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What could happen in China which is not factored into our markets yet?

December 2014 | Written by Andrew Stanley, Head of Investments, Ralton Asset Management

Executive summary

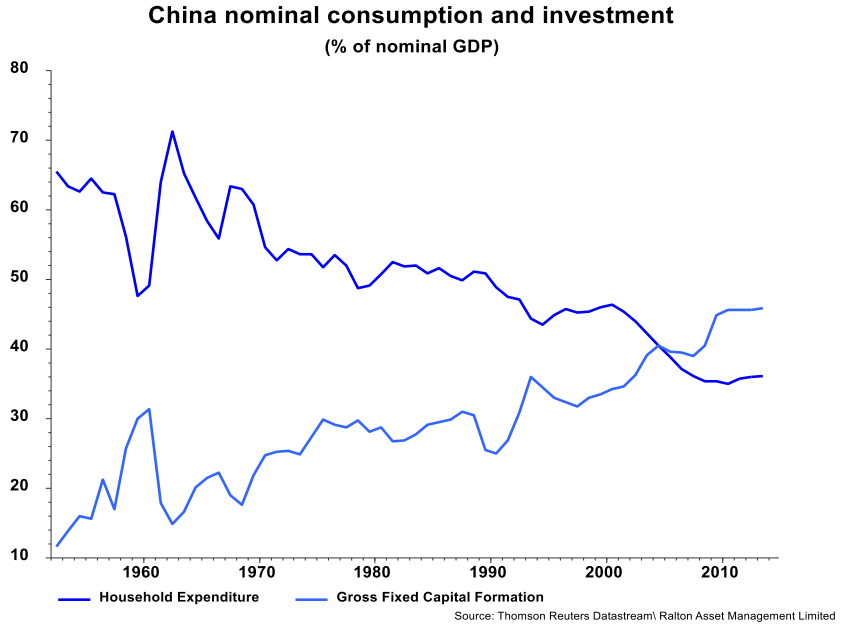
1. The Chinese government has recognised the need to transition the country's growth model from debt-driven fixed-asset investment to a more sustainable household consumption model.
2. The Chinese residential property market is now in a recession on key metrics and what we know today is likely being factored in by the financial markets, although the true depth of the underlying problems are unlikely to be fully apparent yet.
3. In our view, China eventually faces a further tightening of domestic monetary policy if it doesn't allow the renminbi to decline materially in value given the change in the structure of its capital account over the past few years.
4. A devaluation of the renminbi will also improve the competitiveness of Chinese exports, particularly given the large devaluations of the euro and the yen during 2014.
5. This will have a number of implications for the Australian equity market:
   (a) the pressure on our key commodity exports including iron ore and aluminium is unlikely to be over yet
   (b) the Australian dollar is likely to come under further pressure which should continue to support the outlook for a number of the internationally focused domestic corporates
   (c) China will be exporting disinflation to the world, along with Europe and Japan, and this means bond yields are likely to remain under downward pressure, and
   (d) domestic income growth will continue to remain under pressure as the terms of trade adjusts making it more difficult for domestic-focused companies, including some of our major companies at the larger end of the market (particularly those that have benefited from the duopoly/oligopoly-nature of a number of Australian industries).

1. Structure of Chinese GDP growth

The Chinese government began highlighting the need to transition from a fixed-asset investment and export-driven growth model to a consumption-driven growth model as far back as 2006. Back then, fixed-asset investment represented about 40% of GDP, but over the following eight years, the share has increased to over 48% (as shown in Figure 1). The problem for the government is that it's much easier to drive fixed-asset investment when you control most of the key levers (i.e. the State Owned Enterprises (SOE), the major banks and local government borrowing vehicles), than it is to convince households to simply spend more.

The issue is the use-by date for the current growth model has now arrived and China must accelerate the transition given the debt burden and overcapacity that has arisen since the GFC. According to Credit Suisse, no economy has been able to sustain an investment share of GDP in excess of 40% without experiencing a severe recession shortly afterwards. China has now been going for over seven years at this level. However, the cracks are clearly starting to emerge in the domestic economy.

Figure 1



2. Chinese residential property market

While it's not the purpose of this paper to analyse the problems of the Chinese residential property market, it's clear the property sector is now in recession with the key indicators around house prices (refer Figure 2), construction, commodity prices and land sales all painting an unfavourable picture. This is one of the outcomes of the excessive reliance on fixed-asset investment over the past seven years in China.

Figure 2

The question from this point is whether this is the start of a protracted downturn or whether there will be another burst of government stimulus to provide more levitation for the residential property sector for a while longer (i.e. the government pushes the problem out into the future). At this stage, the Chinese government is heading down the path of reforming the economy in a range of very substantial ways. Its focus appears to be on creating jobs in the service sector to offset those lost in the construction sector. Further, it has moved to improve the availability of mortgage loans for prospective purchases while keeping a squeeze on funding to property developers. Of course, this position may change if unemployment begins to move higher in an alarming way.

The extent of the overbuild in China is a matter of much conjecture. However, it appears there's somewhere between a two-year and three-year supply of excess housing inventory, but the degree of overbuild varies by region. This includes developer inventory and inventory held by investors as empty shells. The Tier 2, 3 and 4 cities are going to be the hardest hit as these have the largest inventories. However, they're also the ones that have been the biggest drivers of growth over the past couple of years. As Figure 3 highlights, there's still considerable downside potential given the growth rate is still positive.

Figure 3

In our opinion, the property sector is in the early phase of a material correction which is going to take many quarters to finish unless the government intervenes to delay the inevitable. This information is known and largely factored in by the market.

The stalling of the property market is likely to have negative ramifications for the banking and shadow banking systems. We're in the very early stages of the bad debt cycle. The Chinese authorities have been through this before employing vehicles modelled on the US Resolution Trust Corporation, which were used to clean up after the US Savings & Loans problems. These vehicles still exist with Cinda Asset Management listing in Hong Kong earlier this year to raise capital to participate in the clean-up (there's suggestion Huarong Asset Management will follow the same path early next year to raise additional capital).

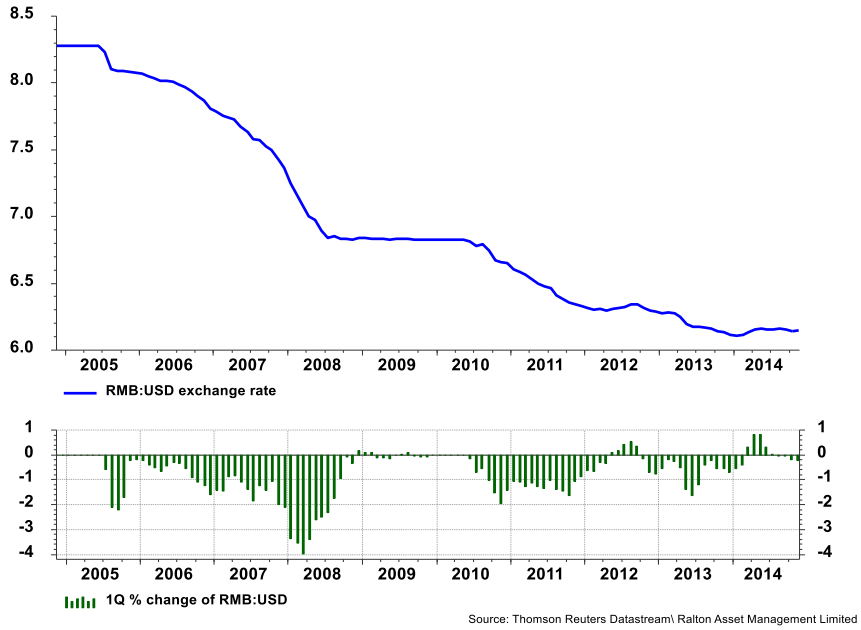
3. What could surprise the market?

The view for many years has been the renminbi is a one-way bet to appreciate. However, when you look at the underlying fundamentals, the case for a material devaluation of the Chinese currency is strong. This is a function of the implications for China of operating with a largely fixed exchange rate to the US dollar, weakening capital controls and the decline in global competitiveness of China due to rising domestic wages.

3.1 Balance of Payments

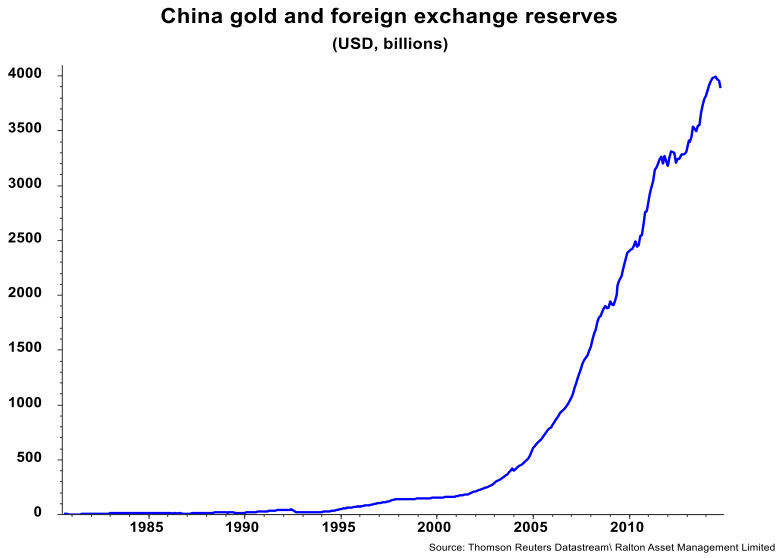
The Chinese currency has appreciated by approximately 30% in real terms since 2006 and the Chinese current account has declined from 10% of GDP to around 2% over the same period. In the first quarter of 2014, there was no trade surplus at all. This is the type of adjustment you would expect to see given the extent of the currency appreciation over the period.

Figure 4: Change in RMB:USD exchange rate



Yet China has still managed to accumulate foreign exchange reserves at a massive rate over the same period (refer to Figure 5). The reason being China runs a capital account surplus as well as a trade surplus. This is an unusual state of affairs as economic theory would suggest the exchange rate should adjust over time, even if it's a fixed rate, to clear this balance of payments surplus.

Figure 5



However, many investors have accepted the surpluses on capital and trade accounts as a normal state of affairs for China. First, they look at this and say, 'what a great position for an emerging market to have a surplus on both current and capital accounts; this shows great financial strength'. Second, however, they say this doesn't matter as the People's Bank of China (PBOC) has sterilised the excess funds.

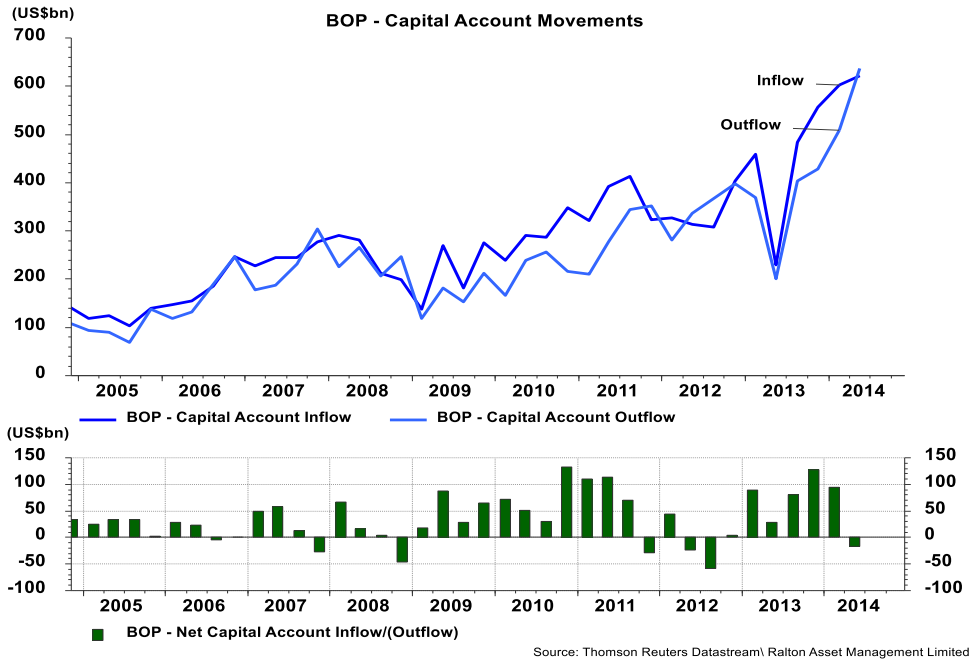
It's the issue of whether the PBOC has actually sterilised all the inflows which is important for present purposes. The creation of money by the banks requires access to excess reserves liquidity. As these foreign funds have flowed into China since 2006, they haven't been fully sterilised. This has provided the banking system with the capacity to advance new loans which then creates deposits. In fact, it's allowed the Chinese banking system to replicate the US banking system, some $14 trillion, over the past five years.

The rampant creation of credit by the banking system from these foreign currency flows is an integral part of how fixed-asset investment has been able to run at the rate it has since the Global Financial Crisis (GFC). That is to say, it's been a key contributor to the inventory overhang we now see for residential property today.

3.2 Capital account flows

To understand where the stresses are now emerging, we need to look at how the composition of the capital account inflows have changed over the past six years.

Figure 6



As the lower part of Figure 6 highlights, prior to 2012, there were solid net inflows and these built very substantially post the GFC. The reasons for this were the domestic restraints on capital outflows, strong capital inflows seeking the attractive investment returns available in China, coupled with a view the renminbi would continue to appreciate, made this an even more attractive bet. During this period, investors would've done well from this positioning.

However, in 2012, things began to change as the capital outflows grew more strongly (interestingly timed with the dramatic lift in the turnover level for Macau VIP gaming). As the lower part of Figure 6 highlights, China actually saw a deficit on capital account for 2012. This led to a sharp slowdown in the growth rate of the money supply and GDP growth. As the year

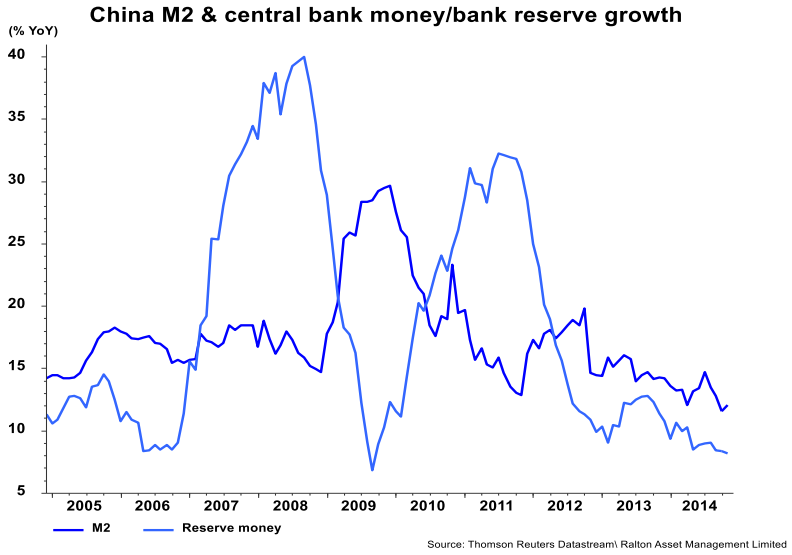
progressed, bank funding tightened and some may recall this was the last time we saw iron ore prices under heavy pressure as traders and mills struggled to get access to funding.

Since 2012, the capital outflows have continued to grow at a faster rate. The capital inflows have also lifted quite markedly, but the composition of these inflows has now changed. Rather than being mainly foreign direct investment or equity portfolio inflows, it is now far more substantially from borrowed funds. While China's level of foreign borrowing doesn't present any systemic risks for China (as it has for other emerging markets given the size of the country's foreign exchange reserves), it's a much lower quality form of inflow than more permanent capital if it's being used to fund the purchase of renminbi assets.

Therefore, at the time when the size of China's current account surplus has been declining, it's been escalating the inflow of funds on the capital account to keep the exchange rate steady while delivering easy monetary policy. The catch is that this can only be achieved by ever-higher levels of foreign borrowing. This mix can't be sustained as the self-correcting mechanisms that operate to correct the value of a fixed exchange rate will eventually kick in. The acceleration of capital outflows in recent years is likely to be the beginning of the end of what seemed to be a structural capital account surplus.

As Figure 7 shows, Chinese monetary policy is tightening as bank reserve and M2 growth rates approach historically low levels. This is an issue as Chinese GDP growth has been very credit intensive. Tighter monetary policy while the economy transitions its growth model is only going to put more pressure on growth.

Figure 7

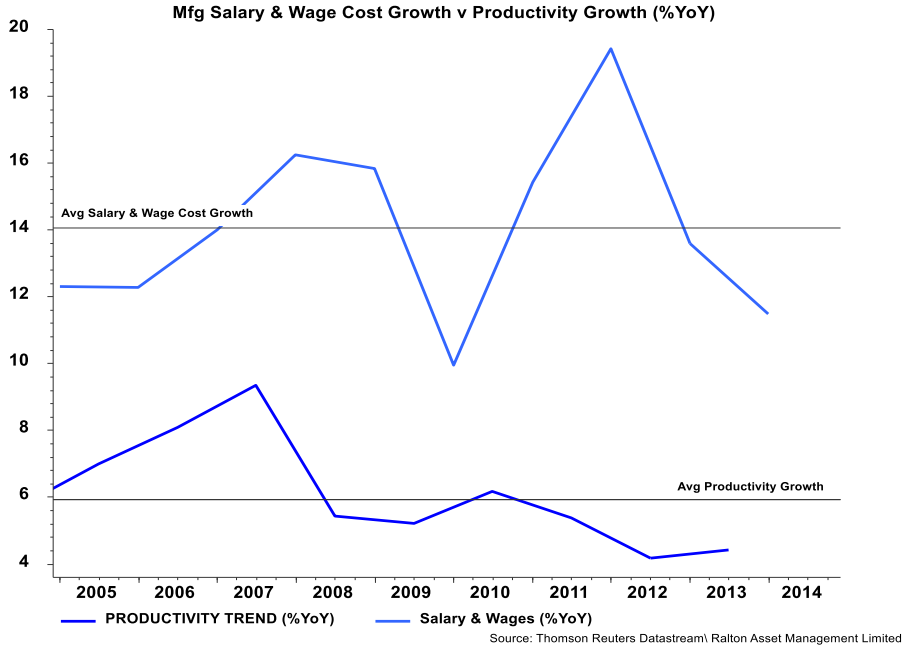


If China doesn't allow the currency to depreciate, all the pressure of slowing money supply growth is going to fall on the domestic economy. We've already seen indications this year that the PBOC may not defend the current level of the currency. First, we saw the currency weaken earlier in the year. Second, we've seen the announcement of a form of quantitative easing in the third quarter of 2014.

3.3 Declining competitiveness

Another way to consider the impact of the currency on China is to consider the decline in competitiveness of Chinese labour costs against the US since 2006.

Figure 8



As Figure 8 shows, China has seen a substantial decline in its international competitiveness over the past decade as wage growth has been averaging about 14%, but productivity growth has slumped such that it's only averaged 6%. In addition, there's also been the sharp appreciation of the renminbi over the same period. This equates to a decline in competitiveness of about 11% per annum for China.

This is a positive development for household consumption over time, but it detracts from international competitiveness at a time when growth in net exports could assist in the re-balancing of the economy and when a higher absolute trade surplus would be useful to offset the level of capital outflows. At this stage, corporates have been absorbing the increased costs to remain competitive in global markets. However, this has had an adverse impact on corporate profitability.

In addition, the competitiveness of Chinese exports is also coming under pressure from the depreciation of the yen and the euro which has boosted the competitiveness of Japan and Germany, respectively. This is particularly the case in relation to the export of capital goods to other emerging markets. Both Japan and Germany are trying to export their way to prosperity given the lack of domestic demand in each country.

3.4 China options

The need to transition the domestic growth model will require structural reform at the same time as corporates and local government need to deleverage. This will lead to a reduction in domestic demand and cause financial distress at the same time as China's exports are under pressure. Further, domestic demand has already weakened over the course of the past year. The flight of capital from the country suggests "insiders" have a view on the outlook and are heading for the exits.

So, what options do we view the Chinese authorities as having before them to address the changing capital account and the loss of international competitiveness?

3.4.1 Domestic adjustment

The Chinese authorities could elect to simply hold the line and continue on with the structural reforms they have planned, clean up the banking system and accept a slowdown in the growth rate. This can really be viewed as more of the current

policies which have seen a significant slowing of GDP growth over the past couple of years. However, if the capital account remains in deficit this is going to continue to tighten the money supply at the same time as the government needs to retain some stability in lending to ensure there isn't a precipitous fall in bank lending that exacerbates the existing problems in the banking system.

In addition, the international competitiveness of Chinese exports will continue to decline unless its corporates accept lower margins given the improved position of Japanese and German exporters. This will reduce another prop from under GDP growth when domestic conditions are already tough.

3.4.2 Float the renminbi

The Chinese could elect to do what the international community, and particularly the US, has been asking be done for many years and move to a floating exchange rate. In the current environment, this is more likely to see outflows from China seeking better returns elsewhere in the world. Inflows are likely to be restrained until the domestic economic environment improves.

However, opening up international investment options to domestic savers is likely to be very problematic at this point in time. For these purposes, we want to focus on a couple of specific issues we can see. First, the banking system is likely to see an outflow of deposits which would crimp lending growth. This wouldn't be viewed as desirable to the authorities in the current environment. Second, the other asset class domestic investors hold is real estate, and additional sales into an already weak market could exacerbate current problems of falling prices and excess supply.

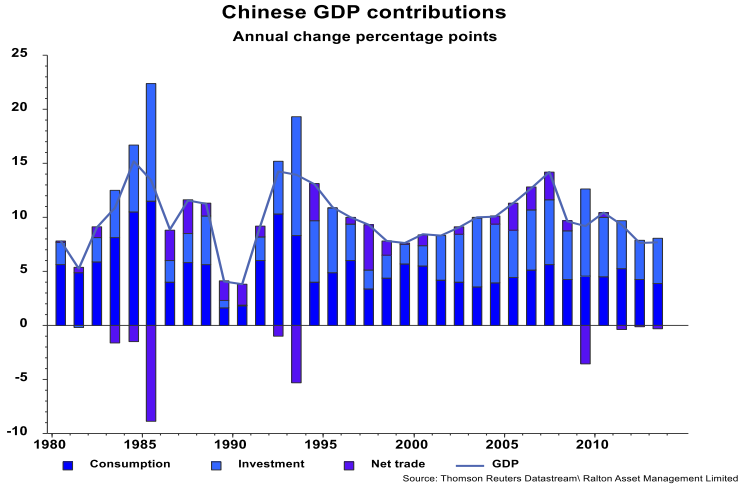
3.4.3 Devaluation

The final option is to devalue the renminbi overnight. A devaluation overnight of between 15 and 25% would assist in restoring some of the competitiveness lost since 2006. This would allow export growth to assist in the growth model transition and this will also potentially reduce the incentive to remove funds from the country.

The Chinese have form on this type of move having devalued by 50% overnight in 1994 when they were trying to overcome a similar overbuild of capacity. Emerging markets were severely hit in 1994 and it is likely to have a similar effect this time. However, it will also impact Japan, Europe and Korea when they are also facing their own issues.

As Figure 9 illustrates, the Chinese net exports have been a detractor over recent years, but a devaluation of the renminbi could well assist in driving GDP growth while fixed-asset investment re-bases from 48% of GDP to a more appropriate level in the mid-30s.

Figure 9



4. Australian implications

As Australia's major trading partner we'll be substantially impacted as China makes the transition from a fixed-asset-investment-driven growth model to a consumption-driven model. A devaluation of the renminbi will also have a number of impacts on us of which we've focused on a couple below.

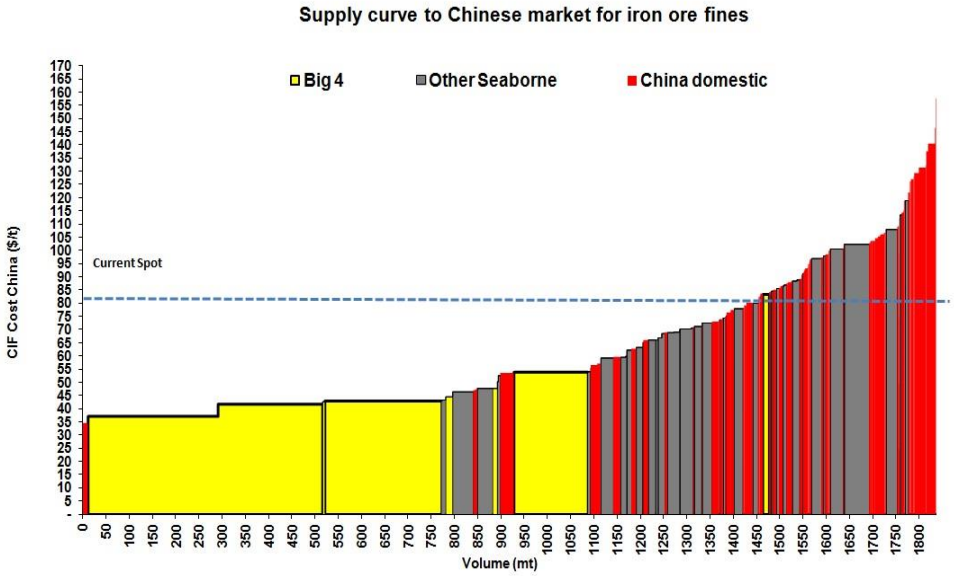
4.1 Commodity exports

A devaluation of the renminbi by say between 15 and 25% (i.e. sufficient to offset a material part of the appreciation since 2006), is likely to place further downward pressure on the current depressed iron ore price as Chinese producers become more reluctant to withdraw capacity from the market. This will impact the mining sector and government revenues further. As a partial offset, this may trigger the larger adjustment the RBA is seeking in the Australian dollar.

The current pressure on the iron ore price has been driven by increased supply. As supply continues to come to market over the next couple of years, the position is only likely to get worse until some production actually exits the market and we see a new equilibrium established. The market currently assumes the long-term iron ore price should be around US$80 to US$85 a tonne. This figure is likely to move lower over the next couple of years as cost deflation continues in the industry.

As Figure 10 highlights, the current cost curve is quite steep with Chinese production being a lot of the more expensive supply. In the same way domestic producers are working to cut costs, so are these producers and the government is cutting charges for them. A depreciation of the renminbi is only going to drop their costs further. It should be noted this cost curve is slightly deceptive as some of this Chinese production will never be removed as it's either SOE production, the mine is beside the steel mill or it is retained for national security reasons.

Figure 10



4.1.1 Terms of trade impact

So, how does this devaluation flow through to the broader Australian economy? The decline in the commodity prices (with iron ore being one example) would reduce our terms of trade (i.e. this will be a negative drag on Australia's Gross National Income). This would affect corporate profitability, government tax revenue and household disposable income (via slower

wage growth and government transfers). This is already happening, as can be seen in Figure 11 and Figure 12, but a devaluation of the renminbi is likely to make the reversion in the terms of trade faster and deeper.

Figure 11

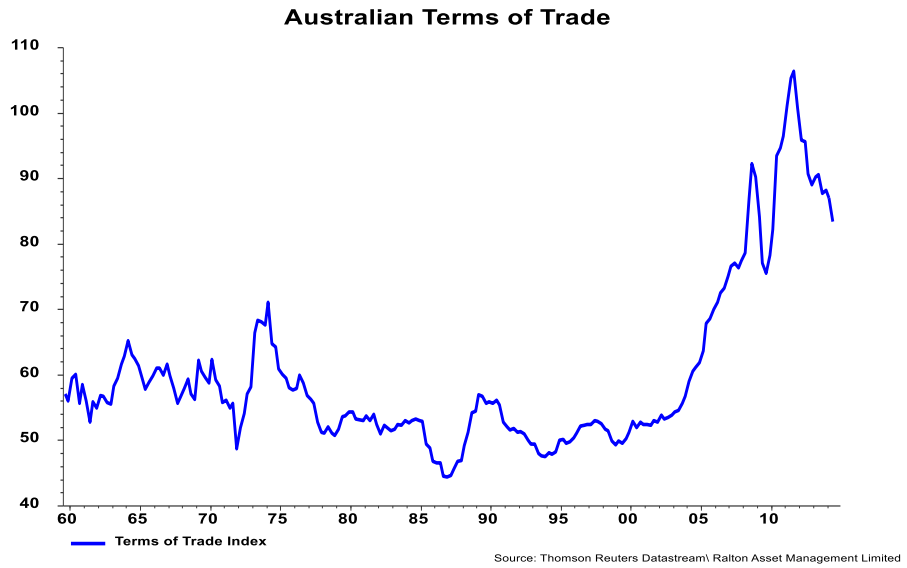
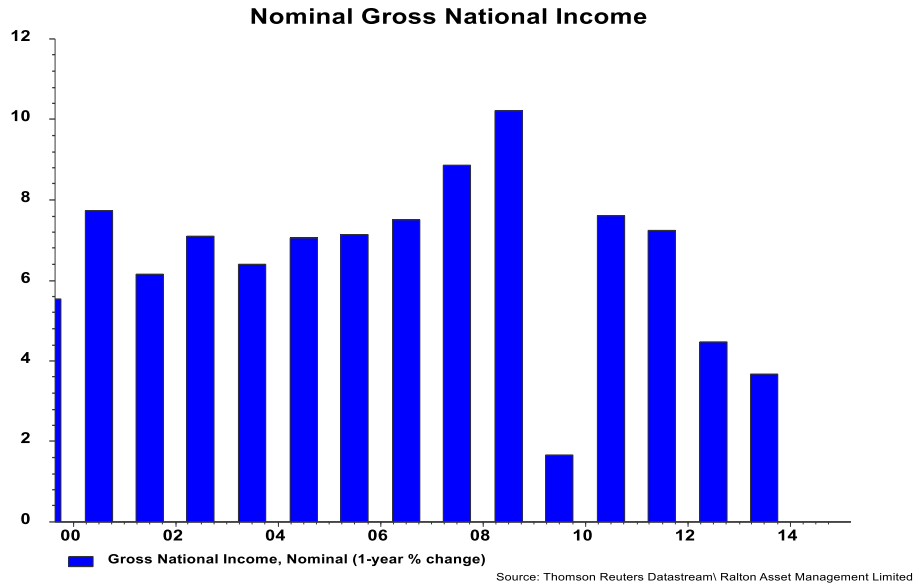


Figure 12



4.2 Disinflationary pressures

China has had a declining Producer Price Index for nearly three years now due to excess capacity in a range of industries and insufficient demand. While declining prices are an issue in the Eurozone, it's potentially a much more substantial issue in China. In our opinion, given China is the world's top trading nation and a major trading partner of many countries, a

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devaluation of the renminbi at this time is only going to make the deflationary pressures in the global economy even more acute. This will be particularly so for Japan, Korea and Germany as they all battle with their own domestic or regional issues.

For this reason, despite many years of quantitative easing by major central banks, we are likely to see even more deflationary pressure. This would lead us to expect further loosening of monetary policy by a range of major central banks. As such, the downward pressure on bond yields from the global savings glut is likely to be assisted by this additional new funding from global central banks.

Contact us

For more information, contact John Clothier, General Manager, Distribution on +61 408 488 549.

For media enquiries, contact Sam Cole, Chief Operating Officer, on +61 3 9602 3199.