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China Market Strategy

Epidemic at turning point; economic cost of quarantine

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Based on the latest official data, we can preliminarily conclude that the first peak of the novel coronavirus outbreak (measured by new confirmed cases) is now behind us. We are less sure about the second peak, if any, but it should be less severe than the first. As such, the darkest time of the outbreak is over, and enforced quarantine must continue to keep the momentum going.

Official data have shown declines in (1) new confirmed cases in Wuhan; (2) new confirmed cases in Hubei Province (ex-Wuhan); (3) new confirmed cases in China (ex-Hubei); (4) new confirmed cases nationwide; and (5) confirmation of suspected cases. The data also show the mortality rate has stabilized at ~2%. The above factors form the basis of our view.

In my Weibo article published on Sunday, 2 February 2020 before the A-share market re-opened, I had already discussed these early signs of a turning point (see *Impact of nCoV outbreak on market and economy*). The market opened Monday (3 February) with epic volatility, and rebounded on Tuesday (4 February) after opening sharply lower at <2,700. I made suggestions of such a trading opportunity on Weibo before the market opened on Tuesday. In retrospect, the timing of the rebound coincided with the peak of new confirmed cases.

Apparently, city lockdowns, quarantines and mobility restrictions have proved highly effective in virus containment. The virus' R0 value, a measure of infectivity, has dwindled. It is also much lower than foreign experts' alarmist prediction of 3.8. Simply put, if the R0 of those who left Hubei before the lockdown was really so high, and considering the incubation period of 7-14 days, then the new confirmed cases outside Hubei should not have fallen so quickly. Intuitively, the decrease of R0 may have caused the turning point.

The question now is to what extent the market has priced in changes in economic growth expectation. In my Weibo article dated 2 February 2020 (*Impact of nCoV outbreak on market and economy*), I projected the impact on economic growth at 0.5-1%, which corresponds to 2,500 (worst case) to 2,700 (base case) for Shanghai Composite. This is identical to the bottom estimated in our report on 10 November 2019 (*Outlook 2020: Going the Distance*), in which our model forecast a trading range of 2,500-3,500 and I elaborated that 2,700-3,200 is most probable.

Some readers have questioned that my forecast last November did not price in the epidemic. Indeed, the havoc, which is caused by more humans than nature, was not in my original forecast. Nor was it predictable. However, our model has been tested by even bigger calamities in history, including the sub-prime crisis of 2008, the US swine flu outbreak in 2009, the stock market crash of 2015, Brexit in 2016 and the US presidential election. Therefore, the historical data on which our forecasts are based have factored in the economic and market impact of various historical events.

Still, the magnitude of current city lockdowns and quarantines is unprecedented. This is an uncertainty that was not and could not have been predicted. For a simple calculation, we assume the daily economic loss of work suspension is represented by 1/360, with 14 days of suspension (rough estimate based on current circumstances) and 50% operation rate nationwide. Then, for a RMB100trn economy with nominal growth of ~7.5%, the new economic growth rate would be (100x(1+7.5%)x((360-14x50%)/360))/100-1=5.4%. Stripping off inflation impact, the growth rate is estimated at 4.x, showing slightly bigger impact than my previous estimate of 0.5-1%. Longer quarantine will lead to more widespread work halts and bigger economic impact.

Still, even our absolute bottom of ~2,500 predicted on 10 November 2019 is only ~100 points below the recent trough of 2,685, the SHCOMP opening level on 4 February 2020. It is up to individual traders to decide whether this difference is important enough to affect trading decisions based on their risk profile.

While we still do not know how long the epidemic will last, the authorities have made their determination heard. Some experts have warned repeatedly that the outbreak has yet to peak; some economists are already calling for another massive monetary stimulus. Such views have obviously overlooked the limited upside room for investment, high local government leverage, and the impact of rising household leverage on consumption. Who would be called upon to take up the task of re-leveraging this time?

In the past, China's economic management has put too much emphasis on hard numeric data, which led to excessive investment and leverage. Albert Einstein once said, "Insanity is doing the same thing over and over again and expecting different results." Barring severe unemployment, there should be greater tolerance of changes in economic growth. In the short term, a more crucial task is to help SMEs to overcome liquidity difficulty.

PS: Punxsutawney Phil, the groundhog I mentioned in my last Weibo post, did not see his shadow on the Groundhog Day last Sunday. He rejoiced in the spring sunshine.

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