KGI CHINA DEVELOPMENT FINANCIAL

Market Strategy

Perfect storm: Encountering black swans and grey rhinos (Part One)

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- **Where are we now?** At the moment, we are at the intersection of a black swan (extremely rare but severe impact) and grey rhinos (highly probable, high impact yet neglected).
- Financial markets have finally realised the possibility of a much larger-than-expected impact of COVID-19 – the likelihood of a global recession will only increase in the coming weeks. With China's economy significantly disrupted in 1Q20, the coronavirus outbreak in the US has the potential to derail US economic growth in 2Q20.
- Thus, with a potential synchronised slowdown in two of the world's largest economies, we believe risk-assets may face more downward pressure in March. Occasionally, there may be bouts of counter-trend rallies on news of fiscal and monetary stimulus.
- We maintain our recommendations to be cautious and not chase rallies. Remain diversified with enough cash to deploy when opportunities arise. Precious metals remain one of our favourite asset class. We reiterate to buy gold and silver, with a target price of US$1,700/oz and US$25/oz, respectively (under review as we have not factored in the surprise rate cuts and potential for more cuts at the next FOMC meeting on 18 March 2020).

Black swan. COVID-19 is deemed a black swan event as it was completely unforeseen, and financial markets had initially shrugged off its potential economic impact. It has been more than two months since the COVID-19 outbreak, yet the number of infected cases continues to surge globally. Although China seems to have contained the spread outside Hubei province, countries such as South Korea, Japan, Iran, and Italy have yet to control the outbreak; the likelihood of COVID-19 becoming a global pandemic is increasing. And just as in 2008's global financial crisis, the consequences will most likely catch people off-guard due to the abrupt downturn of the economy.

Naughty rats! The last time a black swan occurred was in 2008, which coincidentally was also the year of the rat in the Chinese calendar. However, there are fundamental differences in how the 2008 and 2020 events have played out and are currently playing out. The crisis in 2008 was due to over-leveraging which resulted in a liquidity crunch that brought down the global financial system. This subsequently had an impact on the economy and businesses. The reverse is now happening with the COVID-19 outbreak, where a disruption to businesses and supply chains due to the implementation of far-reaching quarantine measures has resulted in trembling financial markets.

Vaccine for the global economy. With more macro data being released, the global economy in 1Q20, especially the economic performances of countries near the epicentre of the outbreak such as China, South Korea, and Japan, will (almost certainly) be underwhelming. Although an effective treatment or vaccine for COVID-19 have not yet been developed, the treatment for an economic downturn has already been established long before. Central banks are now implementing the traditional methods to bring relief to the economy, which mainly include interest rate cuts and liquidity injections. The Chinese government has implemented a series of tax cuts, and expanding public spending on infrastructure projects seems to be simply a matter of time. However, we would like to point out a few grey rhinos that we see.

What are these raging grey rhinos we speak of? Grey rhinos, as described in Michele Wucker's "The Gray Rhino", describe events that are not complete surprises, but occur amid a series of visible warning signals. The global economy prior to the COVID-19 outbreak was widely expected to recover against the backdrop of the trade war 'truce' between China and the US. Earlier in the year, the IMF had projected global growth of 3.4% with the key assumption that China and the US collaborate to resolve the trade dispute, helped as well by the reduction of other uncertainties such as Brexit.

There is still a significant amount of uncertainty of how the current outbreak will play out or when it will eventually taper off, but a key effect is almost certain: this event is a potential catalyst for further de-coupling between China and the US. With the US presidential elections heating up, President Trump may use the opportunity to direct domestic concerns over the slowing economy and the handling of the virus outbreak in the US, towards China.

On the other hand, China seems to be faced with problems both internally and externally. We have been reiterating that China is facing stagflation headwinds, and the authorities are now facing a dilemma of whether to use credit stimulus to boost the economy. Since the global financial crisis in 2008, China significantly increased its debt-to-GDP levels. China's economy over the last decade has been characterised by infrastructure and real estate developments. However, the negative consequences have emerged over the past two years. Provincial government deficits have ***skyrocketed***, together with the rise in household debt (mainly in house mortgage).

The increasing indebtedness in China has put a cap on the authorities' ability for huge credit stimulus to revive growth. Furthermore, there are rising public concerns on rising food prices (adding on to the already unaffordable property prices), which also limits the willingness for more credit expansion. Another point to note is the nationalisation of China's economy since 2014, where a larger share of bank loans and subsidies are tilted towards state-owned enterprises (SOE), whose return on equity (ROE) are seldom insufficient to cover their cost of capital. We have already seen a few top SOEs such as Tewoo and Founder default on multibillion RMB worth of bonds.

Here, we highlight several grey rhinos that investors should pay attention to:

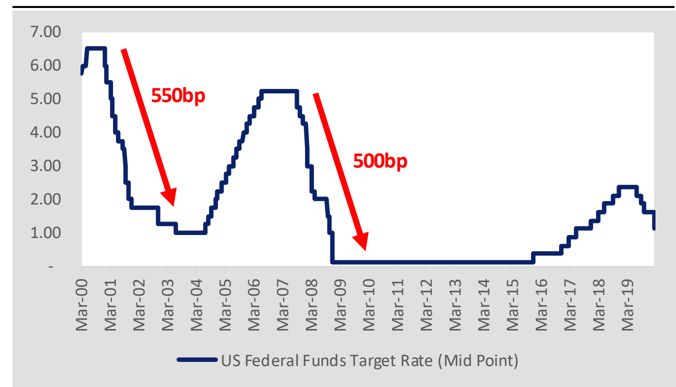
1. **Zero interest rate policy with little ammunition left amid rising recession risk in the US (*We talk about this in the section below*).**
2. **Debt issues in China amid the disruption to the economy.**
3. **Second round of trade dispute between China and the US in the election year.**
4. **Supply chain reallocation in Asia, which in the long-term will benefit Southeast-Asian countries.**
5. **Brexit risks still haunting the EU.**

In the next few weeks, we will give detailed analysis of each issue in subsequent reports.

Historical precedence for US Federal Reserve's emergency 50bp cut. The US Federal Reserve announced an emergency 50bp cuts on 3 March 2020, citing downside risks from the coronavirus outbreak. However, monetary policies such as rate cuts may not be sufficient to prevent a recession if the outbreak affect consumer behaviour and continue to disrupt global supply-chains.

Our analysis of the two previous instances of 50bp rate cuts in January 2001 and September 2007 showed that a recession in the US still followed after around a lag of around 3 months (see Figure 1). Making matters worse, the US Federal Reserve now has less room to cut rates compared to 2001 and 2007, when it slashed rates by 550bp and 500bp respectively. Therefore, recession risks are clearly rising to the highest level since the global financial crisis in 2008.

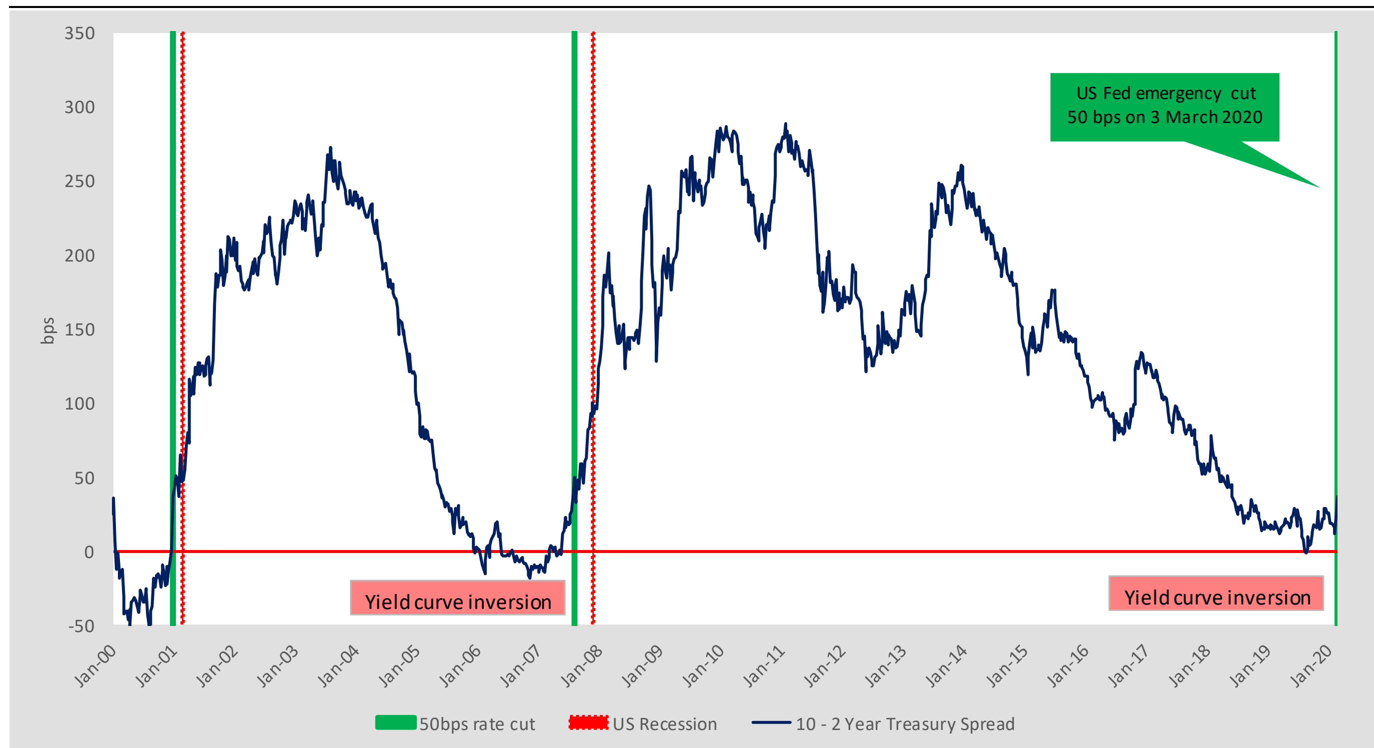
Figure 2: US Federal Funds Target Rate (Mid-point). Interest rates are already near historical lows going into the current economic slowdown.



Source: Bloomberg, KGI Research

US recession risk

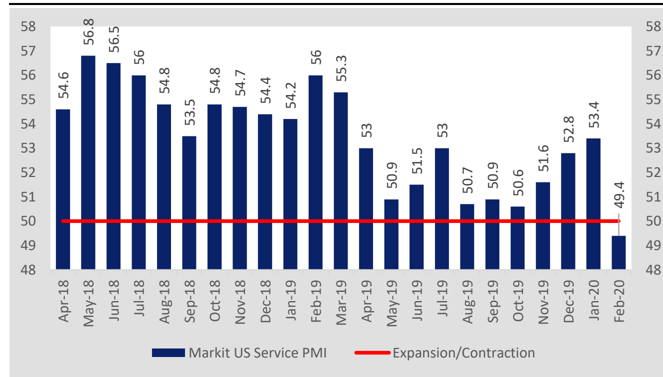
Figure 1: US 10-2 Year Treasury Spread, 50 bps cuts and subsequent recessions (20 Years)



Source: Bloomberg, KGI Research

Fragile economic support; Covid-19's final blow. Early signals such as the US Service PMI, which dropped to the lowest level since October 2013, indicate the growing concerns about the coronavirus outbreak. Given that the US manufacturing sector was already slowing down in 2019 and that the only area holding up the US economy were the consumers, a negative unforeseen and external shock such as the coronavirus outbreak has the potential to deal the final blow.

Figure 3: IHS Markit US Services PMI. The Service PMI surprised with a reading of 49.4 in February 2020, the lowest level since October 2013.



Source: Bloomberg, KGI Research

Watch for US employment and services sector. Over the coming weeks, important economic data tracking employment in the US, specifically jobless claims, and the service sector will be critical. This is mainly because the month of March will be a vulnerable window where we may see a synchronised slowdown of the two largest economies in the world, which would be negative for risk assets in the next few months.

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