Research & Strategy

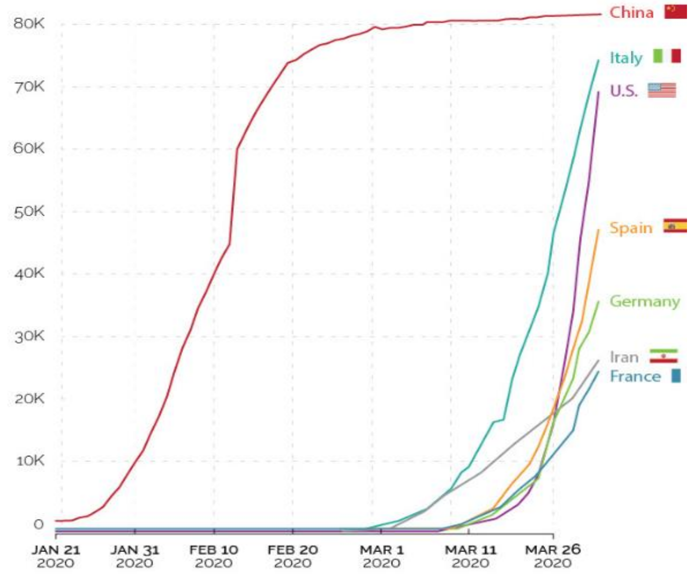
China edges towards recovery as global markets absorb COVID-19 shockwaves

- Although the worst of the global pandemic has shifted westwards to Europe and the United States, countries across the globe are absorbing the economic shockwaves, and will continue to do so for the near term.
- Recession risk is growing across Asia-Pacific as other markets downgrade their 2020 GDP growth outlook. Although the impact will vary between sectors, real estate rental values are set to fall, which would have an adverse impact on pricing.
- As the current crisis continues to unfold, investors should not only remain vigilant but also look beyond near-term volatility. A recovery could be pencilled in as early as the third quarter of 2020.

China's local infection curve flattens, but cases continue to be imported from the West

- The COVID-19 outbreak continues to weigh on business sentiment as the number of infections keep rising exponentially. What started as an outbreak in China in January has escalated to a global pandemic, leading the global economic outlook to tilt towards the downside. Countries are now looking to China, where cases seemed to finally be plateauing, as a possible light at the end of the tunnel for countries still in the early stages of the outbreak (figure 1).

Figure 1: Total confirmed COVID-19 cases



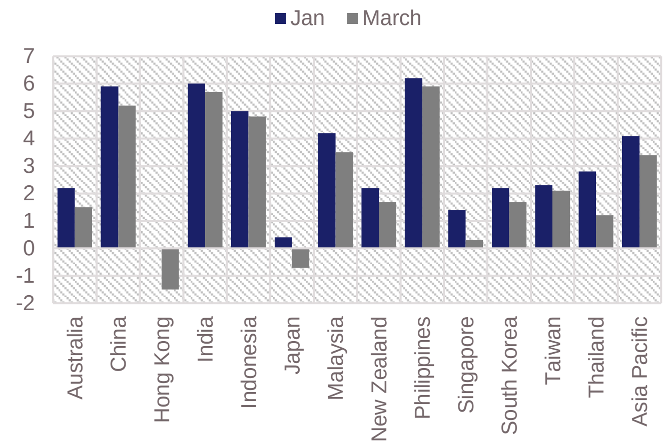
Source: Our World in Data

- According to the World Economic Forum, factories in China have reopened, albeit at two-thirds of their capacity. Since the easing of the lockdown measures in China, airline travel from the country is recovering and shopping malls reopening. Nevertheless, the return to normalcy will remain fragile given the weak global demand.

Recession in the air

- Despite the decline in locally transmitted infections, the number of imported cases continues to rise. This seems to be the case across the Asia-Pacific region. At the epicentre of the pandemic, Wuhan has begun to unwind its lockdown. Medical experts are concerned, however, that lifting restrictions could result in a second wave of cases in China, which has forced a temporary ban on all foreign visitors, even on those with visas or residence permits. The country is also limiting Chinese and foreign airlines to one flight per week, which must not be more than 75% full.
- China International Capital Corporation (CICC) has sharply downgraded its 2020 growth forecast for China to 2.6% from 6.1% in January, with more gloomy news predicted in the second quarter as economic shock waves ripple through China's economy and others globally. **Recession risk is growing across the region as other markets downgrade their 2020 GDP growth outlook (figure 2)**.

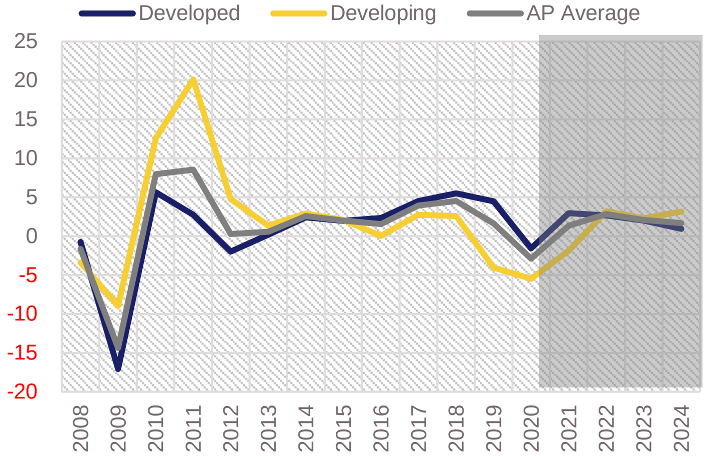
Figure 2: 2020 GDP forecast revisions (%)



Source: Consensus Economics

- Outside of China, travellers returning from North America, Europe and South East Asian countries are bringing the virus back into Asian countries that have controlled domestic spread. This is leading to new restrictions in Hong Kong, Singapore, Malaysia, Thailand, the Philippines and Taiwan.
- Australia and New Zealand are the latest countries in the region to implement a lockdown. According to Capital Economics, this will limit activity to 'essential services' and could knock off as much as 30-40% from Australia's and New Zealand's GDP for as long as it lasts.
- Using China as a reference point, most lockdowns could last more than two months before flattening the infection curve. **A second wave of imported COVID-19 infections from returning travellers may require stricter local measures depending on the adequacy of those in place, extending the recessionary impact.**
- The labour market is the biggest concern for regional domestic economies as the lockdowns intensify, with implications for global supply chains. A common theme is the rise in the unemployment rate, with many small and medium enterprises reportedly struggling to pay wages.
- In the absence of significant policy support to households with debt, job losses and declines in household income will prevent output from returning to full potential. **This has prompted further aggressive stimulus measures through coordinated government efforts to cushion the economic downturn as initial measures fail to calm financial markets.**
- The impact on the real economy and certain commercial real estate sectors is also likely to intensify in markets with the highest number of COVID-19 infections (e.g., China and South Korea) as well as the open economies of Hong Kong and Singapore. With increasing lockdowns and travel restrictions, the most obvious sectors to be hit are retail and hospitality. While the financial sell-off and disruption to supply chains is likely to impact all sectors to some extent, offices and industrial properties have fixed-term leases that are less reliant on retail trade or tourists for their income streams.
- Given the uncertainty surrounding the COVID-19 impact on the economy, the hit to real estate markets remains to be seen. **With the anticipated sharp decline in economic output in H1 2020 alongside a risk-off investment environment, rental values are set to fall, which would have an adverse impact on pricing.** Developing markets, particularly those with a large deficit, are likely to see a sharper near-term decline in rental growth plus significant fiscal stimulus to cushion the recessionary impact (figure 3).

Figure 3: Prime office rental growth trends and forecast: 2009 vs. 2020 crises



Source: PMA

Investment opportunities amid crisis

- **With investors in wait-and-see mode and deal flows drying up, high quality assets could become attractively priced, similar to 2009–10.** This would follow a protracted period of asset inflation, though, and much hinges on how quickly the pandemic is contained. We expect a re-rating of lagging real estate prices due to the ongoing lack of liquidity and uncertain economic environment in the near term.
- We are of the opinion that the flight to quality and risk aversion will sustain in the near term. As such, interest rate arbitrage remains appealing – for example, investment in Australia and Japan relative to other markets where property yield spreads over bond yields are wider.
- Lessons from past crises also highlight the need for strong local access to deals. We expect some price dislocation for deals across the region, which could result in significant returns if in the medium term as assets enter a new phase of price discovery.
- The risk-off sentiment and tighter credit environment also presents other opportunities, such as for alternative lenders or debt funds given the lack of such products in Asia at the moment.
- A host of factors, including aggressive government stimulus, consumer confidence, social distancing and signs of decline in COVID-19 cases, are key indicators that may signal an end to the current pandemic. **As the current crisis continues to unfold, investors should not only remain vigilant but also look beyond near-term volatility. A recovery could be pencilled in as early as the third quarter of 2020 in the most optimistic scenario.**

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The current COVID-19 pandemic has created material uncertainty in many areas of real estate as well as within the macroeconomic environment, including valuations and market transaction levels. As a result, all forecasts are subject to further volatility.