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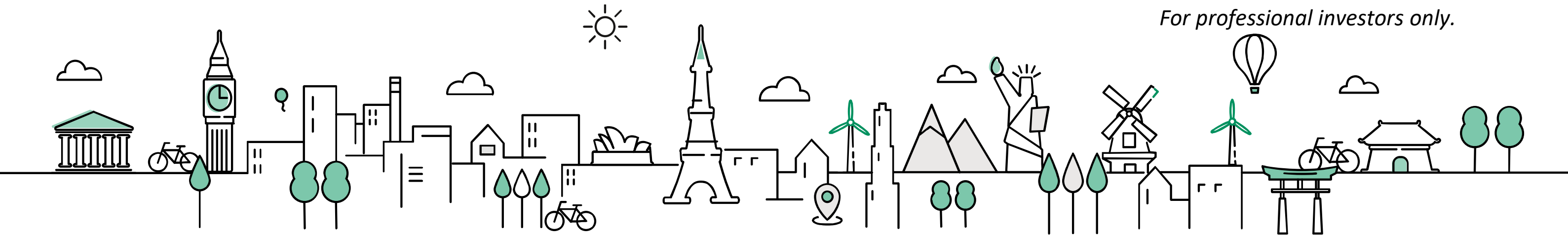

Coronavirus & China equities

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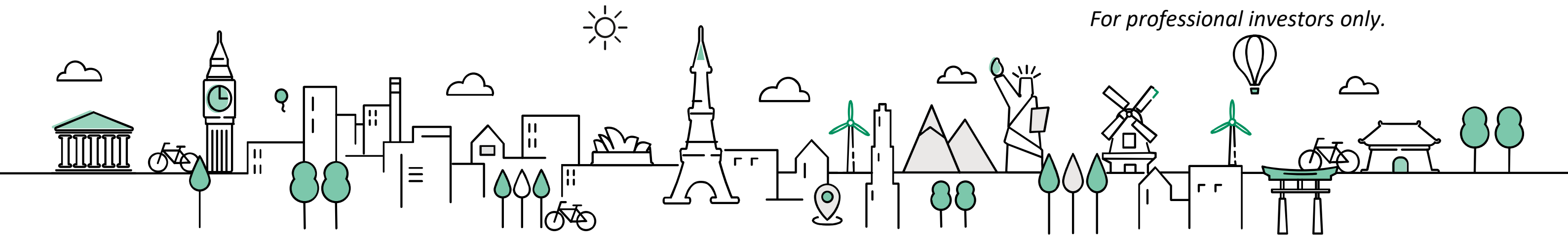
10 burning questions from investors

Our update in brief

1. The recent rebound in China's onshore equity market indices and the surge in inflows after the Chinese New Year period were initially mostly led by investment coming from national team money and insurance companies. Now, investors seem to regain confidence in the market with the outbreak being more controlled in China (outside Hubei).
2. It is hard to predict the trajectory of the coronavirus outbreak, but we feel that the Chinese authorities are working hard to manage the situation. According to big data analyses, the outbreak is expected to fade in March.
3. If the situation starts normalising by March, our team estimates the negative impact on corporate earnings to be 20-30% (excluding financials) for Q1 2020 (vs. initial estimates). Although Q1 2020 GDP growth is expected to be severely impacted, we expect the downside risk to full year growth to remain manageable so far.
4. In contrast to SARS in 2003, we believe that the Chinese authorities are now better prepared, taking firmer actions, locking down cities and issuing warnings against travelling to Wuhan. There is greater policy support from the government. The increase in online sales may offset the loss in offline sale. Medical care is also more advanced.
5. We expect China's monetary easing and fiscal policies to continue to support economic growth in a calibrated manner (e.g. more interest rate cuts in the lending facilities, more infrastructure spending).
6. The key risks for 2020 include a longer-than-expected duration of the outbreak (as workers return to work and infection cases are rising further globally), and US-China trade tensions escalating.
7. Unless the outbreak prolongs for much longer than expected, further downside risks may create entry opportunities for investors looking for longer-term returns in Chinese equities.
8. Retail sales and travel are likely to be most impacted during Q1/Q2 2020, while e-commerce, IT, mobile games or healthcare should benefit the most. This outbreak should accelerate the digitalisation trend across many businesses.
9. Our Greater China equity team is highly focused on our disciplined stock selection process; we favour the technology, healthcare, consumer sectors and selective macro-driven industries such as cement.
10. We seek to identify those long-term investment opportunities in China that are primarily supported by three structural trends: 1) technology/innovation, 2) consumption upgrading, and 3) industry consolidation.

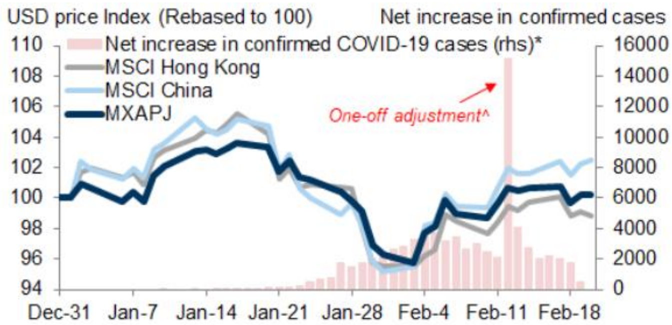


1. Despite China being the epicentre of the virus, how do you explain the recent rebound in onshore equity indices and the surge in inflows?

Amid an accelerating number of coronavirus (Covid-19) cases, rising risk aversion led to a sharp fall in Chinese equities when markets re-opened on 3 February, after the Chinese New Year holiday. The offshore MSCI China index dropped by 6.7%, while the onshore CSI 300 index fell by 9.9% from its 13 January peak, mostly due to panic selling by retail investors.

Soon after, the local markets rebounded: as a result, the MSCI China and CSI300 only corrected by 4.3% and 1.3%, respectively between the 13 January peak and 21 February.

Chinese equity markets have rebounded since early Feb 2020



Source: Goldman Sachs, NHS, FactSet, as of 22 Feb 2020.
* calculated as the change in cumulative confirmed cases, which is equal to the reported new cases minus downward (or plus upward) revisions.
^ starting from 12 Feb 2020, Hubei province has included 'clinically diagnosed' cases in the number of confirmed cases.

We were relatively surprised by the magnitude and speed of the rebound in onshore market. We believe these investments mostly came from national team money and insurance companies to support the local market sentiment. Chinese local mutual funds were not allowed to sell unless the sales concerned redemptions requests. The market saw some large mutual fund redemptions on 3 February during the sell-off. However, redemptions have now largely stopped.

Overall, given that local mutual funds raised significantly new money at the beginning of the year, net inflows are positive at this point, even taking into account the redemptions. Now, with the epidemic being further controlled in China (outside Hubei), we see investor confidence regaining in the market.

2. What is different this time compared with the SARS outbreak?

Although it is difficult to measure the exact economic implications of Covid-19, what is certain is that the global impact of the economic slowdown in China is much bigger today than 17 years ago during the SARS (Severe Acute Respiratory Syndrome) crisis. China now accounts for 18.7% of the global economy, 12.4% of global trade and 12.0% of global oil demand, compared to 8.2%, 5.0% and 6.0% respectively, in 2003.

While we do not underestimate the potential economic implications of the outbreak for the Chinese economy, we see several reasons for believing that any economic damage will not be as bad as many observers have feared.

1) Faster reaction from Beijing, which has taken firm measures to isolate patients from the rest of the population (vs. during the SARS epidemic). This should improve the chances of containing the outbreak, thus increasing the likelihood that output lost in Q1 2020 can be offset by the increased activity in the rest of the year.
2) Better medical care (vs. SARS in 2003), a higher number of qualified doctors, better hospital equipment.
3) Greater policy support from the government. Monetary easing and fiscal policies continue to support economic growth, including more interest rate cuts in the lending facilities, more fiscal spending on infrastructure, and possible tax cuts.
4) Increase in online sales: In contrast to the SARS outbreak, higher online sales can offset much of the drop in offline sales caused by the epidemic. China is in the e-commerce internet age, with increasing consumers shopping online. The coronavirus epidemic should accelerate digitalisation across many businesses, in our view.
5) Cyclical recovery in manufacturing: we believe the scope for a rebound is largest in construction, manufacturing, industrials, albeit delayed by the current outbreak. Cars and electronics already began to recover late last year.

Note that Hubei, the epicentre of the coronavirus outbreak, only accounts for 4.6% of China's GDP, whereas Guangdong and Beijing (the most affected regions in 2003) accounted for 15.2%.

Based on the market's performance during the onset of other infectious diseases (e.g., SARS, Ebola), investors can assume that the epidemic will not hit local markets for the full year. After the first occurrence of SARS back in 2003, the MSCI China index was up by 55.38% 12 months later.

Epidemic	Start date (Month-end)	6-month % change of MSCI China	12-month % change of MSCI China
SARS	April 2003	59.09%	55.38
Avian flu	June 2006	46.54%	76.95
Dengue Fever	Sep 2006	32.91%	129.26%
Swine Flu	Apr 2009	41.06%	38.57%
MERS	May 2013	8.40%	0.70%
Ebola	Mar 2014	3.91%	20.13%
Zika	Jan 2016	10.42%	20.24%
Covid-19	From 13 Jan (peak) to 21 Feb 2020	-4.34%	n/a

Source: BNPP AM, Bloomberg, as of 24 February 2020

Yet, in the near term, given the lingering uncertainty, we expect China equity markets to remain volatile as we enter the Q1 2020 company earnings season in April. Given the rapid rebound in the markets, we suspect that the markets may not have priced in all the risks amid the outbreak (e.g. there is still a risk of new cases rising as workers return to work in large cities). China is likely to keep the current selective easing policy stance.

3. What could be the impact on growth prospects and company earnings?

The exact economic implications of Covid-19 is difficult to gauge at the time of writing. Much depends on the duration and virulence of the outbreak and the government measures taken to control it.

Although we expect investors to feel the negative impact on Q1 2020 GDP growth, we believe the outbreak could well be transitory with economic damage concentrated in 1Q. We think that the downside risk to full year growth is manageable so far.

The combination of 1) stabilised trade tensions, 2) the recovery in global industrial activity and 3) the room for greater fiscal support should allow for a reacceleration of growth. The importance of the policy goal of doubling real GDP growth by 2020 from 2010 is pressuring China for more easing. Growth should be supported by the rebound in demand for cars and electronics, albeit slowed down by the current epidemic.

Should the situation start to normalise by the end of February, we believe that the overall negative impact on corporate earnings is likely to be 20-30% (excluding financials) for Q1 2020 (vs. the initial earnings estimates). The full-year impact on earnings should be manageable at around -5%, in our view.

Given that markets, particularly equities, are likely to remain volatile ahead of the Q1 earnings season in April, we have positioned our portfolio in sub-sectors/companies that are least affected by the virus outbreak, and have good earnings visibility.

4. Will the authorities move aggressively to ease monetary policy to sustain economic growth?

Government policy plays an important role. We have seen further monetary easing and fiscal support. We can expect more (but still controlled) easing, including more cuts this year in the rates on lending facilities, more fiscal spending on infrastructure, possible tax cuts and a delay on tax payments. Overall, there could be a further delay in the deleveraging process. We may expect more policy support for the consumption sector. For now, we do not expect a significant loosening of housing policy.

If Beijing does not change its implicit growth target (6% YoY) for this year, it will have to raise the dose of policy easing to ensure growth in the rest of the year rebounds strongly enough to offset the Q1 losses. This should be a benign backdrop for risk assets.

5. When do we expect the epidemic to peak?

The course of the outbreak is hard to predict, but we feel that the authorities are managing the situation. Big data analyses by Chinese scientists show the outbreak should fade in March. If this were so, the economic damage would be limited to Q1.

Since the week of 17 February, most companies outside of Hubei have resumed working. Restarting production will be gradual as most cities are still controlling worker inflows strictly. A number of manufacturing companies are running at 30-50% of full capacity (as of 21 February) and should pick up gradually to about 70% in the coming days.

If the number of newly confirmed infected cases in China (outside of Hubei) does not pick up anymore, we can assume that this virus is largely under control and equity markets can stabilise. We are monitoring that figure closely.

6. What are the key risks in 2020?

The potential risks include:

- Upside risks: larger-than-expected stimulus and the outbreak coming under control earlier than expected.
- Downside risks: the outbreak lasting longer than expected; a re-escalation of US-China trade tensions; less fiscal support than expected; rising credit defaults.

The largest downside risks in the near term are:

1) New infection cases rebounding in China as workers return to work.
2) Infection cases rising further globally (Italy, Japan and South Korea are now leading the way) even after China's situation has improved.

These secondary risks could inflict more short-term downside risk in global asset prices, though they could also prompt more dovish global policy measures in the medium-term.

Two key factors to watch in the next couple of months:

1) The number of new infection cases in and outside of China.
2) Whether Beijing will relax its implicit growth target to allow more downside flexibility for GDP growth this year.

7. If there were further downside risks, would you see any entry opportunity?

Unless the outbreak lasts for much longer than expected, we think further downside risks may result in buying opportunities for investors looking for longer-term returns in China equities.

Valuations of both China A- and H-shares remain undemanding vs. developed markets. Also, given that foreign inflows quickly resumed in May 2003 after SARS was brought under control, investors will be keenly watching or the turning point in the number of new infection cases.

8. Which sectors will lose/benefit? Will the virus lead to longer-term changes?

In our view, the sectors to be hit the hardest in Q1/Q2 will be:

- Retail sales
- Property
- Transportation, travel, leisure (tourism, catering services, offline entertainment, Macau gaming).

Conversely, the sectors to benefit the most in Q1/Q2 will be:

- E-commerce, IT
- Online video, PC/mobile games
- Packaged food and food retailers
- Healthcare (rising demand for vaccines/health check-ups)

We expect the negative impact on travel, hotel, restaurants, offline retail, and cinemas to possibly last until the middle of 2020. Smartphones, home appliances and other consumer goods may see pent-up demand picking up further in late Q2 or H2.

On the bright side, we should see an acceleration of industry consolidation. This should play favourably for industry leaders over the longer term and lead to a faster adoption of online working, online education, online entertainment, and higher demand for healthcare devices from hospitals to households.

9. What changes in the portfolio positioning in the near term?

Overall, our Greater China equities team's preference focuses on information technology, healthcare, consumer and selective macro-driven sectors such as cement.

Our team keeps a cautious stance and reacts as the situation develops. We monitor the situation closely while adjusting the portfolio in sub-sectors that are least affected by the outbreak. We keep an eye on the highest-quality companies presenting strong earnings visibility at any given time.

10. Where do you see long-term investment opportunities?

We continue to focus on disciplined stock selection, identifying the highest-quality companies delivering sustainable earnings growth over the long term with sound or improving ESG profiles.

We believe that China will continue to offer significant investment opportunities over the next few years, supported by these three structural trends: 1) technology/innovation, 2) consumption upgrading, and 3) industry consolidation.

Conclusion

We are upbeat on China equities for a number of reasons: a still-benign profit growth outlook, reasonable valuations, as well as constructive portfolio flows amid light investor positioning.

We expect the market impact of the epidemic to be short-lived. We are optimistic about the long-term market trends. Once the situation normalises, we believe investors will be presented with interesting entry points into China equities, allowing them to benefit from long-term sustainable returns