ClearBridge Investments

China's Economic Transformation Boosts Credit Outlook

Key Takeaways

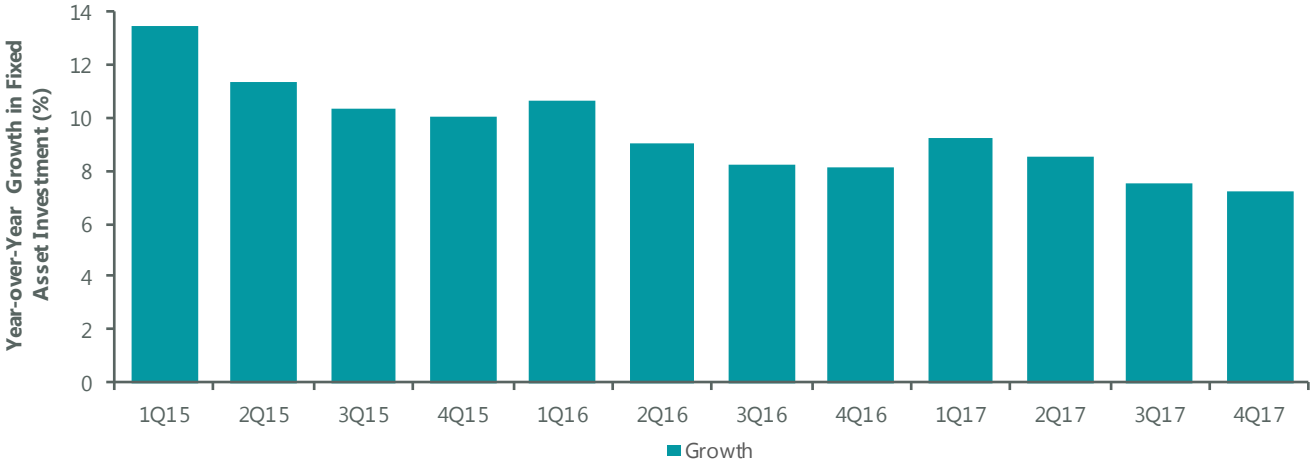
- 2017 provides a good example of how China might be able to sustain growth while executing on reforms.
- Credit conditions improved in 2017, with fewer bond defaults reported and more upgrades than downgrades (10:1) reported for local government finance vehicles.
- Recent regulation has effectively slowed down credit growth and curbed the shadow banking activities that pose the biggest threat to financial stability.
- A look into the mechanism, size and severity of risk from shadow banking in China suggests manageable risks that are being dealt with rather than deteriorating conditions and imminent collapse.

With a growth model heavily reliant on investment in recent years, China's risks for a hard landing (a rapid fall in growth leading to a recession) are well known. For U.S. investors, much is at stake. China is one of the most important earnings growth drivers for many multinational companies owned by U.S. investors, and it accounts for about a third of global GDP growth. A weaker China would reduce global aggregate demand significantly and hurt many of its trading partners. Accounting for more than 50% of the utilization of many commodity categories, China is especially important for commodity producers, many of which are emerging markets countries like Brazil. As a result, a hard landing in China represents a key global tail risk that might trigger a global recession.

We see a confluence of positive forces that tell us the risk of a hard landing has decreased somewhat, due to lower risk of a credit event in China. This lower risk of a credit event stems from:

1. Better internal and external growth — highlighted by China's party congress as "quality growth" — involving more consumption and an increased role for the private sector.
2. Effective regulation aimed at the shadow banking activities.

Exhibit 1: China's Declining Fixed Asset Investment Growth



Source: ClearBridge Investments.

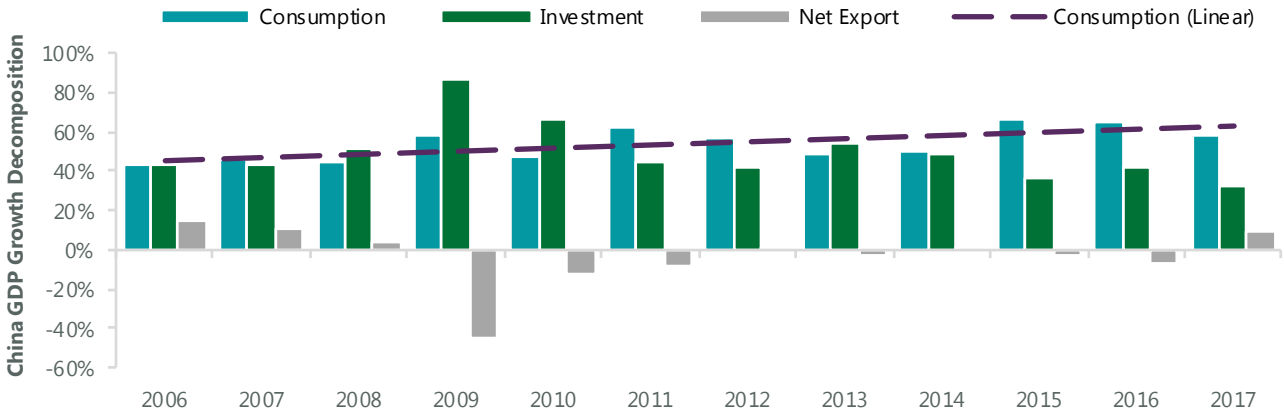
Better Growth Via Less Investment, More Consumer

One of the biggest concerns for China is that to carry out its reform agenda it will have to endure a period of depressed growth. This is because large parts of the structural reform, such as restructuring state-owned enterprises (SOE), cleaning up bad debts and financial deleveraging, generally hurt growth. However, 2017 provides a good example of how China might be able to sustain growth while executing on reforms, albeit with some help from a stronger global economy. Better internal and external growth should allow China to address structural reform, including financial deleveraging and excess capacity reduction, while maintaining growth.

China's growth trends point to more sustainable growth and less need for debt financing. China has been reducing its reliance on investment-driven growth for some time: fixed asset investment has gradually declined to 7% year over year increase in the most recent quarter (Exhibit 1). Meanwhile, consumption, a more sustainable source of growth, plays an increasingly large role — it is already two thirds of China's total GDP growth (Exhibit 2).

From another perspective, the role of the private sector, which requires less debt than SOEs, is growing in importance: it is already driving more than 60% of GDP growth and more than 80% of jobs growth. Only 30% of debt growth goes to support the private sector, while the majority still flows to SOEs. As the SOEs continue to shrink, more capital can be channeled to the more capital-efficient and more productive private sector. Over the next few years, China's need for debt financing should decline even without taking down growth. Importantly, given that private sector growth and services growth create more jobs than the capital-intensive SOEs in the traditional industries, the current mix shift will alleviate China's pressure to grow for the sake of preserving jobs.

Exhibit 2: Growing Role of Consumption in China GDP



Source: ClearBridge Investments.

Excess Capacity Cuts Help Credit Conditions

China's supply-side reform in 2017 exemplifies how China is managing the pace of its reform and resulting execution. China had a goal of cutting 10%–15% capacity in the industries deemed to have excess capacity between 2016 and 2018 and is ahead of its own schedule, largely through company exits and M&A. At the national level, capacity has been reduced in steel, coal and aluminum industries; at the provincial level, there have been additional cuts in areas such as glass, tire and chemicals production. The capacity cuts lifted commodity prices and improved profitability, improving coverage ratios.

The labor force reduction also took place in an orderly fashion. At Shandong Steel, for example, about 25% of workers were laid off, and almost all of them were re-accommodated: 40% transferred to other job openings within the provincial system, 40% took early retirement, 16% accepted severances, and 3% enrolled in new skills training. Although the capacity cut moderately increased nonperforming loans (NPLs), the provincial government has been proactive in setting up a creditor's committee, asset management companies and local financial asset exchanges to acquire and dispose of NPLs and nonperforming assets. As a result, in a year of deleveraging and supply reform, credit conditions improved in 2017, with fewer bond defaults reported and more upgrades than downgrades (10:1) reported for local government finance vehicles.

Reducing Systemic Risk by Tightening Oversights on Shadow Banking

China's effective regulation aimed at shadow banking activities has also reduced the risk of a credit event. Although there is still a long way to go, recent regulation has been effective in slowing down credit growth and curbing shadow banking activities that pose the biggest threat to financial stability.

China's shadow banking system primarily takes the form of wealth management products (WMP). Recent regulations over shadow banking activities from the Chinese government appear to have been successful: shadow banking growth has been flat year over year, compared to 45% CAGR in the past few years.

The riskiest parts of the shadow banking system, to take the most extreme case, are loan-like assets accounted for as investment receivables on the asset side of the balance sheet. These are practically loans, but have an investment wrapper provided by security companies or trust companies and are concentrated in small to mid-sized banks with heavy exposure to geographies and industries with overcapacity. The risks primarily reside in:

1. Managing NPL levels and hiding bad debts: banks package bad debts into these investment receivables, which are not subject to the standard asset quality recognition rules. The rapid growth creates a Ponzi scheme, which helps hide the existence of bad debts. Alternatively, banks can package these bad debts with high-yield bonds, and the higher return of high yields helps cover up the quality problems of the loan.
2. Inflating capital position: these WMPs are not subject to prescriptive provisioning standards and their provisioning can be determined at management discretion. In addition, these products can be applied a lower risk weighting of 25%–50%, instead of the 100% or higher applied to formal loan books.
3. Getting around credit risk approval for loan rollover and industry lending quotas.

Risk has decreased in this area due to several regulations started in May 2016, including capping interbank WMPs at 30% of total liabilities and required disclosure of the underlying assets of WMPs, removing the ability of the banks to bundle NPLs into WMPs. It is estimated that the issuance of interbank WMPs has declined by 60%–70%. According to an interbank broker ClearBridge has met with, most interbank WMPs have nearly disappeared from their trading system. According to Head of the China Banking Regulatory Commission, the committee's stress test, which applies the highest level of risk weighting to these assets, suggests capital risk is manageable.

Housing Bubble Among Remaining Risks

Even with improved credit conditions and more effective regulation strengthening the financial system in China, some major risks remain. The biggest threat to economic and financial stability is an overvalued property market. China's property bubble remains unaddressed. The reacceleration of growth in China last year benefited significantly from the unprecedented wealth effect of housing inflation (Exhibit 3). It is estimated that the value of residential housing went up by 49 trillion yuan in 2017, or 60% of the GDP. Last year, the wealth gain from rising property prices exceeded household annual income in second- and third-tier cities that collectively represent 91% of population and 88% of GDP. Under President Xi Jinping's guidance that "housing should be for living in, not for speculation," the government has already taken steps to place home purchase restriction measures intended to first stop the bubble from further growing and then manage a gradual deflation in the future. The execution risk is high that a slowdown of the housing market could

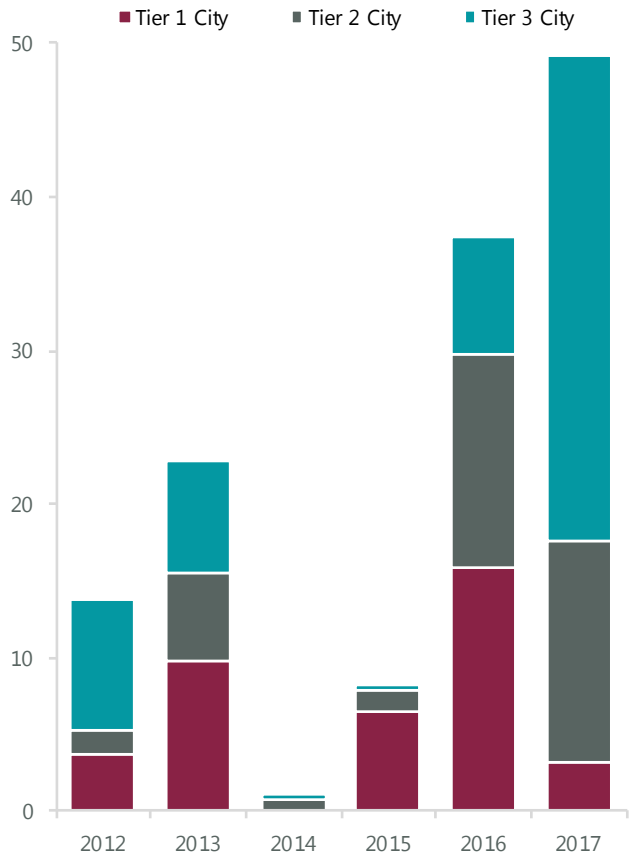
have a surprisingly large negative effect on growth and stability of the overall economy.

Second, there are reasons to doubt economic data coming from China; in 2016 the growth rate held a strangely constant 6.7% in the first three quarters, then inched up to 6.8% in the fourth quarter even while the economy slowed down by other measures. The GDP number had to be guaranteed as "authentic" and "reliable" by the Chinese National Bureau of Statistics. Further, China's government has admitted some data between 2011 and 2014 was fake. If the numbers used to measure China's financial health are questionable, the reality behind them may not be so rosy.

Third, while financial security had been somewhat improved, some argue China's reforms have not gone far enough. The International Monetary Fund's recent assessment of China's financial system finds that even if some reform measures have been effective, credit has still expanded amid strong pressure to keep some non-viable firms open, particularly among local governments.[1] Demand for high-yield investment products has encouraged risky lending in non-traditional areas that are difficult to benchmark and supervise, given their "increasingly complex linkages" and susceptibility to contagion. Also, retail investors make up most of the trades in China's equity market, much more than in most other countries, and household debt, though low, is rising, and is more and more connected with asset-price speculation. Not to mention, holding Treasury bonds in abundance, China is also vulnerable to rising U.S. 10-Year Treasury rates.

These risks notwithstanding, there are aspects to China's growth that hint at a more holistic improvement. For example, technology-driven private sector growth could ultimately be the enabler for orderly structural reform and deleveraging in China. Broadly, however, China's government is clearly focused on the right issues, and while there is still much to be done, several factors are aligning in a positive way to reduce the risk of a credit event that could severely damage growth prospects.

Exhibit 3: Property Boom Creates Large Wealth Effect



Source: Deutsche Bank, CEIC, WIND, websites on secondary property prices.

1 International Monetary Fund, "Financial System Stability Assessment—Press Release and Statement by The Executive Director for People's Republic of China," December 2017.

About the Author

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- 15 years of investment industry experience
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