China A: Short-term volatility provides good entry point for long-term investors

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The China A-share market, in terms of size, influence and investor composition, is markedly different today versus 2003. As such, the SARS episode may not offer an accurate assessment of how the China A-share market would perform. We identify sectors which may be more resilient in the short term, but also highlight opportunities which long-term investors should be prepared to seize.

At the point of writing, the number of confirmed and suspected cases of the novel coronavirus is still increasing. However, the Chinese government has taken decisive measures to quarantine cities, isolate regional populations, extend holidays, suspend public transport operations, as well as encourage residents to cut down on travelling. These measures, especially outside of Hubei province, would have helped to contain a wider spread of the virus.

A "ONE-OFF" IMPACT ON CHINA'S ECONOMY

We expect China's first quarter GDP growth to slip to 4% as both consumption and investment bear the brunt of the impact from the outbreak. Historically, retail consumption during the Spring Festival typically accounts for 10% of the total retail spending for the first quarter of the year. However, because of government restrictions, many Chinese have cancelled their holidays and stayed at home. As such, consumption spending on catering, gifting and travel have fallen significantly.

Economic growth is also closely linked to construction and production activities; and while the State Council of the People's Republic of China has extended the Lunar New Year holiday by three days to February 3, some regions in China have extended the holiday to the Lantern Festival on 8 February. Hubei, for example, has extended the holiday to 15 February, with the possibility of a further extension. We estimate that these regions account for about 60% of the country's national gross domestic product (GDP). In addition, many companies also require employees returning from other Chinese cities to self-quarantine for 14 days. This will inevitably impact the work force in the first quarter, thereby weakening the overall investment.

Yet history tells us that the impact of an epidemic or similar episodes on the Chinese economy is usually temporary.

Take the Severe Acute Respiratory Syndrome (SARS) outbreak in 2003 as an example. In Q2 2003, when the impact of the epidemic was at its peak, China's GDP growth rate fell from 11% in Q1 to 9%, but then rebounded to 10% in Q3. During that period, the year-on-year growth of retail sales of consumer goods slowed from 9.3% (March) to 4.3% (May), but rebounded to 9% in the following months.

With this in mind, we believe that most of China's consumption demand is only postponed and the pent up demand would rebound sharply at a later stage. The turning point will come when we have greater clarity on how to treat the virus, and there is an increase in the availability of drugs. When that time comes, society will resume normality and consumer demand will recover. Demand for catering and tourism should also rebound. As more people return to work, it will not be surprising to see a strong quarter-on-quarter GDP recovery in the second quarter. As such, the Chinese economy can still grow 5% or more in 2020.

CHINA A: THIS TIME IT'S DIFFERENT

Investors may be misguided if they use the 2003 SARS episode to assess how the China A-share market could potentially perform.

First, the state of the Chinese economy in 2003 was very different to how it is now. Before the SARS outbreak, China's GDP growth was more than 10%. However, China's economy was already slowing and undergoing structural changes before the recent coronavirus outbreak.

Second, the A-share market's size and influence have evolved. In 2003, there were only 1,200 A-share listed companies, with a total market value of RMB 4 trillion (representing 30% of GDP). Today, there are nearly 4,000 A-share listed companies, with an aggregate market value of RMB 60 trillion, representing roughly 60% of China's GDP – significantly more than before.

Third, the profile of A-share market participants has changed. In 2003, the A-share market was dominated by retail investors, with only 70 public funds of just RMB100 billion in assets under management. Today, the number of institutional investors and foreign investment funds investing in the China A-share market is much higher. This suggests that there is a significant change in the investment mind set to one that has a longer-term perspective.

As a China-based foreign asset manager, we believe that much of the current market volatility is caused by short-term investor behaviour. With our local expertise, we focus on long-term factors such as business models, quality and sustainability of earnings and tend to look through the short-term noise in the market. As such, we are more confident to take advantage of opportunities that arise amid the short-term volatility.

The recent volatility in the China A-share market could provide discerning long-term investors with attractive buying opportunities. However, when the panic-selling comes to an end, it does not mean that there will be a sustainable rally. The overall market trend still depends on a combination of liquidity, policy, and the ongoing development of the coronavirus outbreak.

IDENTIFYING THE RISKS AND THE OPPORTUNITIES

Although the coronavirus has disrupted China's growth in the short-term, the medium-to-long-term consumer demand trends – driven by technological innovation, a rising middle class and an ageing population – remain intact. That said, a deep understanding of the Chinese economy and market is required to navigate the current situation and identify the genuine opportunities that exist.

We expect China's burgeoning new economy players, such as those in the technology, new energy vehicles (NEVs), healthcare, e-commerce and e-learning sectors to be more resilient, and may even benefit from the outbreak.

Technology: The impact of the outbreak on the technology sector is currently at a macro level. In contrast to traditional industries, the technology industry does not rely on traditional foot traffic. While the outbreak and the extension of the Spring Festival holiday will inevitably disrupt the labour-intensive activities of manufacturing mobile phones, computers and servers, online technology will benefit, to some extent, from the current outbreak.

Online gaming and video content providers are likely to be the key beneficiaries. The holiday extension along with self-quarantine will encourage the Chinese to stay indoors, which, will in turn, increase their time spent viewing online content. Online videos, literature, social media, games, etc., are activities which can be enjoyed by consumers of all ages. In this context, relevant service providers in the various segments should see a significant increase in active users, usage time, and paid user conversion rates.

New energy vehicles: The short-term impact on the NEV industry should be neutral, thanks to its high degree of manufacturing automation. Even if the assembly process still requires some human inputs, the number of workers needed is significantly lower than the consumer electronics industry. As such, we believe that that the impact of the outbreak on the NEV production will be relatively limited. However, if the scale of the outbreak expands, the demand for automobiles, including NEVs, will inevitably suffer.

Healthcare: The healthcare industry is likely to be one of the more resilient industries. In the short-term, sales of pharmaceutical companies should increase significantly, while makers of protective equipment and related medications should probably also benefit. That said, investors need to look beyond the short-term hype and be disciplined regarding valuations.

From a long-term perspective, we believe that episodes of virus outbreaks will have a positive effect on China's healthcare industry and will help raise the country's level of health awareness. Spending on healthcare is still very low in China versus the developed countries and is likely to increase in the future. The research and development capabilities of China's pharmaceutical industry will also be strengthened, which would create more long-term opportunities for investors.

China's medical research and R&D in innovative drugs have gained unprecedented traction during the coronavirus outbreak. Through the social media, the public is witnessing how medical R&D is racing against the epidemic outbreak. We expect to see structural advancements in the industry and more frequent replacement cycles in drugs. We believe that the innovation in the pharmaceutical industry will only accelerate which underpins our investment thesis in this sector.

Education: While schools have been disrupted due to the outbreak, student enrolments at education centres and tuition revenues should not be affected over the long term. The outbreak may draw greater attention to online learning, which is a very cost-effective education platform, but still a small revenue generator for many education providers. As the penetration of online learning increases, online technology providers will also benefit.

Retailing: While department stores have been the hardest hit from the decline in foot traffic, the impact on supermarkets has been mixed while e-retailers have benefited. Demand for supermarket home delivery has surged despite the short-term disruption to capacity and supply chains. Nevertheless, supermarkets are taking this opportunity to aggressively promote their home delivery services – those with established online shopping platforms should benefit in the medium and long term.

The epidemic will further strengthen online consumption habits and lift online penetration. Major e-commerce companies have established special zones and provided special logistical support for epidemic areas. These measures, together with generous donations from large e-commerce players have helped to promote a positive image of the e-commerce platform. We expect the fundamentals for the e-commerce industry to improve significantly from the last quarter of 2020 going into 2021.

LONG-TERM GROWTH DRIVERS REMAIN INTACT

The coronavirus outbreak will inevitably bring pain to the Chinese economy, but this will not last long. The economy will eventually get back on track and while growth would be slower, we are confident about the opportunities brought by China's economic structural shifts. Now is the time to move forward and seize the long-term opportunities that are emerging from this short-term crisis.

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