First Quarter of 2020

CHINA UPDATE

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CORONAVIRUS OUTBREAK LIKELY A NEAR-TERM DRAG FOLLOWED BY V-SHAPED RECOVERY; LARGER THAN USUAL TAIL RISKS IN 2020

> The economic shock from the coronavirus outbreak is coming into focus

The economic effects of China's coronavirus outbreak are coming into focus. The extent and duration of the outbreak, and of the policy response to it, are still unknown. But the Chinese government's aggressive response to it is clear, and it will sharply slow growth in the near term. The government cancelled public celebrations of the January Lunar New Year holiday; imposed restrictions on travel in areas around Wuhan, the center of the outbreak, affecting more than 50 million people; extended the official holiday to delay the restarts of factories, other businesses, and schools; and discouraged migrant workers throughout the country from traveling, delaying their returns from their hometowns to their workplaces.

Furthermore, compelling anecdotal evidence shows that many Chinese people are going above and beyond government restrictions to avoid coronavirus exposure, also reducing economic activity. Consumers are avoiding restaurants, public transportation, and public spaces; cancelling domestic and international travel; and workers are avoiding their workplaces when possible. News reports of surgical mask shortages affecting many Chinese cities, not just those in the province where the outbreak began, emphasize that public sentiment and behavior are reacting to the outbreak nationally, not just in the most affected regions.

> Consumers are pulling back on discretionary spending

Even if the outbreak is quickly contained, real GDP growth will slow sharply in early 2020. The crisis will most directly hit China's economy by reducing discretionary consumer spending, and secondarily through government restrictions on economic activity. This shock will disproportionately affect retail and wholesale trade, 10 percent of GDP; tourism, restaurants and hotels, 5 percent of GDP; and other transportation and logistics services, another 3 percent of GDP (See chart below). These sectors will likely contract in the first quarter of 2020. In addition, the city where the outbreak began, Wuhan, is a center for Chinese auto manufacturing. Delays to post-holiday production and restrictions on movement in the city will reduce auto production. Coupled with coronavirus's drag on the rest of the economy, real GDP growth will

CHART: SECTORS MOST DIRECTLY AFFECTED BY CORONAVIRUS CRISIS ACCOUNT FOR NEARLY A FIFTH OF GDP

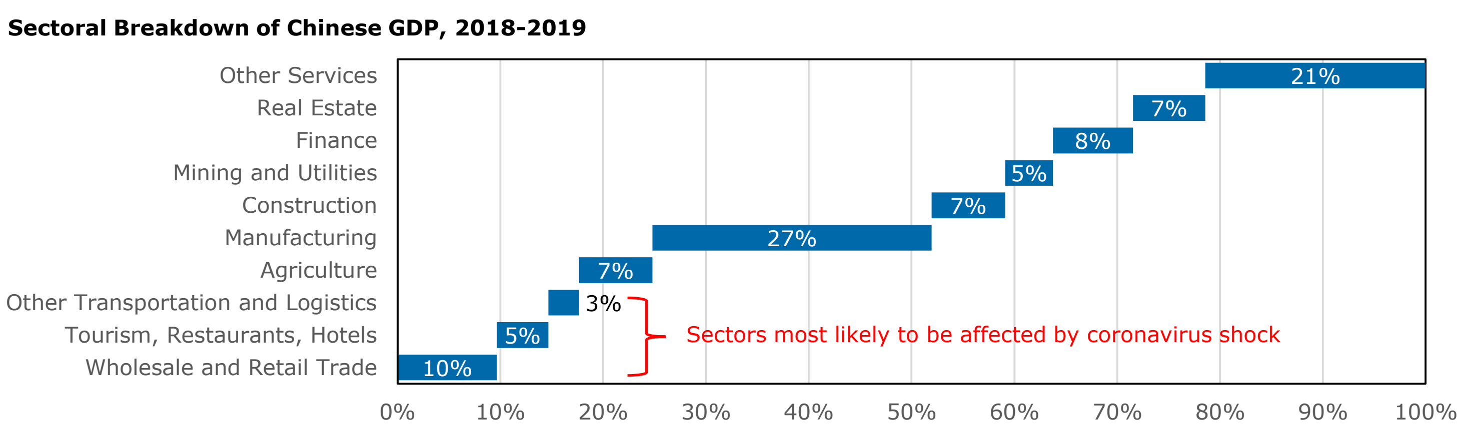

Chart sources: NBS, PNC Economics analysis. Note: share for Tourism, Restaurants, Hotels is from 2018 data, which is the latest reported; other industry shares are per 2019 data.

> If the outbreak comes under control in the second quarter, a V-shaped recovery can begin

slow sharply near term: PNC forecasts Chinese real GDP growth of just 5.2 percent in year-over-year terms in the first quarter of 2020, down from 6.0 percent in the fourth quarter of 2019. This would be the sharpest slowdown in Chinese growth since the third quarter of 2010.

If China gets coronavirus under control by the second quarter, if the government removes related restrictions, and if consumer behavior returns to normal, monetary and fiscal stimulus will likely generate a V-shaped economic recovery to make up for lost output and return displaced workers to their jobs. China's central bank and financial regulators will likely encourage a pickup in credit and money supply growth in mid-2020, fueling an acceleration of growth in the M2 money supply by the middle of this year to the fastest pace since 2016. PNC also forecasts that the People's Bank of China (PBoC) will gradually reduce the benchmark 7-day reverse repo rate 50 basis points between January and August; China's central bank is increasingly changing interest rates as well as targets for growth of loans and other credit aggregates to implement monetary policy.

> Chinese money and credit growth to accelerate, policy interest rates to fall

The PBoC cut the 7-day reverse repo rate only 5 basis points in 2019, since CPI inflation exceeded the government's 3 percent target for much of the year; an outbreak of African swine flu cut Chinese pork output and caused pork prices to double in 2019. CPI inflation will likely slow in early 2020 as the pork price shock fades from the CPI; core inflation in December 2019 was already the weakest since 2016. Monetary policy will loosen as inflation falls, facilitating a V-shaped recovery of growth that will probably peak in the first quarter of 2021.

The yuan depreciated to more than 7.15 per dollar in September as the US raised tariffs, appreciated through mid-January on the Phase One trade agreement, then subsequently depreciated as the coronavirus outbreak spread. PNC forecasts for the yuan in 2020 to average slightly weaker than its January level, with more volatility around that average than in 2019.

> Large tail risks, to the upside as well as the downside

This forecast is subject to larger-than-usual tail risks. The balance of risks is probably to the upside, in that the coronavirus outbreak could be a smaller problem than feared; fire alarms go off much more often than buildings burn down. The outbreak could end faster than currently seems likely, or the government could reduce public anxiety about it. Alternatively, public spending to contain the disease could boost demand near-term. To the downside, the outbreak could worsen or spread globally. China's economy might be hit by a second shock like higher oil prices if geopolitical tensions or trade tensions re-emerge. Or China's central bank could hold off on stimulus measures to avoid exacerbating leverage and financial risk.

CHINA BASELINE FORECAST TABLE, FIRST QUARTER OF 2020

	4Q'19a	1Q'20f	2Q'20f	3Q'20f	4Q'20f	1Q'21f	2Q'21f	3Q'21f	2019a	2020f	2021f
Real GDP, Y/Y%	6.0	5.2	5.6	5.9	6.2	7.7	6.5	6.0	6.1	5.6	6.6
Industrial Production, Y/Y%	5.9	2.3	4.2	8.0	10.0	12.0	10.0	7.0	5.7	5.9	9.3
Fixed Asset Investment, Cumulative YTD, Y/Y%	5.4	4.0	7.0	8.0	9.0	14.0	8.0	6.0	5.4	9.0	5.5
CPI Inflation, Y/Y%	4.3	4.1	3.5	2.9	2.5	1.8	1.8	1.8	2.9	3.3	1.8
PPI Inflation, Y/Y%	-1.2	-1.4	-1.1	-0.5	-0.1	0.2	0.4	0.8	-0.3	-0.8	0.5
Unemployment Rate, Surveyed Urban Areas, % NSA	5.1	5.9	5.6	5.2	5.0	5.3	5.1	5.1	5.2	5.4	5.1
Money Supply M2, Period-End, Y/Y%	8.7	9.0	11.0	12.0	12.0	9.5	7.2	7.2	8.7	12.0	7.3
7-Day Reverse Repo Rate, %	2.53	2.30	2.15	2.00	2.00	2.00	2.00	2.00	2.54	2.11	2.00
1-Year Deposit Rate, %	1.50	1.50	1.40	1.40	1.40	1.40	1.40	1.40	1.50	1.43	1.40
1-Year Loan Prime Rate, %	4.17	3.95	3.80	3.67	3.65	3.65	3.65	3.65	4.23	3.77	3.65
Reserve Requirement Ratio, %	13.0	12.2	11.5	11.0	11.0	10.5	10.5	10.0	13.3	11.4	10.3
Yuan per US dollar, Period-End	6.96	7.05	7.10	7.10	7.10	7.07	7.05	7.02	6.96	7.10	7.00

Table sources: Bloomberg, China National Bureau of Statistics, People's Bank of China, PNC Economics

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