



## China Under Pressure: Short the RMB & SHCOMP

Markets continue to “look through” the Coronavirus, as China’s **containment measures appear to be working** in curbing the virus’ spread outside of Wuhan. However, those measures are draconian, and **may be deemed as unsustainable** by China’s leadership.

Markets are optimistic China can “**thread the needle**” by achieving sustainable virus containment while limiting the economic damage to a degree that’s easily offset by “stimulus.” This bet may well prove a winner, but I don’t view the risk-reward as favorable.

To sum up:

- Draconian containment measures are working
- Near-term resumption of economic activity does not appear consistent with sustained containment
- The Chinese government is nonetheless anxious to get the economy going again
- Hopes for stimulus to save the day are badly misplaced

China’s approach is following the path [I laid out on Jan 31](#):

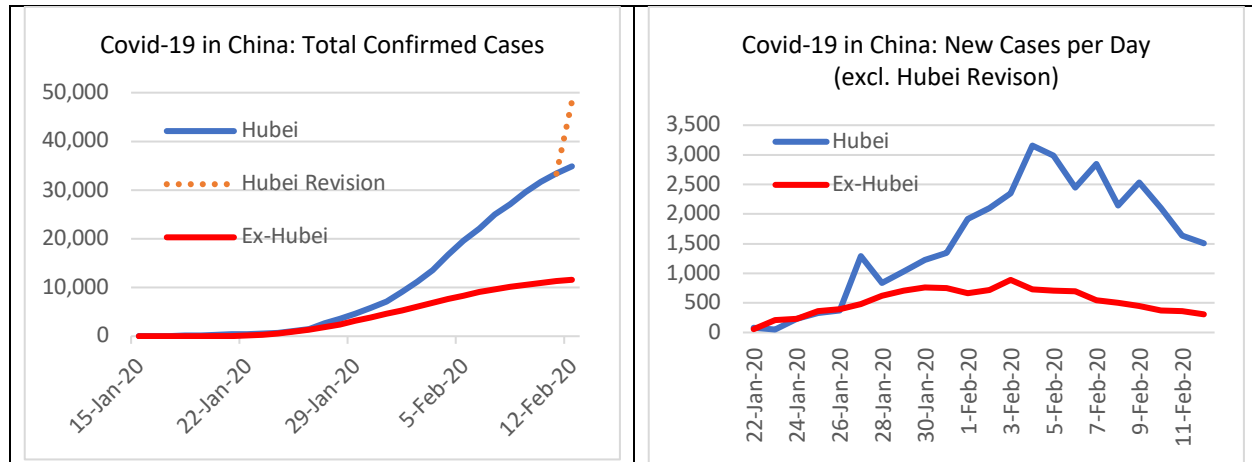
*Maximum Disruption for Minimum Duration:*

*It’s not just Wuhan – reports indicate that an **eerie silence has befallen most major Chinese cities**. This is positive in terms of containing the spread of the virus, but obviously terrible for economic activity, which has come to a virtual standstill.*

*At an extreme, there is some number of weeks for which China could mandate that no one leave their homes, after which everyone would either emerge virus-free, or not emerge. Economic activity would fall towards zero over that period and then recover towards normal levels fairly rapidly.*

**Outside of Wuhan, this approach seems to be working**, as the rate of new case formation has fallen from a peak of 888 on Feb 3 to only 362 new cases reported on Feb 11.

While there are undoubtedly many less-severe infections going unreported, these data are should be representative of the trend. Outside of Hubei, testing-capacity issues are unlikely to be as problematic as they have been in overwhelmed Hubei province, and local officials are unlikely to repeat the error of their colleagues in Hubei by downplaying the threat.



So that's the good news: the rate of increase in new cases has decreased noticeably outside of Wuhan. (On Feb 12, China added 13,332 confirmed cases which had been diagnosed using CT scans to the Hubei total, clouding the picture as to the daily pace of new infections in the province.)

The bad news is that containment has depended on [widescale urban lockdowns](#) which have **brought the economy to a standstill**.

The Chinese government is now faced with an impossible-to-solve multivariate equation: what is the scope and duration of containment measures that minimizes the economic damage while remaining consistent with sustained containment of the outbreak.

From Wednesday's NY Times:

*The two most powerful bodies in China... had been holding meetings over the past two days, and each issued similar orders. Both groups produced hints of what many economists expect will be a fairly broad stimulus program in the weeks and months to come to offset the drag on the economy from the epidemic.*

*But none of the announcements directly addressed the **difficult balancing act** that China now faces: how to put more than 700 million workers back on the job without bringing together large groups of people that could allow the virus to spread.*

Several aspects of the epidemiology speak to the difficulty in that balancing act. Complicating issues include:

- High communicability
- The fact that asymptomatic transmission [might be possible](#)



- Uncertainty surrounding the incubation period: generally believed to be similar to SARS (at 2-11 days with a median around 7), it [may in fact be as long as 24 days](#) in some cases
- A high rate of [false negative test results](#) (perhaps as high as 30-50%)

Hopefully, the Chinese government has some inside information that is leading them to a decision that is better-informed than it seems to external observers:

*“What we’ve seen is a flattening out of the numbers of case, particularly in Wuhan and Hubei province, which is quite reassuring,” Ben Cowling, a professor of infectious disease epidemiology at the University of Hong Kong, [tells TIME](#).*

*[but] experts say that resuming work presents new risks.*

*“**I think there will be a surge in new infections**,” Cowling says, though he adds that approaches to testing differ in China outside of Hubei province, where Wuhan is located, so a jump in the number of publicly confirmed cases might not be apparent. “The objective of control measures is to reduce transmission while they are implemented. They don’t have an effect after you stop doing them,” he says.*

In fact, even some [internal observers are warning](#) that it’s too early to sound the all-clear

*Zhang warned that even as growth in the virus outside Hubei seems to be slowing, the outbreak is on track to enter a stage of **second-generation local infections**. This stage involves the virus spreading to people who have neither traveled to Wuhan nor been in contact with anyone who has. Moreover, as people return to work, this kind of infection will become more likely, so local governments will have to improve their screening and diagnosis capabilities, Zhang wrote.*

I guess he’s worried about [this kind of thing](#):

*A bullet train cleaning staff member tested positive for the new coronavirus, now known as Covid-19, fueling fears that **the virus might have been spread to passengers on more than a dozen trains**.*

*The worker, surnamed Tao, had a fever Feb. 8 while at work and was sent to a hospital. Tao later tested positive for the virus, the Xuzhou city health authority in Jiangsu province said Thursday **at a briefing**.*

*Tao worked aboard 15 high-speed trains between Jan. 20 and Feb. 8 that traveled through cities including Beijing, Nanjing, Ningbo, Hangzhou and Yancheng, according to the Xuzhou health commission.*



It's not clear that the Chinese government knows any more than we do about the epidemiology of Covid-19. But they certainly know more about the true extent of China's economic vulnerabilities. And recent policy actions - from the resistance to heavy stimulus to the urgency of securing a Phase One trade deal - reveal a healthy respect for the risks inherent in China's extreme macro leverage levels.

This week's [senior pronouncements](#) betray a high level of concern for the economic costs imposed by virus-containment:

*BEIJING (Reuters) - Chinese President Xi Jinping warned top officials last week that efforts to contain the new coronavirus had gone too far, threatening the country's economy, sources told Reuters, days before Beijing rolled out measures to soften the blow.*

*The ruling Communist Party's propaganda department last week ordered state media to focus on "economic recovery"*

The [Global Times exhibited a tinge of paranoia](#) in taking up the Chairman's call:

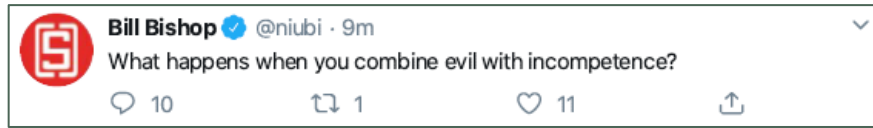
*The unusually long holidays must come to an end as China is determined to return to work to restart its economy amid efforts to combat the novel coronavirus pneumonia (NCP).*

*Even in the midst of the epidemic, companies and local governments across the country should work together toward the same goal of business resumption, which is essential not only to bring the Chinese economy back to normal, but also to counter the hype over the "China collapse" theory.*

*The more headwinds facing China, the more imperative it is for businesses nationwide to resume production, or at least to prepare for the return to work. Of course, this doesn't mean that all companies across the country should return to work at the same time, disregarding their epidemic control conditions. Authorities and companies should arrange work resumption in a safe and orderly manner based on the virus control situation. It is unrealistic for local governments to expect companies to resume production only after the NCP is declared completely under control.*

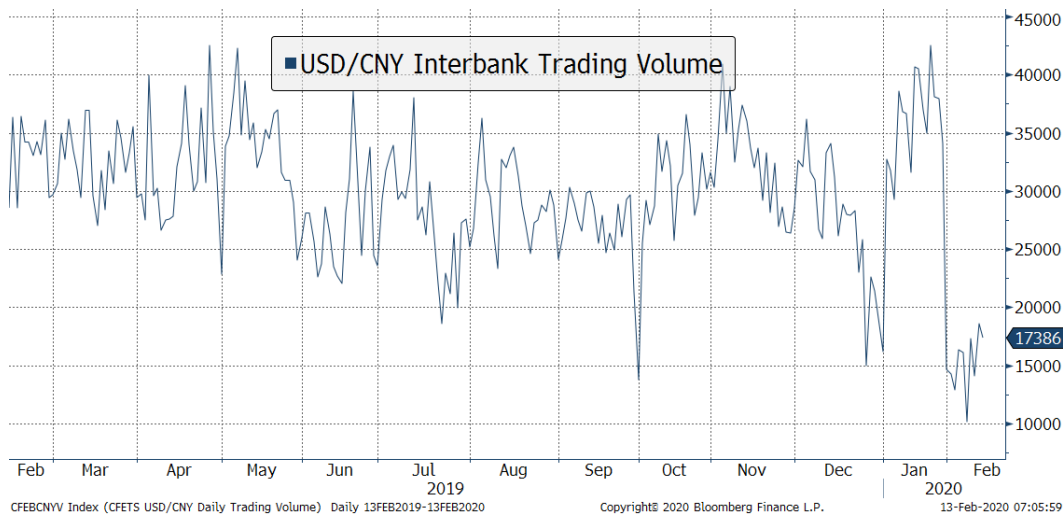
Of course, the concerns for the economy are not unwarranted. As [Caixin reports](#):

*The outbreak has hit small firms especially hard, with most saying they are suffering a severe cash crunch that could put them out of business. A survey of 995 small and midsize companies by Tsinghua University and Peking University found that 34% of respondents said they could only survive for one month on their current savings, one third said they could keep going for two months, and 17.9% said they could endure three months.*



This tweet from Bill Bishop at Sinocism might seem harsh, but I echo the sentiment. When Bloomberg reports that [China's Top Leaders Vow to Meet Growth Targets Despite Virus](#), one can only wonder how many lives a completely arbitrary policy target is worth.

I believe **Xi Jinping suffers from megalomania**. Too often in the economic realm have I seen the pursuit of incompatible objectives and a belief that any resistance can be overcome by the brute force of leadership (in the short-term it often can be). For example, to the incompatible commands of “easy money, stable currency and no use of FX reserves” the response has been a gradual closure of the Chinese FX markets. Like this...



Now Xi has commanded the provincial leaders to get the economy back up to speed AND make sure the virus remains contained. Are those objectives compatible? It only takes one under-pressure locality to get the balance wrong, and another Wuhan could be created.

Lastly, please refer to last week's "[The RMB is Infected](#)" for an explanation of what monetary stimulus can and cannot accomplish in the face of an adverse supply shock. **Stimulus cannot reverse the lost real output**. It can only “fill that hole” with inflation, in this case to take the form of severe RMB weakness. “Stimulus” is not a magic bullet.

Markets are far too optimistic that China can manage an efficient balance between virus-containment and reviving economic activity across the country with heavy top-down leadership. In fact, **the problem appears ripe for widespread mismanagement**.



## Conclusions

- The Chinese economy is set to take a debilitating hit
- Stay short the RMB.
- Gap Filled: short the bounce in SHCOMP: sell 2900, s/l 3050, target 2500

