A Five-Stage Framework for Assessing the Virus and China’s Economy in 2020

Obviously the most pressing question confronting markets right now is how the spread of the coronavirus will impact China’s economy and financial markets in 2020. Given the uncertainty about how long travel restrictions and supply disruptions will remain in place, while workers remain at home, there is still considerable uncertainty about the cyclical outlook for the economy this year. In this brief commentary we attempt to outline the probable phases of the market response to the outbreak and its economic consequences, over the course of 2020.

Phase One: Panic. This is where we are now, with over 3,000 new cases announced overnight, additional news of deaths in China, additional cases of travel restrictions being imposed on travelers from and within China and Hong Kong, and additional evidence of human-to-human transmission of the virus outside of Hubei province itself. This phase will likely continue as long as there are new types of bad news being reported: problems among suppliers, problems in transportation of basic goods, food shortages on the mainland, reports of factories being unable to make shipments or start production, and other similar stories. It is difficult to determine how long this phase will last, of course, because it depends not only on the numbers of reported cases and deaths, the pace at which people actually return to work from the Chinese New Year holiday, and the possibility of unforeseen complications from impaired transportation networks and corporate funding chains. While markets may recover slightly at times during this phase, risk assets linked to China’s cyclical activity will remain under pressure from the continued flow of negative news about the virus and its incomplete containment.

Phase Two: Relief. At some point, however, increasingly bad news will stop accumulating. At this point, news will become either modestly better concerning the numbers of cases and deaths, the mortality rate, or the possibility of successful treatment, and markets will start to look ahead to the possibility that the outbreak will come under control in a matter of weeks rather than months. This phase probably results in a bullish turn in China-linked risk assets even in the absence of genuine optimism, because of a belief that the worst of the crisis is past.

It is difficult to venture a guess when this phase might begin to take hold, but if we were forced to do so, we would argue the last week of February or the first week of March are probably the best-case scenario for more optimism about the numbers of cases and numbers of deaths starting to peak, given the continued possibility of human-to-human transmission outside of China at present. Many migrant workers returning to factories starting next week may still be subject to quarantine measures in their temporary locations. Nonetheless, this phase will suggest markets will start looking ahead to the policy response from China and how effective it might be in generating a rebound in activity growth later in the year. Beijing also has strong incentives to keep the National People’s Congress at its scheduled time starting on March 5, if only to project an image of stability and that control measures targeting the virus are becoming more effective.
Phase Three: Bargaining. This is the most interesting period, which will probably follow immediately after the relief experienced in Phase Two. In this phase, economic data will start to be released in mid-March, and there will be an assessment of the true state of the impact on China's economy relative to the data being officially reported. (See our initial assessment of this impact in the Jan 27 note, "Preliminary Economic Virology"). This is highly meaningful for the market's perception of the likelihood of a stronger policy response to stabilize growth, as well as the credibility of Beijing's messaging about the virus outbreak's impact on the economy overall. Market participants will compare their own estimates of the impact of the outbreak compared to Beijing's own public assessment. Too wide a gap between those two levels of cyclical activity could create additional problems for China-related risk assets later in the year.

GDP growth for Q1 is not the only important indicator here, as markets will be watching for clues about the true state of the economy in credit, trade, inflation, and industrial output data and PMIs as well, but GDP growth is probably the most important in this broader reassessment of the shape of the economic cycle this year. For example, should China release a GDP growth rate in Q1 of something in the range of 3.5-4.0% y/y, markets will likely interpret this positively, not because of the sharp decline in Q1 growth, but because such a release implies a more realistic possibility of a stronger policy response from Beijing to counter the impact on the economy. In addition, there would be a stronger probability that later-year reported growth rates from Beijing will be much higher than the Q1 levels, and perhaps above 6%, as pent-up activity occurs in later months.

However, should China release a higher level of GDP growth in Q1 than markets generally view to be credible (something around 5.0-5.5% y/y, for example), then this would change perceptions of the shape of the cycle for the rest of the year, and might cause markets to reduce expectations of additional policy support (since growth has officially not slowed very much). In addition, many market participants would point out realistically that cyclical activity is much weaker than Beijing was admitting, and therefore would start focusing on the unacknowledged costs of the outbreak in industrial output and within China’s financial sector (to be discussed in Phase Five).

The Bargaining phase is therefore the most interesting and potentially consequential for the full-year cyclical outlook, and the first meaningful economic data will be released from mid-March to mid-April (for Jan-Feb and for the full Q1). The January-February data releases are always distorted, and those distortions will be more meaningful this year, but the March and Q1 data will be highly consequential for this market assessment of the direction of the economy over the full year.

Phase Four: Optimism. This will occur as economic data actually starts to improve and there is evidence that activity suppressed earlier in the year is starting to take place, with the worst fears about the economic consequences of the outbreak fading slightly. Cases of the disease will likely continue to be reported, but the market optimism is likely to extend as long as there are not similar containment measures imposed as in late January and early February. Should the Q1 GDP and economic data report sharp declines, it is reasonable to expect a rebound in reported data for secondary indicators of activity (industrial output, for example) to levels above trends from previous years. In any case, the return of temporary optimism within markets will likely start to build before stronger data releases, and then will extend upon the release of more supportive data. Timing is difficult to gauge depending upon how long the shutdown of economic activity extends, but it is possible the optimistic stage could start sometime in the middle of Q2 and extend into early Q3.

Phase Five: Realism. At some point, however, the temporary optimism that economic conditions are improving will give way to a more realistic concern about the damage that was done to the financial system and the corporate sector during the extended shutdown of the economy, and how that will implicate both growth in 2021-2022 and the government’s capacity to stimulate the economy in future years. In particular, it is easy for the central bank to provide support during a clear emergency, but it is more difficult to extend that support after economic conditions normalize. Banks and regulators
will be called upon during the outbreak to provide forbearance for distressed borrowers; returning conditions to “normal” will be more difficult and will suggest new asset quality problems at banks and an expanded central bank balance sheet at the central bank. Banks struggling with low capital levels will face difficulties maintaining credit and asset growth at previous rates. Both may potentially implicate future views of the currency as well, as conditions will probably not be strong enough to see policy interest rates rise once again, with monetary easing steps driving the yuan to continue depreciating.

Central to the concerns about overall cyclical momentum in the economy in 2020 even after the panic-relief-bargaining-optimism cycle fades are conditions in the property sector. As we have argued (Dec 2019, “The Property Sector and China’s 2020 Cyclical Outlook”), property construction is the key swing variable for momentum in the economy as a whole. As property developers have become increasingly dependent upon revenue from pre-construction houses, any dropoff in presales revenues will probably slow 2020 construction activity as well. It was already going to be difficult for China to maintain the previous year’s pace of sales growth given that policy toward the sector was already restrictive; the virus outbreak only increases the potential for a decline in full-year sales, particularly in the quarantined areas. Given the decline in demand from the shantytown redevelopment program, a drop in prices and a slowdown in investment-driven demand for housing could accelerate weakness in construction and raw materials demand throughout the economy.

Obviously, this is a highly speculative assessment about the shape of the economic cycle in 2020 given the impact from the virus, and the potential for markets to respond. There may be unforeseen waves of good news (a miracle treatment) or bad news (a surge in new cases inside and outside of China, or a slew of new supply problems given the extent of economic dislocation) ahead in the coming weeks. But we hope this framework is useful in assessing the nature of the transition points between the probable stages of policy-makers’ and markets’ reaction to news about the disease in the coming months.

Disclosure Appendix

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