IS CHINA A SAFE HAVEN?

After an initial cover-up and more than 3,000 deaths, China appears to have brought COVID-19 under control, just as the spread of the coronavirus is accelerating across the U.S. and Europe. With China’s domestic-demand driven economy set to rebound and mainland investors avoiding the panic that has smacked western markets, its economy could put a floor under global growth and offer a safe haven to investors.

Progress towards controlling COVID-19 is key

When thinking about prospects for the Chinese economy through the rest of 2020, one of the most important factors is whether the coronavirus remains under control. At this point, China appears to have wrestled COVID-19 into submission. Over the five day period ending March 18, the average number of daily new cases was 21. During the five days ending February 18, the average was 2,067 new cases per day.

China’s progress in containing the virus gives hope to and offers lessons for the rest of the world. A study by a team of researchers from the U.K., U.S. and China found that the non-pharmaceutical interventions (NPIs) used in China were effective—especially early case detection by testing and contact reduction (social distancing). Without those measures, “the number of COVID-19 cases would likely have shown a 67-fold increase.”

The study also concluded that delays in implementing these NPIs were costly. “If NPIs could have been conducted one week, two weeks, or three weeks earlier in China, cases could have been reduced by 66%, 86% and 95% respectively, together with significantly reducing the number of affected areas.”

Figure 1. COVID-19 NEW CASES FALLING IN CHINA BUT RISING ELSEWHERE

China mainland outside Hubei

Hubei surged to 14,840 on Feb. 12 due to revision of diagnosis criteria.

Sources: CEIC, Johns Hopkins CSSE, Worldometer

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1. https://www.worldpop.org/events/COVID_NPI
The number of hospitalized patients with COVID-19 fell to 7,263 on March 18, down from a February 17 peak of 58,016. Excluding Hubei, where Wuhan is the provincial capital and where the outbreak began, only 271 patients were in hospital across the rest of mainland China. The recovery rate is now 87% nationwide (up from 19% a month ago), and 97% excluding Hubei.

In China ex-Hubei, there have not been any new local cases (as opposed to cases in people arriving from overseas) since March 12. Continuing to keep the virus under control is critical, as COVID-19 is the root cause of the China’s current economic distress.

Unfortunately, it appears that the coronavirus situation is getting worse in much of the rest of the world just as it is improving in China.

Economic damage in China so far

A few days ago, China published the worst macro data since the Tang Dynasty. Retail sales declined 21% year-on-year (YoY) in nominal terms, and 24% YoY in real (inflation-adjusted) terms during the first two months of the year. Industrial value-added fell 14% YoY during January/February, including a 27% month-on-month decline in February, when the virus was at its peak. Electricity generation declined 8% YoY in January/February. Fixed asset investment was down 25% YoY during the first two months.
Figure 4. KEY MACRO DATA WAS DISMAL IN JANUARY/FEBRUARY

We should keep a few things in mind when looking at these dismal numbers for January/February (combined because of the floating nature of the Lunar New Year holiday). First, this was not a surprise. With the coronavirus raging and most shops, factories, offices and restaurants shuttered, the economy was on lockdown. The numbers were even uglier than most anticipated, which is good! First, because it reflects that China’s leaders were focused primarily on fighting the virus, rather than on short-term economics. Moreover, these ugly numbers indicate that the leadership didn’t fudge the data to hide the seriousness of the situation.

Keeping the timeframe in context is also important. For example, the first two months of the year typically account for only 6% of full-year fixed asset investment by value, and the first quarter accounts for only 14%. (Winter weather and the Lunar New Year holiday limits construction activity.) So, as life gradually returns to normal, and assuming that most businesses see activity pick up by next month, the majority of missed construction activity will likely be postponed, not cancelled.

Residential property sales declined 39% YoY during the first two months, but that period usually accounts for only 7% of full-year sales. Assuming that middle-class income does not suffer a longer-term hit, demand for new apartments is likely to only be postponed, not eliminated.

Prospects for economic recovery

It is important to recognize that the dismal economic numbers for the first two months are not the result of structurally weak supply or demand, nor is it about structural weakness in China’s financial system. The problem has been that COVID-19 forced everyone to shelter in place behind closed doors. Now that the virus has been brought under control in China, those doors are gradually opening, and life is starting to return to normal. The Zhou family that was planning to buy a new car or apartment over the last couple of months, is probably still going to do so later this year.

This return to normal will take time, and the March and first quarter numbers will also be soft.

There will be sectoral differences. It may take longer for services like restaurants and entertainment to bounce back. Not because the Wang family can’t afford to eat out or go to the movies, but because it may take them a while to feel safe from the virus in crowded places.
During the 2003 SARS (severe acute respiratory syndrome) outbreak, retail sales and other economic activity was halted, generating similarly dismal first quarter macro numbers. But, after the SARS coronavirus (which is genetically similar to COVID-19) was reined in, the economy bounced back quickly. By the end of 2003, looking back at the full-year data, it was difficult to see the impact of SARS.

**Figure 5. LIMITED IMPACT OF SARS IN 2003 AND BIRD FLU IN 2005-2006**

![Graph showing limited impact of SARS in 2003 and Bird Flu in 2005-2006](image)

This is not a perfect analogy: SARS affected 26 countries and resulted in more than 8,000 cases, while COVID-19 has affected more than 150 countries and resulted in over 200,000 cases, including more than 80,000 in China. But SARS was also a short-term health crisis that shut doors, and while the economic recovery from COVID-19 will take significantly more time, it is likely to be as complete. While the recovery from SARS was “V” shaped, this time it is more likely to be “U” shaped.

This recovery is underway. For example, daily coal consumption at major power generation plants is now back to about 70% of where it usually is at this time of year. Most of the migrant workers who staff China’s urban factories and shops had returned to their home towns and villages for the Lunar New Year holiday and were stuck there when travel restrictions were imposed. About three-quarters of them are now back in the cities where they work. Friends and colleagues in China report that life is gradually getting back to normal.

**Figure 6. CHINA IS GETTING BACK TO WORK**

![Graph showing rate of recovery post-Lunar New Year (LNY)](image)

Sources: CEIC

Sources: WIND, Baidu
Consumers are optimistic about the future, according to a survey conducted in 56 cities between February 27 and March 5 by the China Quantitative Insight team at Credit Suisse. Of the 800 consumers surveyed, more than 80% said they expect their family’s disposable income in 12 months will be the same (33%) or higher (50%) than the current level.

**Figure 7. CONSUMERS ARE OPTIMISTIC ABOUT THE FUTURE**
Survey of 800 consumers in 56 cities across China, February 27–March 5

You expect your family’s disposable income will ___ in 12 months, compared with the current level

<table>
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<th>% of respondents</th>
<th>September 2019</th>
<th>October 2019</th>
<th>November 2019</th>
<th>December 2019</th>
<th>January 2020</th>
<th>February 2020</th>
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<td>100%</td>
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</tbody>
</table>

Sources: CQI/Credit Suisse, Matthews Asia

It is also worth remembering that the Chinese economy was healthy ahead of the arrival of COVID-19. Last year, final consumption accounted for almost 60% of GDP growth, and consumption rose 9.4% YoY in the fourth quarter, up from 7.3% in the first quarter.

Another buffer is that Chinese families have a very high savings rate (about 34% of disposable income for urban residents), as well as a relatively low household debt-to-GDP ratio of 54%, while household bank deposits are equal to more than 80% of GDP. To put this into context, Americans save 7.9% of their disposable income, the U.S. household debt-to-GDP ratio is 75%, while household (plus nonprofit organization) savings deposits are equal to 47% of GDP.

**Figure 8. DOMESTIC DEMAND WAS HEALTHY AHEAD OF THE CORONAVIRUS’ ARRIVAL**
Household consumption rose 9.4% in 4Q19 vs. 7.3% in 1Q19

Sources: CEIC, NBS
The Chinese government has plenty of dry powder

China’s central bank and finance ministry have not hefted their stimulus bazookas, preferring to take a more cautious and targeted approach to mitigating the economic impact of the coronavirus. They are keeping their large stores of powder dry, while they wait to see if the domestic demand drivers can recover under their own power.

China has taken modest steps to ensure adequate liquidity, and to reassure consumers, corporates and investors that the government has their back. I think most in China believe that their government has the political will, tools and resources to undertake the kind of large-scale stimulus that enabled China to put a floor under global growth during the Global Financial Crisis (GFC). This is one reason why China’s domestic stock market has fallen far less since the start of the year than many of its overseas counterparts.

Beijing’s cautious approach is based on the understanding that they are still paying off the world’s largest Keynesian stimulus from a decade ago. The government is also wary of relaxing restrictions on new home purchases, to avoid a sharp spike up in prices.

I have no doubt, however, that if the domestic economy fails to show clear signs of reawakening in April, the government will step in with some of the bazooka-like measures deployed during the GFC. Interest rates in China are relatively high, so there is room to cut. More importantly, the growth rate of credit outstanding in the economy has been modest by Chinese standards, so there is room for the kind of dramatic credit stimulus undertaken in 2008-09, much of which could be used to ramp up infrastructure construction for the purpose of creating temporary jobs to manage rising unemployment.

**Figure 9. ROOM FOR CREDIT STIMULUS IF NEEDED**

Augmented TSF outstanding = total social financing (TSF) outstanding - equity financing from Jan. 2017, TSF includes treasury bonds.
Source: CEIC, Matthews Asia estimates

**Key risks**

There are two key risks to the scenario in which China becomes a global safe haven. First, that the virus roars back as people in China resume their normal interactions. But, life has been slowly returning to normal in much of China over the last couple of weeks, and the virus has remained under control. This will remain a risk, however, in part because the virus is being brought back to China by travelers from other countries. (Over the last week, all of the new COVID-19 cases in China ex-Hubei were imported from other countries. The total number of new cases across China was only 34 on March 18.) The government has begun quarantining arrivals from many countries in an effort to manage this risk.
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The second risk is that the smaller, privately owned companies that drive China’s growth and job creation (and thus the consumption story) may have difficulty surviving long enough to see their businesses recover. These firms are not likely to have a lot of savings, or access to bank loans. Can they find a way to pay rent and salaries, and then restock inventory while waiting for normal transaction volumes to resume? Here, government policy will be important, and the Party has acted far more decisively than many other governments, suspending collection of taxes and fees (everything from social security and unemployment to housing provident fund contributions), and encouraging landlords to do the same with rent. Other assistance to small, private firms is likely, and while the success of these measures is far from guaranteed, I’m optimistic.

There are two other risks that investors have raised with us, which worry me less. Stress on small private firms may result in some bankruptcies and inability to service loans, but this is very unlikely to have a significant impact on the health of China’s banking system. Loans to small and micro-sized firms account for only 7.6% of total loans outstanding, and the average size of those loans is about RMB 428,000, or roughly US$ 61,000.

Finally, some investors have asked about the risk that a global recession might derail a Chinese recovery. I think this risk is low, as China is a domestic-demand driven economy. Last year, consumption accounted for almost 60% of GDP growth. The gross value of exports was equal to 17% of China’s GDP last year, but almost 30% of those exports were processed goods for which little value was added in China. Significantly, over the last five years, net exports (the value of a country’s exports minus its imports) have, on average, contributed zero to China’s GDP growth. So while a collapse in demand for Chinese exports would be a drag on the recovery, it would likely be a modest drag.

In my view, the most likely scenario is that in the coming quarters China’s domestic-demand driven economy will rebound, enabling the PRC economy to put a floor under global growth (as during the GFC) and offer a safe haven to investors. China is likely to continue to account for about one-third of global economic growth, larger than the combined share from the U.S., Europe and Japan.

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