 2020, which showed one of the lowest in 5 years



Source: Bloomberg, KGI Research

Impact on technology sector. In the technology sector, the largest impact from supply chain disruption will be on components used in high-end electronics products such as phones and computers. In particular, disruptions to companies such as Samsung and SK Hynix would have a significant impact on the technology supply chain as they produce critical components such as LEDs and memory chips.

Just yesterday (20-Feb), SK Hynix announced that 800 of its workers in South Korea had quarantined themselves following news that one of its trainee has a close contact with a virus patient in the Southern city of Daegu, which is now the epicentre of the outbreak in South Korea. SK Hynix is the world's 2nd largest memory chipmaker and supplies to key phone makers such as Apple and Huawei.

Tourism to take a hit but less impact than on Japan. Similar to Japan, South Korea's tourism industry relies heavily on Chinese tourists. There were 6mn Chinese tourists which made up 33% of the total number of inbound visitors to South Korea in 2019. However, we think that the impact may not be as severe given that the tourism industry only makes up 2.7% of South Korea's economy.

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