China View

February 2020: The corona effect

China's short-term growth prospects have been weakened significantly by the coronavirus. Future growth depends very much on how the virus spreads and how quickly the economy turns to a recovery phase.

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Macro: The coronavirus will have a substantial negative impact

The coronavirus will have a substantial negative effect on the Chinese economy. In the light of the current information, we estimate the production loss in the first quarter of 2020 to amount to 3-4% of the quarterly GDP, which would take the annual growth rate to around 3% compared to 6% in our baseline. If recovery starts in the second quarter of 2020 as we now expect, the growth rate for the whole of 2020 could be 1 pp lower than in our baseline, ie around 5%.

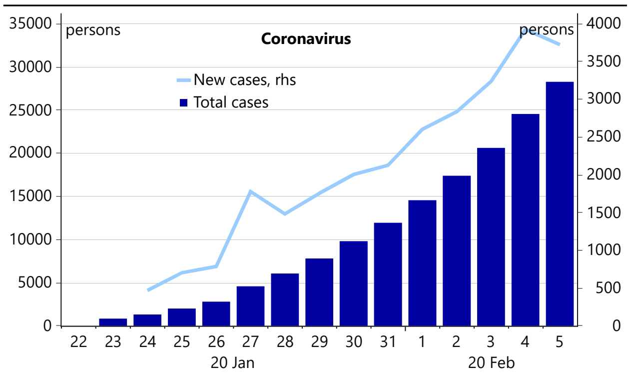
Uncertainty related to the outbreak is high

At the moment, it is of course impossible to give any estimate of the size of the impact with any degree of certainty. We do not have reliable information about how devastating the virus is and especially whether the measures determined by the Chinese authorities have been effective in containing the outbreak such that the number of new cases will peak at relatively low levels over the coming weeks.

CNY: Virus fears

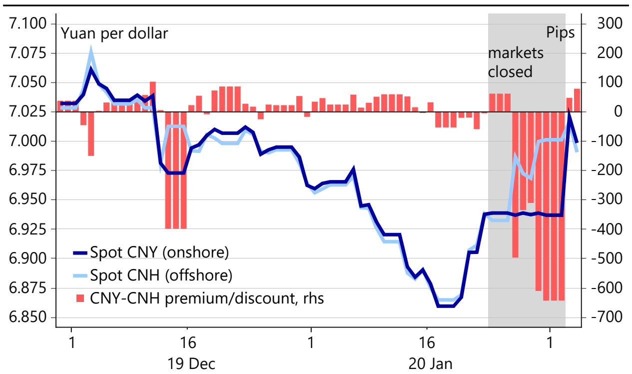
The outbreak of the coronavirus has unnerved investors and sent markets in a rout. The PBoC is taking measures to restore confidence. Until the spread and impact of the virus become clearer, the CNY will remain volatile.

THE OUTBREAK OF THE CORONAVIRUS



Source: Macrobond and Nordea

CNY CATCH-UP EFFECT AFTER LUNAR NEW YEAR CLOSURE



Source: Nordea and Macrobond

Macro: Corona effect

China's short-term growth prospects have been significantly disturbed by the coronavirus. There is a lot of uncertainty related to future developments in terms of the spread of the virus, but whenever the recovery starts we expect it to be rapid.

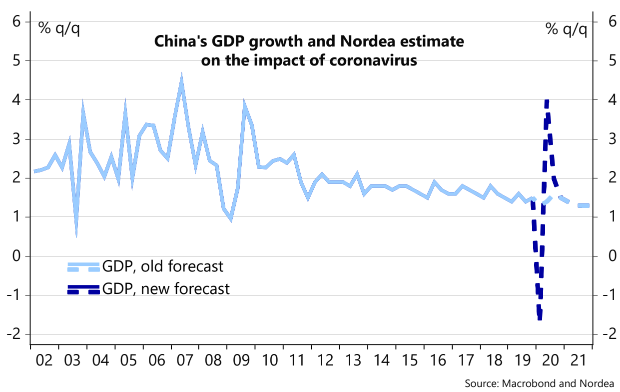
We expect negative growth for China in the Q1 2020, but for a post-epidemic recovery to be rapid

The coronavirus will likely have substantial negative effects on the Chinese economy. In light of the current information, we estimate the production loss in the first quarter of 2020 to amount to 3-4% of quarterly GDP, taking the annual growth rate to around 3% compared to 6% in our baseline. As we assume a quick recovery after the epidemic, the growth rate for the whole 2020 could be only 1 pp lower than in our baseline, ie around 5% (see more detailed calculations below). We of course acknowledge that it is impossible to estimate the size of the impact with any level of certainty at the moment. Furthermore, the official GDP numbers are likely to smooth developments after all.

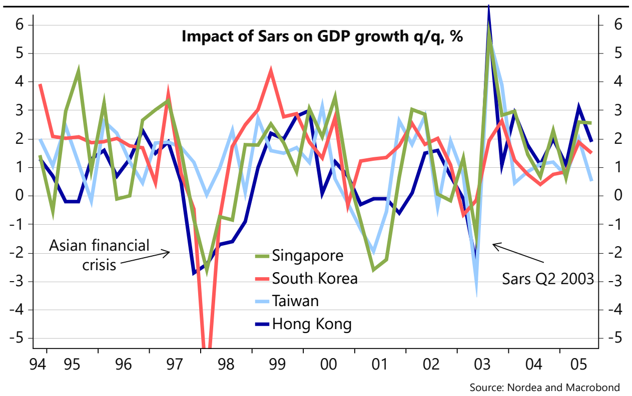
Key question: How long will the epidemic last?

One of the key assumptions we have to make to come up with the above numbers is the duration of the epidemic. Based on the official numbers, the epidemic does not seem to be spreading exponentially at the moment, but we do not know whether this is a sign that China's drastic measures to limit movement are efficient or if it is due to eg insufficient capacity to diagnose the cases. At this stage, we rely more on the first option and assume the number of new cases will peak in coming weeks at relatively low levels. However, many experts point to a scenario that is much longer, and we note that took months to get SARS under control in 2003 which implies to us that there is a substantial risk that it will take longer than is in our calculations to get the economy back on track.

Q1 GROWTH Q/Q EXPECTED TO BE IN NEGATIVE TERRITORY



REBOUND AFTER SARS WAS FAST



Expecting annual GDP growth to drop to 3% in Q1 2020

Our very rough estimate is that during the original holiday period until 30 January, the extremely low activity touched mainly sectors related to leisure time, like transport, tourism, culture and catering, which we calculate to cover less than one tenth of the economy. A serious drop for one week in that type of activity could have taken around a 0.5 pp bite out of GDP in quarterly terms.

When the shutdown continued longer, it started also to hurt areas where activity was supposed to return to full speed after the holiday (eg education, manufacturing, construction). On the other hand, the shut down has not covered 100% of those sectors or the Chinese territory. such areas, or 100% of activities within them]. Thus, we assume that the significantly limited production covers around 40% of the whole economy at present, and takes away 40% of the activity in those sectors. This would imply another loss of around 1.5% from the quarterly GDP by 9 February, we calculate.

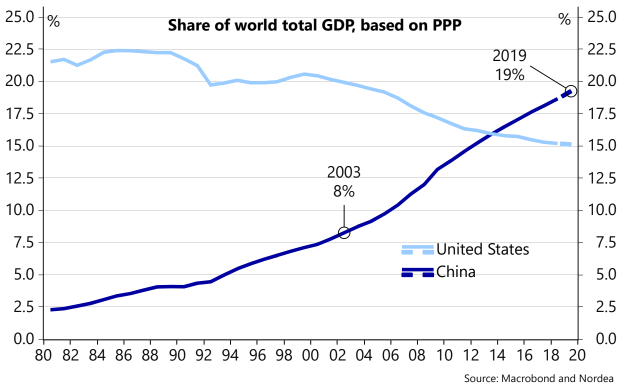
In addition, we see a high probability that the shutdown and weak economic activity level will continue for at least for the rest of February, but perhaps at a somewhat milder pace. If we assume March is already in our baseline, the whole Q1 2020 GDP could see a quarterly drop of around 2% compared to our original growth rate of 1.5%. In annual terms, growth would slow down to 3%.

Epidemic should not cause

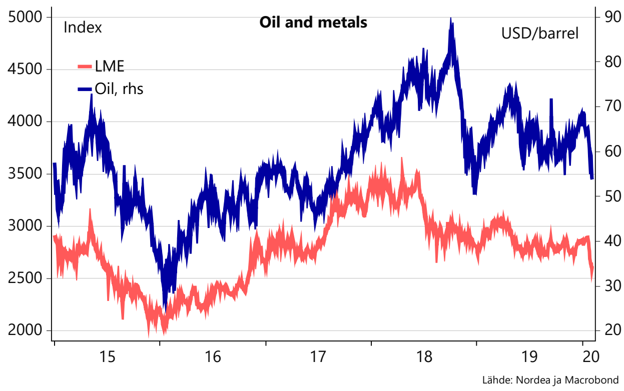
Given our assumption of how the virus will be contained, the negative effect in the first permanent output losses

quarter will be devastating, but the recovery will be fast. The epidemic should not have a significant impact on China's long-term potential, and we assume that, for example, the household saving rate will not rise permanently and that the factories are capable of increasing production in order to catch up with the output losses in the beginning of 2020. This was the experience after SARS and also after several terrorist attacks in Europe. Thus, the quarterly growth rate in Q2 could be above 4%. That would imply annual growth for 2020 of around 5% and some carry over also for 2021. However, there is a high chance that the official numbers will not show such volatility after all.

CHINA'S SHARE IS ALREADY LARGE



WEAK GROWTH PROSPECTS IN CHINA DOMINATE METALS



Global impact mainly via confidence, raw materials, tourism and supply chains

Given that China is the most important growth engine in the world and its share of the global GDP has risen almost to a fifth, a significant drop in China's GDP will certainly have global impacts as well. The negative reaction in the global financial sector of course reflects this fact. Furthermore, if the virus starts spreading outside China, we expect the impact in the infected countries to be comparable what we now see in China.

In addition to tourism, one of the most negative immediate global impacts of the coronavirus has been visible in many raw material sectors, where China often dominates the market moves. The duration of the impact is critical from the raw material suppliers' point of view. A short shock to the prices is not that critical for their economic development, as contracts are often fixed for at least a few months. However, if low prices stay for longer, the economic activity will weaken in a number of raw material producing nations.

It is hard to estimate how fast the shutdowns of manufacturing production will cause substantial negative effects on the global supply chains. The global companies had of course stocked up at least a certain level of inventories in order to cope with the Chinese New Year, and the US tariffs and rising production costs in China have already pushed some companies to move a part of their supply chain to other countries. However, we believe there will likely be a lack of some products in the coming months if the factories remain closed. For many global companies, this of course implies less profits.

CNY: Virus fears

The outbreak of the coronavirus has unnerved investors and sent financial markets into a rout. Until the spread and impact of the virus become clearer, the CNY will remain volatile.

The virus is dominating the financial markets

With the phase one trade deal just behind us, the Wuhan virus outbreak has given markets a new and unpredictable focal point during the past weeks. The rapid spread of the virus has alarmed investors and prompted sharp sell-offs in Chinese and Asian markets. If the spread of the virus is contained in the coming weeks, this main source of risk and volatility should fade and allow markets to calm down again, even if the economic effects will linger.

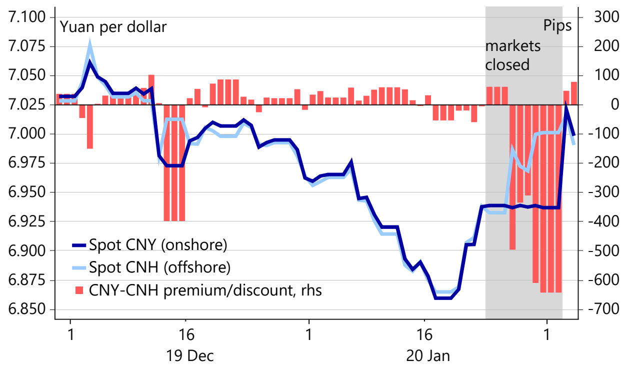
The PBoC is providing much-needed support to restore confidence

The PBoC plays an important part in controlling the financial markets. Liquidity worries mounted as the end of the extended Lunar New Year holiday closures approached, and the PBoC decided to announce an injection of 1.2 trillion yuan into the markets via reverse repo operations just before onshore trading resumed on 3 February.

Monetary policy will however remain modest

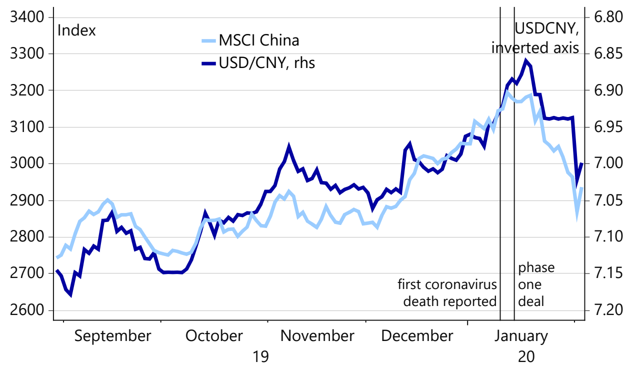
The PBoC also cut its seven-day and 14-day reverse repo rates by 10 bp to boost interbank lending in reaction to the steep sell-off on China's equity market. The measures have so far been rather modest, but they signal that monetary policy will be deployed to support growth in the face of the virus. We were expecting slightly looser monetary policy already before the outbreak, but do not expect any major extra measures now, as financial leverage is still a concern.

CNY KETCHUP EFFECT AFTER LUNAR NEW YEAR CLOSURE



Source: Nordea and Macrobond

VIRUS SENTIMENT RULES THE MARKETS



Source: Nordea and Macrobond

CNY weakened considerably after the holidays

Despite the calming efforts, the onshore yuan temporarily broke through the seven-to-the-USD mark on 3 February, following its offshore counterpart. Some signs of stabilisation and rebound are now showing, partly due to the underpinning by the central bank. The daily fixing rate has been kept on the strong side of seven to the dollar in the past few days, suggesting that the PBoC stands ready to support the currency.

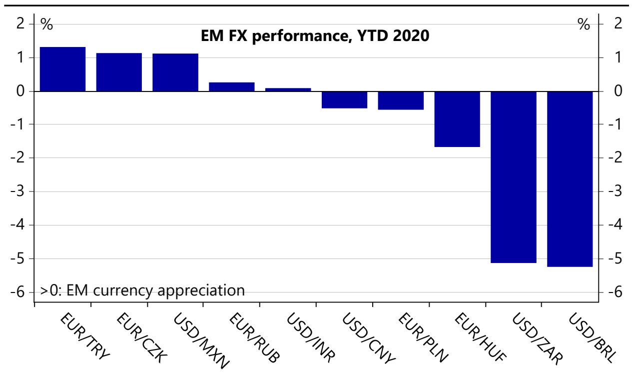
CNY value depends on virus spread and control

The short-term direction of the currency strongly depends on the further unfolding of the virus outbreak, and the measures the government takes to soften the blow.

JANUARY SEASONAL PATTERNS

Source: Nordea and Macrobond

YTD RELATIVE PERFORMANCE AMONG EM PEERS



Source: Nordea and Macrobond

Nordea forecasts for China

MACRO FORECASTS FOR CHINA

	2017	2018	2019E	2020E	2021E
Real GDP, % y/y	6.9	6.6	6.2	5.9	5.7
Consumer prices, % y/y	1.6	2.1	2.9	3.0	2.8
Current account, % of GDP	1.6	0.4	1.0	0.9	0.8
Public sector balance, % of GDP	-3.9	-4.8	-6.1	-6.3	-6.3

Source: Macrobond (spot) and Nordea estimates

FINANCIAL FORECASTS FOR CHINA

Forecasts	Spot	3M	Mid-2020	End-2020	End-2021
USD/CNY	7.00	7.04	6.95	6.95	7.10
EUR/CNY	7.73	7.67	8.06	8.54	8.66
Policy rate	4.35	4.10	3.6	3.6	3.6

Source: Macrobond (spot) and Nordea estimates

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