Much Better Than Expected – three months after quarantine

Eduardo Morcillo, Managing Partner of InterChina, explains why there is much cause for hope in China in the wake of Covid-19.

Overview

The recent decision by China's National People's Congress to abandon its 2020 GDP target speaks volumes. Instead, the rest of this extraordinary year is all about recovery and protecting society from any future waves of Covid-19.
In the months ahead the government will continue to bring together national resources in an unprecedented effort to eliminate the virus, building capacity and infrastructure where needed. Indeed, for a measure of its determination, one need look no further than at how Wuhan recently tested 10 million inhabitants for the virus in a 19-day campaign which identified 300 positive cases – all of whom had no symptoms.

The wider point here is that this security now underpins everything in China. Crucially it gives consumers the confidence to return to something like normality and spend. And it gives companies the confidence to invest and rebuild their businesses, safe in the knowledge that consumer demand is returning.

It also gives businesses the confidence to make necessary structural change now that they are through the immediate post-Covid recovery phase. In particular, as technology takes an ever greater hold over society, attention now turns for instance to the adoption of SaaS (Software as a Service) models and new CRM systems to enhance digital offerings.

Such 'retooling' in this new economic and social environment is all about how to connect in a different way with the market and suppliers, and about ensuring that cost structures are brought down and better adapt to the new world of work. Admittedly this isn't without its challenges, and perhaps the greatest test for companies now is how to reinvent their operations while still retaining their existing culture and way of doing business.

To V or not to V?
So the point I would stress is that the outlook is very much one of hope. Earlier this year we surmised at InterChina how quickly and strongly the Chinese economy would rebound, and whether we would see an immediate V-shaped recovery.

Well, macro indicators would appear now to show that we will see more of a V-shaped recovery after all as the recovery picks up pace during the second half of 2020. Indeed, after a 6.8% fall in GDP in Q1, the macro recovery has been dramatic and much better than many expected.

Arguably the most interesting indicator has been the rebound in the PMI figure of economic activity. Although in Q1 it dropped below 30%, it then rose quickly to more than 50% by May, even before a formal stimulus package was announced by the government.

Given the huge global economic slowdown in the wake of Covid-19, the macro numbers coming out of China show just how strongly its economy is now driven now by domestic demand with less dependence on exports. The ‘go local’ drive has gone into overdrive.

For sure, exports have been hit hard with year-end forecasts indicating a possible 15% drop. Although much of this shock will be attributable to the first quarter of 2020, there are fears that exports could remain weak in the second half of the year given the continued global economic impact of Covid-19. Although domestic consumption is covering the ‘hole’ as much as possible, the likely result in the short term is a deflationary impact in China with export-oriented companies lowering prices to gain business and so driving a glut in many products.

Government stimulus

This pressure is also playing its part in the unemployment situation which, according to some forecasts, could reach more than 10% this year. It is hard to know precise details, but this is undoubtedly a key priority for the government right now.

In this context it was interesting at the National Congress how the government announced a determined effort to lift the poor into a new lower middle class, specifically looking to improve living conditions among China’s estimated 600 million people with income below 1000 yuan per month.

The state has also recently announced two major reforms both of which, in my view, are ground-breaking:

Firstly it is proposing to relax the ‘hukou’ household registration system, similar to an internal passport, that is used by the government to regulate population distribution and which ties the ability of citizens to access public services to the city where their household is registered. The reforms aim to bring millions more workers (including migrant workers) into formal social security, labour and taxation systems and could, in theory, lead to a significant boost in consumption growth.

Secondly, there is a significant move towards strengthening rural real estate and land ownership to private individuals, a move which would naturally give millions of households far more security.

Indeed, the importance of housing to China's long-term economic growth should not be underestimated. For instance a fascinating parameter is household net worth which measures the average balance sheet for every household in the country. Latest data from the People's Bank of China suggests that the median net worth of an urban Chinese household stands at 1.41 million yuan (approx. $200,000) with real estate accounting for nearly 60% of household assets.
One theory for this striking figure is that the single child social family structure has led to the unification of properties. For instance in tier 1 and 2 cities the urban household typically owns two houses, and each set of grandparents also owns two houses. So today's single children might inherit up to six properties and many will already be, effectively, millionaires. Not surprisingly this will give them enormous consumption power in the years ahead.

Sector analysis

So what are businesses saying on the ground? Well, the overwhelming sense I get from talking to CEOs is that the above projections around a consumer rebound from Covid-19 are not being overplayed.

Demand is very real and several indicators show that levels of consumer confidence are high with levels of income and retail expenditure bouncing back in most categories in Q2.

There is a palpable sense that the recovery from Covid-19 has been much better than expected and they have been pleasantly surprised by their company's strong performance since March. Based on these conversations, below is a snapshot of how different sectors are faring. You find comments on the following sectors:

- Food and Beverage
- Industrial
- Medical
- Automotive
- Chemicals

Food and Beverage
With consumers at home far more have got used to a whole new way of life. For instance they are favouring home cooking over going out for a meal, while at work preferring to eat food brought from home. Given this trend it is unsurprising that supermarkets are seeing a strong recovery in sales and demand, although the takeaway market is more challenging.

The ingredients sector is also seeing a recovery after a tough start to the year, with a strong focus on higher standards of quality. Likewise the flavouring industry is rebounding well with a focus on better quality ingredients, sugar reduction and new protein solutions. Even food distribution activity, which has was hard hit by travel restrictions during lockdown, is gradually returning to pre-Covid levels of activity.

"Consumer demand is very robust and the whole sector is returning to normal from the supply side. Our restaurant business is also picking up and moving towards normality." (Drinks manufacturer)

Industrial
A particular driver of industrial markets is the need to restock inventory that was depleted earlier this year, while also matching expected demand growth driven by government stimulus. Although there remains considerable variation across this broad sector, markets such as agriculture and mining are holding up well, while any business exposed to e-commerce markets is in a strong position too.

CEOs also report strong growth in renewable energy and new technologies, such as the construction and servicing of large data centres. Covid-19 has also increased awareness of air quality and the need to have more structured solutions on fresh air circulation technologies in buildings, while there is also growth in high energy management solutions and virus contagion circulation.

"February, March and April have been fantastic months, while May looks really good as well. Not only are we replenishing depleted inventories, but big local customers are ramping up production to fulfil stimulus-driven demand growth." (Industrials manufacturer)

Medical
With hospitals and health services dedicated to tackling Covid-19, the broader healthcare market has seen reduced activity because people have been unable to go to hospitals and clinics, or take up non-critical services.

However the situation is now starting to return to normal. Attendance at local hospitals is starting to rise, in part because increased budgets for lower-tier hospitals enables them to have better equipment and resources, so encourages people to visit these hospitals rather than larger ones.

Another trend in the wake of the pandemic has been the further growth of telemedicine and the distribution of health-related services and information via the internet. After initial medical analysis is done in a hospital the follow-up, including the refill of drugs, is increasingly being done remotely.

"Q1 was finally good. Q2 looks very sound. This is caused by inventory build-up and consumers coming back to normal medical consumption after lockdown." (Healthcare products manufacturer)

Automotive

The sector continues to be hard-hit by the pandemic, and the picture is particularly bleak for small Chinese OEMs in the sector with many forced to close. Although supply chains are recovering, the big challenge remains continued weak demand and concerns that consumers will continue to forego big-ticket purchases at a time of such uncertainty. However the premium automotive sector appears to be more resilient as people buying cars are typically the upper middle class and not first car owners.

In recent weeks there have also been some encouraging announcements from global OEMs. For instance VW is spending €1bn raising its holding in an electric vehicle joint venture with China's JAC Motors, and another €1.1bn on acquiring a 26% stake in Shenzhen-listed battery manufacturer Gotion High-Tech. In May, VW said demand for its cars in China was now almost as high as it was in May 2019.

"In March the sector was only at 60% of normal capacity. Demand is coming back but slowly and we expected to return to normal times from July. The problem is that many sales today could be to build inventory, creating a decrease in the second half." (Automotive components maker)

Chemicals

The drop in the automotive market is having a knock-on effect on other sectors, especially chemicals players which serve the market. But more widely there is encouraging news across this sector. CEOs report factories returning gradually to full capacity as orders return, with e-commerce particularly driving consumer products demand and inventory in areas such as personal care and food packaging.

Domestic growth in the chemicals and specialised plastics markets is returning, but the weaker export market is hampering growth.

“We have five factories in China and all are running at full capacity. Downstream demand from the consumer sector is particularly strong, likely driven by growth in high-end segments and ecommerce.” (International chemicals player)

Outlook

All roads lead to consumption

We may be living in turbulent times globally, but most multinationals (MNCs) are still betting on Asia. They see that both China and large parts of South East Asia have recovered well from the crisis, and that these nations will continue to be clear global growth engines in the coming decade due to their growing middle class.

What is very clear is that multinationals are now ‘doing China for China’, already decoupling China from other markets in the region because the size of the Chinese market is enough on its own to support their ambitions. We are also continuing to see huge investment by MNCs in the country, driving consolidation across many markets, a stance which contrasts rather sharply with their current experience in many western home markets where demand continues to be shaken by Covid-19.

The pandemic is also multiplying the speed of consolidation and new business transformation, and MNCs continued to be well-placed to capitalise on these trends as they seek scale and to fill supply chain gaps in China.

Headwinds

China is not immune to the current turbulence. As mentioned in this article, major short-term risks include the reduction of exports and the rise in unemployment. Fearful of a second Covid wave Chinese consumers are still cautious, so the retention of savings could be a drag on demand. Global trade tensions and the fraught US/China relationship add to the turbulence.

But CEOs we speak to are bullish about their growth prospects in China, not just for the second half of this year, but for 2021 and beyond. This has also been significantly helped by the government’s pragmatic support measures for businesses post Covid-19, its clear focus on domestic stability and growth, and its continued positioning of China as the world’s global consumption market. Indeed in this new world the flexibility and capability to manage the complexities of Covid-19 will be a key advantage – not just for companies but countries too.

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