ARTICLE FOR THE EDGE

THE CRISIS DEEPENS: WHAT COULD SURPRISE MARKETS?

The coronavirus crisis continues to dominate the headlines and remains the primary driver of financial markets and the economic outlook. However, while we are all focused on the immediate issues of the rate of new infections and deaths and so on, are there other factors that we might be under-estimating which could hit markets or the economy?

If we look beyond the direct effects of the coronavirus crisis, there seem to be four areas of potential surprise: an upside surprise in the Chinese economy; the risk of an emerging market crisis; a bad turn in US-China relations; and the oil market rout turning nastier than expected for the world.

Could China's economic rebound blow past expectations?

The data now emerging for the Chinese economy's performance in March is better than expected. The official purchasing manager index (PMI) for the manufacturing sector rose strongly to 52.0 in March from the record low of 35.7 in February. The improvement was broad-based, with big recoveries across different industries and benefiting businesses of varying sizes. The Caixin manufacturing PMI, which is a better representation of private sector performance also surged, to 50.1 from 40.3 in February. The official PMI for the non-manufacturing sector also depicted a massive recovery, rising from 29.6 in February to 52.3 in March.

This positive picture is supported by other high-frequency indicators. For example, coal consumption in power plants in the coastal economic powerhouses had more than doubled by end-March from its low in early February. A survey by IHS Markit showed that 90% of China's shopping centres had resumed business while 70% of small and medium-sized enterprises had restarted operations by the middle of March. Large state enterprises are ploughing ahead on major projects - China Railway announced that 93% of its major construction projects were now going ahead again.

Basically, the Chinese economy is not out of the woods yet, but it is improving rapidly.

What this shows is the tremendous capacity of the Chinese economy to resume production very quickly. But there is a second factor that will drive the economy even higher and that is government policy.

The Chinese Communist Party Politburo meeting last week signalled a shift in policy, away from a total focus on containing the coronavirus to a new, and huge, emphasis on economic recovery. China's top leaders urged officials to strengthen counter-cyclical policy measures, and stated explicitly that they wanted the stimulus efforts to be expanded. They called for the fiscal deficit to be raised and permitted the issuance of Special Treasury bonds to finance the spending. At the same time, China's top leaders also approved an increase in the quota for

local government special bond issuance which will be used to fund a surge in infrastructure construction. Finally, the meeting also pressed for interest rates on loans to businesses to be reduced.

Immediately after the Politburo's statement, the central bank cut its policy rate and promised measures to ease liquidity in the system. Soon after that, the State Council, China's cabinet, issued a comprehensive set of measures directing how monetary and fiscal policies will be used to ramp up economic growth. Of note were new financial policies to direct credit to small and medium enterprises. This makes sense since these firms are the most dynamic part of the economy and the biggest employers. Local governments will also be provided massive funding to splurge on infrastructure expansion.

There are compelling reasons why China's leaders will pull out all the stops to ensure a strong economic recovery. As the Chinese Communist Party (CCP) will celebrate its 100th anniversary in July next year, President Xi Jinping is keen to showcase China's extraordinary achievements under the CCP's rule. No doubt President Xi would like to demonstrate how China's system can so efficaciously manage its economy in contrast with the United States and Europe, which are now so overwhelmed by the coronavirus that they are likely to see a painful economic contraction this year. The CCP leaders may also want a strong economic rebound to help overcome domestic criticism of their early handling of the coronavirus crisis.

Will a second wave of infections set China's recovery back? Our baseline scenario for China has always incorporated such a second wave, since the relaxation of restrictions on social mingling would probably lead to some new infections. However, we believe that any second wave is likely to be smaller and much less lethal than the first one. The healthcare system is now better resourced and also experienced enough to better handle a new surge of infections. Moreover, as treatment regimes are improving rapidly, the new cases are less likely to turn serious or fatal. In short, a second wave is a material risk but one that can be managed.

Will the severe global downturn limit China's rebound? Yes, certainly, the export-oriented sectors will not recover soon. Indeed the latest PMI figures show new export orders, while improving from February, were still in negative territory in March. Export demand is sure to contract even more sharply in April as the American and European economies sink into a deep recession.

So, China's recovery will have to be domestically driven - and mainly led by investment. Even though China has already built infrastructure on a vast scale there is still ample scope for productive investment. After all, China's strategy for creating multiple urban agglomerations such as the one planned around the Beijing-Tianjin-Xiong'an cluster can always be expedited: The plan envisages a network of high-speed railways and roads, for instance, to provide the superb connectivity needed to make this agglomeration work. China can also take the lead in implementing 5G mobile telephony networks. Finally, the next phase of Chinese economic development requires companies to move up the value chain in terms of innovation and research and development, all this will require large investments as well.

What this means is that, after a weak first half of the year, we could see a vigorous recovery in the third quarter of this year followed by an impressive surge in the fourth quarter.

Could an emerging market crisis compound our woes?

While China's recovery could help the rest of the world, there is a risk that this good news might be offset by a crisis affecting one or more of the other large emerging economies. The confluence of shocks we are seeing now is particularly damaging to emerging economies. Global demand for their exports is likely to collapse, tourism earnings will decline and remittance inflows slow while the prices of the natural resources they export will probably fall further.

So, their external deficits will grow, even though lower oil prices will help a number of emerging economies, especially India. But funding these deficits just got a whole lot more difficult. Rating agencies have started to downgrade some large emerging economies such as South Africa, raising their borrowing costs. Because global investors will remain highly risk-averse, much-needed capital will be withdrawn from emerging markets rather than be made available to fund current account deficits. In the near term, a critical shortage of US Dollars is also hurting vulnerable emerging economies who need the Dollars to repay debts that are coming due. This is a big deal - in the period after the global financial crisis, internationally traded corporate debt in emerging economies rose by more than four times to USD2.3 trillion. Fortunately, most Asian emerging economies look like they can ride through the storm but others such as Brazil, Turkey and South Africa could go into a crisis without extensive help.

US-China: tempers are fraying, it could get worse

At a time when cooperation between the two most powerful countries in the world is direly needed, the United States and China are engaged in a series of ill-tempered squabbles. There has been a blame game between the two over the source and handling of the coronavirus crisis. Although a telephone chat between Presidents Xi and Trump helped to soothe that spat, other more fundamental issues are likely to keep the relationship on edge. Despite the apparent bonhomie between Xi and Trump, there is no let-up in the Trump Administration's efforts to scupper the rise of China's technology giant, Huawei. Last week, Senior administration officials were reported to have completed a draft new policy that will attempt to restrict the global supply of vital semiconductors to Huawei. Foreign suppliers using American equipment will be required to obtain a license from the United States government in order to supply these critical components to Huawei.

Worse still, American policy on Taiwan is hardening. A day after the Huawei move above was disclosed, President Trump signed into law The Taiwan Allies International Protection and Enhancement Initiative Act, which obliges any American administration to help Taiwan regain international support. Not since the United States switched formal recognition from the Republic of China to the People's Republic of China has American policy been required to so formally promote Taiwan's international profile. China has made it clear that Taiwan is a highly

sensitive "core" issue for it. This American move is not something that China can simply ignore. When it reacts, US-China tensions will certainly worsen.

Lower oil prices help most of us but what if there is a further collapse?

The one thing that has helped most economies in recent months has been the sharp fall in oil prices. The lower cost of energy and transportation provides relief to consumers and businesses all over the world. India which imports most of its oil needs is a particular beneficiary. Apart from the oil exporting countries and companies, the fall in oil prices has generally been a good thing.

But one could get too much of a good thing. Even as oil demand is cratering, neither Saudi Arabia nor Russia show any signs in relenting in their face off – both are keeping production high, adding to a gargantuan oil glut. As the American and European economies suffer sharp contractions in the second quarter, this excess supply will become so huge that we could see another big fall in oil prices. If so, the ill effects of low oil prices could exceed the benefits:

- The fiscal positions of Saudi Arabia and many other Middle East, African and Latin American oil exporters will deteriorate so badly that they will be forced to cut back on social spending and the provision of essential government services. The political consequences could be dire.

- Several companies in the oil producing business and related areas would have to shut down. Capital spending by shale oil companies in the United States would collapse, dragging down overall investment and depressing the economy further.

The only thing that can avert this crisis is a compromise between the Saudis and Russia, of which there is no sign right now. A political crisis in the Middle East which disrupted the production or transportation of oil could support oil prices – but such a crisis would have other ill effects on the world.

Conclusion

The coronavirus crisis will persist for some time but is not the only factor shaping the landscape for investors. Apart from the possible upside surprise in China, the other potential surprises could be unpleasant ones. Caution is still warranted!

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