China Market Strategy

Impact of nCoV outbreak on market and economy

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- On the first trading day of the year of the "rat", the negative sentiment pent up during the holiday triggered a sharp fall in the Chinese stock market. However, the introduction of a basket of measures to maintain stability has to some extent eased the bearish sentiment, as the market experienced a technical rebound after the sharp fall. Yet, the reliability of forecasts on epidemic has a greater impact on market bottom, and economic cycles hold bigger sway over market trends.

- Reliable forecasts on the peak of epidemic help the market bottom. Many observers pointed out that the market will bottom out once new infected cases peak. Consensus is that the market would quickly hit the bottom on Monday and then behave as it did in previous outbreaks. To this, we must add that the novel coronavirus (nCoV) is highly contagious with a long incubation period and cases of asymptomatic transmission. These characteristics, coupled with the failure of early virus containment that led to its unbridled spread, make it difficult to predict the degree of outbreak and to forecast its peak. During the SARS outbreak, it was not the market bottom that anticipated the peak of epidemic, but indeed the reliable forecasts on the peak of epidemic that helped the market bottom.

- Market rallies during previous outbreaks were fueled by economic recovery due to monetary easing, but today's low interest rate environment has squeezed the room for such monetary operations. In fact, the peaks of both SARS and swine flu outbreaks coincided with the bottom of the economic cycle. Before the outbreak, the Fed had cut rates sharply in response to the US economic downturn in 2002 and 2008, fueling a cyclical recovery in the economy starting in 2003 and 2009, respectively. The outbreak could only moderate rather than reverse such cyclical trajectories. With the Fed's balance sheet reaching 20% of US GDP and the global interest rates hitting the lowest in 5,000 years, our expectations on monetary easing should be tuned down. It was the economic recovery on the back of monetary easing that boosted the market, rather than the market itself being immune to the contagion.

- The outbreak's toll on the economy is widely palpable. During the Spring Festival, tourism, entertainment and catering industries were affected significantly. These industries may lose trillions of yuan in revenue. Restrictions on travel and work will depress industrial output. GDP growth for the whole year is set to decrease by 0.5-1ppt to 5.x in 2020 and fall to ~4.x in 1Q20. It is thus fair to expect some monetary easing. Even though inflation may have picked up during the Spring Festival due to the epidemic, limiting the room for rate cuts temporarily, there is still further room to cut RRR. Market rates should also fall due to safe-haven demand. Given the above, we expect the Shanghai Composite to trade between 2,500 (worst case) and 2,750 (base case) (0.5-1% GDP growth ~ cap rate). This is generally in line with the trading range predicted by us in "Outlook 2020: Going the Distance" issued on 11 November 2019.

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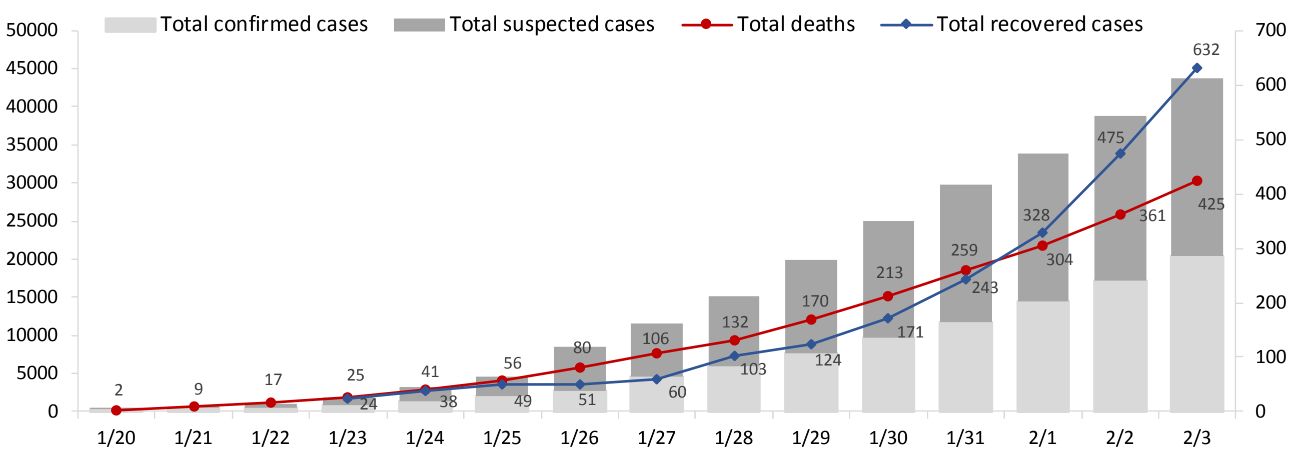
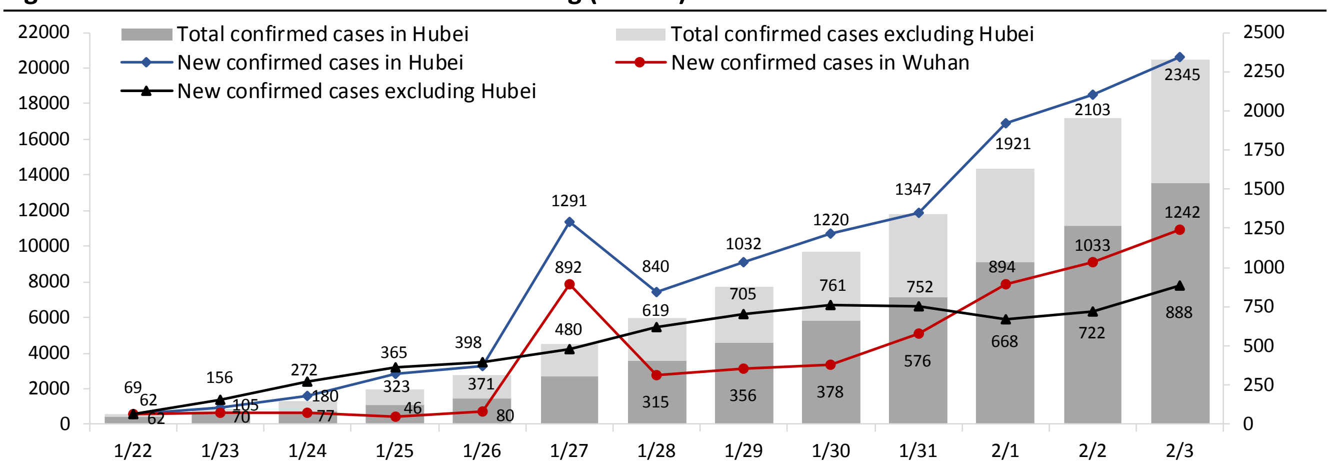
As of 3 February, 20,438 cases of novel coronavirus (nCoV) infections had been confirmed in mainland China, and the total number of suspected cases had risen to 23,214. While the data shows that cases of infections are still rising, we note that the total number of recovery cases exceeded total deaths on 1 February, and the number of recoveries continued to increase significantly. After the procedure of extracting the nucleic acid of the virus was optimized, the detection time has been shortened to 2 hours at the fastest, thus greatly improving the speed of diagnosis. In addition, with the completed construction of Wuhan Huoshenshan Hospital on 3 February, the hospital has started to receive confirmed nCoV patients, while Leishenshan Hospital is also expected to be completed on 5 February. If all developments stay on track, there would be a glimmer of hope, although the task of epidemic containment remains daunting. Of course, with the number of returnees to cities beginning to rise after the Spring Festival, controlling the second peak of outbreak still has a long way to go.

Figure 1: Cases of nCoV infections are still rising



Sources: National Health Commission of the PRC, BOCOM Int'l

Figure 2: Cases of nCoV infections are still rising (Cont'd)



Sources: National Health Commission of the PRC, BOCOM Int'l

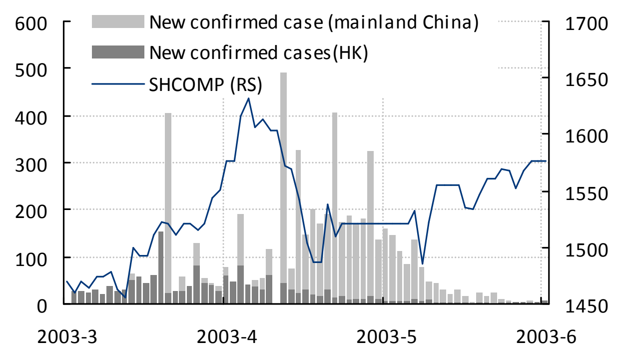
Impact of nCoV on Market and Economy

On the first trading day of the year of the "rat", the panic and negative sentiment pent up during the holiday triggered a sharp fall in the Chinese stock market. Shanghai Composite dived 7.7% to 2,746 points, a level broadly in line with our forecast of 2,750 points (base case). It was the worst Lunar New Year opening since 1997, and also the heaviest one-day loss since the stock market crash of 2015. However, the introduction of a number of policies to maintain stability has to some extent eased market pessimism. The market experienced a technical rebound after the sharp fall. The reliability of the forecasts on epidemic has a greater impact on market bottom, and economic cycles hold bigger sway on market trends.

Market observers pointed out that, during the 2003 SARS outbreak, the market bottomed out once new infected cases peaked. The markets fared similarly during the outbreak of other infectious diseases. For example, the number of infections and deaths of the US swine flu outbreak in 2009 far exceeded those of the nCoV, which eventually resulted in the CDC giving up recording the epidemic data due to limited resources. However, the market bottomed out in March 2009, corrected in April after the swine flu outbreak, and then continued to rise. While consensus now believes that the market will hit the bottom quickly on Monday and then behave as it did in previous outbreaks, we believe the potential impact of nCoV needs more profound analysis.

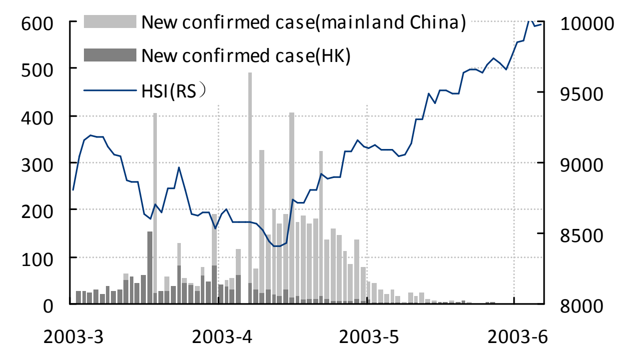
Our knowledge of an epidemic is being constantly updated. Especially during the 2003 SARS outbreak, relevant departments came to recognition of the situation, and afterwards the international community coordinated efforts to investigate. The peak of infections in April 2003 was almost the same as that of nCoV during the Spring Festival. Meanwhile, SARS infected others after the patient started showing symptoms. These characteristics make it easier to identify the transmission path after recognizing the source of the virus, in order to prevent further contagion. Thus, the prediction of this outbreak peak is more effective. However, the current nCoV is highly contagious with a long incubation period and asymptomatic transmission. These characteristics, as well as the failure of early containment, have led to the rampant spread of the virus. Thus, it is more difficult to predict the degree of outbreak and less effective to forecast its peak. Thus, we should say the reliable forecasts on the epidemic peak help the market bottom, rather than the market bottom anticipates the peak of epidemic.

Figure 3: Reliable forecasts on the epidemic peak help anticipate the bottom (A shares)



Sources: WHO, Wind, BOCOM Int'l

Figure 4: Reliable forecasts on the epidemic peak help anticipate the bottom (HK market)



Sources: WHO, Wind, BOCOM Int'l

At the same time, the respective peaks of SARS and swine flu outbreaks coincided with the bottom of economic cycle. Before the outbreak, the Federal Reserve had cut rates sharply in response to the US economic downturns in 2002 and 2008, respectively, fuelling the cyclical recovery of the economy starting in 2003 and 2009. The outbreak can only moderate rather than reverse the trajectories of the economic cycle. With the Fed's balance sheet reaching 20% of US GDP and the global interest rate hitting the lowest in 5,000 years, our expectation on monetary easing should be tuned down. It is not that the market was immune to contagion, but that the QE-driven economic recovery gave equity markets a boost.

We should also note that, before the Spring Festival, the total amount of capital raised in the A-share market reached the level in January 2018 – exactly the point of the big bear market in global stock markets in 2018. Before the holiday, the position of A-share fund managers also reached nearly 90%, while the cyclical stocks, GEM, and small cap stocks in A-share market had a good run. This type of allocation bears the characteristics of excessive risk appetite – high leverage, high position, and high beta. When the market has a chance on Monday to price in the impact of the latest epidemic on markets and the economy, the slump should also lead to the unwinding of some financing positions and the reduction of high beta holdings. Therefore, there is a great deal of uncertainty about whether the market will be able to bounce back immediately after the plunge.

The outbreak's impact on the economy is widely palpable. During the Spring Festival, tourism, entertainment and catering industries were hit hard. We estimate these industries may lose trillions of yuan in revenue. At the same time, due to the restrictions on travel and work, industrial output will also be depressed. These factors will drag down GDP growth for the whole year by 0.5-1ppt, knocking down GDP growth to about 4.x in 1Q20 and to 5.x in 2020. Certainly, some monetary easing can be expected. Consumer inflation may have picked up during the Spring Festival because of the epidemic, thus limiting the room for rate cuts temporarily, but the RRR can be lowered further. Market rates should also fall due to safe-haven demand.

The epidemic would increase the downward pressure on China's economy, and EPS growth estimates are set to be revised down, as should the bottom forecast. In our outlook report titled "*Outlook 2020: Going the Distance*" issued on 11 November 2019, we estimated that, in the coming 12 months, the Shanghai Composite's bottom will likely be ~2,700 and the trading range will be 2,500-3,500. Indeed, we estimated the bottom for the Composite at 2,450 in our report titled "*Market Bottom: When and Where?*" on 6 June 2016 – more than two years before the market eventually bottomed at 2,440 on 4 January 2019. As China's economy grapples with the epidemic, growth will slow. This should result in a trading range for Shanghai Composite between 2,500 (worst case) and 2,750 (base case) (0.5-1% GDP growth ~ cap rate). The forecast is generally in line with the trading range predicted by us in "*Outlook 2020: Going the Distance*" on 11 November 2019.

Effects of nCoV on Industries

The outbreak's impact on China's economy is felt far and wide. During the Spring Festival, tourism, entertainment and catering industries were dampened. The loss of revenue for these industries may be in trillions of yuan. In addition, the quarantine measures will take a toll on sectors including technology, real estate, logistics, banking, insurance, etc.

For the **banking** sector, we expect looser system credit and faster NIM contraction. This should support online lenders' funding, while borrowing demand may be hurt given borrowers' unstable income amid the outbreak. MSE and low-income individuals are the most vulnerable during the outbreak of coronavirus. We expect banks' overdue loans and online lenders' delinquency ratios to increase in 1Q20, and the latter may grow faster. Impact on provision pressure and NPL numbers depends on outbreak duration.

For the **insurance** sector, we expect nCoV to increase claims in the short term, but to a limited extent given limited insurance penetration. nCoV will directly affect agent team and business expansion, drag short-term FYP/NBV growth, but help strengthen insurance awareness. The outbreak should have short-term negative impact on several kinds of P&C insurance, but milder impact on auto insurance.

For the **China property** sector, given a high base and novel coronavirus, we expect GFA sold to drop >10% YoY in 1H20, and that for 2H20 to depend on the pace of epidemic spread, the actual fatality rate, and when the spread is contained. Valuation turns cheaper but it is still too early to bottom-fish. We believe valuation could continue to be compressed on prolonged virus spread and thus further hit to sales sentiment. It will be a better timing to bottom-fish when the number of new confirmed cases starts to drop.

For the **internet** sector, the nCoV outbreak may have short-term impact on the financial performance of food delivery and education industries. However, it accelerates the penetration of new businesses such as new retail and online education, and benefits emerging industries such as online healthcare and remote office. In the short term, the OTA and movie industries will suffer the most. The scale of OTA may fall 13-24% in

2020E before likely recovery in 2021E, while the box office may decline 12% in 2020E. Thanks to quarantine measures, the online entertainment sector should gains, and long video content payment benefits the most. The outbreak may affect the financial performance of food delivery and offline training in the short term, but boost further growth in unmanned distribution, online education and new retail distribution including fresh food.

For the **technology** sector, with supply chain and logistics disruptions and longer-than-expected factory closure in some cases, we expect the Greater China smartphone supply chain revenue and component shipments to remain soft in Feb. We expect the current nCoV outbreak to slow down economic activities, which will impact China device demand and hurt component orders in the near term. For the semiconductor sector, the current disruption could lead to slowdown for China-based foundries in 1H20, as China revenue accounts for >50% for most. We also see the possibilities for equipment order delay, impacting the global semiconductor equipment sector.

Amid the nCoV outbreak, the **consumer** sector is arguably one of the worst hit. Chinese consumers stayed at home and businesses closed over the Chinese New Year holiday, hurting discretionary spending across the board, while staples sector remains defensive as time at home increases. Sales of supermarkets, staples and food delivery were strong. We expect staples' valuation premium over discretionary to widen.

As for the **healthcare** sector, nCoV spurs medical product demand, including drugs and devices, despite ST share price pressure. Pharmaceutical companies benefit in the long term. In addition, online and offline medical services show synergies. In the case of overload of hospitals in Hubei province, Alibaba Health, Ping An Good Doctor, and other platforms provide free online consulting, which effectively filters out non-infected cases, and reduces the burden on offline medical institutions.

For the **gas utility** sector, we expect a short-term hit to commercial & industrial (C&I) gas sales volume. We expect the negative impact to be mainly on retail gas sales growth in 2020, due to the delayed C&I work commencement after the prolonged lunar new year holidays and suspension of public transport between various cities ordered by the government. Yet, we believe the drag on gas consumption should now be buffered by seasonality.

For the **power** sector, we expect limited impact on thermal power generation from the nCoV outbreak, given its highest proportion in China's total power supply mix. We expect power consumption decline of industrial users due to lower utilization in 1Q20E to hit the top 5 IPPs' power sales volume, while dark spread may be under pressure. We believe market sentiment will take time to recover amid the outbreak, which will also add pressure to share performance of the 5 IPPs in the short term.

For the **renewable energy** sector, we believe the current epidemic will delay the return to work after the Spring Festival, causing a temporary YoY decline in China's power demand. However, due to renewable power's grid-access priority, most regions in the country will be little affected. The worst-hit Hubei accounts for ~2.4% of the country's total renewable installations. 1Q is usually the off-season for China's renewable energy installations, and we believe a brief delay in the return to work will not have a significant impact on China's new installations in 2020.

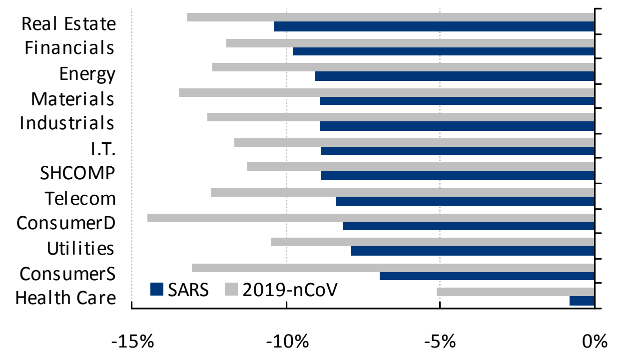
For the **automobile** sector, we expect the disruption to the supply chain and logistics and the potential longer-than-expected factory closure to hit auto OEMs' sales in 1Q20. If the nCoV outbreak does not ease before the 2Q peak season for auto sales, we expect weaker 1H20 earnings, and likely stronger 2H20 earnings once the outbreak is under control. We expect the drastic measures of major cities to limit travel and outside activities to reduce foot traffic and purchase sentiment at auto dealers. The current disruption could weaken new car sales and after-sales revenue growth in 1H20.

For the **logistics** sector, freight volume growth may appear weak due to extended holiday and slow production at factories and logistics operations, in our view. For the **infrastructure** sector, slow construction activities could be led by the outbreak. Moreover, weak demand for road and rail travel within mainland China may also drag new contract growth of infrastructure companies in the near term. We expect the outbreak to drag operating performance of both sectors in 1Q20.

For the **shipping** sector, we expect the nCoV outbreak to prolong the traditional lull season and hit the sentiment in the container shipping sector. Cargo volume on the major East-West tradelanes will experience a decline in 1Q20, as manufacturing and shipment will possibly be interrupted for 2-3 weeks. We expect carriers to make further capacity adjustment, if production does not fully recover by early March.

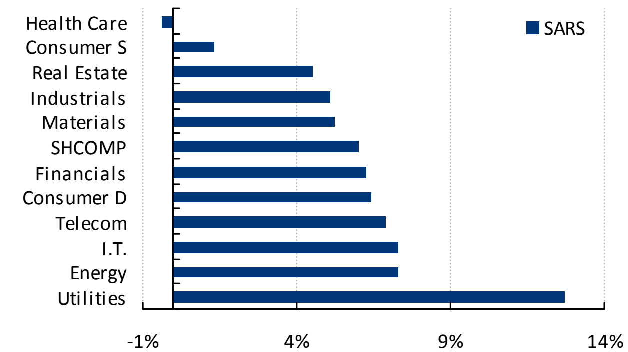
For the **aviation** sector, we believe the reverberating effects of nCoV may dwarf those of SARS in 2003 as global aviation industry has grown >2x as of 2020. China's air passenger traffic may fall 25% per month if the outbreak escalates throughout February-March, by our estimates. We expect total air traffic for the 2020 Spring Festival travel season to range between 63m-65m passengers, down ~12% YoY. We expect earnings impact to be limited in 1Q20. We believe nCoV may provide attractive ST entry points for the growth-bound industry as a whole.

Figure 5: Sector performance during panic period (A shares)



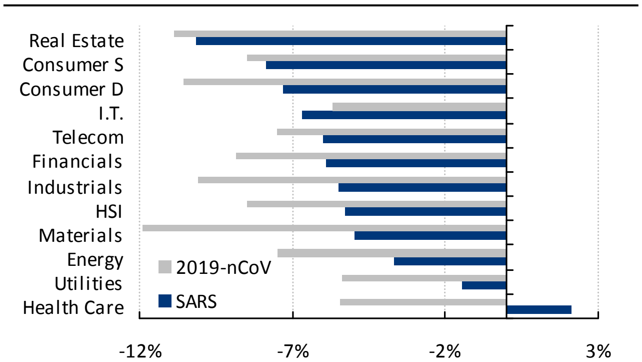
Source: Wind, BOCOM Int'l (coronavirus panic period: 2020.1.20-2020.2.3, SARS panic period in A-share market: 2003.4.16-2003.4.25. On 4.15.2003, the WHO listed Toronto (Canada), Hanoi (Vietnam), Singapore, Taiwan, and Guangdong, Shanxi provinces and Hong Kong (China), where the outbreak began, as the 'Infected Areas'.)

Figure 6: Sector performance during mitigation phase (A shares)



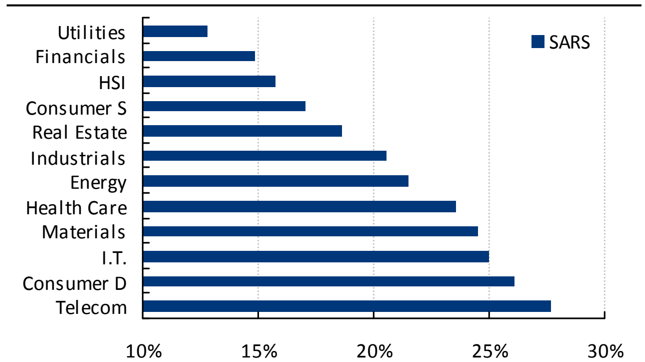
Source: Wind, BOCOM Int'l (A-shares market rebounded after the growth of new SARS patients slowed down. In order to investigate the performance of the stock market, we listed 2003.4.26-2003.6.2 as the mitigation phase)

Figure 7: Sector performance during panic period (HK stocks)



Source: Wind, BOCOM Int'l (coronavirus panic period: 2020.1.20-2020.2.3, SARS panic period in HK stock market: 2003.3.13-2003.4.25. On 3.12.2003, the WHO issued a global health alert for SARS.)

Figure 8: Sector performance during mitigation phase (HK stocks)



Source: Wind, BOCOM Int'l (SARS mitigation phase: 2003.4.26-2003.6.23. On 6.23.2003, Hong Kong was removed from WHO's list of 'Affected Areas'.)

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