Perspectives
MAR 2020

Following China's Lead?

Year-to-date, China has suffered the least among global equity markets, down 18%. In comparison, the U.S. and Eurozone have produced losses greater than 30%. Why have Chinese equities outperformed? Does that performance provide us with any insights into future expected returns? In this newsletter, we will examine several data points to provide some possible answers to these questions.

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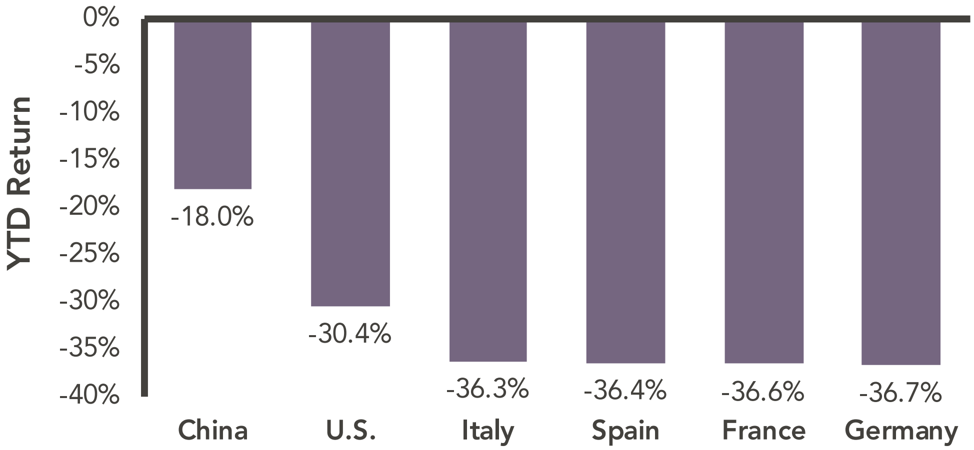
Exhibit 1: Year-to-Date Performance through March 23, 2020

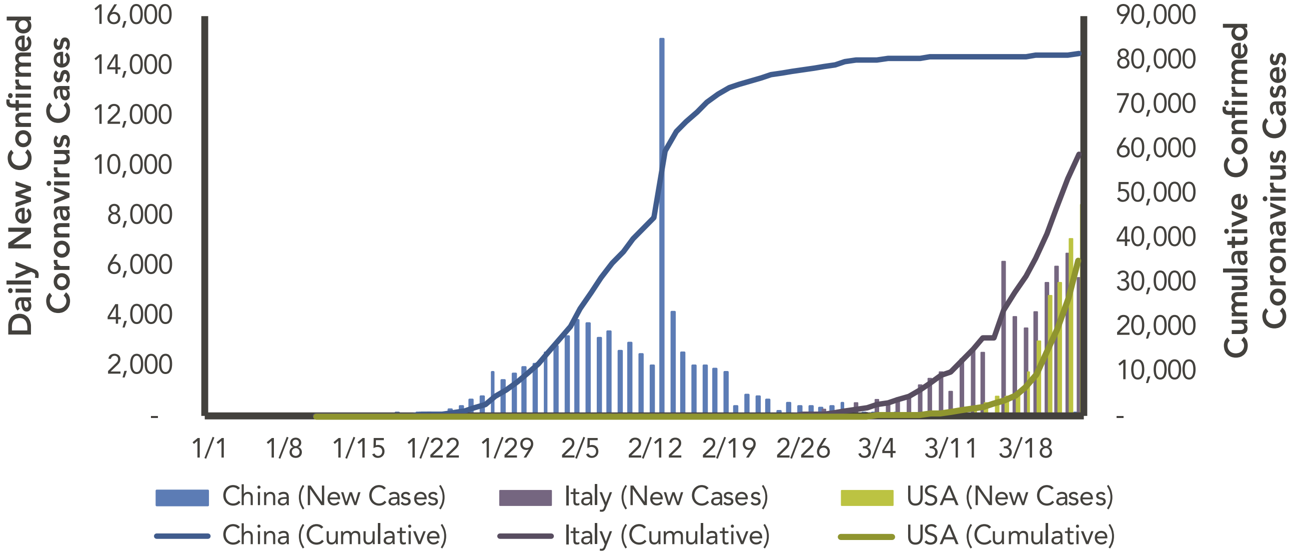


Source: Bloomberg. All indices are MSCI country indices except for U.S. which is the S&P 500

Coming into 2020, investors had high hopes on the back of a U.S.-China trade deal and accommodative monetary policy throughout much of the world. The S&P 500 moved higher to start the year but reached its peak on February 19th, 2020. Since then, it has fallen fast and hard, entering into bear market territory within 16 trading days, the quickest in history.

Four weeks prior to the S&P 500's peak, China was at the start of a country-wide shutdown to combat the spread of COVID-19. With the Chinese New Year on January 25th, celebrations and festivals throughout the region were cancelled. The country's economy came to a virtual standstill as people were ordered to stay home. The number of new daily cases in China accelerated, but thanks to the strict measures taken, they began to show signs of slowing on February 8th, 11 days prior to the S&P 500 peak.

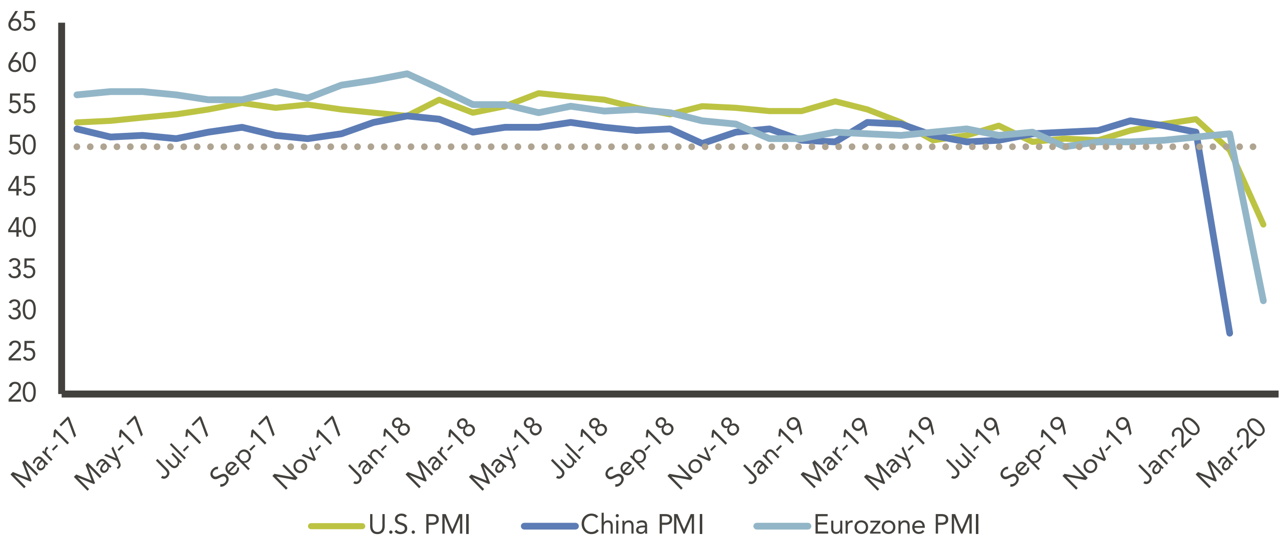
Exhibit 2: Daily and Cumulative Coronavirus Case Count: China Grew First and Slowed First



Source: European Center for Disease Control through March 23, 2020

Exhibit 2 illustrates how the U.S. and Europe (using Italy as a proxy for the region) are several weeks behind China in navigating this pandemic. The number of daily cases is accelerating in these regions while China has dramatically slowed its pace. We can see a similar trend when looking at economic data. Exhibit 3 displays the composite PMI Index for the U.S., China, and the Eurozone. In February, China's economic indicator fell dramatically from 51.5 in January to 27.5 in February as confidence regarding future activity sunk to record lows. The U.S. and Europe, not yet impacted by the spread of the virus, had a February reading of 49.6 and 51.6, respectively. This week however, Markit released preliminary March numbers showing dramatic drops for both the U.S. (40.5) and the Eurozone (31.4).

Exhibit 3: Composite PMI: China's Economic Activity Dropped First

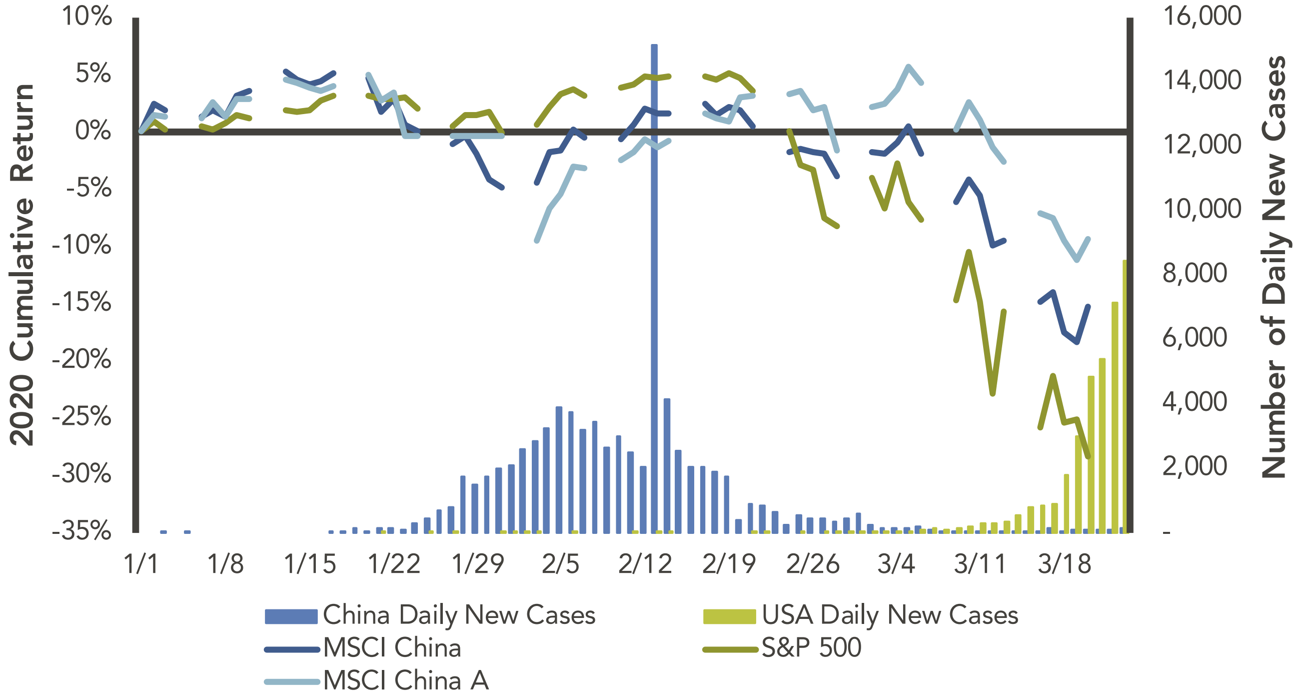


Source: Bloomberg; March is flash data, China March data not yet available

Using the daily new cases data, it is reasonable to estimate that Europe is six weeks behind China and the U.S. is eight weeks behind China. The economic data also supports this trend with the Eurozone PMI falling 40% in March while the U.S. fell roughly 20%.

So, what does all this mean for equity returns? Looking at Exhibit 4 we see that China began underperforming the S&P 500 (on a cumulative basis) on January 23rd, 2020 as the virus began to spread at an accelerating rate. On February 8th the daily new cases slowed, and Chinese equities began to rebound. By the end of the month, they were outperforming the S&P 500 and that trend has continued into March.

Exhibit 4: Daily New Cases and Equity Performance



Sources: Bloomberg and European Center for Disease Control; returns through March 20, 2020, number of new daily cases through March 23, 2020

The data above suggests that China's containment of the virus has been a key reason for the outperformance of its equity market. We have seen a peak in the number of new daily cases and we have seen a major drop-off in economic activity. Additionally, though still in the early stages, China's economy has moved towards more normal operations with people returning to work. In comparison, the Eurozone and the U.S. have not reached their peak new cases and we are just now starting to see degradation in economic data. Additionally, shelter in place orders have only really taken hold over the last week in the United States.

Chinese equities have also benefitted from government support. The PBOC cut reserve ratio requirements and encouraged corporate lending to support the economy. Many of these actions were taken in January. In the last several weeks we have seen countries throughout the world announce both monetary and fiscal stimulus measures. Over the last two weeks, the Fed has employed emergency cuts to its target interest rate, announced an asset purchase program, and taken additional steps to improve liquidity. The ECB boosted its current asset purchase program and several countries including Italy, France, Spain and Germany announced fiscal spending plans.

CONCLUSION

Year-to-date, the Chinese equity market has outperformed the U.S. and most other countries. China is certainly farther along in the process of navigating the negative effects of the coronavirus, which is undoubtedly a key reason for their outperformance. The number of new daily cases has slowed, the government has taken supportive action, and the Chinese economy is now in the early stages of a return to normal.

In contrast, Europe and the U.S. are farther behind China's timeline; the data in this newsletter suggests an estimate of six to eight weeks behind. Both regions have taken steps to control the virus and have provided support to their respective economies via monetary and fiscal stimulus. We believe reaching a peak in the number of new daily cases would serve as a large milestone in these countries; once that occurs investors should expect the recovery process to begin for both economic growth and financial markets.

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