China Macro Thematic

Cutting growth forecast amidst escalating global COVID-19 pandemic

Against the backdrop of escalating global COVID-19 pandemic & early signs of financial market contagion, we revise down our 2020 China real GDP growth forecast to 2.6% YoY from 6.1% YoY. We now see higher probability of severe global recession, and therefore adopt our previous "bear-case scenario"[1] as the central case (~6ppt dent from the pandemic on 2020 GDP). With smaller projected fiscal revenue & higher expenses, much of the planned deficit expansion will now be deemed "cyclical" & generate less positive "fiscal impulse"[2], We see China GDP growth rebounding to 9.0% YoY in 2021, driven by a low base & stabilized sequential growth.

- **Sector wise, we expect export growth[3] to contract by ~18% YoY in 2020 & be the main drag on growth in 2-4Q2020. Nominal import growth may take a larger hit of ~25% YoY contraction in 2020**. Overall consumption may still grow below trend in 2Q20. Private inv't may be muted before nominal growth improves more visibly in 3Q2020, property inv't growth may recover after mid-2020. Therefore, gov't & SOE-led investment may bear the brunt of the counter-cyclical efforts.

- **In regards to the cyclical path, the recovery in external demand may start in 3Q20, & pick up pace visibly in 4Q20.** We see a "global lockdown" (i.e. T=0) partially resembling that of China in Jan-Feb for most of 2Q20. Based on China's trajectory but augmented the "path" w/ more realistic assumptions of epidemic control execution, COVID-19 may reach "plateau stage" overseas in 2-3 months. After a gradual ramp up, we expect more forceful global restocking by 4Q20.

With real GDP growth below trend in most of 2020, we expect nominal growth to slow meaningfully to 2.8% YoY in 2020, before rebounding to 11.1% YoY in 2021. Industrial products may experience severe deflation, but prices of staples & healthcare products will be better supported – we keep 2020 CPI forecast at 3.3% & cut 2020 PPI forecast to -3.7% from 1.2%.

We now expect greater cyclical mgmt. efforts on both fiscal & monetary fronts, & a *stronger* RMB at 6.72 vs. the dollar by end-2020. With a now larger "cyclical" fiscal deficit expansion of est. ~4-5% of GDP, overall broadly defined fiscal deficit may expand by 6-7ppt of GDP in 2020 vs. 2019. The expansion will likely be financed by higher gov't & quasi-gov't borrowing. We expect another 40bp of LPR cut, 150bp more in RRR cuts, & 25bp of benchmark deposit rate cut in the remainder of 2020. As the "USD liquidity crunch" subsides in 2H20, CNY may rise vs. the dollar & the basket, due to widened growth & interest rate differentials b/w China & rest of the world.

Both the upside & downside of our forecast rest on 2 factors: 1) effectiveness of the efforts in stemming the pandemic & preventing further financial market contagion; 2) the scale of China's counter-cyclical efforts.

[1]See China Macro Thematic Report, *Estimating the impact of COVID-19 on growth in China*, published on March 13, 2020.
[2]See China Macro Brief, Quantifying the Loosening Impulse post COVID-19, published on March 15, 2020.
[3]nominal, in USD terms

Eva YI
Analyst
SAC Reg. No.: S0080515050001
SFC CE Ref: AMH263
eva.yi@cicc.com.cn

Hong LIANG
Analyst
SAC Reg. No.: S0080513050005
SFC CE Ref: AJD293
hong.liang@cicc.com.cn

Related reports

- Macroeconomy | Signs of weakness in external demand; policy focus on employment stability (2020.03.22)
- Macroeconomy | March LPR pricing was kept unchanged (2020.03.20)
- Macroeconomy | Global activities slow rapidly; US easing starts to follow the "2008 playbook" (2020.03.20)
- Macroeconomy | Containment continues to tighten; great liquidity stress forces policy action (2020.03.19)
- Macroeconomy | Macro implication of falling oil prices (2020.03.19)
- Macroeconomy | >100k confirmed cases worldwide; global travel severely disrupted (2020.03.18)

Cutting growth forecast amidst escalating global COVID-19 pandemic

I. The COVID-19 outbreak overseas is still some time away from the "moderation stage"

The global COVID-19 pandemic may be wider-spread, more severe, and longer-lasting than previously projected. As of March 21, cumulative overseas confirmed cases of COVID-19 have surpassed the 200,000 mark, with consecutive days of DoD addition of ~30,000. More worrisome is the fact that daily new confirmed cases are still growing at ~20% DoD, showing no definitive signs of slowdown, even in terms of the "third derivative" (Figure 1&2). In addition, the pandemic has escalated in multiple major economic blocks, including Europe, the US, the Middle East, and Asia. Meanwhile, countries where the outbreak used to appear more benign are suffering a serious influx of imported cases and the consequent local infections (Figure 3).

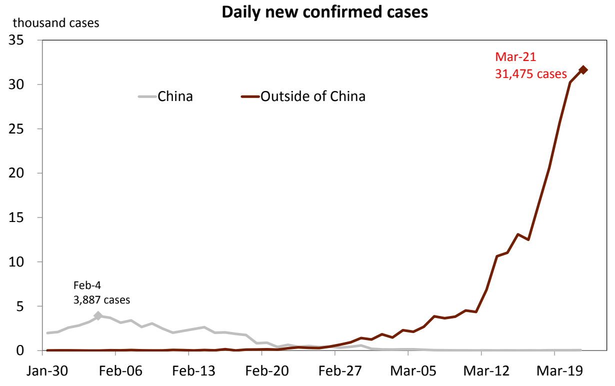
- **COVID-19 outbreak in Europe continues to escalate, seriously affecting all major economies.** As of March 21, cumulative confirmed cases have reached 142,443 in the Schengen Countries and 5,068 in the UK. Even with an already-large base of 53,578 cases and 14 days since the nation-wide "lock-down" commenced, daily new addition of confirmed cases are still growing at 16% DoD in Italy, indicating that the epidemic control may have been less than effective. Moreover, cases in the larger EU countries like Spain (25,496 confirmed cases), Germany (22,426), France (14,459) are rapidly ramping up. <u>Daily growth of new additional cases are still averaging at 11% DoD in the past 3 days, while cumulative cases in EU double every 4-5 days</u> (Figure 3). Meanwhile, it appears that the English Channel fails to stem the virus, with cases in the UK reaching (5,068) and doubling every 2-3 days.

- **The situation in the US has deteriorated swiftly, with daily new cases reaching ~7,000/day.** Despite a later start with COVID-19 testing, confirmed cases in the US have quickly ramped up to 26,664 from 1,328 in 10 days. Moreover, with nation-wide testing speeding up the conversion of suspect cases into confirmed ones, the US has added 12,332 cases in the past 2 days. <u>With daily new cases still mushrooming at the rate of 30%-40% DoD and cumulative cases tripling every 3 days, US has taken over most of the EU countries, and is set to approach Italy in total cumulative cases in the next 1-2 weeks</u> (figure 3).

- **The Asian block, esp. the ASEAN countries, are witnessing a resurgence of new cases as expats flock back from EU/US**. In Asia, especially the South East Asian Block where the epidemic was relatively benign in the first round of the outbreak, we are witnessing a re-acceleration of daily new cases in the past week as expats return from EU/US. More specifically, new cases in Singapore, Malaysia, Hong Kong have all picked up visibly in the past week. Meanwhile, <u>a few other countries that were geographically more removed from the epidemic previously are seeing rapid increase of new cases as well, including Canada and Australia.</u>

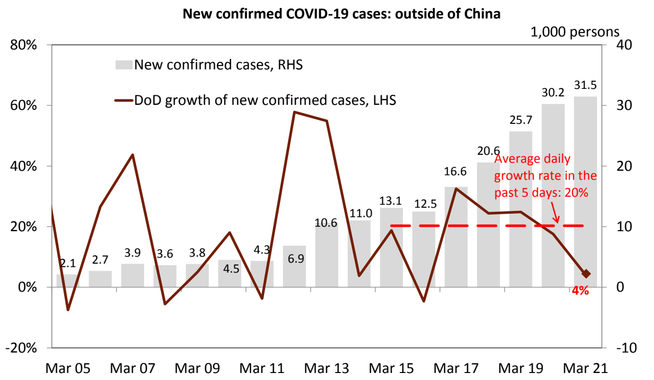
Even assuming effective quarantine and precaution measures being taken globally, the pandemic may continue escalating in the near future, as most of the affected countries are still in the early stage of epidemic control (Figure 4). Since the more serious epidemic control measures (i.e. quarantine and precautions) have only been taken since early-mid March (i.e. T=0), most of the countries are still in the "escalation stage" or "early control stage" of the epidemic. Figure 4 shows that most of the affected countries are still at least 1.5 months behind China on the "curve", where countries like the US and UK may be 2-3 months behind. Considering the fact that even China's economy is still <u>*not*</u> operating at full production capacity at T=59, it may be a while before we can start to plan production resumption in the rest of the world.

Figure 1: Global daily new cases is now 7-8X that of China at its early-Feb peak



Source: WHO, ECDC, WIND info, CICC Research

Figure 2: Daily new addition of confirmed cases overseas has been growing at ~20%, yet to show signs of slowdown



Source: WHO, ECDC, WIND info, CICC Research

Figure 3: The most affected overseas countries at a glance – escalation all around

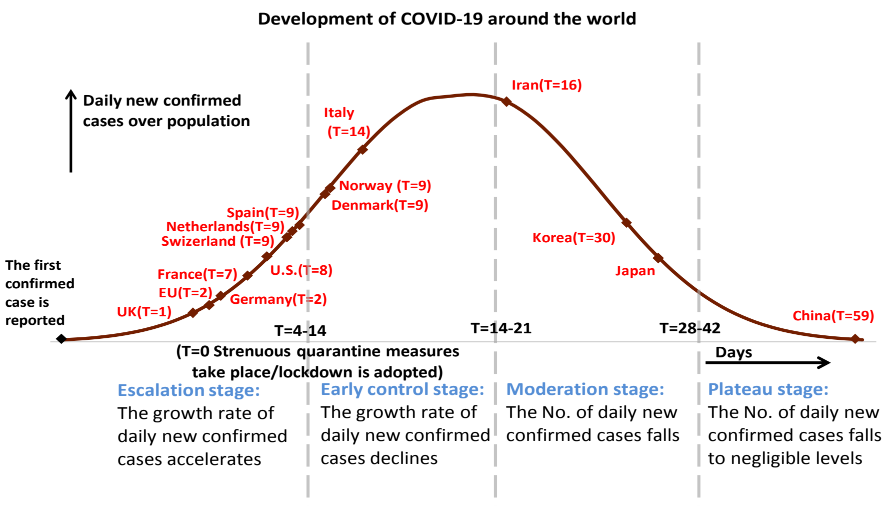
	New confirmed cases, Mar-21 (persons)	Total new confirmed cases in last 3 days (persons)	Average DoD growth of new confirmed cases in last 3 days (%)	**Cumulative confirmed cases Mar-21 (persons)**	Cumulative confirmed cases 3 days ago (persons))	Cumulative confirmed cases 10 days ago (persons)	Total change of cumulative confirmed cases in last 3 days (%)	Total change of cumulative confirmed cases in last 10 days (%)
Outside of China	**31,471**	87439	15%	**225,982**	138,543	45,516	63%	396%
Schengen area	**18,856**	54724	12%	**142,462**	87,738	22,928	62%	521%
Italy	**6,557**	17123	16%	**53,578**	36,455	12,598	47%	325%
U.S.	**6,902**	17248	33%	**26,664**	9,416	1,328	183%	1908%
Spain	**3,925**	10727	10%	**25,496**	14,769	2,277	73%	1,020%
Germany	**2,578**	10099	-5%	**22,426**	12,327	1,966	82%	1,041%
Iran	**966**	3249	-7%	**20,610**	17,361	9,000	19%	0,129%
France	**1,856**	5339	10%	**14,478**	9,139	2,281	58%	535%
Korea	**98**	332	-14%	**8,897**	8,565	7,869	4%	13%
Switzerland	**1,108**	3585	45%	**6,652**	3,067	654	117%	917%
U.K.	**1,053**	2423	15%	**5,068**	2,645	464	92%	992%
Netherlands	**637**	1583	23%	**3,642**	2,059	503	77%	624%
Austria	**372**	1375	6%	**3,021**	1,646	246	84%	1,128%
Belgium	**558**	1329	32%	**2,815**	1,486	314	89%	796%
Norway	**199**	549	15%	**2,164**	1,615	630	34%	243%
Japan*	**40**	134	-1%	**1,768**	1,634	1,331	8%	33%
Sweden	**131**	469	8%	**1,770**	1,301	500	36%	0,254%
Denmark	**83**	303	-3%	**1,420**	1,117	516	27%	175%
Canada	**241**	601	23%	**1,328**	727	118	83%	1025%
Portugal	**260**	638	10%	**1,280**	642	59	99%	2,069%
Malaysia	**153**	393	9%	**1,183**	790	149	50%	0,694%
Australia	**195**	476	11%	**1,072**	596	127	80%	744%

*Incl. Princess Diamond cruise

Source: Wind info, reported by 0:00 March 22 GMT+8

Source: WHO, ECDC, WIND info, CICC Research

Figure 4: Where is everyone in their battle against COVID-19?



Source: WHO, ECDC, WIND info, CICC Research

II. The pandemic is set to cause larger-scale disruptions than previously expected

The short-term disruption in global economic activities may be of the scale never seen in modern history; we now expect a severe global recession, to say the least. In a synchronized effort to stem the highly infectious COVID-19 pandemic, most of the major economic blocks have entered the "lock-down" mode, the global machine of goods & services exchange has "grinded to a halt". As of March 21, 42 countries have declared the "State of Emergency", collectively making up 50% of global GDP (incl. China, Figure 5). Meanwhile, 130 countries have closed schools nation-wide or in most densely-populated parts of the country, these economies contributed to 93% of global GDP last year (Figure 6). According to our observation, the short-term disruption to the real economic activities, both domestically and abroad, will likely far exceed that of the 2008-09 GFC on many accounts.

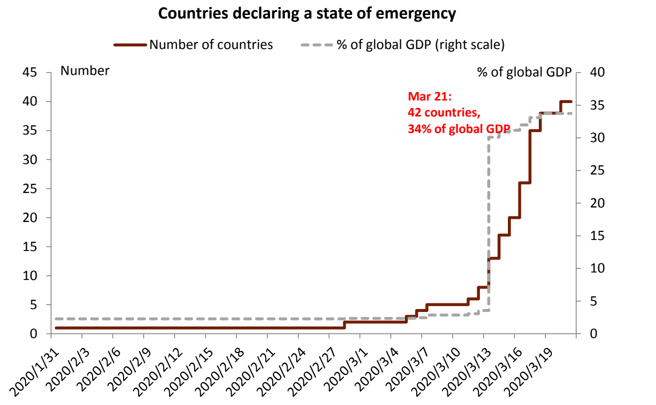
- **We will likely witness unprecedented disruption to global travel and logistic activities in modern history.** Moreover, almost all the larger countries have placed travel bans or quarantine requirement for travelers from China, selected Asian countries, US, and European Countries—e.g. >100 countries have placed border control against travelers from China, >100 countries stopped admitting travelers from Korea without quarantine. In the meantime, incoming passenger traffic from Europe is either banned or placed under quarantine in >70 countries, while travelers from US are placed under strict scrutiny (banned or quarantined) now in >50 countries. Needless to say, we will likely witness unprecedented disruption to global travel and logistic activities in modern history. For example, out of the 40 major airline routes that we track, total number of flights weekly has already been reduced by 30-40% in a matter of 8 weeks (Figure 7), not to mention the load factor have also declined substantially.

- **Domestic production and consumption will also be severely interrupted** –e.g. table booking on opentable.com, the leading global online reservation platform, shows a 98% YoY decline in dining reservations as of March 19, with the impact being felt in all major economic blocks (Figure 8).

Early signs of financial market contagion point to higher probability of a more prolonged recession. Understandably, with severe and abrupt disruption to economic activities and more importantly, no certainty of an imminent recovery in sight, cash flow of corporate, household, and the government sectors are severely impaired. The financial market, unable to precisely price the cash flow pressure and bankruptcy rate, has seen violently de-risking across asset classes, including corporate bonds, sovereign bonds (EM and affected areas), commodities, equities, and EM currencies. "Stress barometers" such as VIX and HY bond spread point to a sharp tightening of financial conditions globally (Figure 9 & 10), which will likely add to the downward pressure on real activities. Understandably, with cash flow vanishing in the real economy and liquidity drying up in the financial market, the likelihood of larger-scale bankruptcy wave is on the rise. Even assuming effective policy actions taken imminently and no further escalation of financial market stress, it is likely for the G3 to fall under severe depression in 2Q2020, while all of the G3 may experience negative growth in 1-3Q 2020.

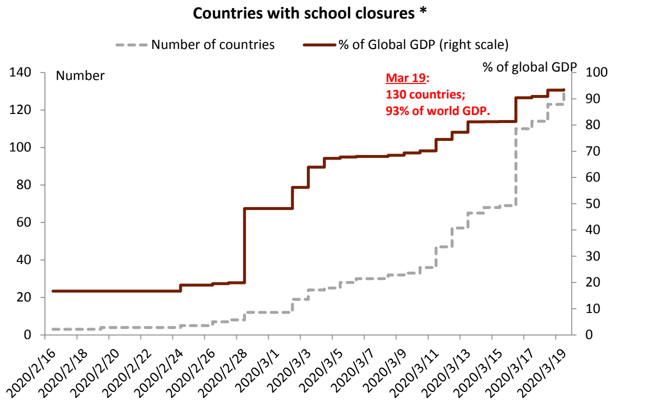
(Continued next page)

Figure 5: 42 countries, with a collective share of 34% global GDP (not incl. China), has declared the "State of Emergency"



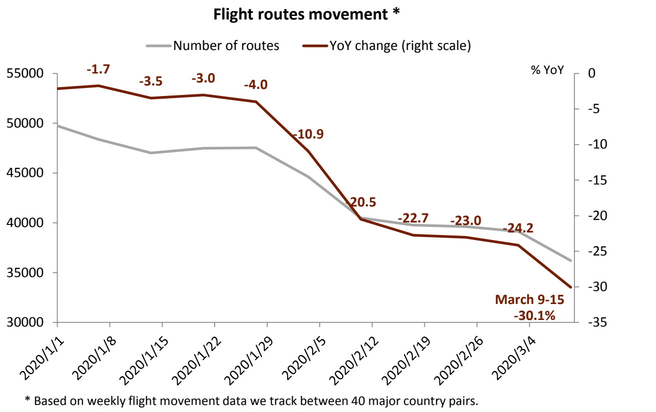
Source: WIND info, CICC Research

Figure 6: 130 countries have closed schools; these economies contributed to 93% of global GDP last year



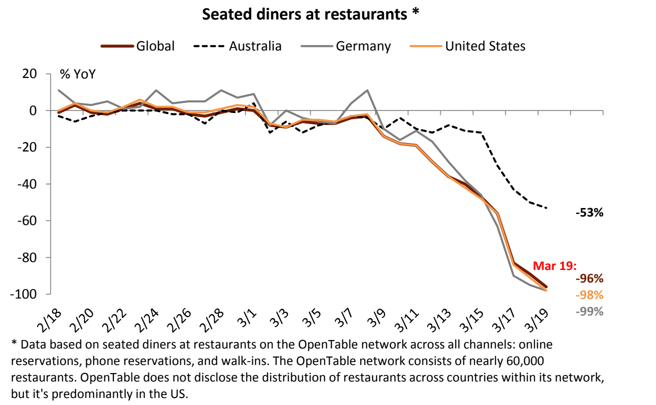
Source: UNESCO, CICC Research

Figure 7: Airline flights are cut aggressively



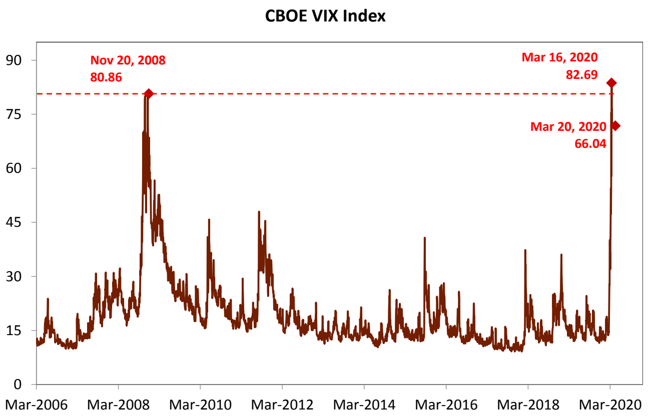
Source: CAPA, CICC Research

Figure 8: Dining out consumption vanished



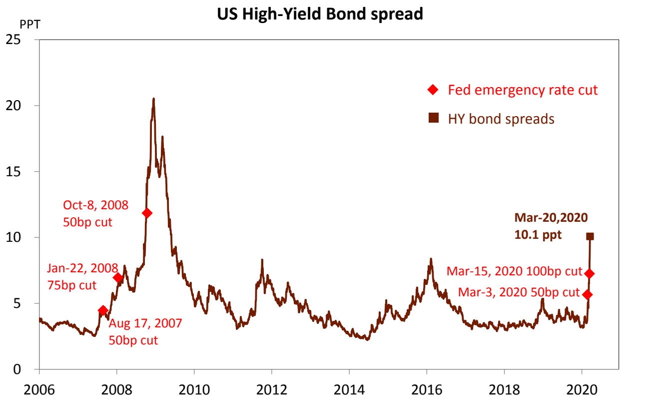
Source: OpenTable, CICC Research

Figure 9: VIX has topped the peak in 2008



Source: Bloomberg, CICC Research

Figure 10: Surging spread of High-Yield bonds has more than offset the effect of Fed's rate cut



Source: Bloomberg, CICC Research

III. China growth amidst the once-in-a-century pandemic

Against the backdrop of escalating global COVID-19 pandemic and early signs of financial market contagion, we revise down our 2020 China real GDP growth forecast to 2.6% YoY from 6.1% YoY previously. Since we now see a higher probability of severe global recession, and therefore adopt our previous "bear-case scenario"[4] as the central case (~6ppt dent from the COVID-19 outbreak on 2020 GDP). Consequently, with smaller projected fiscal revenue and higher potential expenses, much of the planned deficit expansion will now be deemed "cyclical" and generate less positive "fiscal impulse"[5]. Therefore, domestic counter-cyclical policy may only offset around 2-3ppt out of the ~6ppt negative shock from the COVID-19 outbreak domestically and abroad (See more details in Section V on Page 11). Meanwhile, we see China real GDP expanding at 9.0% YoY in 2021, driven by an exceedingly low base for 1H2021, as well as stabilized sequential growth.

Figure 11: A summary of our updated macro forecast in 2020-21

% change, unless otherwise stated

		2017	2018	2019	New 2020E	New 2021E	Old 2020E	Old 2021E	1Q2019	2Q2019	3Q2019	4Q2019	1Q2020E	2Q2020E	3Q2020E	4Q2020E
Real GDP	% yoy	6.8	6.7	6.1	**2.6**	**9.0**	*6.1*	*6.0*	6.4	6.2	6.0	6.0	**-9.3**	**4.3**	**5.8**	**6.4**
	% qoq, ann.	-	-	-	-	-	-	-	6.5	6.3	5.6	5.6	-43.0	86.0	12.0	8.0
Nominal GDP	% yoy	11.5	10.5	7.8	**2.8**	**11.1**	*8.5*	*7.5*	7.9	8.3	7.6	7.4	**-7.3**	**4.9**	**5.7**	**6.3**
Nominal domestic demand*	% yoy	12.8	11.5	7.3	2.4	11.9	*8.9*	*7.8*								
IP	% yoy	6.6	6.2	5.8	**1.0**	**8.7**	*6.0*	*5.6*	6.5	5.6	5.0	5.9	**-11.2**	**4.1**	**5.1**	**6.1**
Nominal urban FAI**	% yoy	7.2	5.9	5.4	**1.4**	**9.1**	*6.0*	*6.1*	6.3	5.5	4.8	5.4	**-12.8**	**1.9**	**4.2**	**5.9**
Nominal Retail Sales	% yoy	10.2	9.0	8.1	**2.2**	**13.1**	*8.0*	*7.1*	8.4	8.6	7.6	7.7	**-14.0**	**5.8**	**7.9**	**7.9**
Nominal customs Exports	% yoy	7.9	9.9	0.5	**(18.0)**	**11.2**	*5.1*	*4.1*	1.4	-1.0	-0.3	1.9	**(19.9)**	**(21.9)**	**(20.0)**	**(11.0)**
Nominal customs Imports	% yoy	16.1	15.8	-2.7	**(24.5)**	**16.6**	*7.0*	*5.7*	-4.1	-3.7	-6.2	3.2	**(14.2)**	**(31.3)**	**(29.5)**	**(22.1)**
current account surplus	% of GDP	1.6	0.4	-	-	-	-	-	-	-	-	-	-	-	-	-
trade surplus	% of GDP	3.4	2.5	2.9	**3.3**	**2.6**	*2.6*	*2.3*	-	-	-	-	-	-	-	-
M2 Supply	% yoy	8.1	8.1	8.7	**9.0**	**8.6**	*8.8*	*8.6*	8.6	8.5	8.4	8.7	**8.7**	**8.8**	**9.0**	**9.0**
Outstanding TSF	% yoy	14.1	10.3	10.7	**11.3**	**10.6**	*10.8*	*10.6*	11.2	11.2	10.7	10.7	**10.8**	**10.8**	**11.2**	**11.3**
	% yoy															
RMB New Loans	RMB trn	13.5	16.2	16.8	**20.7**	**20.9**	*18.9*	*20.7*	5.8	3.9	4.0	3.2	**6.9**	**5.3**	**5.1**	**3.4**
CPI	% yoy	1.6	2.1	2.9	**3.3**	**1.5**	*3.3*	*1.2*	1.8	2.6	2.9	4.3	**5.0**	**3.9**	**2.9**	**1.4**
	% qoq, ann.	-	-	-	-	-	-	-	1.3	4.1	4.3	6.9	4.7	0.0	0.0	1.0
PPI	% yoy	6.3	3.5	-0.3	**-3.7**	**1.9**	*1.2*	*1.7*	0.2	0.5	-0.8	-1.2	**-1.0**	**-4.3**	**-5.2**	**-4.4**
GDP Deflator	% yoy	4.1	3.5	1.6	**0.6**	**1.6**	*2.3*	*1.4*	1.4	2.0	1.5	1.3	**2.2**	**0.6**	**-0.1**	**-0.1**
1Y LPR (period end)	%	-	-	4.15	**3.65**	**3.65**	*4.00*	*3.90*	-	-	4.20	4.15	4.05	**3.75**	**3.65**	**3.65**
>5Y LPR (period end)	%	-	-	4.80	**4.50**	**4.50**	*4.70*	*4.65*	-	-	4.85	4.80	4.75	**4.55**	**4.50**	**4.50**
7 day reverse repo rate (period end)	% p.a.	2.50	2.55	2.50	**2.00**	**2.00**	*2.35*	*2.25*	2.55	2.55	2.55	2.50	**2.40**	**2.10**	**2.00**	**2.00**
1Y MLF rate (period end)	%	3.25	3.30	3.25	**2.75**	**2.75**	*3.10*	*3.00*	3.30	3.30	3.30	3.25	**3.15**	**2.85**	**2.75**	**2.75**
nominal RRR (large banks)	%	15.5	12.5	11.0	**9.0**	**8.5**	*10.0*	*9.0*	11.5	11.5	11.0	11.0	**10.5**	**9.5**	**9.0**	**9.0**
10Y treasury bond yield (period end)	% p.a.	3.88	3.25	3.16	**2.80**	**3.10**	*3.00*	*3.00*	3.09	3.25	3.15	3.16	**2.70**	**2.60**	**2.80**	**2.80**
USD/CNY (period end)	Market	6.53	6.86	6.98	**6.72**	**-**	*6.72*	-	6.73	6.87	7.07	6.98	**7.08**	**7.08**	**6.88**	**6.72**
Budget fiscal balance by NPC	% of GDP	(3.0)	(2.6)	(2.8)	**(4.0)**	**-**	*(3.0)*	-	**-**	-	-	-	**-**	**-**	**-**	**-**
Realized budget balance	% of GDP	(3.7)	(4.1)	(4.3)	**(6.0)**	**-**	*(4.0)*	-	**-**	**-**	**-**	**-**	-	-	-	-
Local gov't special bond quota	RMB trn	0.80	1.35	2.15	**3.95**	**-**	*3.35*	-	**-**	-	-	-	**-**	**-**	**-**	**-**
Realized local gov't special bond net issusance	RMB trn	0.80	1.35	2.15	**4.95**	**-**	*3.75*	-	**-**	**-**	**-**	**-**	-	-	-	-

* we estimate nominal domestic demand using nominal GDP - merchandise trade balance , i.e. service sector trade balance is assumed to be largely constant
**the monthly reported nominal urban FAI published by the NBS is subject to notable data quality issues and had been adjusted numerous times in various provinces, our "forecast" of this series is reflective of our view on the underlying trend, rather than the actual number that will be printed

Source: CEIC, WIND info, CICC Research

(Continues next page)

[4] See China Macro Thematic Report, *Estimating the impact of COVID-19 on growth in China*, published on March 13, 2020.
[5] See China Macro Brief, *Quantifying the Loosening Impulse post COVID-19*, published on March 15, 2020.

Sector wise, we expect external demand to be the main drag on real growth from 2Q onwards, while domestic consumption and private investment may grow below trend in 1H2020. Government and SOE-led investment will likely accelerate.

- **We expect export growth[6] to contract by ~18% YoY in 2020 and be the main drag on growth in 2-4Q2020.** More specifically, while Jan-Feb trade activities has been interrupted by China's own COVID-19-induced lockdown, we believe the negative impact on China's external demand from the "worldwide lockdown" should have already kicked in around March 10th, based on the following observations: 1) high-frequency indicators of global activities took a cliff-dive around March 10, including traveling, entertainment, or even day-to-day traffic (Figure 7-8 on page 5, Figure 12), and 2) domestic indicators also started to soften around the same time, including heavy duty truck capacity utilization in Guangdong province, the import/export price index, and etc (Figure 13&14). The timing also coincides with the time where a growing number of countries started to close their boarders/schools/public activities (Figure 5 & 6 on page 5)

  Based on the premise of a potential global slowdown more severe than in 2008, we expect China export growth to contract more than 20% YoY in 1-3Q2020, before recovering to a rate of decline ~10% YoY in 4Q2020 (Figure 11 on page 6). The abrupt and sizable contraction of external demand will likely result in a negative knock-on effect for domestic growth of mfg. investment, employment, overall income, and consumption as well.

  Nominal import growth may take a larger hit of ~25% YoY contraction this year, since 1) we expect a sizable decline in import demand corresponding to that of processing exports (~40% of exports); 2) plummeted raw material prices will likely depress the nominal import value substantially (Figure 15), as well as 3) import substitutions amidst a lower capacity utilization. However, we expect import growth to recover more notably on sequential basis than that of exports starting from 4Q2020, as commodity price may see a moderate recovery from the depressed levels with progress of production resumption, while China's domestic demand growth will also help lift overall capacity utilization.

- **Domestic offline consumption, esp. that of discretionary products and services, may continue to grow below trend in 2Q2020, before recovering more visibly in 2H 2020**. As we have discussed in recent research[7], with a temporary "dip" in household savings rate in 1Q2020, which was a typical reaction in the face of short-term "shocks" such as natural disaster and epidemics, we expect the "normalization" of savings rate to continue dampen overall consumption growth in 2Q2020. This assessment was in line with the experience immediately after SARS, where consumption growth recovery lagged that of industrial production and investment. Meanwhile, service consumption that requires larger-scale gather or traveling may recover later than the rest. Furthermore, given our forecast of still-depressed nominal GDP and income growth in 1-2Q2020, consumption demand is unlikely to grow above trend before corporate profitably and household payroll growth normalizes. Among consumer products, we expect staples consumption to hold up relatively well. In addition, domestic-demand driven discretionary items with an exceedingly low base may lead in the recovery as well, such as passenger cars.

- **Private mfg. investment demand will likely be depressed before nominal growth show visible improvement (in est. 3Q2020), property investment growth may also recover after mid-2020**. Private mfg. investment growth usually lags the profit cycle, therefore, with lower projected nominal GDP & corporate profit growth in 1H2020, private mfg. investment growth will likely stay muted for most of the year. On the other hand, there may also be some time away from a notable pick-up in property investment growth, as

[6] Nominal, in USD terms, same applies for imports
[7] See China Macro Thematic Report, *Estimating the impact of COVID-19 on growth in China*, published on March 13, 2020.

developers' source of funds growth has slowed notably in Jan-Feb 2020 (Figure 16). Against the backdrop of a markedly tightening of USD liquidities, property developer fund-raising overseas has contracted visibly, which may in turn dampen overall source of funds growth in March (Figure 17). Looking forward, property investment growth may also see meaningful recovery after source of funds growth starts to pick up, driven either by improved sales value growth or easier *domestic* financial conditions for developers.

- **Government & SOE-led investment may bear the brunt of the counter-cyclical efforts**. As discussed above, there is little room for either external demand or other components of domestic demand to be lifted in a relatively short period of time. Judged by the historical patterns, government-led investment has been the designated counter-cyclical tools during cyclical downturns – Figure 18 shows a distinct negative correlation between PPI and the gap between infrastructure investment growth vs. that of total FAI. During times of more severe demand disruptions, SOE capex may also be summoned to boost aggregate demand growth (e.g. 1998, 2008). In the near term, we may witness an increase of government and SOE leverage, in order to partially offset the contractionary impulse from the sizable external demand shock. Meanwhile, as we will discuss in more details in Section V, a visible expansion of broadly-defined government deficit will help propel government investment as well. While the "new infrastructure FAI" may be the preferred area of investment, but the small share of "new FAI" dictates that some of the traditional FAI projects may also be activated to boost aggregate demand more effectively. More specifically, traditional infrastructure investments that cater towards urbanization (incl. low-income housing) and building modern city-agglomerations may pick up pace more visibly.

In regards to the cyclical path, we expect the recovery in external demand to start gradually in 3Q2020, but pick up pace visibly in 4Q2020. As we see the "shock" from external demand growth as the main "swing factor" of GDP growth in 2020, we expect aggregate demand recovery in China to coincide with the stabilization of external demand situation in 3Q2020.

- **On the sequential basis, we would still witness a recovery of headline growth in 2Q2020 after the nation-wide lock-down in 1Q2020, which may have knocked GDP growth down to -9.3% YoY in 1Q**. According to our CICC production activity tracker (PAT)[8], overall (offline) production utilization rate came in at ~90%, 45%, and 80% for Jan-March, bringing the 1Q weighted average to ~70%. We expect capacity utilization to recover to ~85% in 2Q, even after taking into consideration the sizable export slowdown. Therefore, with ~20% QoQ (non-annualized) recovery in domestic capacity utilization, 2Q headline real GDP growth may still recover to 4.3% YoY.

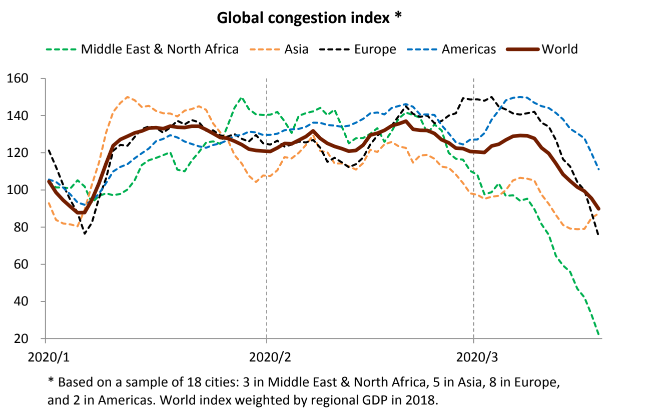
- **We expect severely dampened external demand growth in 3Q2020, followed by a more visible recovery starting from 4Q2020**. Based on the trajectory in China but augmented the "path" with more realistic assumptions of epidemic control execution, global COVID-19 outbreak may reach a "plateau stage" before end-2Q2020 (Figure 4 on page 3). Considering a more "gradual" pace of production resumption overseas in 3Q2020, which they typically are for highly specialized economies after almost a "full-stop", we expect a more forceful global "restocking" cycle by 4Q2020[9].

(Continued next page)

[8] See China Macro Thematic Report, "Quantifying" the progress of nation-wide production resumption | Introducing the CICC Daily Production Activity Tracker (PAT), published on February 23, 2020

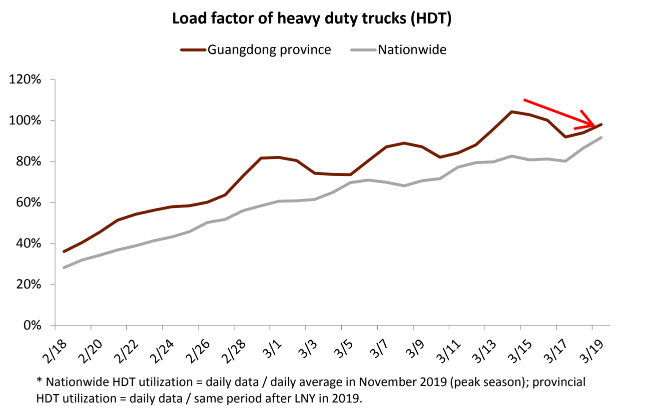
[9] for more detailed explanation on the assumption of more "gradual" production resumption process overseas, which we believe may take up to 3 months, please refer to China Macro Thematic Report, Estimating the impact of COVID-19 on growth in China, published on Mar 13, 2020

Figure 12: Global congestion index has fallen visibly



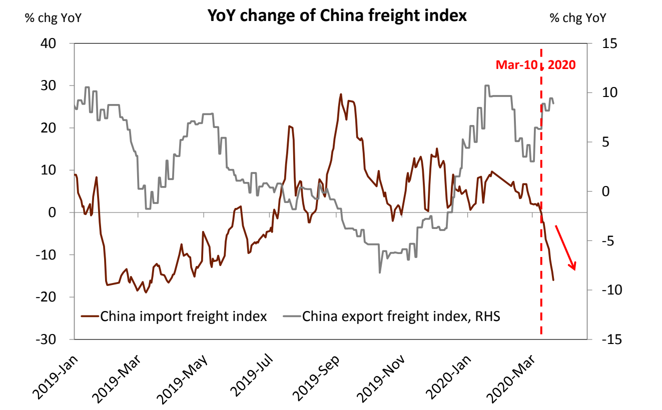
Source: Google maps, CICC Research

Figure 13: Heavy duty truck capacity utilization started to soften in Guangdong province



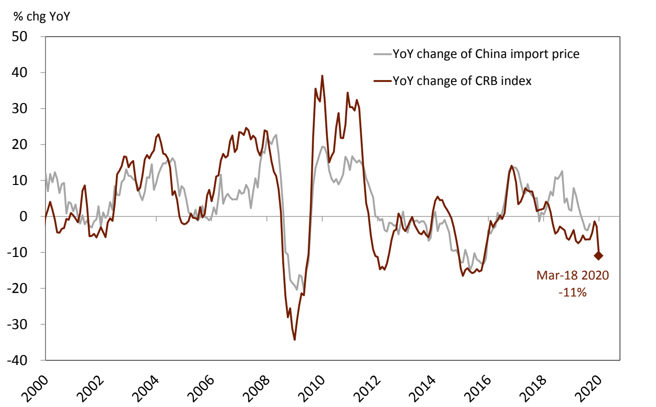
Source: G7, CICC Research

Figure 14: Import/export freight price index points to weakening external demand



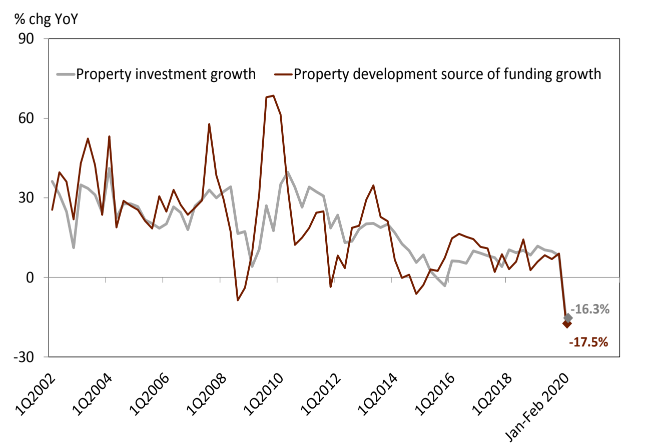
Source: Wind info, CICC Research

Figure 15: Plummeted raw material prices will likely depress the nominal import value substantially



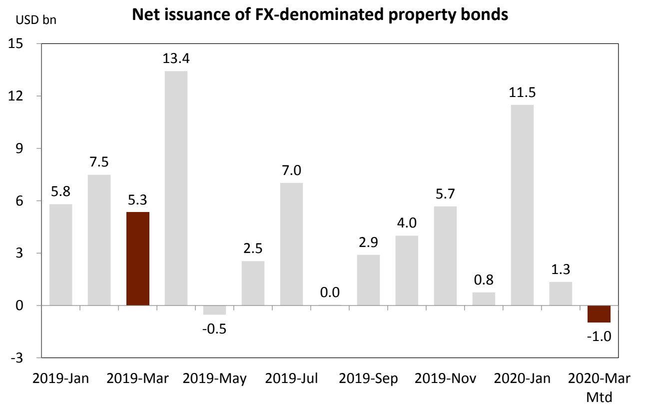
Source: Wind info, CICC Research

Figure 16: Developers' source of funds has slowed notably and may continue to drag the investment growth



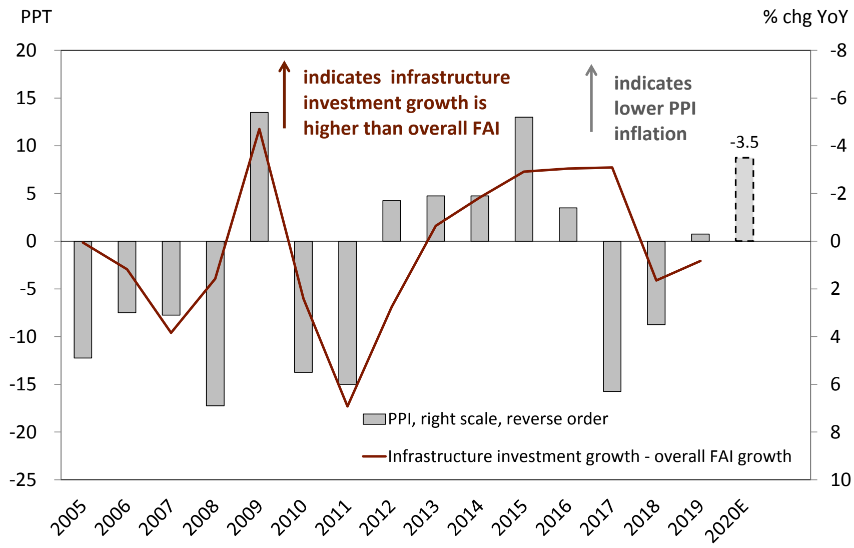
Source: Wind info, CICC Research

Figure 17: Property developer overseas funding has declined visibly



Source: Bloomberg, CICC Research

Figure 18: Infrastructure FAI has a distinct "counter-cyclical" characteristic



Source: Wind info, CICC Research

IV. Inflation (deflation) outlook

We expect both CPI and PPI to trend down in 2020, with the latter recovering sooner in 2021. With a sizable "shock" to global demand, we expect the overall price level of industrial products to deflate notably in 2020, led by upstream commodities. Meanwhile, supply destruction and relatively resilient demand may support the price of staples consumer items, esp. for food and healthcare products.

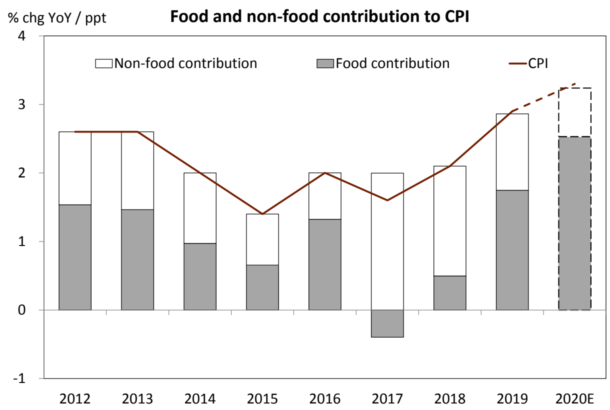
- **We keep our 2020 headline CPI forecast constant a 3.3%,** but lift the underlying assumption for food price inflation in 2H2020, while lowering our non-food CPI forecast for the year (Figure 19). We now expect non-food CPI to drift below 1% in 2H2020, lowest in decades.

- **We cut our 2020 PPI forecast to -3.7% from 1.2% .** With the help of an ultra-low base and improved sequential growth, we expect 2021 PPI to bounce back to 1.9%. We foresee the lowest sequential growth of PPI in 2Q2020, preluded by the plunge in global commodity prices and economic activities in March. Meanwhile, headline PPI may bottom in 3Q2020 (Figure 20).

With real GDP growth far below trend in most of 2020, we expect nominal growth to slow meaningfully to 2.8% YoY in 2020, before rebounding to 11.1% YoY in 2021. The underlying GDP deflator forecast stands at 0.6% and 1.6% in 2020-2021. Apart from our headline CPI and PPI forecast, the underlying assumption for GDP deflator is deflation of non-food price (essentially the weighted average of non-food CPI and PPI) and depressed property/land price in 1-3Q2020.

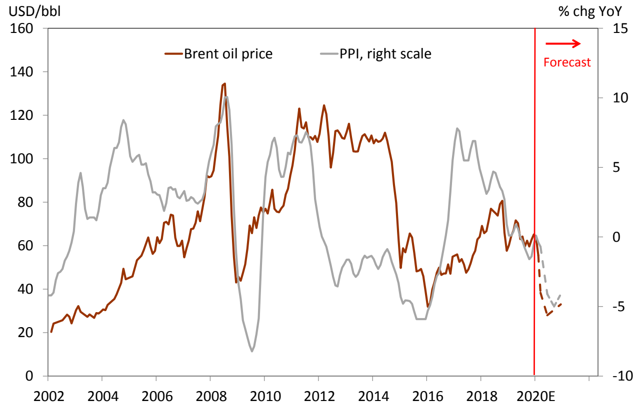
(Continued next page)

Figure 19: food CPI may be better supported, while non-food CPI may dip below 1%



Source: Wind info, CICC Research

Figure 20: PPI may remain below zero for the rest of 2020



Source: Wind info, CICC Research

V. Counter-cyclical policies and the Renminbi

Although the "broadly-defined" fiscal deficit will likely expand visibly, but the share of "structural" deficit expansion may shrink in the face of the sizable external shock, eroding the effectiveness of counter-cyclical management policies. As we have discussed in more details in our recent research[10], China's "fiscal" deficit, in the broadest sense, includes the deficit on the central government level (general budget deficit), local government funding gap (government fund deficit), social security fund (SSF) balance, policy bank bond net issuance, LGFV bond net issuance, as well as the government income statement specific to the SOEs parent Cos.

We expect the "broadly-defined" fiscal deficit to expand by 6-7ppt in 2020, and more if the pandemic-induced global "lockdown" drags on beyond 2Q2020. The expansion of deficit will likely be financed by the increase of bond issuance by government and quasi-government entities, as well as mobilizing idle fiscal reserves, including the fiscal deposits, housing fund, and expediting the reallocation of SOE assets to SSF to facilitate more cuts in social security contributions (SSC) rates. More specifically, we expect the expansion of broadly-defined fiscal deficit to be financed via the following channels:

- **General budget deficit may be expanded to 3-4% from 2.8% in 2019**, against the back-drop of the severe global impact from the once-in-a-century pandemic. The expansion may be somewhat "symbolic", as it only makes up for a fraction of the required fiscal expansion, cyclical or structural. The expansion may be used to finance (part of) the widening gap of central government income and expenditure, driven by falling tax revenue, epidemic-relieves from temporary waiver/reduction of value added tax and income tax, as well as increase in government expenditures in general in times of need.

- **We cannot rule out the possibility of special treasury issuance this year, aimed at epidemic relief.** Special treasury as a major counter cyclical tool was adopted in 1998 to combat the deflationary pressure, driven by a sharp external demand shock amidst the Asian Financial Crisis. Special Treasury, more "explicit" in nature, is a preferred policy tool for fiscal expansion. The more "explicit" government financing are better suited in this environment as it carries lower financing cost, less future NPL implications, and consumes less or none of the banks' capital.

- **Local government bond issuance quota will likely be expanded meaningfully, for both special and common local gov't bonds.** Local government bond issuance has become an

[10] See China Macro Brief, *Quantifying the Loosening Impulse post COVID-19*, published on March 15, 2020.

increasingly important tool for counter-cyclical management since 2015 (Figure 21). We expect local government bond issuance quota to expand by Rmb2-3 trillion in total, with most of it addition to the Rmb2.15trn quota for local government special construction bond last year. Meanwhile, it is also possible for the introduction of a new type of local government bond specific for epidemic relief.

- **Total SSC relief announced so far may add to >Rmb 1 trillion in broadly defined fiscal deficit, recorded under the SSF balance.** It is worth noting that fiscal expansion via tax cuts and/or SSC relief efforts are "structural" and generate positive fiscal impulse. The MOF recently announced that the total "tax" relief' from lowering social security contribution this year may exceed Rmb 1 trillion[11]. In a coordinated effort of epidemic control, the obligation of Social Security Contribution (SSC) may be reduced or temporarily waived (Rmb 600-700 bn in total relief[12]), while healthcare insurance may also see a broad-based, short-term cut (Rmb 150-200bn) by the local governments. In addition, the impact of the 4-5ppt reduction in SSC rate from last May will add more to the total SSC "tax" relief this year[13].

- **Policy bank credit quota and bond issuance may be expanded as well, in order to finance the epidemic relief efforts and/or to boost infrastructure investment growth**. The first batch of policy bank special credit quota for epidemic control has already added another 0.3-0.4% of GDP to the broadly defined gov't borrowing. The State Council meeting on February 25 has announced an Rmb 350bn addition to the policy bank credit quota amidst the global COVID-19 outbreak, which is equivalent to 0.3%-0.4% of GDP. Meanwhile, further additions to the policy bank credit quota cannot be ruled out. As a result, the policy bank bond net issuance will expand accordingly.

- **Last but not least, potential transfers from SOE profitability to the real economy may amount to 0.5-1ppt in quasi fiscal relief as well.** This is part of the "1998 playbook of fiscal easing. These "transfer" include short-term policies to lower rent, utilities, and high-way tolls; extending low-cost credit lines / waiving delinquency fees for the SMEs; and etc. More specifically, "easing" via the SOEs include waiving all highway tolls for 1H2020; granting temporary discounts for electricity, water, and gas bills; reduction of rent by the SOE landlords in a number of major cities, lowering financing cost for SMEs and extending loan durations, and etc. The total "relief" via this channel might add up to a sizable amount – e.g. waiving highway tolls for half a year alone would amount to Rmb 200bn in savings (0.2% GDP)[14,] the State Grid estimates that the discount in electricity fees may amount to Rmb 49bn in savings[15,] discount for rents in many cities will amount to a few billion Rmb each[16,] and etc. In addition, more lenient repayment schedule and lower cost of loans[17] may also lighten the burden of corporate cash flows.

However, cyclical fiscal deficit may expand by 4-5 ppt, leaving only ~2ppt net fiscal impulse, i.e. support to the real economy. With our nominal GDP growth forecast at -7.3% YoY and 4.3% YoY for 1-2Q 2020 (Figure 11 on page 6) , the "cyclical" budget deficit in 1H2020 alone may amount to ~3-4 trillion RMB—our back-of-the-envelope estimate suggests 1H tax revenue may contract more than 20% YoY, while expenditure could see a 10-20% YoY growth. While we expect the real economy to continue growing slightly below trend in 3Q2020, there may be further room for the cyclical deficit to expand in 2H2020, albeit on a much smaller scale.

[11] http://www.gov.cn/xinwen/2020-03/04/content_5486583.htm
[12] See China Strategy Brief, *Reduce, exempt social security insurance to lower corporate burden*, published on February 19, 2020.
[13] See China Macro Thematic Report, *Tax cuts in 2019: This time may be different*, published on April 29, 2019.
[14] See Transportation, *S-T toll fee waiver: A boon to express delivery firms; toll roads' L-T value intact*, published on February 19, 2020.
[15] http://www.gov.cn/xinwen/2020-02/24/content_5482581.htm
[16] For example, 34 SOEs in Shanghai have reduced rent by Rmb 2.5bn; SOEs in the Chaoyang District of Beijing have reduced rent by >Rmb300mn; SOEs in Zhejiang may reduce rent for SMEs by ~Rmb2bn.
[17] http://www.gov.cn/guowuyuan/cwhy/20200205c04/index.htm

The notable expansion of broadly defined fiscal deficit calls for coordinated monetary expansion, in order to keep liquidity conditions accommodative and the funding costs low. Therefore, the PBoC may also ease via base money expansion, RRR cuts, and rate cuts. The PBoC has already issued a total of Rmb 800bn in relending quota, which constitutes an expansion of the base money. Considering money multiplier of 6.1-6.2, the base-money expansion planned so far may generate up to ~Rmb 5 trillion in additional money supply. At this juncture, China still has ample room for further monetary easing – on one hand, global central banks have already cut policy rates to record lows (Figure 22), meanwhile, China's core inflation measures will likely fall rapidly in the near term., we expect further monetary easing in the following forms:

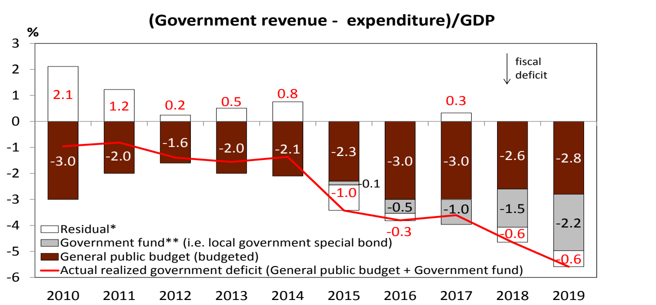
- We expect another 40bp of 1Y LPR and OMO rate cuts in the remainder of the year, most of it front-loaded in 2Q, as the global demand shock will likely see the most notable impact in the next few months (Figure 22).

- We expect RRR to be reduced by another 150bp in the remainder of the year. The PBoC will also likely lower RRR to promote money supply and TSF growth, as external demand is set to contract in the short term and FX reserves may largely stay flat.

- We may also see higher probability of a 25bp cut to the benchmark deposit rate in 2Q2020. The likelihood of a benchmark deposit rate cut has risen substantially, considering the downward pressure on banks' profitability amidst falling rates, and potential deflationary pressure for core CPI & PPI in the pipeline.

We expect the CNY to strengthen against the dollar and the basket after the "dollar liquidity squeeze" is behind us. We maintain our year-end USD/CNY forecast at 6.72. It is worth noting that despite the "headline" depreciation of CNY vs. the dollar since March, the performance of the CNY has been highly resilient among EM currencies (Figure 23). In fact, the Renminbi appreciated notably vs. most of China's trading partners, which we see as a manifestation of China's stronger fundamentals (Figure 24). Thanks to the earlier adoption and more strenuous execution of the quarantine and precaution measures against the pandemic, China managed to stem the COVID-19 outbreak before it spread more widely in the country. In retrospect, China is now 2-3 months "ahead" in terms of effective epidemic control vs. the US and some EU countries (See Figure 4 on page 3), furthermore, the overall "lead time" may be longer considering a relatively fast ramp-up of capacity utilization after the nation-wide lockdown. The sharper short-term contraction of economic activities was a worthwhile price to pay, in order to prevent the potential longer-term damage to the economy and potentially the financial system. Therefore, we expect the "growth differential" between China and the rest of the world to widen from 2Q2020 onwards, which underpins higher risk-free rates in China and a stronger currency.

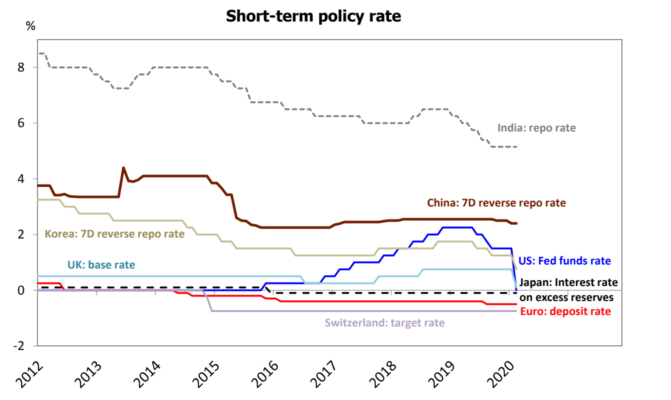
Figure 21: Local gov't special bond issuance has become an important channel of broadly defined deficit financing



*Residual captures the difference between realized fiscal deficit and budgeted fiscal deficit, which possibly includes fiscal reserve deployment, especially for recent years. The data for 2019-20 is our estimation.
** We have included the est. front-loaded quota from the next year here, that's why the governmetn fund deficit realized is higher than the budget. We use historical GDP and our 2019-20 forecast to

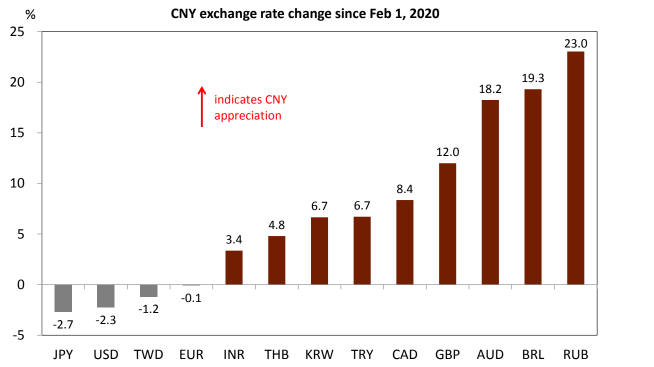
Source: Wind info, CICC Research

Figure 22: Policy rate in China stands out, with the gap widening drastically vs. the major economies



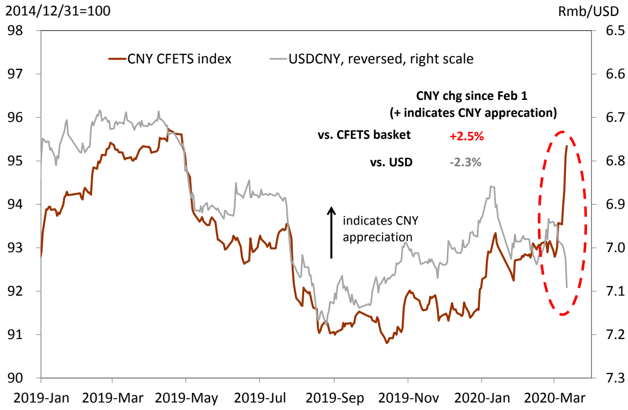
Source: Wind info, Bloomberg, CICC Research

Figure 23: Despite moderate weakening vs. the USD, CNY appreciated vs. most major currencies



Source: Wind info, Bloomberg, CICC Research

Figure 24: Renminbi has appreciate notably vs. the basket, despite a sizable USD "liquidity crunch"



Source: Wind info, Bloomberg, CICC Research

VI. Concluding thoughts- 2020, a year of great uncertainties

Looking forward, the potential upside to our growth and inflation forecasts lies in more efficient epidemic control efforts in US and EU, and the scale of potential policy stimulus from China. At this juncture, the uncertainties around this set of forecast cannot be over-appreciated. The root-cause for the economic contraction and the potential financial market contagion has been the escalation of COVID-19 pandemic, which drove the global economic activities to a "standstill" in a very short period of time. The rapid depletion of corporate and household cash flow and the uncertainties around the duration of this "cash crunch" has made it extremely difficult for the financial market to price the credit risk. Needless to say, if the pandemic reaches "plateau" sooner than expected, we can hope for a smaller shock to the economy and less collateral damage on the collective balance sheets of the corporate and households sectors, as well as the financial institutions.

On the other hand, however, if it takes longer than expected for the pandemic to reach the "plateau stage", the downside to growth may widen, so are the risks for wider-spread and longer-lasting financial market turmoil. If the economic "standstill" last longer than expected, the required policy support to keep the corporate and household balance sheet afloat may grow exponentially, so are the risks of more severe damages to the financial system and more prolonged global recession. In this case, China's economic growth and asset prices will also *not* be immune from the global turmoil.

Although the COVID-19 outbreak has presented a great deal of short-term challenges, it has also provided added incentives and much needed "push" for some long term structural reforms in China, including repurposing the (idle) housing fund, expediting the reallocation of SOE assets to replenish the Social Security Fund, and lowering social security contribution rates. The now-largely-obsolete housing fund system in China had led to a total of Rmb5.8trn (5.8% GDP) of fiscal "reserves" that may be deployed more efficiently. Meanwhile, the corporate contribution ratio to the basic retirement insurance stays at 16% in China, notably higher than the world median of 10%. There is plenty of room for social security contribution rates to be lowered further. In our view, these M/L-term structural reforms will help alleviate burden of the corporate sector, lift corporate profitability, and help boost consumption and investment demand without propping up the leverage ratio. These long-awaited structural reforms will promptly help China weather the short-term "shock" from global slowdown, boost domestic demand, and improve China's growth structure. At this juncture, China has already made headways in combating the COVID-19 outbreak. Timely and thoughtful policy responses will not only help China mitigate the short-term impact on growth from COVID-19 outbreak overseas, but also widen the lead of China's mfg. sector, and promote the development of China's services sector.

Important legal disclosures

General Disclosures

This report has been produced by China International Capital Corporation Hong Kong Securities Limited (CICCHKS). This report is based on information available to the public that we consider reliable or the information of market survey , but CICCHKS and its associated company(ies)(collectively, hereinafter "CICC") do not represent that it is true, accurate or complete. The information and opinions contained herein are for investors' reference only and do not take into account the particular investment objectives, financial situation, or needs of any client, and are not an offer to buy or sell or a solicitation of an offer to buy or sell the securities or the financial products mentioned. Under no circumstances shall the information contained herein or the opinions expressed herein constitute a personal recommendation to anyone. Investors should make their own independent evaluation of the information contained in this research report, consider their own individual investment objectives, financial situation and particular needs. CICC does not provide tax, accounting, or legal advice to our clients, and all investors are advised to consult with their tax, accounting, or legal advisers regarding any potential investment. Neither CICC nor its related persons shall be liable in any manner whatsoever for any consequences of any reliance thereon or usage thereof.

The performance information (including any expression of opinion or forecast) herein reflect the most up-to-date opinions, speculations and forecasts at the time of the report's production and publication. Such opinions, speculations and forecasts are subject to change and may be amended without any notification. At different periods, CICC may release reports which are inconsistent with the opinions, speculations and forecasts contained herein.

The analysts named in this report may have from time to time discussed with our clients, including CICC salespeople, traders, and other professionals, or may discuss in this report, trading strategies that reference catalysts or events that may have a near-term impact on the market price of the securities or the financial products discussed in this report, which impact may be directionally counter to the analysts' published price target expectations for such securities or the financial products. Any such trading strategies are distinct from and do not affect the analysts' fundamental rating for such securities or the financial products as described herein.

CICC's salespeople, traders, and other professionals may provide oral or written market commentary or trading ideas that may be inconsistent with, and reach different conclusions from, the recommendations and opinions presented in this report. Such ideas or recommendations reflect the different assumptions, views and analytical methods of the persons who prepared them, and CICC is under no obligation to ensure that such other trading ideas or recommendations are brought to the attention of any recipient of this report. CICC's asset management area, proprietary trading desks and other investing businesses may make investment decisions that are inconsistent with the recommendations or opinions expressed in this report.

Unless stated otherwise, any performance data quoted represents past performance. Past performance is not a indicator of future performance. No representation or warranty is made that any returns indicated will be achieved. Certain assumptions may have been made in this analysis which have resulted in any returns detailed herein. Changes to the assumptions may have a material impact on any returns detailed.

To the extent this material is provided to any recipient, this material is provided solely on the basis that the recipient has the capability to independently evaluate investment risk and is exercising independent judgment in evaluating investment decisions in that its investment decisions will be based on its own independent assessment of the opportunities and risks presented by a potential investment, market factors and other investment considerations.

This report is distributed in Hong Kong by CICCHKS, which is regulated by the Securities and Futures Commission. Queries concerning CICC Research from readers in Hong Kong should be directed to our Hong Kong sales representatives. The CE numbers of SFC licensed authors of this report are disclosed by the authors' names on the cover page.

This report is distributed in Singapore only to accredited investors and/or institutional investors, as defined in the Securities and Futures Act, by China International Capital Corporation (Singapore) Pte. Limited ("CICCSG"), which is regulated by the Monetary Authority of Singapore. By virtue of distribution by CICCSG to these categories of investors in Singapore, disclosure under Section 36 of the Financial Adviser Act (which relates to disclosure of a financial adviser's interest and/or its representative's interest in securities) is not required. This report is not intended for and should not be distributed or passed on, directly or indirectly, to any other person in the jurisdiction of Singapore. Recipients of this report in Singapore should contact CICCSG in respect of any matter arising from or in connection with this report.

This report is distributed in the United Kingdom by China International Capital Corporation (UK) Limited ("CICCUK"), which is authorised and regulated by the Financial Conduct Authority. The investments and services to which this report relates are only available to persons of a kind described in Article 19 (5), 38, 47 and 49 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005. This report is not intended for retail clients. In other EEA countries, the report is issued to persons regarded as professional investors (or equivalent) in their home jurisdiction.

This report will be made available in other jurisdictions pursuant to the applicable laws and regulations in those particular jurisdictions.

Special Disclosures

CICC does and seeks to do business with companies covered in CICC Research. As a result, investors should be aware that CICC and/or its associated persons may have a conflict of interest that could affect the objectivity of this report.

V190710
Editing: Carol Keaty

China International Capital Corporation Limited
28th Floor, China World Office 2, 1 Jianguomenwai Avenue, Beijing 100004, P.R. China
Tel: (+86-10) 6505 1166
Fax: (+86-10) 6505 1156

United States
CICC US Securities, Inc
32th Floor, 280 Park Avenue
New York, NY 10017, USA
Tel: (+1-646) 7948 800
Fax: (+1-646) 7948 801

United Kingdom
China International Capital Corporation (UK) Limited
25th Floor, 125 Old Broad Street
London EC2N 1AR, United Kingdom
Tel: (+44-20) 7367 5718
Fax: (+44-20) 7367 5719

Singapore
China International Capital Corporation (Singapore) Pte. Limited
6 Battery Road,#33-01
Singapore 049909
Tel: (+65) 6572 1999
Fax: (+65) 6327 1278

Hong Kong
China International Capital Corporation (Hong Kong) Limited

29th Floor, One International Finance Centre
1 Harbour View Street Central, Hong Kong
Tel: (+852) 2872 2000
Fax: (+852) 2872 2100

Shanghai
China International Capital Corporation Limited – Shanghai Branch
32nd Floor Azia Center
1233 Lujiazui Ring Road
Shanghai 200120, P.R. China
Tel: (+86-21) 5879 6226
Fax: (+86-21) 5888 8976

Shenzhen
China International Capital Corporation Limited – Shenzhen Branch
72th Floor,PingAn Finance Center
5033 Yitian Road, Futian District
Shenzhen, 518048, P.R. China
Tel: (+86-755) 8319 5000
Fax: (+86-755) 8319 9229