China After "Liftoff" And A Glimpse Into The Post-Covid World

In This Report

The lockdown of Wuhan, China's epicenter of the Covid-19 outbreak, was officially lifted last week – a major milestone in the country's fight against the pandemic. But uncertainty remains high, ranging from the immediate challenge of preventing a "second-wave" infection to dealing with some potential long-term social, economic and geopolitical challenges in the post-Covid world. It is impossible for the Chinese authorities to map out all policy actions in advance, and our contacts in Beijing confirmed heated debates among top policymakers on the optimal policy combination to deal with the rapidly evolving situation. Our view is that China's growth-boosting efforts will likely target a base-case scenario, with many contingency plans depending on ever-changing signposts. What's more certain is that as China is ahead of other countries in the pandemic curve, the situation in the country provides valuable clues for the rest of the world.

The Risk Of A "Second Wave"

We've been talking to some top Chinese epidemiologists and infectious diseases clinical specialists in recent weeks to better understand the pandemic situation in China. Almost all of the experts we spoke to agree that the risk of a second-wave infection is an important concern, so long as the virus is still circulating in other parts of the world. However, these informed professionals are also confident that the risks should be manageable. There are two potential sources for a second wave, both of which are being closely watched by the authorities (**Chart 1**).

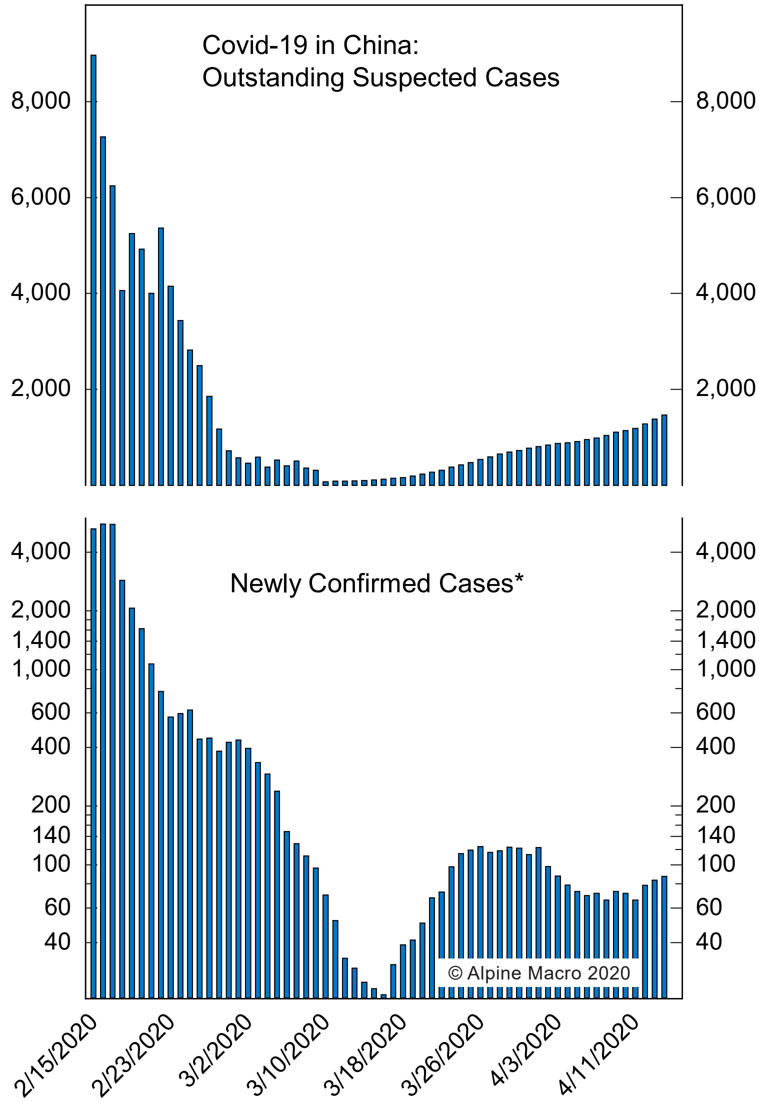
The first is "imported cases" from people traveling from other countries. International arrivals now face mandatory quarantine upon entering China, which should minimize the risk of community transmission. Moreover, the country's public health emergency response system in place has proven effective in dealing with infectious diseases originated from abroad. Historically China has had a fairly successful track record in containing the local spread of some other recent outbreaks originated from other countries, such as H1N1, MERS and Ebola. The sets of procedures and measures in place have been repeatedly tested when the system is on high alert.

The second potential source is asymptomatic patients. Health authorities concede that this is the bigger concern, but they are also cautiously optimistic. First, the country is broadening testing to detect as many asymptomatic cases as possible. Second, not all infected cases will stay asymptomatic. Eventually they will spread to people who will show symptoms, which will then trigger surveillance activities to isolate these cases, start contact tracing and break the chain of transmission. Nonetheless, the threat of asymptomatic cases and transmission needs to be closely monitored, particularly in the next two to four weeks as Wuhan gets back to normal.

Moreover, most experts believe that a second-wave infection, if it happens, should not be as disruptive as the first one, because the country's medical system has become better prepared after an extreme stress test. In general, the onset of an outbreak is particularly threatening because the medical system is mostly caught off guard. Overall, the risk of a second wave infection that would lead to another largescale "lockdown" appears very low at the moment.

A bigger concern among Chinese public health experts is potentially low "herd immunity" among the Chinese population, particularly outside of the Hubei province, the epicenter. This means that the population is more susceptible to the disease, even when the pandemic runs its course in other countries, where the general public develops "herd immunity" and business returns "back to normal." Low immunity could continue to depress the Chinese economy until an effective vaccination becomes widely available. For now, the Chinese authorities' focus is shifting to prepare for large-scale nucleic acid testing to detect asymptomatic patients, and serological testing to collect antibody data among the population. This will provide important epidemiologic data for future medical strategies. Meanwhile, scientists have been racing to develop a vaccine. So far three Chinese vaccine candidates have been approved for clinical trials, one entering phase II trial starting this week.

Chart 1 Guard Against The "Second Wave"



*Shown as 5-day moving average and in logarithm
Source: China National Health Commission

Conditions For "Liftoff"

China's "first in, first out" experience with the Covid-19 crisis could give some clues as to when and under what conditions other countries can gradually resume business activity. Most Chinese experts we talked to would prefer to delay the "liftoff" as much as possible to minimize the risk of a second wave. From the government's point of view, however, the decision eventually boils down to how much social and economic disruption a country can afford in order to protect public health. China's "lockdown" decision was to a large extent due to the fact that the outbreak erupted during the Chinese New Year holiday when business was already very slow. The decision would have been a lot more difficult if it had happened during another period.

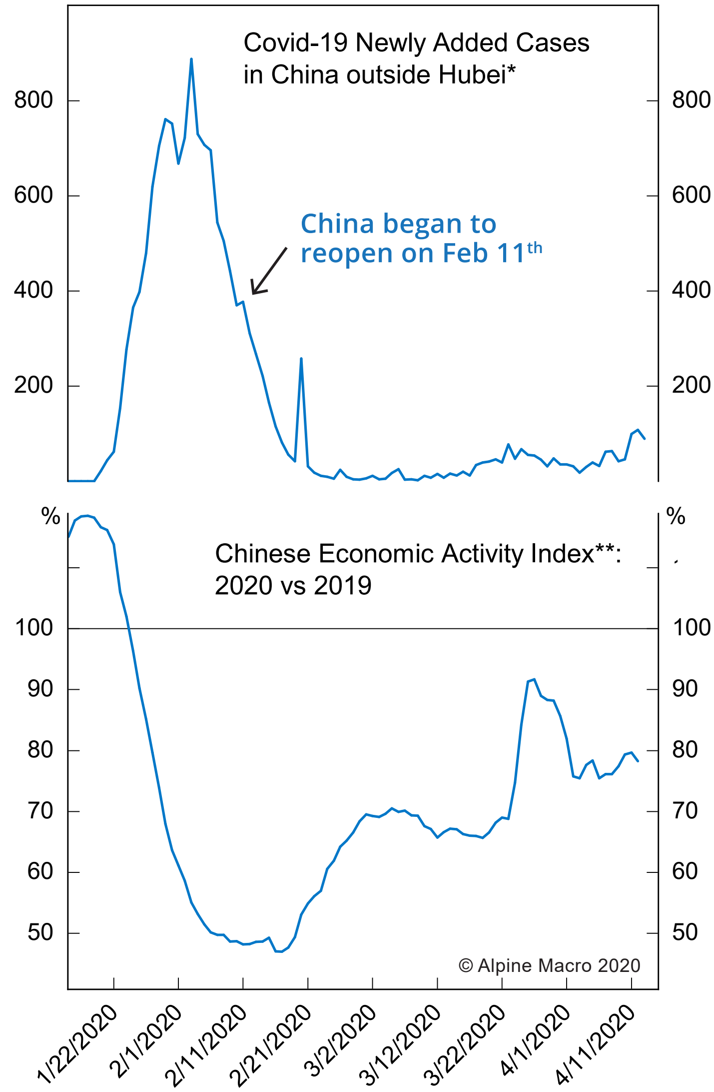
Therefore, conditions to lift the lockdown will inevitably vary among countries. From China's experience, a few conditions could be important.

- Signs that the spread of the pandemic has peaked. Chinese businesses outside of Hubei province began to reopen as of February 11th while the number of newly confirmed cases peaked on the 5th (**Chart 2**).

- Hospitals should be confident to have enough capacity to handle another potential increase in infections. The Wuhan lockdown was lifted, almost all patients were discharged from temporary makeshift hospitals and all medical teams from other provinces were sent home.

- Precautionary measures will need to be in place to reduce the risk of infections. In the early days after China's business-activity resumption, wearing facemasks for both factory and office workers was mandatory; employees were required to keep a minimal distance; partitions were built

Chart 2 China Began "Liftoff" After New Infection Cases Peaked



*Source: China National and Hubei Health Commission
**Average of relative major six power plant coal consumption, property transactions, national steel inventory and labor migration; adjusted for Chinese lunar new year

to separate canteen dining tables and smaller office spaces where social distancing was difficult to follow.

- A system needs to be in place to monitor confirmed infections and trace contacts. China has adopted "health code," a mobile app to monitor users' travel history to evaluate potential risk of infection. Different colors from the app grant different levels of accessibility to public spaces.

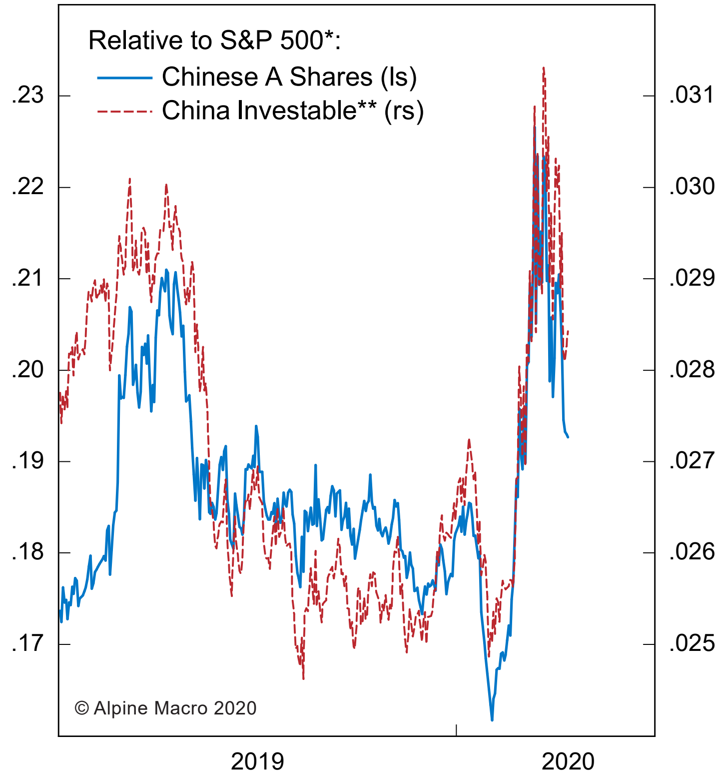
Searching For The Optimal Policy Mix

Compared to the dramatic and unprecedented monetary and fiscal easing among other major economies, particularly the U.S., China's growth-boosting measures so far have been less aggressive and less clearly defined.[1] So far Chinese stimulus measures have been primarily focused on back-stopping the crisis with liquidity and credit support targeting hardest-hit industries and regions. Even though the government has pledged to increase fiscal thrust to boost domestic demand, no concrete numbers have been offered as of yet. This to some extent explains why Chinese stocks have begun to underperform other major bourses in recent weeks after the massive relative gains earlier this year, as markets may be underwhelmed by China's more recent policy responses, or lack thereof (**Chart 3**).

It is possible the Chinese government is overly stingy in offering support which would cause the economy to suffer even greater losses, but odds of such a policy mistake are low in our view, as policymakers recognize the mounting growth difficulties that require timely and decisive measures to stabilize expectations and boost confidence. A more likely explanation is that the authorities are formulating the optimal policy mix.

- Cyclically, more direct relief measures to companies and households will likely be released, along with a push on infrastructure spending. When faced with a major growth downturn, the Chinese government's default reaction is to ramp up infrastructure construction. This time around, infrastructure will still hold the key, but there are growing voices calling for the provision of direct subsidies to corporations and households through large-scale value-added tax cuts, consumption coupons and even cash distributions. It will take time for public infrastructure to "trickle down," while companies and households need immediate relief to survive.

Chart 3 China's Policy Response So Far Has Been Underwhelming



*In U.S. dollar terms
**Source: MSCI

- Structurally, the government is also mulling important long-term reform measures to unleash new growth impetus. Particularly noteworthy is a document published last week on further market reforms on factors of production, in which the

1 Alpine Macro *EM* & *China Strategy* "China: A What-Shaped Recovery?" (April 8, 2020).

government pledged to further deregulate land, labor, capital markets, technology and digital resources. Detailed implementation guidelines are yet to be published, but it raises hope that some long-awaited liberalization of rural farmland and hukou restrictions on labor movement could be pushed forward.

In short, as the economy has suffered an unprecedented crash and is still facing a highly uncertain global environment, we expect the Chinese authorities will take aggressive steps to boost domestic demand, with a combination of cyclical and structural reform measures. The National People's Congress, postponed by the pandemic, will likely be held at the beginning of May, during which the government's fiscal budget and growth objectives will be presented in detail.

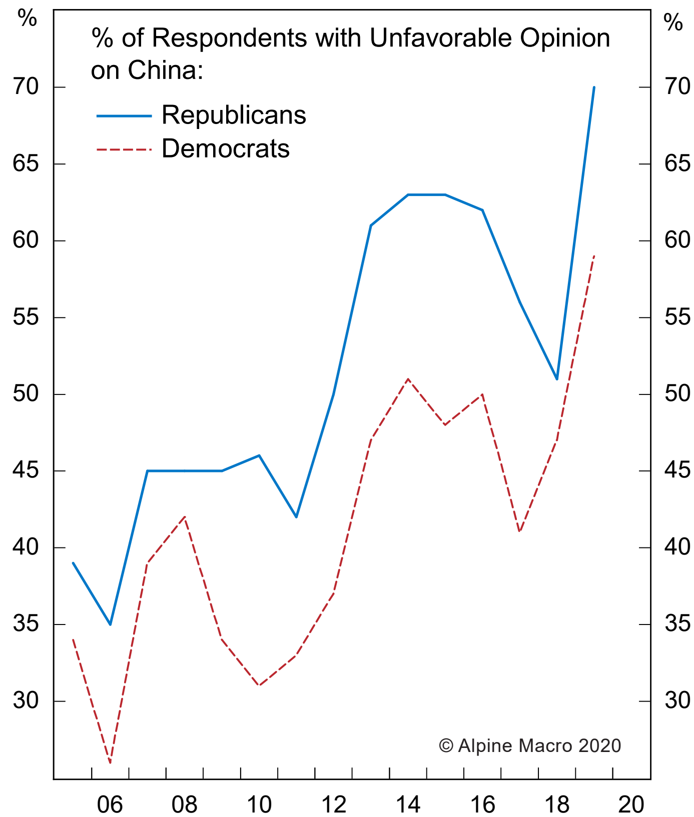
Reflecting On The Legacies Of Covid-19

There is no doubt that the pandemic has a profound impact on all countries. It will accelerate some major trends that were already well entrenched in recent years.

First, the U.S.-China rivalry and decoupling will likely continue to intensify. Unlike the close cooperation between the two countries in dealing with previous major pandemics, such as SARS and Ebola, the Covid-19 outbreak has been highly politicized, largely due to the deterioration in the bilateral relationship in the past several years. The Covid-19 fiasco will amplify suspicion and antagonism between the two countries.

Although the pandemic may have temporarily shifted the focuses of both governments to the

Chart 4 Anti-China Sentiment Will Rise Further In The U.S. After Covid-19

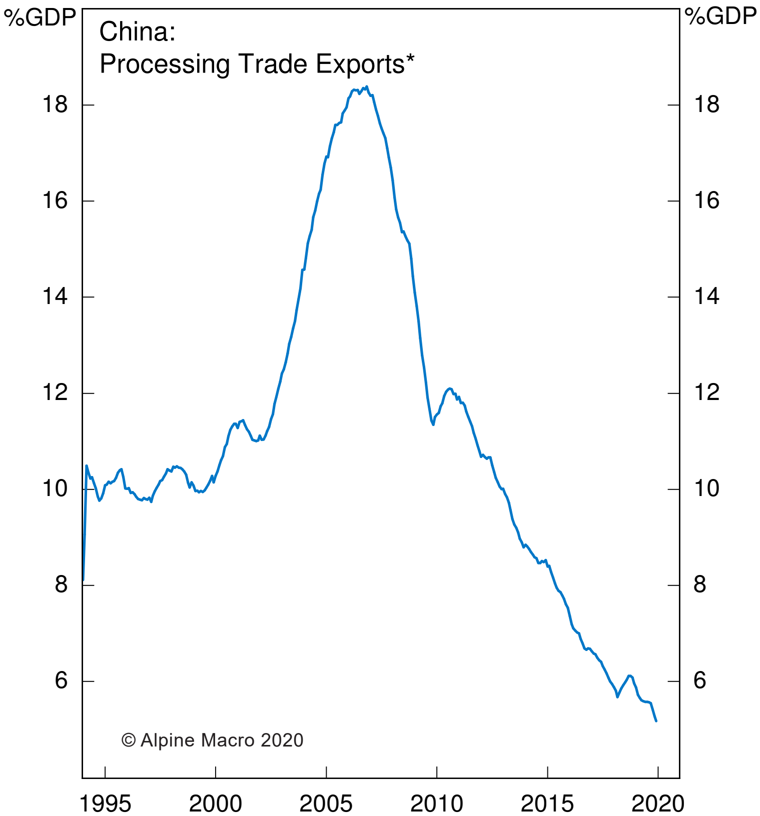


Source: Pew Research Center

health crisis — bilateral relationship will likely further deteriorate after the crisis subsides. Anti-China sentiment has continued to climb in the U.S. amid the outbreak, and will likely be ramped up even higher during the presidential election campaigns later this year (**Chart 4**). It will be even more difficult for the two countries to solve trade disputes through the bilateral negotiations, and even the prospect of the "Phase One" trade deal could be in jeopardy.

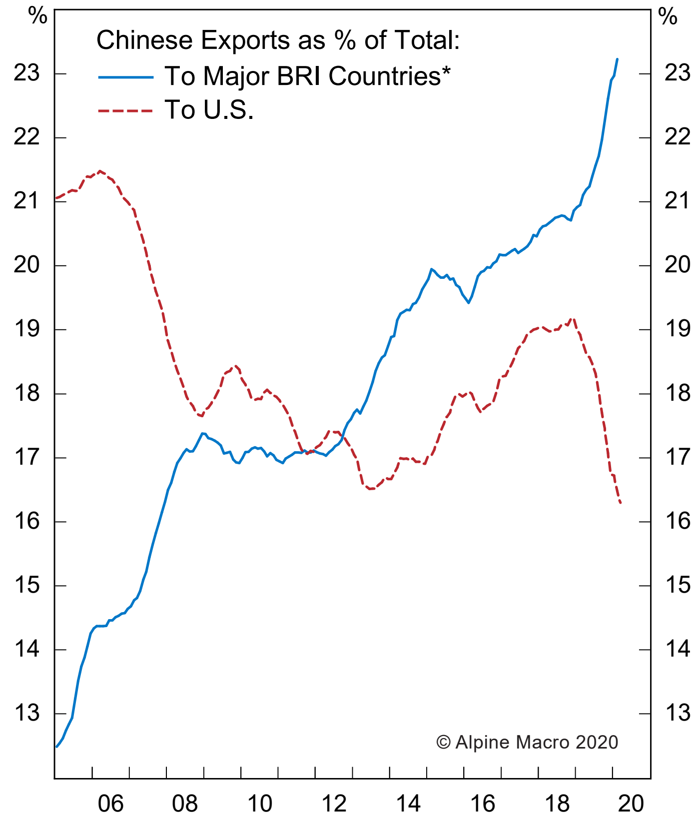
The U.S. will likely keep squeezing China on trade, technology and even finance and investment fronts. From China's perspective, it will continue to reduce its dependence on the American market and technology and will try to build closer ties with other major economies through multilateral free

Chart 5 China Has Become Less Vulnerable To Supply Chain Rearrangement



*Shown as 12-month moving sum

Chart 6 BRI Countries: China's "External Hinterland"



*Alpine Macro proprietary calculation; shown as 12-month moving sum

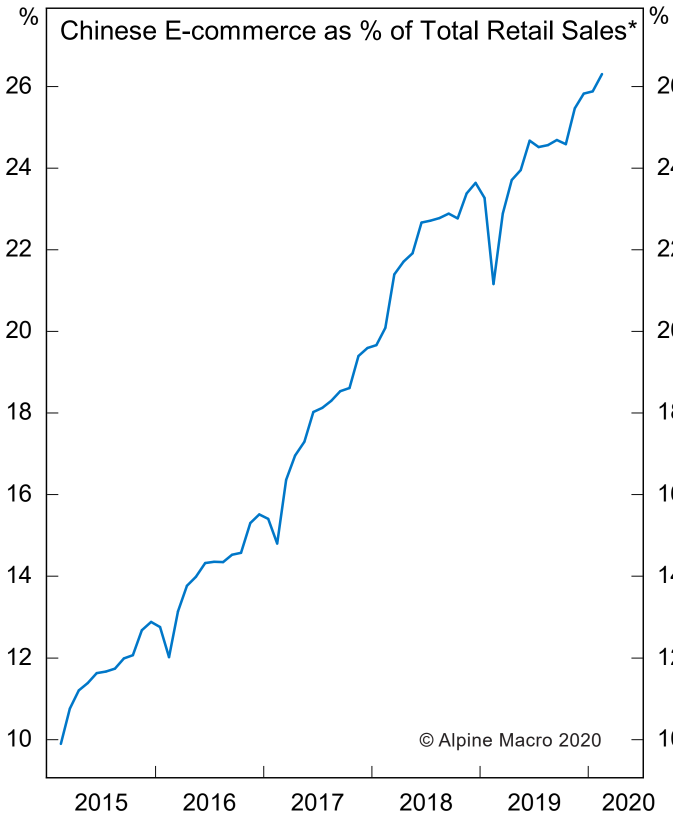
trade deals. It will also likely begin to distance itself from U.S. financial assets.

Second, global supply chains will be further rearranged. The global supply chain had already begun to become less China-centric due to the U.S.-China trade war and will be reshaped to a greater extent by the pandemic, as all countries will reprioritize strategic considerations. The crisis relief packages released by many countries include measures encouraging "onshoring" of domestic manufacturers. National security will trump efficiency. Supply chains will likely become shorter, more localized and more diversified.

This is clearly negative for China's growth outlook, but the country has also become much less dependent on exports, especially processing trade, the most vulnerable part to supply chain rearrangement. Processing trade, in which China imports parts and materials and processes for external final destinations — has shrunk dramatically. Currently, processing trade accounts for a mere 5% of Chinese GDP, down from 19% at its peak in 2007 (**Chart 5**).

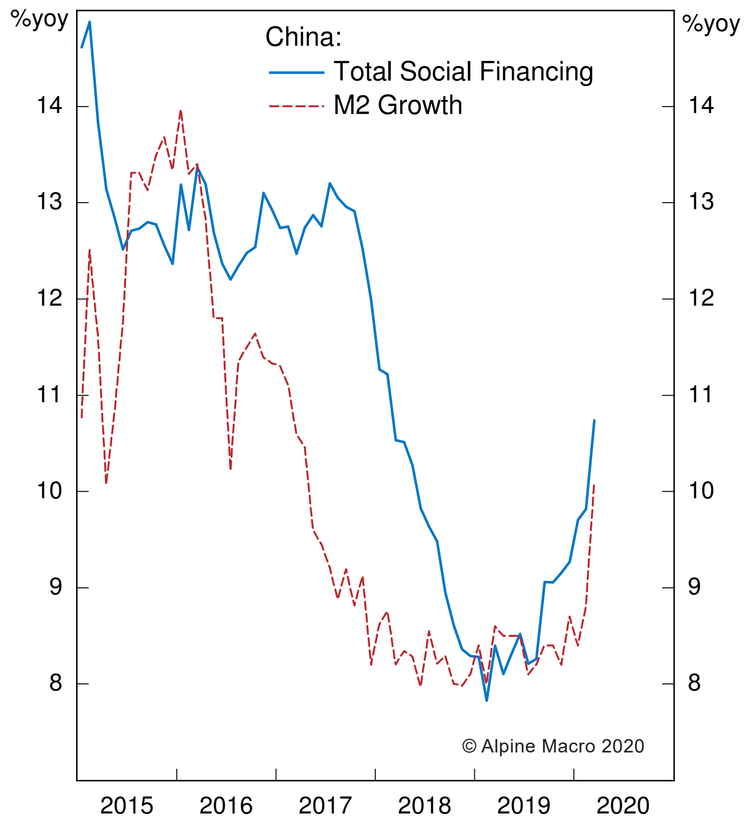
Moreover, China will try to build an "external hinterland" to integrate other countries into its economic sphere. Its "belt and road initiative" (BRI) will likely gain additional momentum. Chinese exports to countries along the BRI project have massively outpaced sales to other countries, currently accounting for 24% of China's total exports, 50% higher than sales to the U.S. (**Chart 6**).

Chart 7 Massive E-Commerce Boom Will Be Supercharged



*Based on year-to-date data

Chart 8 Chinese Credit Cycle Picking Up Decisively



Finally, the crisis will also accelerate some well-established trends at the industry level. E-commerce, mobile payment and virtual experiences that prospered massively in recent years, have gotten an additional boost by the lockdown (**Chart 7**). A tell-tale sign is that this year's Canton Fair, China's largest global trade fair that long predated the country's economic reforms, will be moved online due to travel restrictions. Some traditional drivers for the world economy, such as global trade, international travels and cross-border investments will likely suffer a long-lasting sub-par growth, which could depress global growth in the post-Covid environment. Investors will be willing to pay ever higher premium for growth opportunities. By the same token, many EM countries could also command a higher "growth premium" due to their higher growth potential. We will follow up on this issue in the coming weeks.

A Word On Chinese Growth And Financial Markets

Chinese credit and monetary aggregates accelerated last month, one of the most important signposts on our radar to monitor China's growth recovery (**Chart 8**). Total social financing has rebounded significantly, driven by all major components including bank credit, undiscounted bankers' acceptance bills and corporate bond issuance, and broad money supply has accelerated to a multi-year high. Importantly, China's money and credit cycle remained extremely weak throughout last year, even though the authorities were easing policies to offset the economic damage from the U.S.-China trade war. This means the pandemic-induced growth slump has finally forced the Chinese authorities to step on the gas pedal more forcefully.

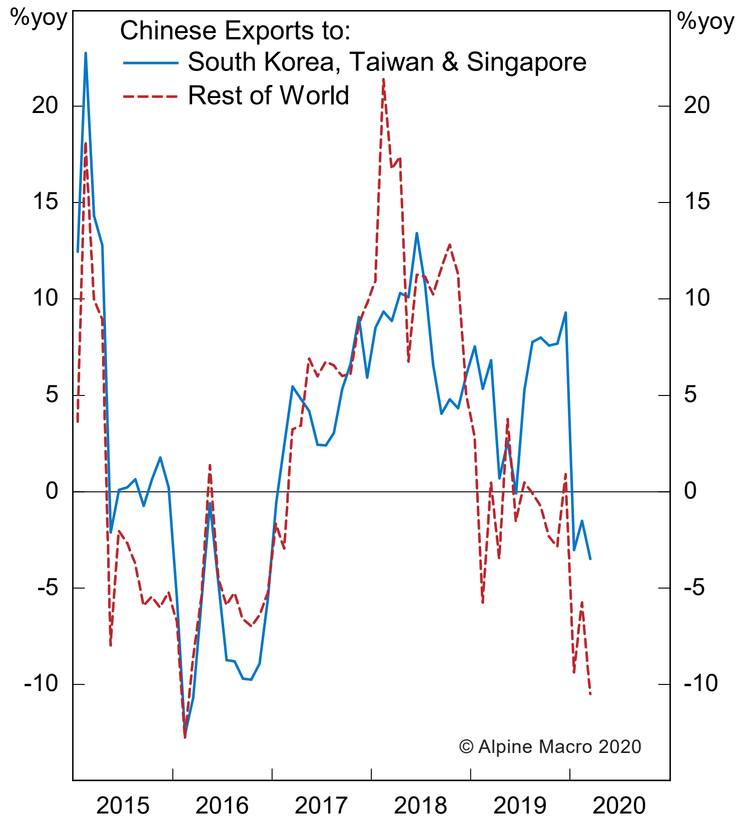
Moreover, Chinese external trade numbers released earlier this week also surprised to the upside. Looking forward, it is unrealistic to expect significant recovery in Chinese exports, due to a large part of the world economy now in hibernation. However, it is important to note that Chinese exports to some neighboring Asian economies, such as Korea, Taiwan and Singapore, have significantly outperformed sales to the rest of the world (**Chart 9**). These nations have all had better control of the pandemic, and their economies will likely continue to outperform.

Bottom Line: China's growth conditions and policy outlook remain conducive for risk taking from a cyclical point of view. Remain long Chinese equities and favor East Asian bourses within EM and global portfolios.

Yan Wang, CFA

Chief Emerging Markets & China Strategist

Chart 9 Growth In East Asia Will Lead



Note: Both series are shown as 3-month moving average

Investment Recommendations

Strategic Positions (6-12 months)				
Recommendations	**Open Date**	**Closing Date**	**Total P&L**	**Notes**
Long Chinese A-Share, Currency Unhedged	8/28/2018	–	8.7%	Buy Shanghai Shenzhen CSI300 Index, initiated at 499.16, currently 542.76
Long MSCI China Free Index	12/18/2019	–	-6.8%	Long MSCI China Free Index, currency unhedged, Initiated at 1113.2, currently at 1037.14

Tactical Investment Positions (3 - 6 months)				
Recommendations	**Open Date**	**Closing Date**	**Total P&L**	**Notes**
Short PLN, HUF, CZK vs EM Currency	8/21/2018	–	10.4%	Short equal-weighted basket of PLN, HUF and CZK versus MSCI EM Currency Index; includes carry
Short Indian Equities/Long EM Equities, Currency Unhedged	05/29/2019	–	16.3%	MSCI India Index versus MSCI Emerging Markets Index (times 100), initiated at 1.953; INR/USD hedge initiated at 0.014323; includes holding period return 20.27% and P&L on FOREX -3.30%; remove currency hedge on 09/04/2019; stop points at 10%
Long KRW/TWD	09/04/2019	–	-4.4%	KRW/TWD 38.63 at initiation; includes carry
Long KRW/THB	09/04/2019	–	6.1%	KRW/THB 39.66 at initiation; includes carry
Long MSCI Hong Kong Equity Index	01/15/2020	–	-16.3%	Long MSCI Hong Kong Index, currency unhedged; initiated at 2037.04, currently at 1704.39

EM Equity Country Allocation			
Overweight	**Notes**	**Slight Overweight**	**Notes**
		South Korea Mexico Poland Russia Turkey Chile Hungary Taiwan	
Neutral	**Notes**		
China Indonesia Colombia Malaysia Peru South Africa Czech Republic			
Underweight	**Notes**	**Slight Underweight**	**Notes**
India		Brazil Philippines Thailand	

EM Equity Sector Allocation	
Overweight	**Slight Overweight**
	Energy Health Care Information Technology Consumer Discretionary Industrials
Neutral	
Financials Materials	
Underweight	**Slight Underweight**
	Utilities Consumer Staples Communication Services

EM Local-Currency Government Bond Allocation		
Overweight	**Neutral**	**Underweight**
India Indonesia Malaysia Mexico Russia	Brazil China Colombia Philippines South Africa South Korea Thailand Turkey	Chile Czech Republic Hungary Poland Taiwan

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Our Leadership

Chen Zhao, Founding Partner and Chief Global Strategist From 2015 to 2016, Chen was Co-Director of Macro Research at Brandywine Global Investment Management. Prior to Brandywine Global, Chen spent 23 years at BCA Research. As a Partner, Managing Editor and Chief Global Strategist, Chen developed and wrote BCA's China and Emerging Markets publications in the 1990s. Chen became the firm's Chief Global Strategist in the 2000s and was the author of BCA's flagship publication, Global Investment Strategy from 2005 to 2015. He holds an MA in economics from the Central University of Finance and Economics, was a visiting scholar at the University of Illinois at Urbana-Champaign and pursued post graduate studies with a PhD candidacy at McGill University.

J. Anthony Boeckh, PhD, Founding Partner, CEO & Editor-In-Chief Tony was previously Founder, Chairman, Chief Executive and Editor-In-Chief of Montreal-based BCA Research for 34 years. He authored The Great Reflation (Wiley) in 2010 and was publisher of, among others, the Bank Credit Analyst, a monthly big-picture analysis of the U.S. and global economies and financial markets. He is a founding trustee of the Fraser Institute in Vancouver, British Columbia — an economic "think tank" dedicated to free market principles. Tony has a PhD in Finance and Economics from the Wharton School, University of Pennsylvania, and a B.Com. from the University of Toronto.

David Abramson, Partner, Chief U.S. Strategist & Director of Research David was a Macro Strategist holding a variety of senior roles at BCA Research. Most recently, he was Chief U.S. Strategist and also Director of Research for the firm. During his tenure at BCA Research, David launched and managed the European Strategy and Commodity & Energy Strategy services. In addition, he was the Managing Editor for the Foreign Exchange Strategy and the China Investment Strategy services. He has taught international finance to MBAs at McGill University for 20 years, and is on the Client Committee of the Kenneth Woods Portfolio Management Program at Concordia University.

Yan Wang, Partner and Chief Emerging Markets and China (EMC) Strategist Prior to Alpine Macro, Yan spent 15 years at BCA Research, as Managing Editor and Chief Strategist for BCA's China Investment Strategy service, and played a major role in formulating BCA's view on the Greater China region and emerging Asia. Prior to joining BCA, he spent six years as an equity analyst in China and Hong Kong. Yan holds an MBA in Finance from McGill University, an M.A. in Economics from Tianjin Institute of Finance and a B.A. in Finance from Nankai University. He also holds the CFA designation.

Harvinder Kalirai, Partner and Chief Fixed Income & Currency Strategist Before joining Alpine Macro, Harvinder spent a decade with BCA Research, where he headed the firm's Foreign Exchange Strategy service from 2008 to 2016 and Daily Insights from 2016 to 2018. Prior to BCA, Harvinder was Head of Currency Management at CIBC Global Asset Management. Previously, he held various positions at State Street Global Markets, including Senior Macro Strategist (London), Head of Currency Research, Asia-Pacific (Sydney), and Senior FX Strategist (Boston). Harvinder began his career at the Bank of Canada in 1995 with an MA (Economics) and a BCom (Finance) from McGill University. He also holds the CFA designation.