China: Leading the global recovery?

Mike Sell – April 2020

Summary

- China was the first to suffer with coronavirus, and **we expect China will be the first to exit the crisis**
- Although China is a major global manufacturing hub, exports only account for 20% of GDP and **domestically driven demand is more important**
- **Government stimulus** has already been significant, but the incremental nature of the announcements has led to an **underappreciation of the magnitude of the package**
- **China is the largest part of our portfolios**, representing 29.7% of Alquity Asia and 28.4% of Alquity Future World. **We are invested predominantly in domestically-driven stocks**

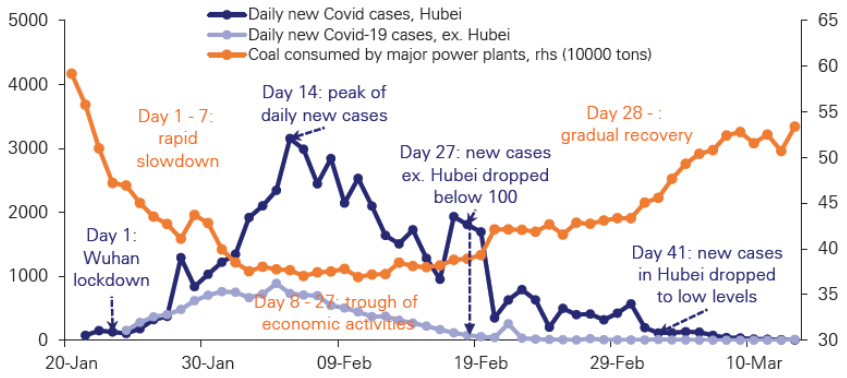
Timeline for the nCovid-19 outbreak

Just when the newsflow relating to the trade war between the US and China had subsided with the signing of the 'Phase One' trade deal in January, headlines started to pop up about the coronavirus outbreak in Wuhan, one of the key industrial centres in China's Hubei province.

The real wake-up call for most was the Chinese government's high-level press conference on the 20th January and the subsequent lockdown of Wuhan on the 23th January, just a day before the Chinese Lunar New Year holiday period. The chart below visualises how the lockdown impacted the economy, using coal consumption as a proxy. It is notable that coal consumption by major power plants rapidly slowed until day 7 of the lockdown, then stagnated until day 27 and started to pick up on day 28 (19th February).

By the end of February, the local government eased restrictions and gradually allowed restaurants and shopping malls to reopen, but it was not until March (day 39 and onwards) that these places started to become crowded. Finally, Wuhan's lockdown was partially lifted on day 63 (25th March) and will be fully lifted on day 77 (8th April).

A timeline of the coronavirus outbreak in China



Source: China CDC, news reports, Bloomberg, Deutsche Bank

The impact of the virus on the economy

During the outbreak households faced a dual shock, as their ability to spend money on consumption was restricted, whilst their purchasing power was also damaged (the official **unemployment rate climbed to 6.2% in February vs. 5.2% in December**). As a result of the dual nature of the shock and the magnitude of the impact, it is unsurprising that households cut back on their spending. Consequently, **retail sales value declined 20.5% YoY** over January and February, according to the official data released by the Chinese Statistics Office.

Businesses were hit hard during the outbreak during the coronavirus outbreak. Both manufacturing and services were negatively affected, as **industrial production contracted 13.5% YoY**, whilst **fixed asset investments declined 24.5% YoY** over January and February. Meanwhile, **the official activities services index dropped 13% YoY** in the first two months of the year.

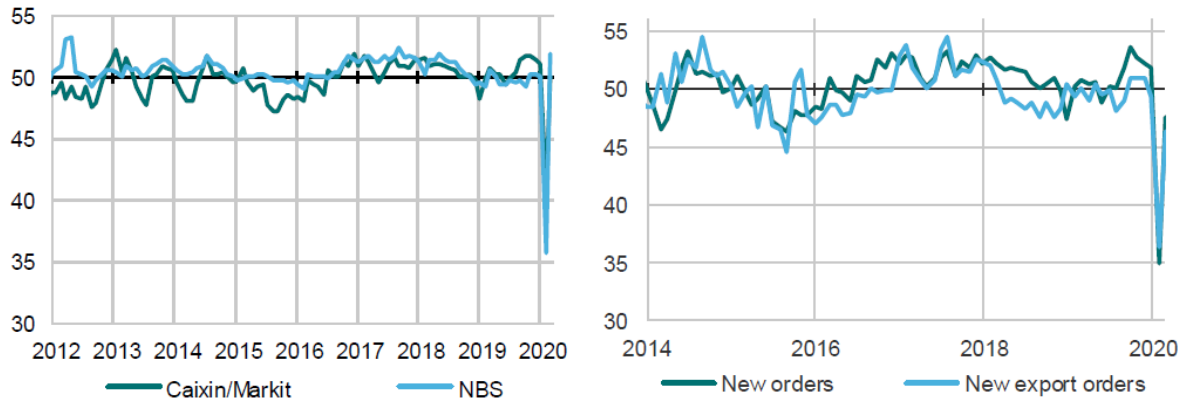
The economic recovery started in March

At the time of writing (early April), the nCovid-19 outbreak appears to have been contained in China and economic activity is gradually normalising. **Daily coal consumption has recovered to about 80% of 'normal' levels, whilst property sales reached about 70% of 'normal'** levels by the end of March.

The most recent set of manufacturing PMI prints indicated that **the Chinese economy hit rock bottom in February** and also started to recover in March. The historic drop in February suggested a sudden stop in economic activity caused by the lockdown. The message conveyed by the PMIs is consistent:

- Employment at medium and large (predominantly state-owned) enterprises started to recover in March
- The recovery of smaller companies could take longer than the recovery in production and employment at larger corporates
- Domestic orders have passed the bottom and rose in March compared with February, whilst export orders continued to contract

Caixin manufacturing PMI (left) and the official manufacturing PMI (right)



Source: Chinese Statistics Office, Markit, Caixin, DNB

Corporate commentary anecdotally confirms this view. For example**, Xiaomi,** a mobile phone manufacturer, **stated recently that production had returned to 80-90%** of normal levels. **Sportswear retailers commented that all their stores are now open**, and March sales revenue had reached 70% of normal levels **with an expectation of 100% normality by the end of June**. In the construction sector, the usage of Glodon – a construction design app – reached 75% of normal levels in mid-March.

Stimulus measures

In order to further foster and accelerate economic normalisation, the government has taken a proactive approach to policymaking. The initial stimulus measures by the Chinese government primarily focussed on the needs of businesses, as their survival is the key for maintaining a high level of employment, whilst their highly leveraged nature makes them vulnerable to sudden economic stops like this one. Among other measures, the administration scrapped social contribution payments by employers.

Later on the 31st March, **the State Council Executive meeting announced another round of new stimulus measures covering fiscal and monetary policy as well as targeted steps to boost domestic consumption**. On the monetary policy front, the State Council announced a **series of support measures for medium, small and micro enterprises** (e.g. through increasing banks' lending quotas, reducing banks' reserve requirement ratios, allowing the issuance of bonds as a means of funding, etc.). Meanwhile, the government increased the bond issuance quota for local municipalities to boost and front-load spending on infrastructure development. **Further measures are aimed at kick-starting auto purchases,** e.g. subsidising auto purchases, incentivising the replacement of old diesel models, reducing VAT on second-hand car sales. Since the government did not detail the size of the respective fiscal measures, it is difficult to gauge the overall quantum of the **supportive fiscal impulse,** but we estimate the size of the overall budgetary package **to be in the range of 4-6% of GDP in 2020**.

We are of the view that the government and the central bank will not hesitate to deliver further stimulus measures to ensure the sustainability of the cyclical upswing. **One area, which has not been directly addressed**, but will most likely need assistance, **is the export-orientated industries**, whose growth prospects are largely a function of US economic strength.

Many commentators have been expecting a 'big bang' announcement similar to the USA's trillion dollar package (signed by President Trump on the 27th March) or the UK's package announced in multiple steps by Chancellor Sunak throughout the second half of March. However, this is not the style of the Chinese government post the Global Financial Crisis, where such measures led to over-aggressive responses from state governments which have taken years to unwind. **The continuation of an incremental approach is to be expected, but this means that the size of the stimulus has perhaps been under-estimated and appreciated by the market.**

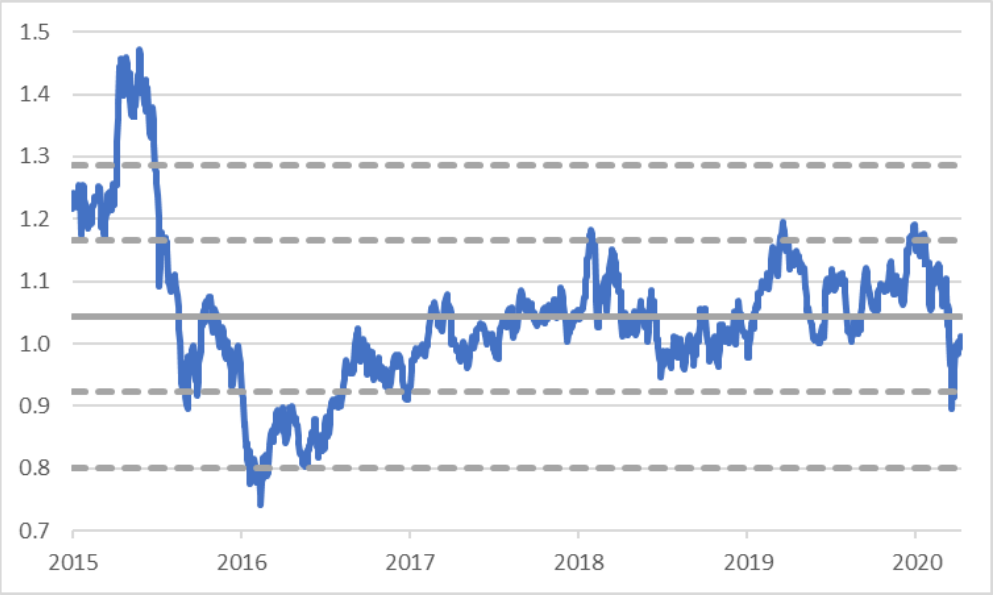
The Alquity Asia and Future World Funds are well positioned to benefit from the domestic economic recovery

We are of the view that the Chinese domestic economy is going to be among the first to go through the process of economic recovery and normalisation. The process is going to be fostered and accelerated by the authorities' stimulus measures (as detailed above). **As our holdings in the Alquity Asia and Future World Funds are predominantly domestically focussed, our funds are well positioned to benefit from the domestic economic recovery cycle**. From valuation and risk-reward standpoints, the Hang Seng Composite index continues to offer an attractive investment opportunity. Despite the recent bounce, the price-to-book ratio of the index remains below both the 5-year and 2002-2020 historical average, as well as substantially lower than valuations prevailing at the beginning of 2020.

Historical 12M trailing P/BV valuation of the Hang Seng Composite index (Chinese "H" shares) since 01/01/2002

Source: own elaboration based on Bloomberg data

12M trailing P/BV valuation of the Hang Seng Composite index (Chinese "H" shares) since 01/01/2015 and +/-2 standard deviation bands



Source: own elaboration based on Bloomberg data

Risks

Investors often are concerned about the accuracy of Chinese macro data, and similar scepticism is applied to China's Covid-19 infection rates. Our view is identical for both economic and Covid-19 data, namely that the trend is the key variable rather than the absolute number. This is unquestionably improving.

At the current time, **our baseline view entails no major second wave in China**, as we see authorities keeping a prudent stance and staying in control. **Thus, we expect economic activity to continue to normalise going forward**. Although we are conscious of the risk of a further significant outbreak- for example international travellers spreading the virus - we assign a fairly low probability to the materialisation of such a scenario at the time of writing. We also know that China's strategy to tackle the coronavirus outbreak (i.e. locking down large geographical regions, introducing curfews, etc.) is highly effective, and thus we can have confidence that this will again be the case in the future. We would therefore expect any market reaction to be less dramatic if such a situation were to occur.

Conclusion

China was the first to suffer with coronavirus, and **we expect the country and its economy to be the first to exit the crisis**. Although China is a major global manufacturing hub, exports only account for 20% of GDP and thus domestically driven demand is more important, which has already shown signs of normalisation. Government stimulus has already been significant, but the incremental nature of the announcements has led to an underappreciation of the magnitude of the package. Further stimulus by the government and the central bank will foster and accelerate the normalisation process.

China remains the largest part of our portfolios, representing 29.7% of Alquity Asia and 28.4% of Alquity Future World, **and we have invested predominantly in domestically-driven stocks with excellent ESG factors** such as **Xtep** (sportswear), **Shimao Property** and **Hangzhou Robam** (kitchen appliances). **We have also been adding to attractively valued companies** such as **Yongda Auto** (auto dealership) that will benefit from looser liquidity and the bounce in consumer sentiment. We believe that the Alquity Funds are well positioned to benefit from the expected Chinese domestic economic upswing.

For more information on Alquity, please

UK
Alex Boggis
+44 207 5577 850
alex.boggis@alquity.com

MIDDLE EAST & ASIA & UK
Suresh Mistry
+44 207 5577 850
suresh.mistry@alquity.com

EUROPE
Benoit Ribaud
+44 207 5577 850
benoit.ribaud@alquity.com

NORTH AMERICA
Renee Arnold
+1 215 350 9063
renee.arnold@alquity.com

UK
Susannah Preston
+44 207 5577 850
susannah.preston@alquity.com

LATIN AMERICA
Cyn Cano
+44 207 5577 871
cyn.cano@alquity.com

www.alquity.com
@Alquity
/Alquity
/company/ alquity-investment-management-limited

The information in this document (this "Document") is for discussion purposes only. This Document does not constitute an offer to sell, or a solicitation of an offer to acquire, an investment (an "Interest") in any of the funds discussed herein. This Document is not intended to be, nor should it be construed or used as, investment, tax or legal advice. This Document does not constitute any recommendation or opinion regarding the appropriateness or suitability of an Interest for any prospective investor.

This material is for distribution to Professional Clients only, as defined under the Financial Conduct Authority's ("FCA") conduct of business rules, and should not be relied upon by any other persons. Issued by Alquity Investment Management Limited, which is authorised and regulated in the United Kingdom by the FCA and operates in the United States as an "exempt reporting adviser" in reliance on the exemption in Section 203(m) of the United States Investment Advisers Act of 1940.

The Alquity Africa Fund, the Alquity Asia Fund, the Alquity Future World Fund, the Alquity Indian Subcontinent Fund and the Alquity Latin American Fund are all sub-funds of the Alquity SICAV ("the Fund") which is a UCITS Fund and is a recognised collective investment scheme for the purposes of the Financial Services and Markets Act 2000 of the United Kingdom (the "FSMA"). This does not mean the product is suitable for all investors and as the Fund is invested in emerging market equities, investors may not get back the full amount invested.

This Document is qualified in its entirety by the information contained in the Fund's prospectus and other operative documents (collectively, the "Offering Documents"). Any offer or solicitation may be made only by the delivery of the Offering Documents. Before making an investment t decision with respect to the Fund, prospective investors are advised to read the Offering Documents carefully, which contains important information, including a description of the Fund's risks, conflicts of interest, investment programme, fees, expenses, redemption/withdrawal limitations, standard of care and exculpation, etc. Prospective investors should also consult with their tax and financial advisors as well as legal counsel. This Document does not take into account the particular investment objectives, restrictions, or financial, legal or tax situation of any specific prospective investor, and an investment in the Fund may not be suitable for many prospective investors.

An investment in the Fund is speculative and involves a high degree of risk. Performance may vary substantially from year to year and even from month to month. Withdrawals/redemptions and transfers of Interests are restricted. Investors must be prepared to lose their entire investment, and without any ability to redeem or withdraw so as to limit losses.

References to indices herein are for informational and general comparative purposes only. There will be significant differences between such indices and the investment program of the Funds. The Fund will not invest in all (or any material portion) of the securities, industries or strategies represented by such indices. Comparisons to indices have inherent limitations and nothing herein is intended to suggest or otherwise imply that the Fund will, or are likely to, achieve returns, volatility or other results similar to such indices. Indices are unmanaged and do not reflect the result of management fees, performance- based allocations and other fees and expenses.

All Fund performance results presented herein are unaudited and should not be regarded as final until audited financial state ments are issued. Past performance is not necessarily indicative of future results. All performance results are based on the NAV of fee-paying investors only and are presented net of management fees, brokerage commissions, administrative expenses, and accrued performance allocation, if any, and include the reinvestment of all dividends, interest, and capital gains. Net returns shown herein reflect those of an investor admitted at inception of the Fund, and are representative of a regular [shareholder], net of applicable expenses and reflect reinvestment of dividends and interest. In the future, the Fund may offer share in the Fund with different fee and expense structures.

The Fund's investment approach is long-term, investors must expect to be committed to the Fund for an extended period of time (3-5 years) in order for it to have an optimal chance of achieving its investment objectives.

This Document may not be reproduced in whole or in part, and may not be delivered to any person (other than an authorised recipient's professional advisors under customary undertakings of confidentiality) without the prior written consent of the Investment Manager.

SWISS INVESTORS:

The prospectus, the Articles of Association, the Key Investor Information Document "KIIDs" as well as the annual and semi-annual report of the Fund is available only to Qualified Investors free of charge from the Representative. In respect of the units distributed in Switzerland to Qualified Investors, place of performance and jurisdiction is at the registered office of the Representative.
Funds other than the Luxembourg domiciled Alquity SICAV mentioned in this document may not be admitted for distribution in Switzerland.

Swiss Representative: FIRST INDEPENDENT FUND SERVICES LTD., Klausstrasse 33, 8008 Zurich.
Swiss Paying Agent: Neue Helvetische Bank AG, Seefeldstrasse 215, CH-8008 Zurich.