Letter n°2

China and the Coronavirus crisis

“It is necessary to take an event by the hand before it seizes you by the throat”, Winston Churchill

This witticism by Churchill translates as the principle of precaution put forward by every government, which pays the price of slower activity for the short term in order to prevent a potentially more serious crisis. The cost of SARS in 2003 was 1% of GDP growth for China and 0.2% for world GDP growth. Four reasons suggest that the impact will be more serious in 2020: China delivers not 4% but 15% of world GDP, Chinese economic growth is weaker – less than 6% today against 10% at the time-, production chains are more intertwined, finally the number of people infected is already ten times higher today.

Regional at the time, the present crisis is felt across the world and already affects more than seventy countries. Supply is disrupted, demand is reduced, financing dries up and growth declines.
Equity prices for the most sensitive sectors – Autos, oil and gas, materials, transportation, have been marked down, but other sectors are now impacted. Recent OECD forecasts of 2.9% for global GDP in 2020 have just been revised downwards to 2.4%. A lost quarter for now, to be followed by some recovery for a subdued year overall.
Nothing to do with the 1917 Spanish influenza which struck one billion people, half of the world population at the time, and 70 million deaths. According to a World Bank study, a similar crisis today would cost 5% of world GDP. Nothing to do, but fear weakens growth.

We can look at this crisis under four angles: political, economic, financial and micro-economic.

Political angle

Xi Jin Ping did sack local officials, tightened government control of the media and cancelled the parliamentary session. His position could nevertheless be affected by growing public discontent if the crisis goes on. Let us recall the aftermath of the Great Leap in 1962, Mao was then held responsible for the death of 35 to 50 million people during the great famine and Liu Shao-Chi, President of the Republic, attacked him sharply. Mao had to wait for the Cultural Revolution to be able to take revenge, to have Liu arrested by Lin Piao, Minister of Defence and faithful to Mao. Liu, then aged 70, was beaten up by the crowd and died in 1969.
According to the WHO, the peak of new contaminations in China came on February 2 but, even if Xi denies it, its economic consequences compromise the objective of achieving 5.5% GDP growth in 2020 and erasing poverty by the end of 2020, defined as under $ 335 yearly income.

The crisis reveals the shortcomings of the Chinese health system. In Europe, everyone is ecstatic over building a 1000-beds hospital within one week but this feat must not mask weaknesses of the Chinese health system: public health amounts to5% of GDP only, one doctor caters for 5000 to 6000 people as against one for 1500 to 2000 inhabitants in developed countries on average, or 4 beds per 1000 people against 12 per 1000 in South Korea. Therefore, one should expect Europe to better deal with the medical crisis, owing to the more accurate knowledge granted by delayed contamination and to its depth of equipment, health manpower and organization.

Macro-economic angle

Chinese growth weakened

The first economic statistics after the virus outbreak are terrible. The PMI figure at 40 is worse than in 2008. The industrial production indicator decline at 28 in February against 52 in January was expected but the fall of activity in the services is fraught with consequences as it represents 60% of Chinese GDP. Only environmentalists will rejoice at the pollution indicators decline. A likely 10% drop in household consumption means over 1% economic growth gone.
The most impacted sectors: air and sea transport, port activities, auto industry -China being the N°1 world market with 26 M. vehicles produced against 17 M. in the US, banks because yield curves flatten again and bad debts worsen, tourism – 20% ($280 billion) of the total industry revenues are spent by Chinese tourists (in France, they account for 2.5% of the total but more than 7% of revenue). In faraway memory now lies year 1990, Chinese tourists were then spending $ 500 M abroad. Today's impact is major. Nevertheless, one should not worry too much, the potential is still enormous because still only 5% of Chinese have a passport.

Global growth impacted

While the Chinese economy is more turned on itself than a few years ago, it has not represented such a weight in the world economy since the eighteenth century. In 2007, exports represented 30% of GDP, today 22% only but that means $ 2,630 billion in 2018, including $ 540 bn to the US, $ 180 bn to Japan and $ 90 bn to Germany. Chinese imports are stagnating or declining today in relative terms but still bring a significant contribution to world growth, and China remains the global industrial production leader despite the new trend of offshoring production out to Asia or to the Americas. While the trade surplus no longer represents 10% of GDP and foreign exchange reserves are down $ 1000 billion, at $ 3200 bn these remain the world largest, and China remains together with Japan the first foreign holder of US Treasuries, with ownership of just over $ 1,100 bn. Tight control of capital outflows prevented the currency from weakening, and all along the crisis the Yuan was stable against USD at around a 7.0 rate.

According to recent statistics from the World Bank, China represents 34% of international trade flows, compared to 1.2% in year 2000. A 2% decline in the Chinese GDP growth rate would imply a 0.4% GDP slowdown in Japan, 0.25% in Germany, practically nothing in France or in the United States More vulnerable are Australia (30% of its exports to China), Brazil (20%), South Korea and Vietnam (22%) and Japan (20%).
Also vulnerable to production interruptions in China and supply problems are Australia (25% of total imports from China), Japan (23%), the US (22%). In Japan and South-East Asia business confidence indicators are down to less than 50, potentially forewarning a recession.

Constraints on international trade

The momentum in international trade has been slowing down for some years. Foreign trade flows previously grew at double the rate of global economic growth. But rising protectionism plus increasing competitiveness for robotization of production chains and 3-D production had opened perspectives for companies to repatriate production in developed countries. The coronavirus crisis is laying bare the fragility of complex production chains, leading whole industrial sectors to re-evaluate operational deployment strategies. Potential growth could adjust lower for Chinese industry and SingAlliance investment policy will have to integrate this shift.
Trade balance usually has a major impact on exchange rates, and the resistance of the Yuan during this crisis may come as a surprise. Let us not forget that China keeps tight and efficient control of capital flows as a first line of defence and a dual currency system as the ultimate weapon for currency

stability. Within China's current 15% share of world exports, 40% originates from subsidiaries of foreign multinationals producing locally. Over the past ten years China has reduced its dependence on external markets and domestic consumption has increased its share of total GDP. For the long term, erosion of competitivity relative to other emerging economies leads to a still larger share of domestic consumption in total GDP and calls for accelerating concentration towards operational excellence. Achieving the latter trend may be slowed by the strategic imperative of independence, in which case global trade growth will lose its main driver.
Consumption share of GDP was 35% ten years ago, lowest among large countries. At 55% today, it is on par with India or Japan, and stands as one of the two vectors of Chinese growth for the next generation. Facts: 4% of world population lives in the US and accounts for over 25% of world consumption spending. Figures for China are resp. 20% of population and 10% of consumption. This is a challenge for China.
China FDI (foreign direct investments) to the US dwindled from $ 45 billion to $ 5 billion between 2016 and 2019, from $ 80 bn to $ 13 bn to Europe between 2017 and 2018. Scrutiny by developed countries governments is on the rise, a negative factor for Chinese investments abroad. The long-term trend towards globalization through regional centres of excellence is not going to reverse but will shift away from offshoring towards a world of economic blocks. This is already taking shape around 5G and technology, for instance Huawei with its launch of a 55,000 applications virtual store.

Monetary policy, budget policy and markets angle

The temporary inversion of US yield curve reflects anticipations of further reductions in official rates rather than recession fears. Yesterday dismissed by the FED, now discounted by markets, a new rate cut by June currently provides a floor to equities and to bonds. FOMC members do not dismiss this possibility. Of course, the limit to expectations is the ineffectiveness of monetary policy as a cure to a supply shock. In the meantime, the gap between asset valuations and real-world fundamentals will prosper.
China is resorting to various tools to compensate for the slowdown: lowering interest rates, easing bank lending to large companies, providing stimulus measures to the tune of $ 170 billion, but it will have to do much more if we refer to the magnitude of the stimulus in 2009, almost 10% of GDP. In Italy, the Government just disclosed budgetary measures up to Euros 3.2 bn to help sectors in difficulty.

Micro-economic angle

While Tencent is prospering with the crisis thanks to online games and Chinese techno equities are still up 25% this year, most of the economy is disrupted.

Disorganization of production chains

Transportation, energy, materials, luxury goods, auto industry: major sectors impacted by the crisis, that will have to be bought back later. For many firms' production is currently impacted by a lack of manpower while quite a few service companies can cushion the crisis with telework. One can mention Qualcomm for half of its chips production or Apple for 1/6th of its sales.

Bankruptcy risks for Chinese companies

The Association of Chinese SMEs represents companies with less than 3000 employees, which altogether produce 60% of Chinese GDP and employ 80% of salaried workers. It just made public a February 14 survey which disclosed that one third of companies believed they could only survive a month. Notwithstanding public aid, a prolongation of restrictions due to the coronavirus crisis could thus be fatal for many Chinese companies whose financial fragility is known. By extension, it could affect the banking sector already weakened by bad debts, officially at 2% but certainly higher.

Conclusion

"The justification of doom prophecy is to prevent it from being realized", Hans Jonas

This is the other side of the precautionary principle at work today. At the end of this crisis, the rebound in activity in statistics will be significant but the Chinese virus, spread around the world, is indicative of structural weaknesses that investors must integrate.

Instability in countries with low savings rates, dependent on foreign capital, today confronted with losses in forex reserves and with a weakening of their currency. We think of Turkey, where reserves fell to $ 24 billion from $ 37 billion at the start of the year, South Africa, Argentina, India or Brazil; all of these, countries where investment requires discernment. The most exposed state and the most fragile regime is Iran which, despite American sanctions, has continued to trade with China and sees its borders with Pakistan, Iraq and Turkey closed because of this epidemy that it struggles to master.

Precariousness of indebted, marginally profitable companies, just getting by thanks to low rates and now helpless against the brutal slowdown and the cyclical recovery in inflation - 5.4% in January for China, caused by supply disruptions.
Uncertain prospects for corporate profits growth almost everywhere in the world in 2020 and for the long term, fragility for operating margins which could fall with a retrenchment of globalization and optimization carried out by firms in the last twenty years, and this is but partly discounted in the financial markets decline.
Volatility of raw materials and energy prices, respectively -10% and -20% this year.
As stated above, further rate cuts will not prevent economic destruction brought by supply disruptions. Extended recourse to tax measures and to local, focused initiatives will be more efficient. One thinks of Germany, rich in surpluses and poor in prospects, and of many other countries too.

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Geneva, March 3rd, 2020

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