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China Data: Q1 Will Test The Lower Limit

- China's manufacturing PMIs in January were in line with expectations and only marginally lower, but did not capture the impact from the latest coronavirus outbreak. Real activities and PMI data is set to worsen in the next few months as most economic activities were suddenly halted after the authorities locked down Chinese cities to prevent the rapid spread of virus.
- We think the coronavirus outbreak will likely be a temporary shock to China's growth and we remain cautiously optimistic that China's longer term growth momentum will likely be stable if the authorities decisively step-up counter-cyclical policies in the near term to offset the negative impact.
- As Chinese financial market re-opens from a longer than usual Chinese New Year holiday, the PBoC moved swiftly to inject a net CNY150bn liquidity in open market operations and lowered both 7-day and 14-day reverse repo rates by 10bps to 2.40% and 2.55% to stabilise financial market sentiment.
- China's growth momentum may face greater downward pressure in the near term and the authorities will likely prioritise support growth again in the upcoming National People's Congress (probably in early March). We think both fiscal and monetary easing policies will be stronger to ensure growth momentum stabilises into H2.

Chinese markets re-opened today with the Shanghai Composite Index down by 9% and USDCNY spot trading above the key level of 7.00 after a longer than usual Chinese New Year holiday. The new coronavirus outbreak forced Chinese authorities to extend the holiday by one week day, and also led to a travel lockdown in several cities to prevent rapid spread of the virus. Prior to market open, the authorities have pledged firm support to the financial markets in the near term. **The PBoC announced a net CNY 150bn liquidity injection via open market operations by 7-day and 14-day reverse repos and has lowered both 7-day and 14-day reverse repo rates by 10bps to 2.40% and 2.55% respectively. The 10bps rate cut in reverse repos was unexpected, and it increases the chance of lowering 1Y and 5Y Loan Prime Rate (LPR) in the upcoming announcement on 20 February.** We think the PBoC will likely to continue support the banking system with ample liquidity to help commercial banks tide through the temporary liquidity crunch.

China's manufacturing PMI data has shown some stability after the US-China Phase I deal greatly reduced near term risks of escalation. Official manufacturing PMI slowed marginally by 0.2 percentage points to 50.0 and was in line with market consensus. Caixin manufacturing PMI also came in line with expectations at 51.1, down marginally from 51.5 previously. Business confidence improved marginally prior to the virus outbreak as corporates turned optimistic about both domestic and external demand into 2020. **However, the stability may be short-lived as the new virus situation forced China to lock-down several cities and halted almost all economic activities during the Chinese New Year to prevent rapid spread of the disease.**

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We expect China's real activities data and PMI data to plunge in the next few months and that will weigh on the full year real GDP growth.

Drawing parallel to the SARS epidemic in 2003, we think the negative shock to China's real GDP growth will likely be drastic but temporary. During SARS outbreak in 2003, China's real GDP went down by 2 percentage points from 11.1% in Q1 '03 to 9.1% in Q2 '03, but it quickly rebounded to 10.0% in Q3 '03 and maintained high growth level for the remaining year. Unlike 2003, China's now relies more on consumption rather than investment as the government has imposed strict deleveraging policies to prevent excessive debt accumulation by the local governments' since 2018. **Therefore the sudden halt in economic activities – especially the consumer sector such as tourism, box offices, transportation and services sectors – will likely have a bigger impact on Q1 GDP growth compared to 2003.**

The impact on the manufacturing sector and employment will depend largely on when migrant workers return to the cities. Chinese New Year is typically the season when the manufacturing sector production and activities usually slow as migrant workers leave the factories. As a result of the outbreak of virus, this year most migration back to the cities has been delayed, causing some disruption to production activity. The impact is still uncertain and will depend on how the virus situation evolves. Based on the central government's briefing, companies will likely resume production as early as this week, which may cause less negative shock to the overall growth momentum.

We expect the authorities to use the traditional lever of infrastructure sector investments more forcefully in 2020 as the economy faces more downside pressures. Even before the virus outbreak, the National Development and Reforms Commission (NDRC) has accelerated approvals and implementations of major infrastructure projects to offset the downside pressures from the lack of corporate investments and slowing consumption.

Despite the negative shock to near term growth momentum, we think the market does not need to be overly pessimistic about China's longer term growth outlook due to the following reasons:

1) The PBoC moved swiftly to cut rates by 10bps showed the authorities' determination to support growth.

The PBoC's rate cut today increases the chances of Loan Prime Rate (LPR) cut in February, which is not what we previously expected. We think the rate cuts today signal stronger and more decisive support to stabilise the financial market sentiment in the short term. We now expect a 5-10 bps LPR cut in February.

The upcoming National People's Congress (NPC), which usually takes place in early March, will be an important time window for the market to confirm China's pro-growth policy bias. As China is set to achieve a few medium term growth targets in 2020 such as doubling 2010 GDP by 2020 and fulfil its 13th Five Year Plan, we think the government will still tilt towards stabilising growth with stronger countercyclical easing policies in the next few quarters.

2) Earlier easing policies are set to have some positive impact on the economy, and the authorities may step up decisively with stronger countercyclical fiscal and monetary easing policies to offset the negative impact on growth in the short term.

China's credit impulse has picked up in recent months as the PBoC extended more credit to the real economy. We think the gradually stronger credit support will likely have some positive impact on the economic growth momentum as activities and demand picks up. We expect the credit impulse to rebound a little further into 2020 to around 5.0% from 1.9% as of December 2019, providing more support to the expected increase in credit demand.

In conclusion, we think the virus outbreak will likely be a temporary shock and we will watch closely as the situation evolves. If the virus situation could stabilise by Q1, we expect the growth momentum to resume into H2 with more countercyclical easing policies in place and recovering sentiment. **We think if the domestic situation on coronavirus could stabilise by the end of Q1 and economic activities rebounds sharply with stronger easing policies, China's real GDP may slow to around 5.0% yoy in Q1 and recovers to around 6.0% for the remaining quarters which will put the full year GDP growth at around 5.7% to meet its goals of doubling 2010 GDP by 2020.**

Chart 1: Credit Impulse and Manufacturing PMI

Source: CEIC, NatWest Markets

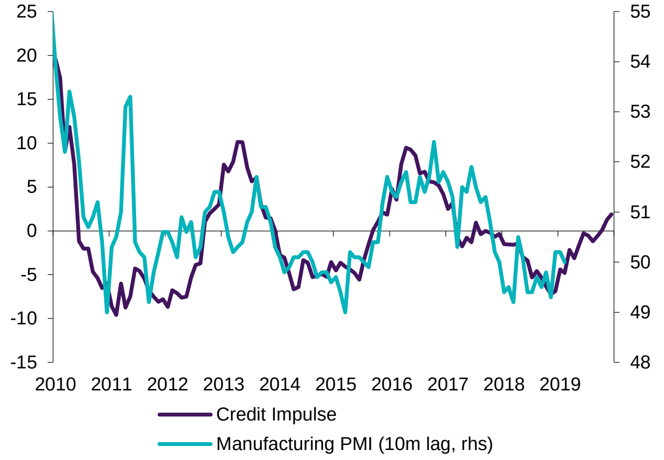

Chart 2: Infrastructure Projects Pipeline and Investments

Source: NDRC, Bloomberg, Natwest Markets