March Marks a Critical Point for China's Economy

The Full-year Impacts of the COVID-19 Epidemic May be Determined by Economic Activity in the Month

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Scenario Summary

As the COVID-19 epidemic continues to unfold, we believe its ultimate impact on China hinges upon the resumption of economic activity in the key industrial sectors. While we remain cautiously optimistic on the economy's resilience in 2020, we present in this report three likely scenarios that may materialize in the remainder of the year (exhibit 1). These scenarios inform our views on individual corporate sectors and we will continue to review our macro assumptions as new data points become available.

Scenario 1: Base Case. Our base-case scenario assumes that the epidemic has largely been contained and that economic activity will gradually recover from late-February. In this scenario, we expect the short-term economic impacts to be the most severe for the retail, hospitality, entertainment, travel, and transportation sectors. The industrial and construction sectors may also come under pressure to some extent. Overall, we regard the short-term impacts on consumption and industrial production to be manageable, bottoming out in the first quarter. Our sector-level assumptions lead to our GDP growth forecasts of 3.3% for 1Q20 and 5.5% for the full year, which represents a downward revision of 50 basis points from our original expectation. Meanwhile, we expect the consumer price index (CPI) and the producer price index (PPI) to be 3.5% and -1% for 2020. Our forecasts on retail consumption growth and fixed asset investment (FAI) growth for the full year are 9% and 5%, respectively.

Scenario 2: Pessimistic Case. In our pessimistic case, we assume economic activity will remain stagnant until late-March. We expect that, under this scenario, the government will implement more drastic stimulus measures, which will fuel a turnround in early-April. If this scenario emerges, we anticipate that a meaningful number of corporate entities, especially micro, medium and small enterprises (MMSEs), will default on their contractual obligations as a result of a sharp contraction in revenues and liquidity shortage. While we consider the ultimate impact to be short- to medium-term, a significant part of the economic loss may not be recaptured in subsequent months. These more conservative assumptions lead to our GDP growth forecast of 0.7% for 1Q20 and 4.9% for the full year. We expect the resulting imbalance in supply and demand conditions will drive full-year CPI up to 3.8% and drag PPI down to -1.5% in 2020. We also anticipate that the growth in retail consumption and FAI will moderate to 8% and 4.6%, respectively.

Scenario 3: Severe Case. Our severe scenario assumes that the COVID-19 outbreak will continue to spread nationally and social order will not be restored until late-May, and that economic activity will largely be stalled until early-June. Should these conditions occur, we anticipate that a significant number of small and medium enterprises (SMEs) will have defaulted. A considerable number of mid- to large-sized issuers may also be under liquidity distress, leading to a sharp decline in investments and widespread unemployment. We consider the resulting impact to be structural and mid- to long-term. Under this scenario, we expect full-year GDP growth to fall to 3.1%, CPI to spike to above 4.5% driven by a structural distortion of economic supply and demand, and PPI to worsen to -2%. Growth in retail consumption and FAI are forecast to drop to 5-6% and below 4%, respectively.

To mitigate the potential impacts of the above scenarios, we are of the view that a proactive policy stance is necessary. Specifically, we believe the current environment calls for: (1) a more aggressive fiscal stimulus program, coupled with an accommodative monetary policy; (2) targeted policies to boost consumption; (3) continued reforms towards economic restructuring; (4) temporary relief in corporate and household financial burden to stabilize employment; and (5) prudent risk oversight to maintain systemic financial stability.

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Exhibit 1: Key Macro Assumptions

	Base Case	Pessimistic Case	Severe Case
2020E			
Real GDP Growth	5.5%	4.9%	3.1%
CPI	3.5%	3.8%	> 4.5%
PPI	-1.0%	-1.5%	-2.0%
Retail Consumption Growth	9.0%	8.0%	5.0 – 6.0%
FAI Growth	5.0%	4.6%	< 4.0%

Source: Pengyuan International

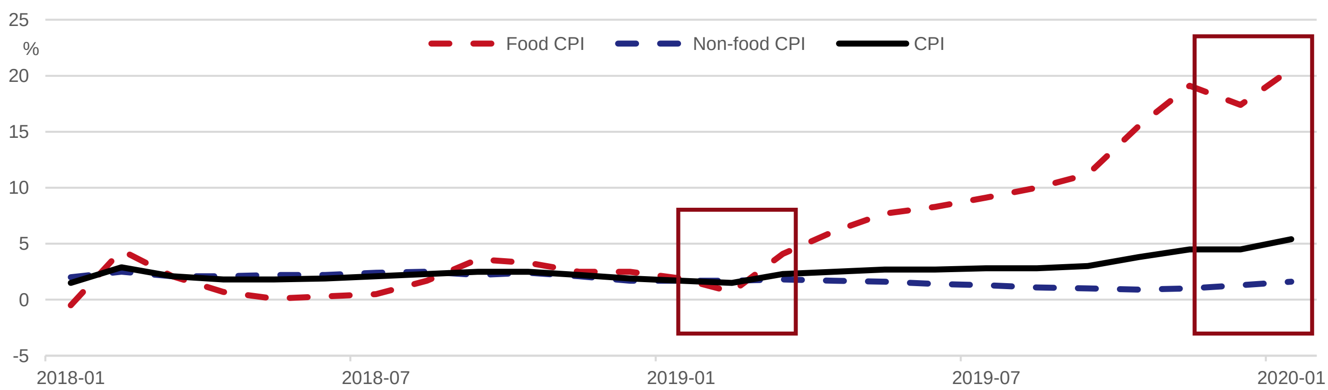
The Tail Risk of Inflation

In our analysis, we assume that China's CPI will rise by 3.5% to above 4.5% in 2020, depending on the severity of economic disruption. However, we note that inflation may present a tail risk to the economy in a low-probability, high-impact scenario. Even before the onset of the COVID-19 epidemic, China's inflation started to face significant upward pressure, largely due to the increase in food prices. The rise in food CPI has been driven by the African swine fever outbreak, which continues to create a national pork shortage despite policies to promote large-scale production. The risk of a widespread locust and other insect outbreaks also adds to inflation concerns. This has resulted in an increasing divergence between food and non-food CPI, putting policymakers in a precarious position (exhibit 2).

As far as food CPI is concerned, we see the risk of the country's critical spring planting season being disrupted as a major concern. As the epidemic continues in February and March, we believe the harvest season for last Autumn's crops may already have been affected to a certain degree. The current spring crop planting cycle begins in early March, with harvests due for the summer. In our pessimistic scenario, we assume that economic activity will begin to pick up in early April. But if the COVID-19 epidemic becomes rampant in rural areas and farmers are unable to resume production due to labour constraints or disruptions in the supply of fertilizer and pesticides, there may be a significant impact on staple food supply as we head into the third quarter. Should the epidemic continue into the autumn planting cycle, which starts in August to September, the impact on CPI and social stability may be severe. The disruption may also extend to non-farm food production, such as poultry and pork farming, etc. China's massive food reserve system may provide a buffer for the government to control food prices, but its effectiveness remains untested in extreme conditions.

The extreme case for non-food CPI is more nuanced. While the epidemic may ease prices in discretionary industries – such as textiles and entertainment – it may drive up the costs of goods that require long-distance supply chains. At present, we are witnessing initial production recovery in select regions, but we caution that work resumption may be uneven across sectors. We also highlight that if the country's major ports – such as Shanghai and Tianjin – remain backed up, companies that require imported inputs may experience further delays in production. On aggregate, we believe the risk of non-food CPI inflation is on the upside, particularly if the economy experiences our severe scenario and national logistics networks remain highly congested as we approach the summer of 2020.

Exhibit 2: Divergence of China Food and Non-food CPI (Year-on-Year Growth)



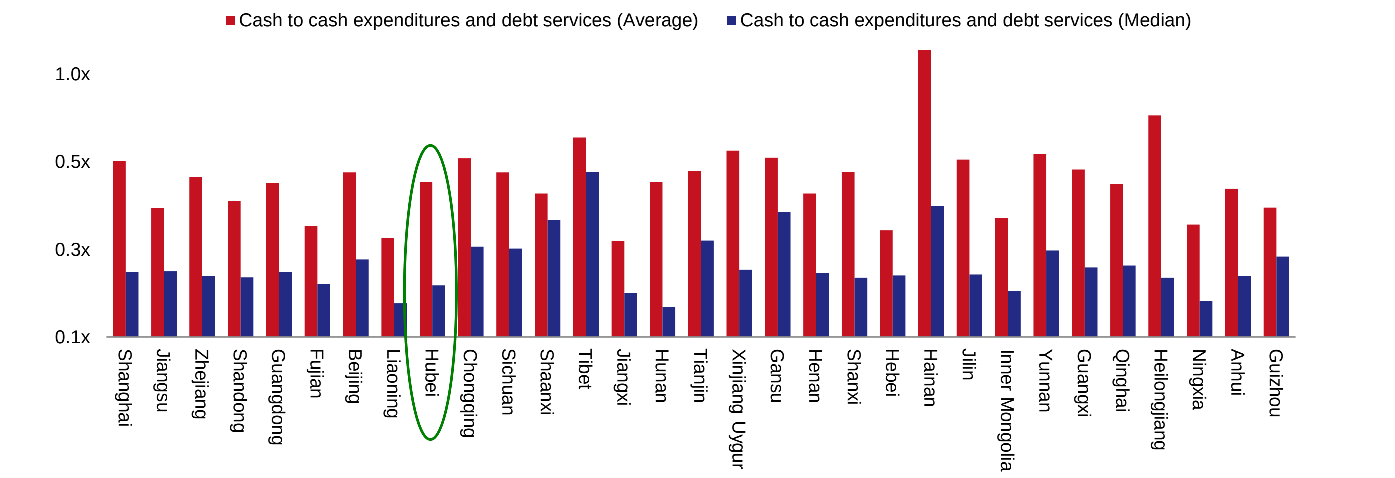
Source: National Bureau of Statistics of China

Corporate Cash Stress Varies

Usually, most Chinese corporates prefer to hold large amounts of cash and liquid assets on their balance sheets when possible, which often provides liquidity protection in extreme events like the COVID-19 outbreak. However, such cash buffers are typically only available to mid- to large-sized corporates and state-owned enterprises, while MMSEs tend to be cash-strapped even under normal economic circumstances. In our base-case scenario, we believe most Chinese corporates, including SMEs and MMSEs, will survive the COVID-19 epidemic despite their cash flow tightness and operating losses. But as we stretch our assumptions to the pessimistic and severe case scenarios, we believe defaults and bankruptcies among the SME and MMSE group will pick up rapidly as a result of the extended economic disruption. Out of China's 22 million legally-registered business entities, the vast majority of them are micro and small corporates, which are the ones that are most negatively impacted by the epidemic, in our view.

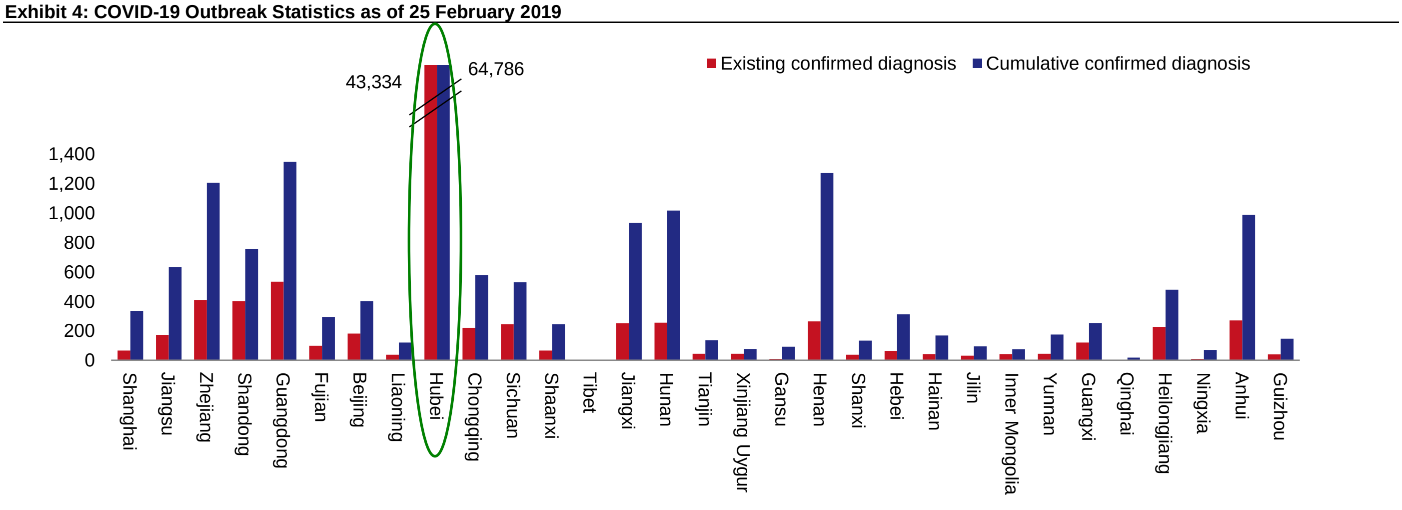
Due to the lack of economic and financial data for the vast group of small and micro entities, we focus on the publicly listed A-share corporates to analyze cash and liquidity conditions for different industries and regions (exhibits 3 and 4). We use the narrowest measure of cash, without assuming operating cash inflows (most likely to be disrupted by the epidemic) and additional bank support, over the company's cash expenditures and debt service needs. Cash stress varies among different industries and regions, but we expect such distress will increase across the board as the epidemic continues. Enterprises in Liaoning, Jiangxi, Hunan and Ningxia provinces seem to face the most severe cash shortage problems compared to other regions; whilst the median company's cash stress in the epidemic center of Hubei province is also greater than peers outside the province.

Exhibit 3: Cash Stress Varies Across Different Province (Annualized 2019 Data)



Source: Wind, Pengyuan International estimates

Exhibit 4: COVID-19 Outbreak Statistics as of 25 February 2019



Source: DXY, Pengyuan International estimates

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