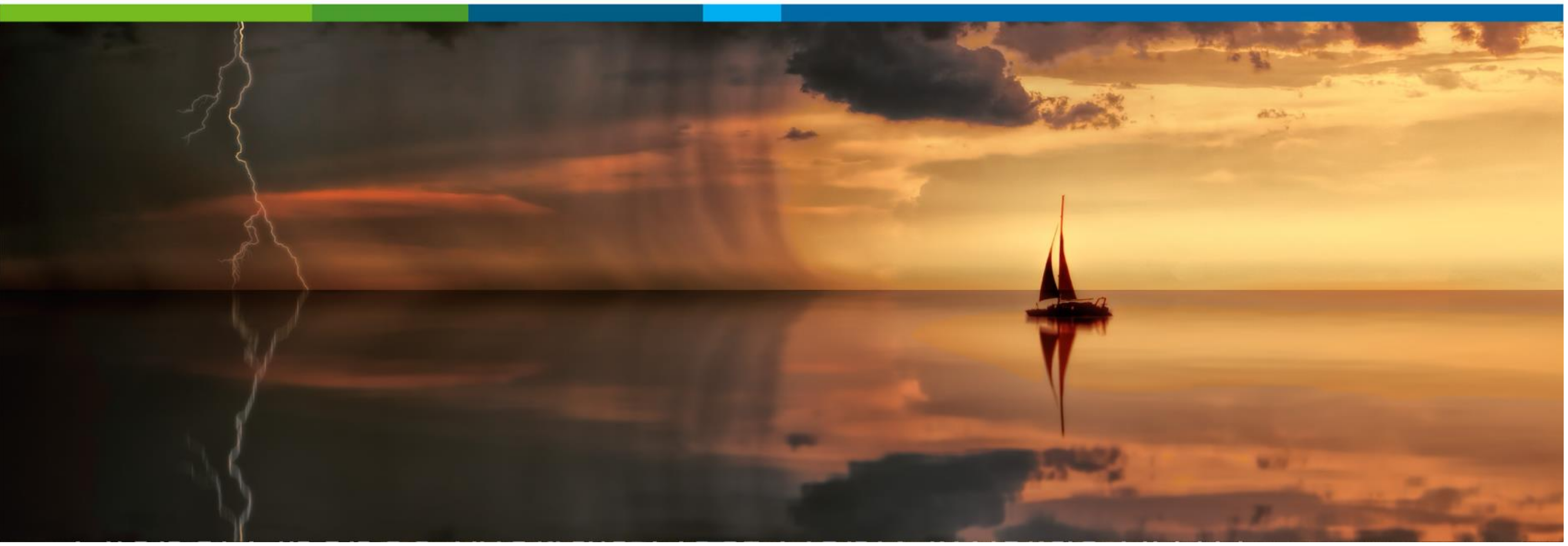

China: recovery in sight - 5.5 per cent growth by end of year

China was the first market to be hit by COVID-19 and now, two months into lockdown with a flattening infection curve, it could be the world's first recovery story.

But the virus is now a global pandemic and China's recovery will be impacted by the unfolding global recession, which we predict at -0.6 per cent for 2020. The virus is expected to lead to a contraction in China's GDP of 6 per cent year-on-year (YoY) in the first quarter, the first drop in four decades. Due to the lockdown, industries and services production fell 13 per cent YoY between January and February.

In this context, we have lowered our 2020 GDP growth forecast for China to 2.5% (from 4.0%).

Both the Coronavirus and US election in November cast uncertainty on the US-China trade truce.

Hope on the horizon?

China's falling (coronavirus) infection rate, lifting of travel restrictions and strong policy response, aligned with the global "whatever is necessary" approach, lead us to expect GDP growth to recover to 4 per cent in the second quarter, reaching 5.5 per cent in the last quarter of 2020.

Initial signs of recovery can be seen in China's Purchasing Manager's Index, which points to confidence in the manufacturing and service sectors. Figures for both manufacturing and non-manufacturing bounced back to 52 and 52.3 respectively, after falling to 35.7 and 29.6 in February.

However, we see two main risks to China's recovery:

1. 17 per cent of China's economy is driven by external demand, so it needs to brace itself for a prolonged period of slow export growth, given the global recession. That said, the negative impact of a global recession on China may be cushioned by China's ability to restore and maintain production relative to other economies; this could allow it to gain market share as production capacity elsewhere is reduced.
2. Services now account for 54 per cent of China's GDP and 60 per cent of annual growth, a slow services recovery could delay economic normalisation, since the fear of infection will continue to keep people away from travel, hotels and restaurants.

"Whatever is necessary" policy stimulus continues

As the government steps up stimulus post virus, we expect China to set a broad budget deficit of at least 8.0 per cent of GDP in 2020, up from 5.6 per cent in 2019. To pump liquidity into the economy, we expect the People's Bank of China to cut the Reserve Requirement Ratio by 100bps, the Medium-Term Lending Facility rate by 30bps and the deposit rate by 25bps in Q2-Q3. The State Council has pledged more support for Small and Medium Enterprises (SMEs) and people affected by the virus outbreak, encouraging SMEs to raise CNY800 billion via supply chain financing.

Trade truce in the balance?

Both the Coronavirus and US election in November cast uncertainty on the US-China trade truce – questions are being asked whether China will be able to increase its 2020 imports from the US by USD77 billion versus the 2017 level, as required under the deal; this would imply an increase of more than 90% from the 2019 level, which appears unlikely in the current environment. If China misses the import requirement, US-China tensions could re-intensify as the US presidential election approaches, further complicating the negotiation of a phase two trade deal.

Looking ahead

We expect the CNY to maintain its relative strength, supported by higher interest rates, likely subdued capital outflows and a potential earlier economic recovery.