China's coronavirus challenge

China faces broad-based challenges from the coronavirus outbreak, from retail to manufacturing to possible defaults in bank loans and bonds. But the government is going to give a strong dose of fiscal stimulus

1 Retail takes a hit

The coronavirus has hit China's services sector hard. Shops are empty and restaurants are suffering, as people stay at home. Worries that the virus could be spread through delivery services has dealt a further blow to the industry.

Some services--such as children's after-school classes- have stopped completely.

Mass transportation and inbound tourism have taken a hit and outbound tourism has fallen, too. While the drop in Chinese spending abroad will help China's GDP growth, the rest of the world will pay for it.

2 Manufacturing will suffer, too

The manufacturing sector is also feeling the strain. Many factory workers went back to their home towns for the Lunar New Year holiday and have been unable to return to work following the lockdown of Chinese cities. It's unclear when or if they will be able to go back. Local governments are likely to relax travel restrictions only when the virus has been contained.

For now, many workers are concerned that they won't be allowed to return, and even if they do, the factory may not have enough workers to function. That said, workers may struggle to find a job in their home towns. Hence the uncertainty. The situation should be clearer two weeks from now.

There is a high chance that some production lines will be stopped, which will hurt output and exports. The more labour intensive the factory, the more it will be affected. This will delay investment in production lines even if there is demand.

3 Loans and the credit sector at risk

We highlight two points for the loan and credit sector as a result of the coronavirus:

1. Regardless of whether companies are hit by sales or production, they may struggle to repay debt. The non-performing loan ratio could increase from the level of 1.86% recorded in the third quarter of last year. In fact, we expect this to go up to around 2.5%, a level similar to that seen in the fourth quarter of 2008. History tells us that when the NPL increases, bank loan growth falls and so too, does GDP growth.
2. In China, it is common for borrowers to pledge equities as collateral for loans. If the A-share stock market falls, the collateral value will fall as well, and borrowers may need to top this up. However, it will be difficult to top up collateral when asset prices are falling. Though some news reports claim that the Chinese government could install administrative measures to stop A-shares from falling, e.g. by the four state-owned asset management companies buying stocks, this may not prop up every stock that is being used as collateral for loans and credit. Without enough collateral, borrowers may need to wind down their outstanding loans and credit or risk default, which will also hit GDP growth.

Fiscal stimulus is the cure for the coronavirus

We expect that the Chinese government will increase fiscal support to stabilise GDP growth. Before the outbreak of the coronavirus, we predicted 2 trillion yuan of fiscal stimulus, but we now believe this will go up to at least 3.5 trillion yuan in 2020, which is 3.5% of nominal GDP for this year.

Most of the fiscal money will be used in the medical sector to try to combat the virus, to cure patients and to prevent more confirmed cases. This will directly and indirectly support GDP.

Two hospitals have been built, and we expect more to come. With the additional hospitals, there will be a need for more hospital beds, medical equipment and medical vehicles.

Monetary easing will calm the market

Aside from fiscal stimulus, monetary policy will ensure ample liquidity in the market so there is no squeeze in short-term interest rates. This reduces the possibility of market volatility.

We expect one more rate cut of 10 basis points and one more RRR cut of 0.5 percentage point in the second quarter if the coronavirus continues in the coming months.

Low energy price will support real GDP growth

As activity has slowed down, energy prices have dropped, providing some support to China’s real GDP. However, this is not good news for producers.

Our GDP forecasts for 2020

Assuming that the coronavirus is contained in the second quarter (without new confirmed cases) we expect China's economy to grow 5.4% year-on-year in 2020, revised down from our previous estimate of 5.6%, reflecting lower loan growth.

1Q20- 5.0%

2Q20- 5.2%

3Q30- 5.5%

4Q20- 5.8%

What will the recovery look like

We do not expect a speedy recovery for the economy, even in the unlikely event that there are no new confirmed cases. After the coronavirus has been contained, it may still take four quarters to see a full recovery.

Consumers will still be cautious, which will continue to affect both inbound tourism and global tourism. They will avoid crowds and places like the gym room, swimming pools, and cinemas.

Factories should recover faster than the consumer sector, which will help loan growth to recover as well.

Our forecasts on USD/CNY for 2020

We are maintaining our USD/CNY forecasts (by end of the year) as we see the currency market remaining calm. Our range forecast for the USD/CNY in 2020 is 6.5-7.2.

In a worst case scenario, which includes a rapid increase in new confirmed cases and a rise in the mortality rate, the yuan could weaken to 7.20. When the virus is completely under control, e.g. with no new confirmed cases, we see the currency rallying to 6.5.

Other factors, notably the technology war and the trade war, may re-emerge as the key drivers of the currency once the virus has been contained. The market is already anticipating RRR cuts and interest rate cuts, so we don't expect that easing by the People's Bank of China will have much impact on the USD/CNY.

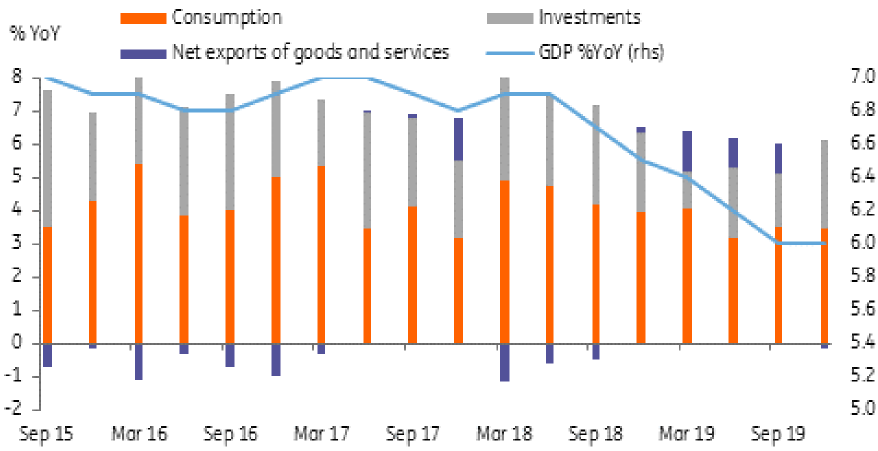
1Q20- 7.050

2Q20- 7.000

3Q20- 6.950

4Q20- 6.850

China GDP by component. Going down to 5.0 in 1Q20?



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