ChinaIntelligence
Financial and business advice on China

themonthlydragon #14

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China-related topics which appear in many media

We want to provide some background information on topics which recently have surfaced in Western media and give our own assessment. The topics and our related summary conclusions are:

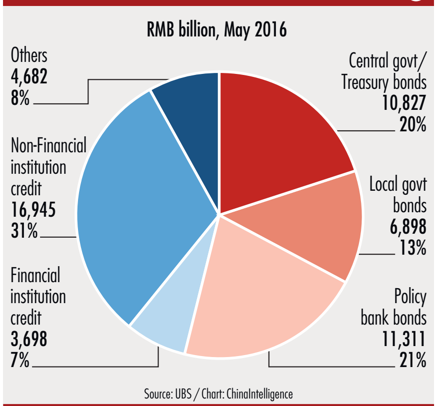
- **Defaults:** we see them as good (they reduce moral hazard) and manageable (both in terms of number of defaults and RMB amounts); overall, very many questionable loans and bonds are outstanding, but the Chinese financial system will weather the storm because the government already owns the majority or all of the financial institutions that matter; the restart of the asset-backed securities market is good news, but it will be much too small to solve the problem of non-performing loans.
- **MSCI A-share inclusion** (decision coming up in June): If A-shares are included in the MSCI Emerging Markets index, then probably only partially, demand for A-shares will thus not be strongly affected in the short term; if not, there will be another review next year; in any case: A-shares will become a regular investment market for global investors in the coming years.
- **RMB depreciation vs. the US-Dollar:** unavoidable and sensible for the Chinese economy, if the USD strengthens against other currencies; the monthly trade surplus allows a managed and measured depreciation thanks to adequate foreign currency reserves.

Defaults by corporations in China's loan and bond markets

The number of defaults by bond issuers and bank loan borrowers is increasing: this is only natural in a huge economy where credit has been building up substantially over the last 7 years. China saw its first (!) bond default in 2014. The number of bond defaults still is small, around two dozen in 2016, affecting the equivalent of around USD 2.7 billion outstanding debt. More than half the incidents were triggered by state-owned enterprises (SOEs), which are the dominant issuer group in the «Non-financial institution credit bonds» group in chart #1. But these defaults are insignificant in comparison with a RMB bond market of a total of USD 8.3 trillion (see chart #1).

The problems are much bigger than that. The Chinese bond market is dominated by the government, policy banks, state-controlled banks and SOEs as issuers; corporate bonds only represent a small part. In addition, there is a big market for wealth management products (WMPs) issued by banks. The WMPs often are a form of re-packaged corporate loans, passed on

China's bond market 1



Source: UBS / Chart: ChinaIntelligence

to retail investors. In both the bond market and the WMP market, investors usually have been bailed out in the past. This has given rise to significant moral hazard: investors expect double-digit returns for their money AND safety. They have been getting both so far, which has made everybody a bit reckless. This is not good for the efficiency with which money is allocated to operational needs in China.

Do defaults have the potential to shake the financial system to its core (Minsky moment)? Can corporate loan problems lead to a liquidity crunch in China, causing systemic problems? Probably not. Such a scenario may become more likely if and when the problem has grown to be much bigger by increasing the economy's debt load, not now. First, whether a certain loan is in trou-

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ble or not, often is more a political than an accounting decision. Everyone (the borrower, the bank, the local government, the suppliers to the borrower) has a **strong motivation to keep the loan in question alive** by restructuring, extending, rolling it. And most of the really troubled borrowers are SOEs in the coal, metal, glass, etc. sectors. **The problems thus will only surface over time, its pace controlled by the government, and not all at once.** This does not make the problems smaller, but it does make them more **manageable.** Second, the Chinese financial system is awash in liquidity. Third, the government has enough channels to provide liquidity to its economy if there were a crunch – **it owns the majority or all of all the financial institutions that matter in China.**

Meanwhile, the **manufacturing sector in China still is in big trouble.** A recent survey[1] points out that the time-honored tradition of Chinese companies delaying payments to their suppliers has led to almost half of the companies reporting «significant delays in collecting accounts receivable». As usual, most of the companies are financed by bank debt. The cost of that long-term debt, including interest and service fees, was 10.5%, exceeding the operating margin in most cases. Because the counterparties are state-owned banks, **the government has the capacity to keep these manufacturers alive,** for a while anyway. And: this survey was taken in the province of Zhejiang, one of China's industrial powerhouses, bordering Shanghai, where many successful companies are domiciled.

Asset-backed securities (ABS) are back, with state-controlled banks re-launching this bond market segment after it was closed in 2008. Bank of China sold RMB 301 million (USD45.8 million) in ABS with RMB 1.25 billion in non-performing loans as underlying assets. China Merchants Bank sold RMB 233 million (USD 35.5) of ABS backed by bad loans (incl. 60,000 credit card loans) with underlying assets of RMB 2 billion. This is **good news** and a small sign of market liberalization, since a basically sensible type of fixed income securities is re-emerging. But the amounts of loans transferred from commercial banks to other investors in this way **will not be able to solve the problem of non-performing loans.** The volume will be too small to get ahead of the bad-loan problem China has.

As always in China, we need to ask what the government's interest is in all this. Installing a small dose of discipline in the bond and investment markets through more realistic pricing of risks probably is one. This is why the government may permit more bond defaults to happen. Making the debt problems smaller, step-by-step, by letting non-performing loans increase in a measured way, probably is in the authorities' interest, too. **A large-scale transfer of bad loans to some type of bad banks, coupled with a re-capitalization of the financial sector? The pressure probably is not yet high enough for this, although this would be doable.** So expect more bond defaults, more defaults of WMPs, rising official non-performing-loans ratios (currently officially at 1.75% of the outstanding loans). This would be good news.

MSCI A-share inclusion

China's A-shares (i.e. the publicly traded shares of Chinese companies, listed on the Shanghai or Shenzhen stock exchange) **will become important for financial investors worldwide over time.** They have been neglected by all but few non-Chinese investors, they include some very powerful and successful companies and are severely underweight in all international equity indices. So the only way is up – at least on the list of important equity markets of the world.

Chart #2 shows the underweight in the FTSE All-World index, as an example, against all other metrics which could be relevant. **Why the underweight?** Because the A-share market is only partially accessible for non-Chinese investors (trough the QFII, RQFII and the northbound Shanghai–Hong Kong Stock-Connect programs), because Chinese corporations' corporate governance is weak and (recently) because of some quirks of how Chinese stock exchanges work. These include heavy-handed market interventions by the government (seen in 2015) and the companies' ability to suspend their shares from trading for weeks and months without truly good reasons (at the peak in summer 2015, a little over half the shares listed in China were suspended, representing approx. 30% of the outstanding market capitalization). Many of these regulatory hurdles will disappear over time and alleviate some of the concerns foreign investors justifiably have regarding investments in A-shares.

MSCI's decision-making matters primarily **because it highlights the importance of the issue – investors will no longer be able to simply ignore A-shares sometime soon.** It points to a coming seismic shift in emerging market indices – upon full inclusion, A-shares' weight in the MSCI emerging market index will roughly double from the current 25% of the index to over 50% of the index. But it will **not trigger a flood of money seeking to invest in A-shares all of a sudden,** this would serve nobody's interest. Instead, MSCI will most likely include A-shares in their index gradually. And the Chinese authorities will continue to loosen the restrictions for foreigners investing in A-shares: QFII and RQFII quota, only about 50% of which currently are used, will be further increased; the number of shares investable under the Shanghai-HK Stock-Connect program will be increased; the Shenzhen-HK Stock-Connect program will be opened, possibly in 2016.

Renminbi depreciation vs. the US-Dollar

The Chinese central bank PBoC's policies regarding the Renminbi exchange are somewhat murky. So, **what do we know about them?** We know that 1) the government wants to keep control over its exchange rate; an exchange rate solely determined by the market, or by US hedge funds, probably is the worst case scenario for Chinese officials, 2) the RMB has appreciated significantly against China's trading partners' currencies over the last 4 years (see chart #3), 3) the PBoC announced last August that it intends

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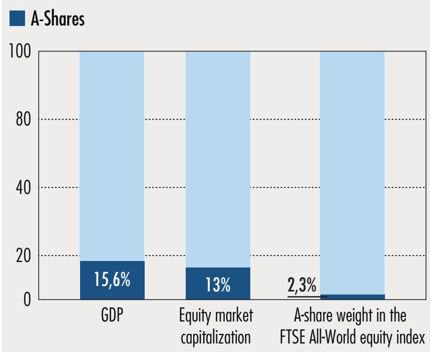
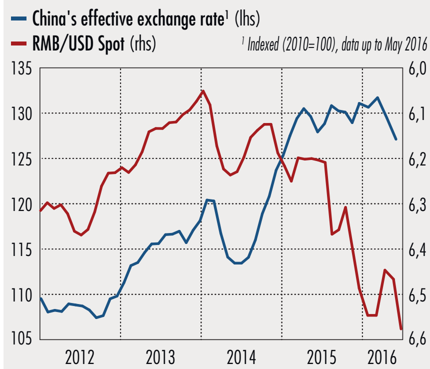
A-shares severely underweight ❷



Source: IMF (estimated GDP for 2015), World Federation of Exchanges (market capitalization, year-end 2015), FTSE Russell (year-end 2015) / Chart: ChinaIntelligence

RMB: weak vs US$, strong against the rest ❸



Source: Bank for International Settlements / Chart: ChinaIntelligence

[1] *China – Zhejiang's day of reckoning delayed, Financial Times Confidential Research, May 13, 2016.*

to depreciate the RMB vs. the US-Dollar and 4) the PBoC announced in November 2015 that it will increasingly use a trade-weighted exchange rate as the yardstick for the RMB, as opposed to a solely USD-focused view.

So what is the logical conclusion based on these facts? **The Renminbi will depreciate gradually against the USD, as long as the USD does not weaken against other currencies.** The more the USD appreciates against other currencies, the more the RMB will depreciate against the USD. We expect a **RMB/USD exchange of 7.00 at the end of 2016 (depreciation of 6–7%).**

In order not to give speculators a way to earn money, however, the PBoC has to keep the RMB currency development somewhat unpredictable. This could be an explanation for the **«stairs approach»** we have seen applied to RMB/USD management recently, i.e. the PBoC depreciating its currency in one step, then letting it gradually appreciate again before the next depreciation move. This way, the mid-term direction for the RMB is down, but there are periods of appreciation in between, and because nobody knows how long these periods will be, it is more difficult to make money by shorting the RMB.

Will the Chinese government want to boost economic growth by **depreciating the RMB by 15–20%,** the way Japan and Europe are trying? **Probably not,** for a number of reasons: 1) such a depreciation is a loss of face, unsuitable at a time China seeks a bigger role on the world stage, and 2) the spectre of such a depreciation might trigger capital outflows which would necessitate a much tighter capital control regime as the one currently in place. Instead, more traditional types of economic stimuli will likely be applied: providing liquidity to growing industries and infrastructure projects.

Important Indicators

	May 2016	April 2016	March 2016	Dec 2015	June 2015	Sep 2014
Quarterly GDP, growth yoy (%)	–	–	6.7	6.8	7.0	7.3
Retail sales of consumer goods, growth yoy (%)	–	10.1	10.5	11.1	10.6	10.8
Official Consumer Confidence Index	–	101.0	100.0	103.7	105.5	105.4
FTCR Labor Demand yoy Index	–	49.7	50.7	57.0	63.2	68.1
Real estate floor space newly started, growth yoy (%)	–	21.4	19.2	–14.0	–15.8	–9.3
FTCR mom Home Price Index	–	72.5	74.6	58.0	61.0	50.0
CPI, growth yoy (%)	–	2.3	2.3	1.6	1.4	1.6
PPI, growth yoy (%)	–	–3.4	–4.3	–5.9	–4.8	–1.8
PMI manufacturing (official)	**50.1**	50.1	50.2	49.7	50.2	51.1
Caixin/Markit PMI	**49.2**	49.4	49.7	48.2	49.4	50.2
Fixed-asset investments, growth yoy (%)	**10.5**	10.7	10.2	10.0	11.4	16.1
Required ReserveRatio (large banks) (%)	**17.0**	17.0	17.0	17.0	18.5	19.5
Benchmark rate for 1-year loans (%)	**4.35**	4.35	4.35	4.35	4.85	6.00
Benchmark rate for 1-year deposits (%)	**1.50**	1.50	1.50	1.50	2.00	3.00
New total social financing, growth yoy (%)	–	–28.9	93.8	6.9	–6.8	–26.0
New bank loans, growth yoy (%)	–	–21.5	16.1	19.4	22.7	9.0
Exports, growth yoy (%)	–	–1.8	11.5	–1.4	1.6	15.3
Imports, growth yoy (%)	–	–10.9	–7.6	–7.6	–6.8	7.0
Trade balance (USD billion)	–	45.6	29.9	59.4	46.5	30.9
Electricity consumption, growth yoy (%)	–	2.9	3.2	0.5	1.3	3.9
Freight Traffic, growth yoy (%)	–	2.2	0.7	4.4	4.2	7.7
Iron ore imprts (million tons)	–	83.9	85.8	96.3	75.0	84.7
Coal imports (millions tons)	–	–	19.7	17.6	16.6	21.2
Crude oil imports (million tons)	–	32.6	32.6	33.2	29.5	27.6
CSI 300 (China Equity Index)	**3'169**	3'156	3'218	3'731	4'473	2'451
RMB trade-weighted, nominal, indexed (2010=100)	–	121.3	123.0	125.9	126.0	116.0
RMB / USD spot	**6.58**	6.47	6.45	6.49	6.20	6.15

Source: ChinaIntelligence

Key developments we expect for 2016/17

We expect political, economic and financial stability despite all the looming challenges. Regarding some key topics, our expectations are:

- *GDP growth: 2016: around 6%, 2017: around 5.5%, below 5% for 2018–2020 (official government figures may indicate higher growth rates).*
- *Labor market: stable to slightly weaker, but with continued wage growth of between 4–7% p.a., at the lower end for high-wage earners, at the higher end for low-wage earners.*
- *Interest rates: one additional cut in the benchmark rates in 2016 by 25 bps.*
- *RMB: controlled weakness vs. the USD, leading to RMB/USD near 7.00 by year-end 2016.*
- *Retail sales growth: approx. 10% p.a.*

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