ASIA PERSPECTIVE

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China Economic Update Report

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China's economy shrank by 6.8% in the first quarter as the country battled pandemic

Following the declining economic growth of 2019, China's economy was heavily hit by the coronavirus pandemic in Q1 2020, resulting in an immense drop compared to the same period last year.

China's Gross Domestic Product (GDP) fell 6.8% during the January – March period. This is the first contraction in China since 1976, and the worst plunge since at least 1992, when official releases of quarterly GDP publications started. The utilization rate of industrial capacity shrank to 67.3% in Q1 2020 from 77.5% in Q4 2019. As a result, industrial production dropped by 8.4% (YoY). In addition, retail sales also fell by 19% during Q1, further contributing to the economic contraction.

The exports dropped by 11.4% in the first quarter, to a total value of USD 466.1 billion. Imports went down by 0.7%, to a total value of USD 457.6 billion. Hence, the recorded trade surplus amounted to USD 13.9 billion.

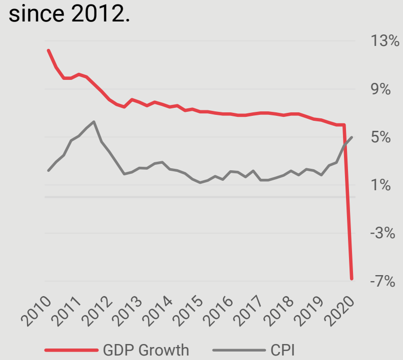
During Q1, trade between China and the ASEAN countries rose with 6.1%, while trade with the EU and US decreased by 10.4% and 18.3% respectively. Therefore, the ASEAN countries took the spot as China's biggest trading partner during January – March.

Lunar New Year holiday extended while all public activities canceled

Due to the outbreak of the coronavirus, that started in January right before the Lunar New Year, the government decided to extend the holiday another week, meaning that workers returned to work later than initially planned. Meanwhile, all social events and gatherings were canceled and cross-province traveling were heavily restricted. Instead of the normal holiday season, millions of people lived in fear, and businesses were frozen during the period, resulting in an economic shrinkage.

China's GDP growth and CPI over the last 10 years

China's economy diminished for the first time since 1976 in Q1 2020 while inflation rose to 4.7%, the highest since 2012.

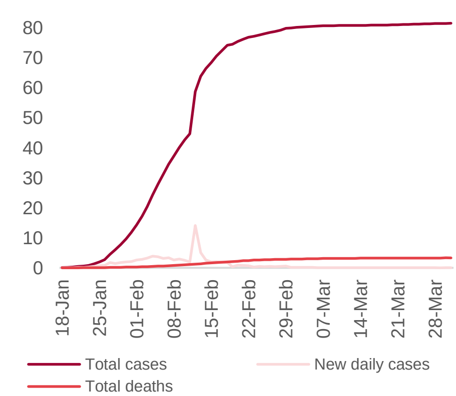


Businesses affected by the pandemic in different ways

Since the outbreak of the novel coronavirus, known as COVID-19, many businesses in China have been hit hard by the economic standstill. However, some industries have found great opportunities to grow and overcome the pandemic.

COVID-19 is believed to have started in Wuhan, China, during the end of 2019. The first case was officially identified in late December, which marked the beginning of a contagious outbreak in China and later other parts of the world. Since then, China has implemented different methods of preventing and controlling the outbreak. During the first few weeks, all people were required to stay home and minimize their movement. Offices across the country were closed down, and most businesses were frozen. By the end of March, the Chinese government's effort was rewarded with a declining number of infected people and an increasing number of recovered patients.

Numbers of infected and deaths in China in Q1 2020 (thousands)

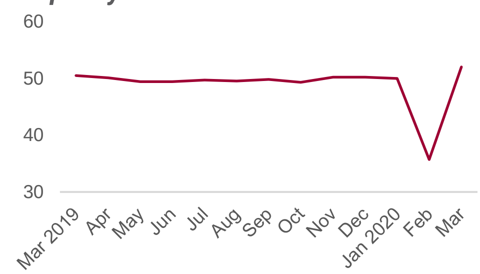


Source: COVID-19 data in China, Worldometers

The outbreak had a negative impact on both manufacturing and consumption, which are two vital parts of China's economy. Restaurants and retailers, as well as companies in the tourism and traveling sector, have experienced significant falls. Specifically retail sales, which dropped 19% in the first three months of 2020. However, online retailing sales stayed relatively stable as consumers turned to online services when staying indoors, falling only 0.8% (YoY). The overall online sales of physical goods expanded by 5.9% to USD 262 billion, accounting for 23.6% of the total retail sales in the first quarter.

Foreign investment in China also experienced a plunge by 10.8% in Q1 due to the coronavirus outbreak, amounting to a total volume of USD 31.2 billion during this period. However, high-tech services attracted a higher amount of foreign direct investments and grew by 15.5% (YoY).

Monthly Caixin Manufacturing PMI over the past year



Source: China's PMI, National data of National Bureau of Statistics of China

The Caixin Manufacturing Purchasing Managers' Index (PMI), which measures the monthly performance of the manufacturing sector and is based on data compiled from questionnaires sent to purchasing executives in over 400 private manufacturing sector companies, declined drastically from Q4 in 2019. After a slight decrease by 0.2 points in January 2020, the PMI plunged 14.3 points in February 2020, the lowest recorded level since the data gathering began in April 2004. The drop was mainly driven by lower output, fewer orders and low employment level due to the extended Lunar New Year holiday. However, since the outbreak in China was under control again in March, the PMI jumped back up to 52.0, beating the market consensus of 45.5, and signaling a broad stabilization of business conditions.

The automobile industry was heavily affected by the outbreak. Short-term production was suspended as domestic and international supply chains were limited, putting smaller producers of car parts and components in a vulnerable position.

Chinese mobile app revenues surge in Q1 amid the COVID-19 outbreak

Due to the unprecedented outbreak of the coronavirus, millions of people were forced to stay at home for a longer time with a lot of spare time to fill. To entertain themselves, people spent more time playing mobile games.

As a result, during the first three months of 2020, the gaming industry's revenue exceeded USD 10.34 billion, marking a 25% increase (YoY). The sales of gaming smartphones also surged quickly while sales of consoles supporting motion-sensor games nearly tripled compared to the same period last year.

Gaming companies quickly grasped this opportunity by extending and introducing new offerings. Since young people are accustomed to almost entirely-free-to-play games, some companies decided to remove the cost to download games, to attract a larger number of players. Instead, they are focusing on in-game purchases . Two of the most popular games in China are currently "Honor of Kings" and "Peacekeeper Elite", both developed by the tech-giant Tencent.

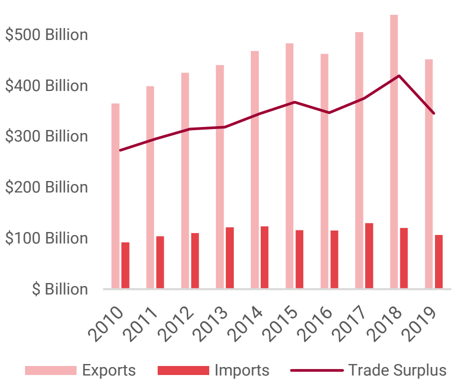
The epidemic has brought a new development momentum to the online entertainment industry, and a large share of people who took up gaming during the outbreak will possibly maintain their gaming habits even after the epidemic is over. Therefore, the gaming industry growth is very much likely to continue at a robust pace upcoming months.

The US – China Trade War Progresses

On 15th January 2020, the US and China signed the phase one trade deal, easing the 18-month tensions between the world's two largest economies. A major part of the agreement is to cut down on US tariffs and increase China's purchases of US products.

Since mid-2018, the US and China have continuously imposed different trade barriers on each other's products. The tensions peaked in September 2019 with additional duties applied on Chinese imports to the US worth USD 375 billion and US imports to China worth 185 billion. As a result, the trade between the two countries shrank by 15.3% (approximately USD 101 billion) in 2019 compared to the year before. Exports from China to the US declined significantly by 16.2%, and Chinese imports from the US dropped by 11.3%.

China's trade with the US (USD billion)



Source: Data of Trade in Goods with China, United States Census Bureau.

Although the tariff relaxations have been applied since mid-January, trade volumes between the two countries has not recovered during the first three months of 2020. This is mainly due to the global coronavirus outbreak that started in China. Specifically, the total US-China trade fell by 20.3% YoY in Q1 2020; the majority of the decline was associated with the export volume from China to the US, which plunged by 23.3%.

Nonetheless, post-pandemic trades may be promising for both countries. The phase one deal has clarified the commitments of China and the US towards a more transparent approach, a greater Chinese market access for US companies in financial services and agriculture, a promise from China to not manipulate its currency to expand exports, and most importantly an increase of Chinese purchases of US produced goods and services. In return, tariffs on many Chinese imports to the US will be lifted. Products valued to USD 160 billion will not bear additional tariffs, and duties on products valued to USD 112 billion will be reduced to 7.5% from 15% thanks to the phase one deal.

China's additional purchases, on top of 2017 baseline, from the US 2020 – 2021 (USD billions)

	2020	2021
Manufactured goods	32.9	44.8
Agriculture	12.5	19.5
Energy	18.5	33.9
Services	12.8	25.1

Source: Economic and Trade Agreement Between the US and China, the US Office of the President

Pre-trade war 2017 recorded the highest export value of US products to China. Therefore, 2017 is used as the baseline for China's additional purchases of US products in the future. According to the phase one deal, China will import an extra worth of USD 76.7 billion in manufactured goods, agricultural products, energy sources and services in 2020, and an extra USD 123.3 billion in 2021, amounting to a total sum of USD 200 billion over the two-year period. The most influential purchase increase is manufactured goods, especially machinery and equipment, pharmaceutical products, aircraft, vehicles and medical equipment.

In addition, China agreed to improve its legal and financial environment. For example, China will enhance legal protections of intellectual property and technological transfers, open up the financial services sector to more foreign competitors, and refrain from any competitive currency devaluation. Related to this, the US officially dropped China's currency manipulator label two days before signing the phase one deal.

Luckin Coffee admitting to financial fraud worth 310 million USD

In January, Muddy Waters Research, a due diligence focused investment firm, claimed that it had received an anonymous report proving that Luckin Coffee, the Chinese publicly listed rival to Starbucks, had been committing financial fabrications throughout 2019. According to the report, the coffee chain had inflated the number of items sold per store, and overstated its advertising expenses to recycle them back to inflate revenue and store-level profit. In response, Luckin denied the entire report, claiming that the methodology of the report was unreliable, and the evidence was unsubstantiated.

At the beginning of April, an internal investigation of Luckin revealed that Jian Liu, the company's Chief Operating Officer, and several employees directly reporting to him, had fabricated many transactions (worth a total of USD 310 million) from the second to the fourth quarter of 2019.

Luckin's stock price immediately dropped more than 80% after the release, wiping out more than USD 2 billion from its market value and causing significant losses to many investors.

The consequences of this scandal may be devastating for Luckin. In addition to getting delisted from Nasdaq, lawsuits from investors seems to be unavoidable, which could lead to large compensations and make the company go bankrupt. Besides, Luckin may also be subject to administrative and criminal fines, while people involved in the fabrication may get sentenced to imprisonment. This is a wake-up call for foreign investors placing money in non-transparent Chinese companies without the required local knowledge.

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