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Ninety One

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Previously Investec Asset Management

First in and first out

China as the vanguard for COVID-19 recovery

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The fast view

— As China was first in and first out of the coronavirus pandemic, its path to recovery offers a potential template for other countries

— The manufacturing and industrials sectors have been the quickest to resume activity, while the service sectors have been slower

— What the 'new normal' looks like could vary across industries, as the demand picture has changed

— Some trends have been accelerated by the pandemic, including China's economic reform

— For investors, a thorough re-evaluation of the situation and the potential winners and losers will be key to securing sustainable returns

How can an economy recover from COVID-19?

The world's second-largest economy was brought to a halt for almost three months to combat the spread of the coronavirus (COVID-19) that emerged in Wuhan, the capital city of Hubei province. Social and economic activities have started to resume, but it will take more time for these to reach normal levels across China's diverse economy. Meanwhile, worldwide COVID-19 cases have passed 4.1 million and the death toll is almost 285,000 at the time of writing. Many countries across the globe are still in lockdown to help combat the fast-spreading coronavirus, with the unavoidable side-effect of economic damage.

We believe that a country's recovery from the pandemic is primarily influenced by three factors. First, the strength of its healthcare system and demographic makeup, including the age and health of the population before the outbreak. In China, more than 50 percent of COVID-19 deaths have been people who are over 70 years old[1]. Second, government effectiveness in proactively responding to the crisis, namely its ability to mobilise resources and capacity to enforce quarantine and social distancing. Last but not least, the capacity of a fiscal response and other measures to support the financial system and nurse the economy back to health.

So what lessons can be learnt from how China has emerged from the crisis? Elsewhere, when and how societies and economies can re-open is the ultimate question for us not just as investors, but as people too. We consider how an economy could progress on its path to recovery from COVID-19.

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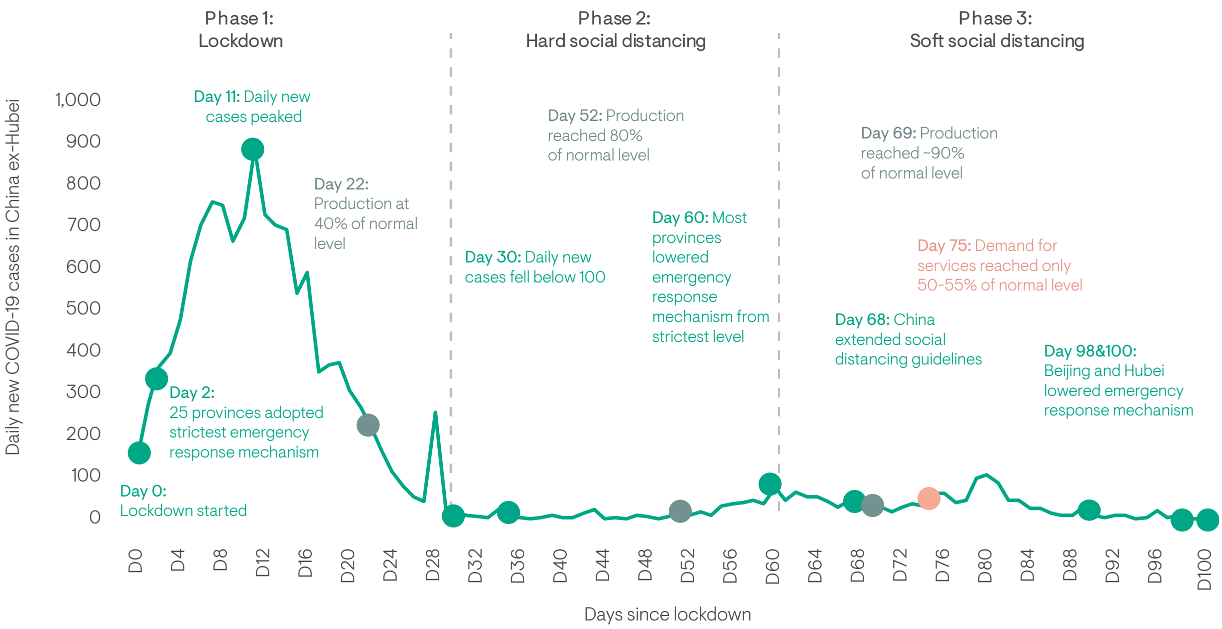
1. Source: Brookings, 'A mortality perspective on COVID-19: Time, location, and age', 23 March 2020.

Wuhan's 76 days of lockdown

After the lockdown in the epicentre of China's outbreak, which began just before the one-week Chinese New Year holiday in January, the rest of China soon raised its emergency response to the highest level. During this important family gathering period for Chinese households, there were no visits to grandparents, no trips to the Great Wall and no hot pot dinners at the local restaurant. The response was swift and strict, which meant that 1.4 billion people stayed at home for almost two weeks and carried out only essential activities.

Figure 1: COVID-19 recovery in regions outside of Hubei



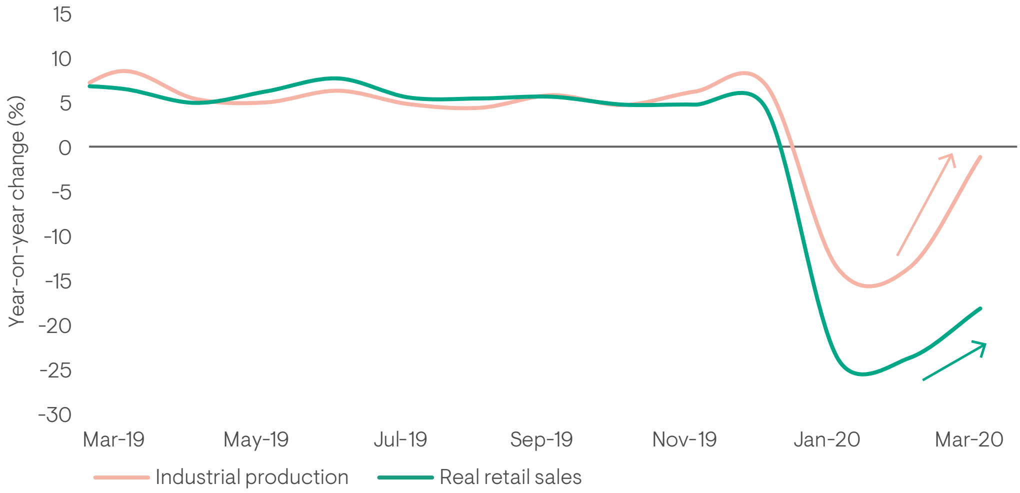
Source: NHC, CEIC, Morgan Stanley research, '1Q data: Bottleneck shifted from supply to demand,' April 17, 2020.

Initial results were encouraging, as COVID-19 cases outside of Hubei peaked at day 11 post-lockdown, and quickly declined to below 100 new daily cases after day 30 (Figure 1). By day 35, provinces accounting for 50% of national GDP lowered the emergency response level, in effect starting to lift the lockdown from its strictest level. Economic production in these provinces reached 65% of normal levels compared to only 40% two weeks before. And on 8 April, Wuhan — a city of about 11 million people — finally opened for the first high speed rail service in 76 days since the lockdown began.

Industrial production and fixed asset investment first to pick up

Manufacturing in China has recovered quickly, with companies implementing staged returns to onsite work for their factory employees, supported by local governments. This is reflected in the rebound in China's manufacturing PMI from 35.7 in February to 52.0 in March. By mid-April, industrial production also appeared to be back at more normal levels (Figure 2). Service supply is patchier, but it has also shown signs of gradual recovery. People ultimately decide what they spend on services, while there are also some provincial differences in the accessibility of services. Given social distancing and more cautious behaviour, demand for service sectors is running at just above half of the normal levels, according to our discussions with companies.

Figure 2: Retail sales recovery lags industrial production

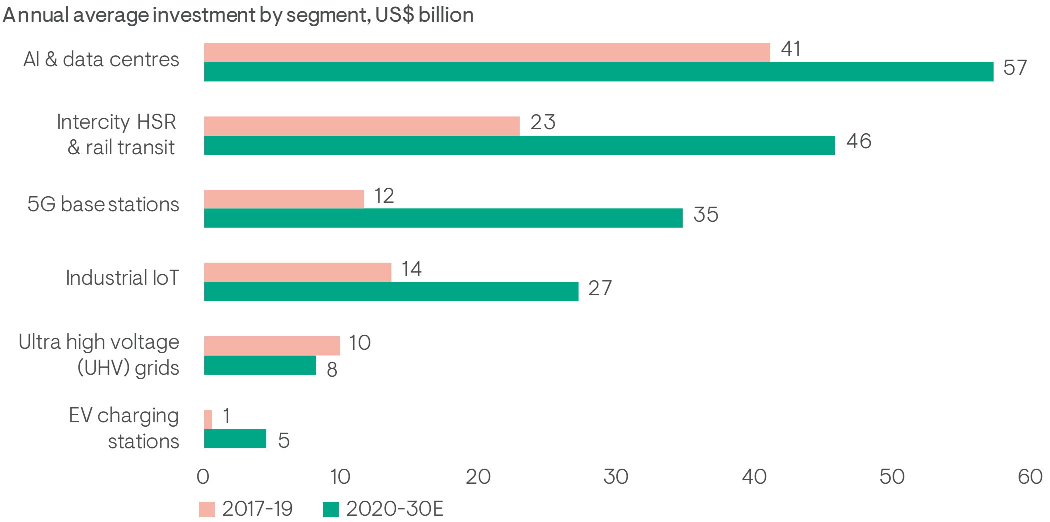


Source: CEIC, Morgan Stanley research, '1Q data: Bottleneck shifted from supply to demand,' April 17, 2020.

Accelerating China's reform through 'new infrastructure' investments

Since the global financial crisis (GFC), countercyclical measures have been commonly used by the Chinese government to prevent the economy from falling into recession. To mitigate the economic impact of COVID-19, the government has initiated stimulus plans to revive the economy. These include "new infrastructure" investments such as 5G base stations, artificial intelligence (AI) and datacentres, intercity high-speed railways, industrial IoT[2], ultra-high voltage grids and electric vehicle charging stations. China's total investment in these sectors is estimated at almost US$180 billion over the next 10 years, according to Morgan Stanley (Figure 3). In addition to countering the near-term economic slowdown, these new infrastructures can boost long-term productivity by leveraging next-generation technologies. This is positive for sustainable economic growth as it mitigates the potential demographic burden as the working population ages.

Figure 3: China ramps up investment in next-generation technologies



Source: Morgan Stanley research estimates, company data, 'New infrastructure opportunities handbook', March 22 2020.

2. Internet of things.

Such development also reflects China's economic competitiveness, epitomised by its efforts to win the global 5G race. In March, the Ministry of Industry and Information Technology (MIIT) published a directive calling on localities to accelerate 5G network buildouts. State-owned telecom companies have raised their target for 5G base station additions from 500,000 to between 550,000 and 600,000 this year, which compares to just 130,000 in 2019. This has proved to boost demand for the telecom equipment supply chain, such as printed circuit boards (PCBs), antenna, and optical fibres. Internet equipment and data server makers have also recently reported strong order intake and sales numbers. Unlike 5G base stations, datacentre investments are led by privately-owned internet giants. Hangzhou-based tech giant Alibaba has announced it will double capex spend on cloud services – the first to do so, and we expect rivals Baidu and Tencent to follow suit, alongside others.

Reviving old economy sectors

Government stimulus plans have also helped shore up 'old economy' sectors, through measures such as expediting the issuance of local government special bonds to fund infrastructure projects. These sectors, therefore, were first to begin recovering from the lockdown. Most notably, excavator sales hit a new high in March — which followed a record year in 2019 (Figure 4). Construction machinery manufacturers, such as Sany Heavy, have raised prices to reflect this increased demand. Hengli Hydraulic, a domestic supplier of excavator components, has reported a more than 50 percent year-on-year jump in orders of high-pressure tanks. Heavy duty truck (HDT) sales have also rebounded. This trend is likely to continue through the traditionally weak summer season as economic activity resumes, in our view.

Figure 4: Excavator sales hit a new high in March

Source: CCMA, Bank of America research, May 2020.

Infrastructure-related materials, such as steel and cement, have also benefited from the anticipation of higher construction. Materials companies are seeing a drastic drop in inventory and price rises from the lows seen in February. Multiple cities across China have relaxed property tightening measures to support housing construction, which also drives the demand for cement higher. Materials company Anhui Conch Cement has performed well, supported by both infrastructure and property demand. The company's operations are focused in Eastern and Southern China where supply and demand dynamics and therefore cement pricing is more favourable.

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A bumpy return to a 'new normal'

Despite lifting the strictest lockdown measures by the end of February, global supply chain disruption and a shortage of workers were bottlenecks to activity returning to normal levels. Migrant workers travelling back to their city of employment were required to spend 14 days in quarantine before returning to work, which created near-term capacity and productivity challenges. The situation improved by mid-March, as most workers returned to their positions and a health code[3] system was introduced and recognised nationwide. With enough supply of protective equipment (mostly face masks) and testing for the virus accessible, 85-95% of industrial production capacity returned to normal by the end of March.

Figure 5: Industrial output returned to 85-95% capacity by the end of March

As % of normal levels	Description	Relative activity level by end-Feb	Relative activity level by mid-Mar	Relative activity level by end-Mar	Estimated date of normalisation
Express delivery		70%	100%	100%	Mid-March
Auto & auto parts	OEM	50-60%	70-80%	90%+	End March*
	Auto Parts	70%	70-80%	80%+	End March*
Consumer goods	Staples (General F&B)	80-85%	90-100%	~95-100%	Late March
	Home Appliances	70-80%	90-100%	~95-100%	Late March
	OEM (apparel)	60%	85-90%	~95-100%	Late March
	OEM (Home Appliances)	60-70%	90-100%	~95-100%	Late March
Tech	Notebook	65-75%	75-85%	100%	End March
	Smartphones	50%	80%	90%+	End March*
Property construction		30%	70%	85%	Mid-April
Industrial	Heavy-duty trucks	50%	70%	~95-100%	End March
	Construction Machinery	80%	100%	100%	Mid-March
Basic materials	Steel	50%	70%	80%	Mid-April
	Cement	50%	80%	~100%	End March
	Coal	80%	100%	100%	Mid-March
Total		**55-75%**	**75-85%**	**85-95%**	

Key: 20-39% 40-59% 60-79% 80-94% 95-100%
Source: Companies, Morgan Stanley research, 'China activity tracker: What does Politburo's new "six securities" mean?' April 20, 2020.
*Production capacity has normalised, but actual production only reached 80-90% of pre-outbreak level due to stalling export and consumption demand.

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3. The health code is a QR code system used to identify people exposed to high COVID 19 risks based on their ID number, address, travel history, and self-reported health status. Shops, stations, and offices ask residents to show or scan their codes before granting them entry. A green code authorises entry, while an amber or red code means further examination or quarantine.

What measures are companies taking to avoid a COVID-19 resurgence?

As companies have reopened for business, this has necessitated a change in practices to keep the infection curve flat, but also to market products to cautious consumers. This could be as simple as disinfecting hands and shoes at the factory gate and temperature checks, to more complex measures, such as requiring a team to stay together day and night to facilitate health tracking, as reported at one manufacturer. Monitoring is achieved through scanning QR codes and using infrared video cameras to detect body temperatures as people walk by. Some additional measures are mandated by Beijing, such as suspending the use of fingerprint entry keypads, opening office windows three times a day for 30 minutes and forbidding workers from sitting directly opposite each other when having lunch. Such protocols will be closely scrutinised as other nations seek to re-open their economies.

While supply is on the path to normalisation, the demand picture is more mixed. As detailed above, domestic demand for IT hardware, industrial goods, building materials is very strong, supported by infrastructure investment. Conversely, export demand has fallen dramatically for some sectors as overseas markets have entered lockdown. For example, production for smartphones, vehicles and auto parts has only reached 80 to 90% of pre-outbreak levels due to stalling consumption and export demand (Figure 5). According to public record database Tianyancha, around 26,000 export-oriented companies went bankrupt during the first quarter due to the global disruption inflicted by COVID-19. Unsurprisingly, the retail sector was among the worst affected industries. To take one example, a fashion watch original equipment manufacturer (OEM) in Guangdong closed down in mid-March, as its biggest customer Fossil cancelled all its orders. Similar cases have arisen in toy and clothing OEMs.

Clear virtual winners as consumption patterns change – possibly forever

An exception to the weakening picture for consumer demand is online businesses, which have emerged as clear winners from the COVID-19 crisis. During the initial stages of lockdown, kill-time mobile apps enjoyed a significant boost in traffic with the shutdown of offline entertainment.

Companies involved in gaming, live streaming and online music all have reported better-than-expected results, which is rare in a pandemic. Mobile gaming revenues jumped 37.6% to US$7.8 billion in the first quarter, compared to the previous quarter[4]. Tencent and NetEase dominate this space, comprising nearly 70% of the Chinese online gaming market, according to Statista.

Similarly, e-commerce sales have accelerated not just in China, but across the world, which has overburdened platforms with unprecedented demand. This has brought even more global consumers to China. For example, in Spain and Italy, first-quarter traffic to Alibaba's AliExpress platform, where shoppers can access Chinese merchants, increased on the prior year by 20% and 14%, respectively, according to SimilarWeb data.

Technology related to homeworking and online education started to take off when the extended holiday finished with people still required to stay at home and limit social activities. Demand from those working from home lifted daily active users (DAU) for collaboration apps Zoom and Dingtalk as much as 300%, according to Bernstein analysis (Figure 6). Alibaba's Dingtalk, collaborating with Ministry of Education, has over 12 million students (c. 10% of China's total student population) participating in its 'online classroom', which launched in early February.

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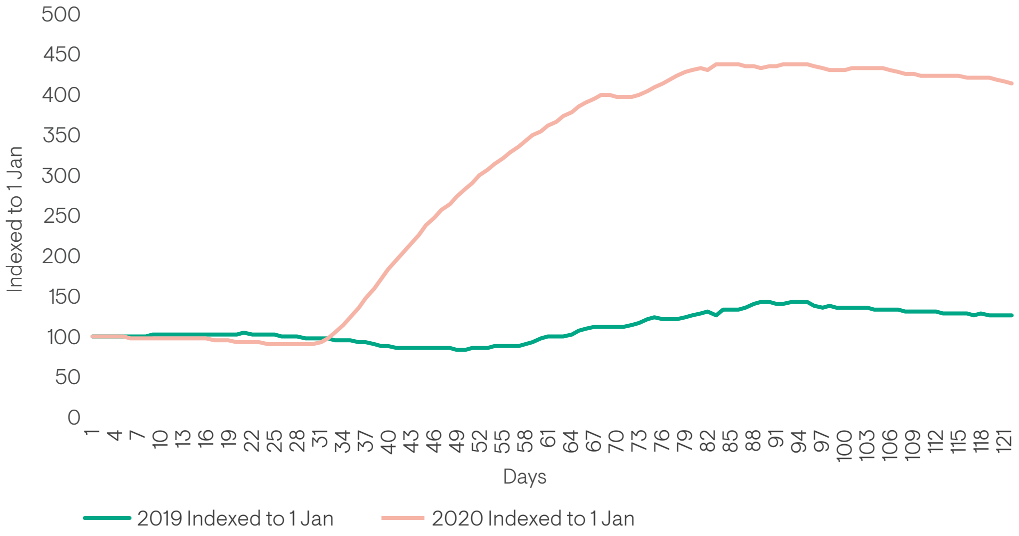
4. Source: China Audio-Video Digital Publishing Association and IDC, April 2020.

Figure 6: Daily Active Users (DAU) of remote working collaboration apps have sharply increased

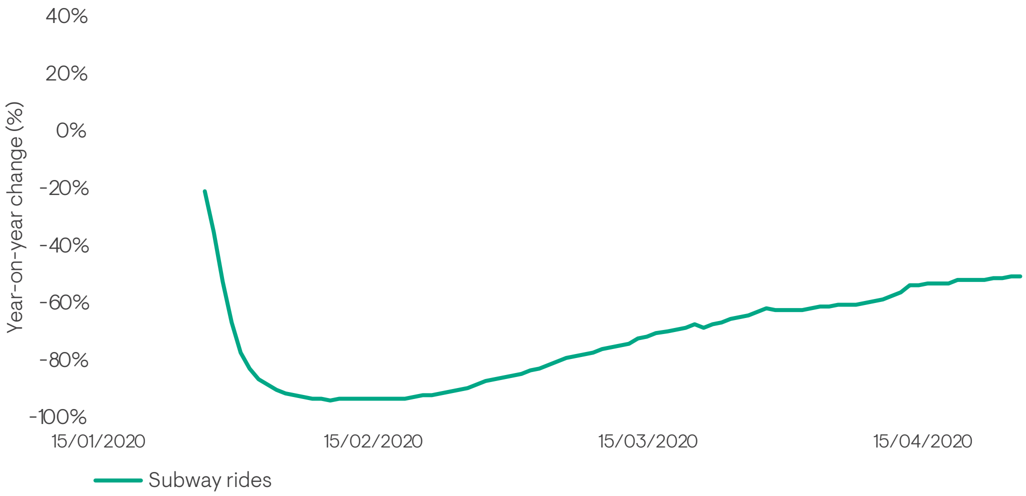


Source: APPTOPIA, Bernstein, 'China COVID-19 tracker: How quickly is China getting back to work?' 2 May 2020.

Transport-related industries have been slower to recover

Other services industries that depend on the physical movement of consumers have been slower to recover. In the early stages of re-opening, local business activities tended to recover the fastest, while travel was curtailed and leisure time was carried out virtually as discussed earlier. Passengers' willingness to travel remains low, and the use of public transportation is 66% lower than a year ago (Figure 7). Travel and accommodation have faced a significant drop in demand. While businesses have reopened, the hotel occupancy rate was around 30% (Figure 8), and airline capacity utilisation was below 60% despite capacity cuts (Figure 9). Looking forward, scheduled domestic flights look set to return to growth in May and June, hinting at green shoots for these under-pressure industries.

Figure 7: Subway and migration data still lower than normal



Source: Bernstein, 'China COVID-19 tracker: How quickly is China getting back to work?', 25 April 2020.

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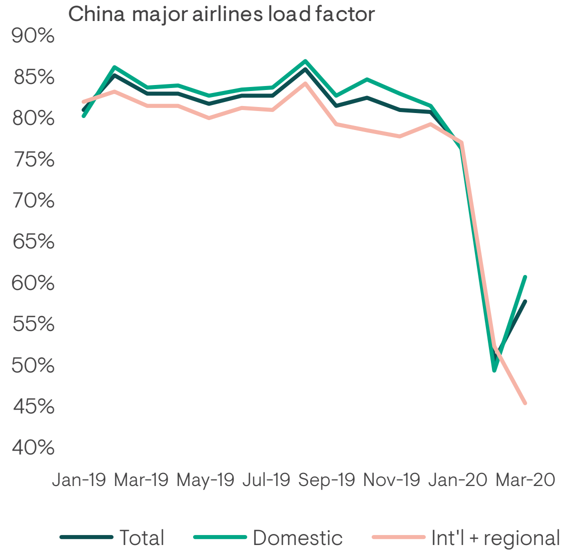
Figures 8 & 9: Slow return to normal for travel-related industries

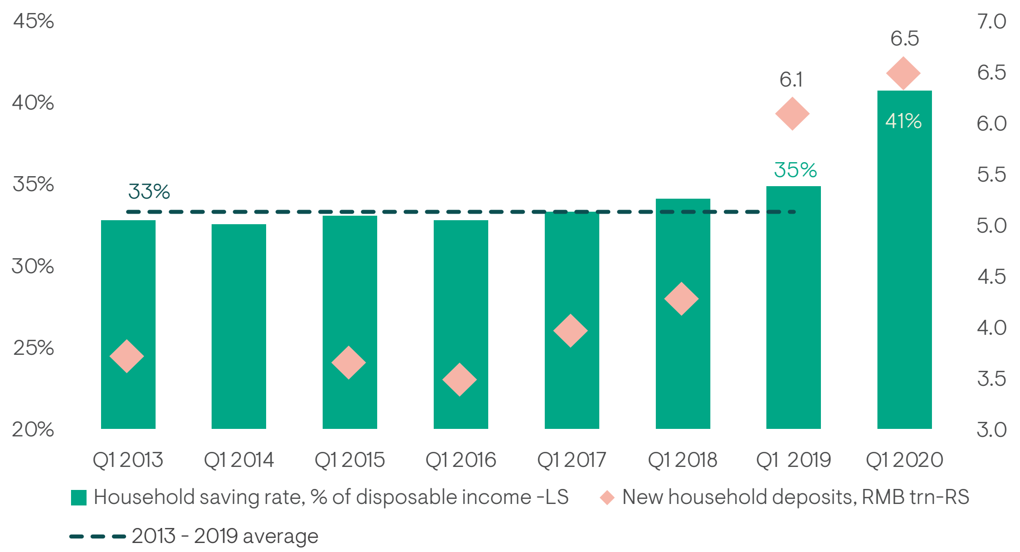


STR, Bernstein analysis, company reports, 'China COVID-19 tracker: How quickly is China getting back to work?' 21 April 2020. Figure 8 data: 18 April 2020. Figure 9 data: 31 March 2020.

Despite the support from e-commerce, the recovery in retail sales also remains slow, as counter-COVID measures continue to affect offline consumption. Restaurants have placed separation boards on their tables and are only running at 50% capacity to reduce the chance of the virus spreading. Entertainment venues, such as cinema, theatre, clubs and museum, remain closed across China.

Muted consumption tends to be associated with an increase in household savings. In the first quarter of 2020, the household saving rate jumped to 41% versus the 33% average from the prior seven years' equivalent to RMB 6.5 trillion of new deposits (Figure 10). This increase in savings potentially creates somewhat of a buffer against job losses or wage cuts due to coronavirus-related impacts. Once the virus fight is over, these savings could re-enter into the economy in the form of consumption, providing a boost to growth.

Figure 10: Household savings increase as consumption drops



Source: CEIC, Morgan Stanley Research, '1Q Data: Bottleneck shifted from supply to demand,' April 17, 2020.

Fiscal headroom to rekindle growth

The Chinese government still has levers to pull to stimulate growth from here, given its fiscal headroom. Measures announced so far this year include special bond issuance, virus control spending, subsidies and reduced employers' social insurance contributions. In total, this amounts to just over 2% of gross domestic product (GDP), according to Reuters analysis. The government effectively enforced quarantine and social distancing, including measures to prevent a spike in new infection cases. This has helped define the length of the shutdown and put China on the path to recovery.

However, there are regional differences across China, which highlights hurdles to overcome in the broad recovery from COVID-19. For instance, local government policy can differ, as regions can have contrasting perceptions of risk. Demographics can also vary considerably. Guangdong, for example, has a large percentage of migrant workers, which meant more near-term manufacturing challenges with enforced quarantine for returning workers from outside the provinces. This highlights why we expect to see stark differences in countries' return to health or sickness from the pandemic compared to how they entered it.

China's decisive actions have helped speed up progress towards returning to economic health. For instance, China has accelerated reforms that were already underway, such as investment in new technologies and reshoring technology supply chains back to the mainland. China has been progressing with rebalancing its growth from investments to consumption, turning up its internal domestic growth engine. We believe the COVID-19 crisis will only fuel this further.

Does China offer a template for the rest of the world?

A crucial question is whether China's gradual exit from the coronavirus pandemic will offer guidance for other countries. China's ability to flatten the infection curve is partly attributable to the government's use of technology to contain the virus. For countries in the West, there will undoubtedly be privacy hurdles to the implementation of a contact tracing system. One is already in production through an unlikely collaboration of Apple and Google using anonymous Bluetooth signals on smartphones.

For investors, this return to a 'new normal' requires a re-evaluation of the winners and losers in a post-COVID-19 world. Our 4Factor team has been re-assessing our existing holdings and new opportunities with this top-of-mind. There have been some existing secular trends that have been accelerated by the outbreak, such as the shift to online in a digital era where social distancing will be prolonged. It remains to be seen which of the changes and trends observed during the pandemic are here to stay in the long run. The eventual effect on globalisation is also unclear at this stage.

For China, being a sophisticated economy with comprehensive supply chains across diverse industries as well as having a significant domestic consumer market are advantageous amid the turmoil of COVID-19. The current situation is unhelpful for companies that rely on foreign supply or demand, but leading companies that have a domestic focus may see the opportunity to strengthen their market position.
For equity investors, we believe it is most effective to focus on picking the winners using a bottom-up approach. In our view, companies with strong business models and solid balance sheets are more likely to be resilient and able to adapt.

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