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CHINA: WHAT TO EXPECT IN THE NEXT SIX MONTHS

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- Concerns over a "Lehman-style" financial meltdown in China are overblown. China is not a typical EM country and the authorities have unique policy levers to manage the magnitude and pace of dele-veraging.
- President Xi is pursuing an aggressive deleveraging program aimed at highly indebted private companies and excess capacity non-strategic SOEs. A credit strategy focusing on the avoidance of micro-idiosyncratic risks may be more fruitful than a bearish China macro overlay.
- Chinese investors have ac-cumulated a large USD hoard, in excess of their liabilities. A period of Chinese yuan stability and strength may lead to a cyclical unwinding of long USD positions.
- The new China "bond-connect" program increases the chance of major bond index inclusion. Global bond investors should consider participating in the world's third-largest fixed-income market.

"Using time to exchange for headroom（用时间换空间）"

~ Chinese saying

In light of concerns over China's rising leverage, yuan stability, capital outflows and risks to emerging economies, Western Asset's Portfolio Manager and Head of Investment Management, Asia (ex-Japan) Desmond Soon shares what we can expect from China's financial markets in the next six months. He goes into detail about why we think a debt crisis in China is not likely, the safeguards in place to help ensure financial stability and the steps China is taking to encourage more foreign investments to conclude that China's fixed-income market continues to be an attractive option for global bond investors.

A DEBT CRISIS IN CHINA IS UNLIKELY

Economic growth in China has exceeded analysts' forecasts for 1H17. Inflation at both the consumer and producer levels has stabilized while indicators such as the Purchasing Managers' Index (PMI), exports and housing starts have rebounded. Against a robust economic backdrop, China shares, credit spreads and the Chinese yuan (CNY) shrug off the Moody's one-notch credit downgrade of China's sovereign credit rating to A1 on 24 May. The credit rating agency cited an increase in contingent liabilities for the government due to a material rise in economy-wide debt.

China's total debt has indeed risen rapidly to more than 260% of GDP from 160% in 2008 – alarming in the context of a developing economy. The growth of leverage has been mostly in debt issued by local govern-ments, private enterprises and borrowings by state-owned enterprises (SOEs) especially those in industries with excess capacity (e.g., iron and steel, and coal production). On the other hand, the debt levels of the central Chinese government and households remain low and manageable (Exhibit1).

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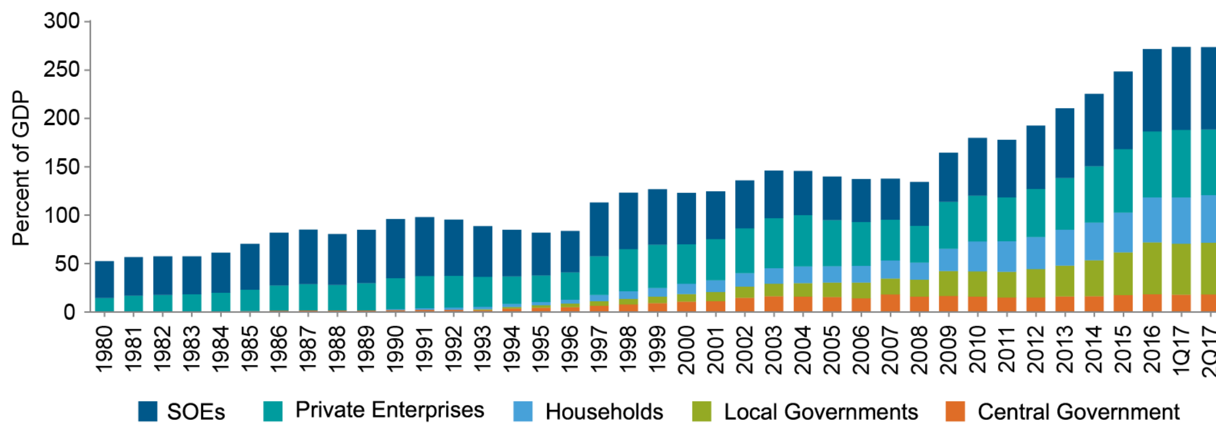
Exhibit 1: China Debt Levels, Climbing Since 2008, Mostly in Non-Government Sector



Source: Deutsche Bank estimates, PBOC, CBRC, CIRC, SAFE, NBS, MOF, CEIC, WIND, Chinabond.com.cn, Trustee Association of China, SAC, HKMA, media reports. As of 30 Jun 17 Note: 1) we have eliminated the overlapping between different financing channels, and 2) we classify LGFV debt into local government debts.

However, China is no ordinary emerging country given its size, influence and the exceptional policy levers in the hands of its authorities. The Chinese government believes that if it reduces the pace of leverage growth, debt-to-GDP levels will drift lower over time as the economy grows (nominally) at about 8% per year (real GDP of 6.5% plus inflation of 1.5%). This gradualist approach is encapsulated by a Chinese expression "Using time to exchange for headroom 用时间换空间" often cited by Chinese policymakers, which, as global bond investors, we understand how time and robust economic growth can be applied to improve debt dynamics. Importantly, we also need to examine various mitigating factors and policy levers that make China different from the typical highly indebted emerging economy.

First, the increased debt levels in China are predominantly CNY-denominated and external borrowing (mostly in USD) remains modest. Holders of Chinese debt are primarily domestic players, and there is little dependence on external markets for financing. Until recently, Chinese capital markets have been mostly closed and foreign holdings of Chinese stocks and bonds were extremely low. Hence, foreign claims on China are limited and there is the policy option – when push comes to shove – for Chinese authorities to buy up bad debt in CNY, a policy response that is analogous to the US Troubled Asset Relief Program (TARP).

Second, most of the onshore debt is in the form of state-owned banks lending to SOEs or local governments. Hence, the possibility that Chinese interbank lending may freeze – in the way that it did post-Lehman in 2008 – is extremely low as the entities are state directed. Third, Chinese authorities have engineered a massive debt relief program by swapping local government financing vehicles (LGFV) bonds into municipal debt. This CNY9.5 trillion (US$1.4 trillion) municipal bond swap program allowed short-term, high-interest-rate debt previously issued by local government funding vehicles to be swapped with longer-dated, concessionary interest rate debt, at 120% of Chinese Government Bond (CGB) yields. The "new municipal bonds" are purchased by Chinese banks as eligible repo collateral. The LGFV-to-Muni bond swap successfully lowered the debt-servicing burden of local governments, and a similar policy for excess-capacity SOEs may also be contemplated.

Finally, most case studies of debt sustainability in highly indebted emerging economies have never dealt with a developing economy the size and with the influence of China. For instance, China has a large domestic savings base, sizable FX reserves, fiscal latitude, capital controls and flexibility in currency management along with a special drawing rights (SDR) currency status – which are policy levers not available to the typical emerging country. The point is, the rise of China challenges the very notion of what should be defined as an emerging market (EM) country, as China leapfrogged from nowhere to become the world's second largest economy.

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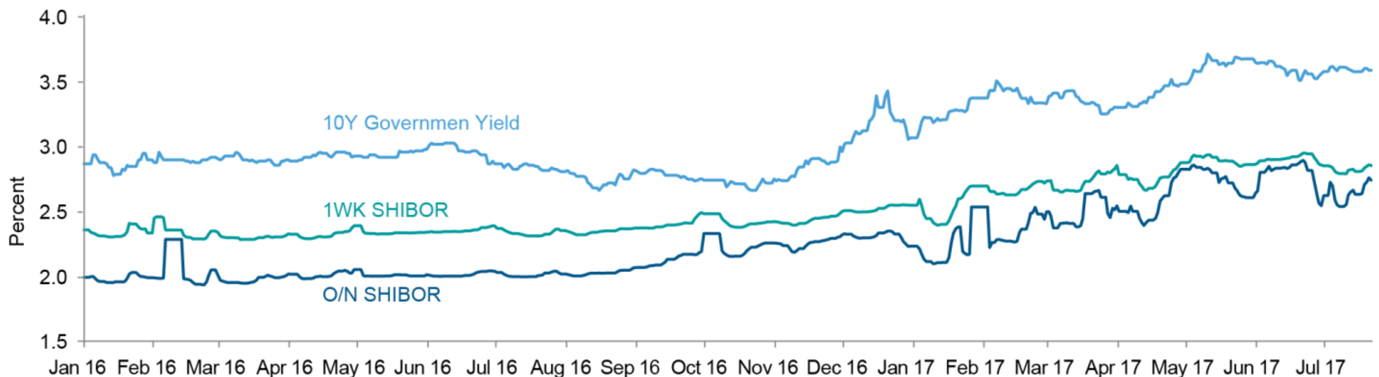
CHINESE AUTHORITIES ADDRESS DELEVERAGING

On April 25, President Xi Jinping stated that "financial security is an important part of national security and an important basis for the steady and healthy development of the economy." As China combats excessive leverage, there are fears that its efforts will result in a sharp falloff in economic growth and large defaults. Economic data over 3Q17 provide assurance and a robust backdrop to rein in leverage on a national scale. There has been a modest uptick in defaults: 80 onshore bonds defaulted in China in 2016, up from just 20 in 2015 and five in 2014. However, there has been little contagion as most of the debt issuers were smaller private companies in challenging industries.

In the Chinese banking system, it is true that non-performing loans (NPLs) have risen and there are continuing debates as to the true amount of non-performing loans (officially at CNY1.5 trillion or 1.7% of total loans outstanding). However, Chinese authorities have a number of levers to deal with the rise of bad assets. First, as a result of stringent regulatory policy, Chinese banks have elevated loan loss reserves that currently cover existing NPLs by over 180%. Second, Chinese banks are quite profitable by global standards with return-on-equity in the mid-teens; they generate CNY3.3 trillion (approximately US$492 billion) of pre-provisioning operating income on an annual basis. Last, the vast majority of China's bank lending is backed by collateral (usually real estate) which has appreciated over time. Underlining our view, Moody's recently changed its outlook on the Chinese banking system from negative to stable, citing "The revision reflects our expectations that nonperforming loan formation rates will be relatively stable at current levels," and "…based on our assessment that the government's adoption of more coordinated policy measures to curb shadow banking will help mitigate asset risks for banks, and address some key imbalances in the financial system."

In addition to the regulatory efforts, the People's Bank of China (PBoC) has been successfully tightening liquidity, and local money rates have been firming, since the beginning of 2017. As a consequence, Chinese Government Bond (CGB) yields have risen by 50 – 60 basis points (bps) year-to-date (YTD) (Exhibit2).

Exhibit 2: CNY Rates Firming, Leaning Against Bubbles



Source: Bloomberg, As of 21 Jul 17. WK=week, O/N=overnight, SHIBOR=Shanghai Interbank Offered Rate.

We view both these developments as reflective of a deliberate policy shift by monetary officials to address potential financial risks associated with asset bubbles. By guiding interest rates higher, the authorities are working with financial institutions to reduce excesses in the shadow banking arena, such as wealth management products and entrusted loans.

Finally, the combination of moral suasion and monetary tightening seems set to be enhanced. During the recent National Financial Work Conference, which convenes only once every five years, President Xi is believed to have instructed China's SOEs to lower their debt levels. This may entail the creation of a new financial super-regulator (with the PBoC playing a bigger role) to rein in mounting risks in the SOE sector. China's financial regulators have continued to tighten supervision and regulation. In 1Q17, the PBoC formally included banks' off-balance-sheet Wealth Management Products (WMPs) in its Macro Prudential

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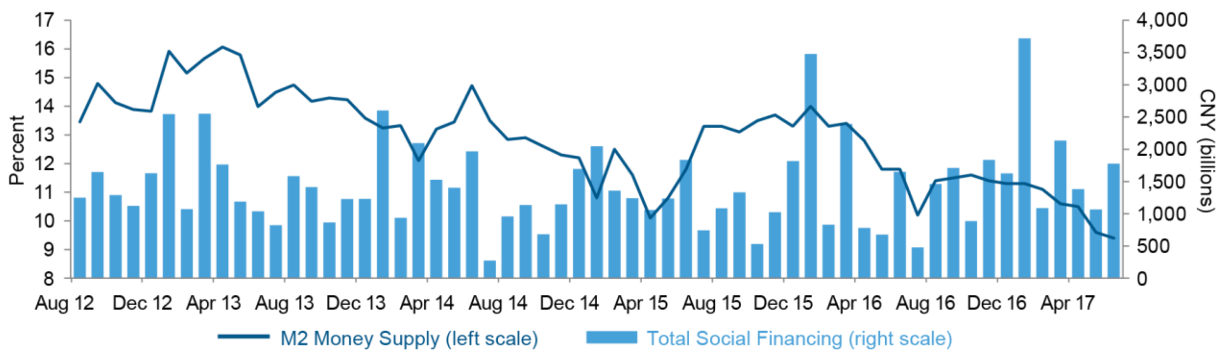
Assessment (MPA) indicators. The China Banking Regulatory Commission (CBRC) introduced a set of stringent directives requiring banks to be more conservative in their loan classification, speed up NPL disposal, raise capital and closely monitor Special Purpose Vehicles (SPVs) and WMP businesses. Recently published BIS data suggested modest deleveraging in the corporate sector, and the PBoC has also successfully lowered its M2 and Total Social Financing (TSF) growth rates (Exhibit 3).

Exhibit 3: Slowing Key Lending and Liquidity Measures



Source: Bloomberg. As of 30 Jun 17.

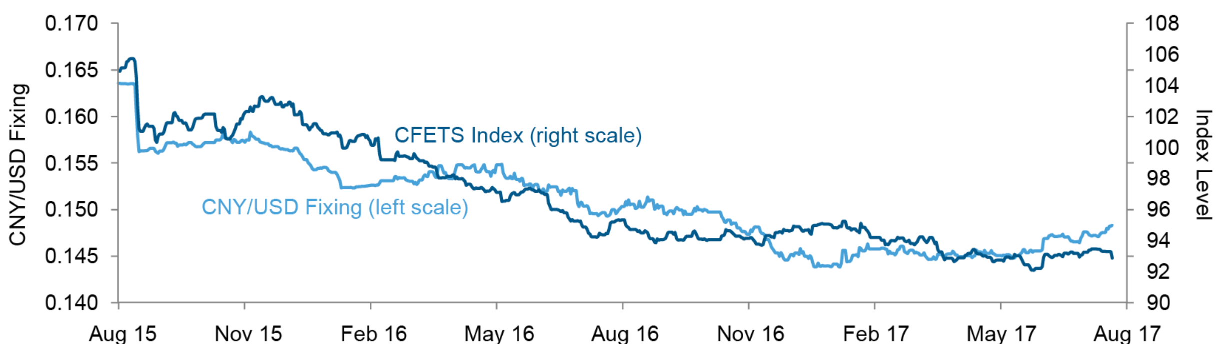
Our view is that the Chinese authorities will conduct the deleveraging exercise in a controlled manner, so as not to jeopardize the proper functioning of the financial system and risk a hard landing for the economy. Indeed, in the run up to the all-important 19th National Congress of the Chinese Communist Party later this year, macro stability is of paramount importance. That stated, we are closely monitoring the policy tightening to determine if there are policy missteps, unintended consequences or negative spillovers.

THE YUAN AND THE RISK OF CAPITAL OUTFLOWS

The PBoC fixes the USD versus CNY exchange rate based on a China Foreign Exchange Trade System (CFETS) trade-weighted basket (consisting 24 currencies) daily at 9:15 a.m. in Beijing. This year, up to May 2017, the CFETS basket had depreciated to a low of 92.09 from 94.82.

However, at the end of May, the PBoC introduced an unspecified “countercyclical factor” in the CNY fixing mechanism to counter speculative devaluation pressures. Subsequently, the CFETS basket has appreciated to above 93 (Exhibit 4).

Exhibit 4: CNY/USD vs CFETS Basket Fixing



Source: Bloomberg. As of 21 Jul 17.

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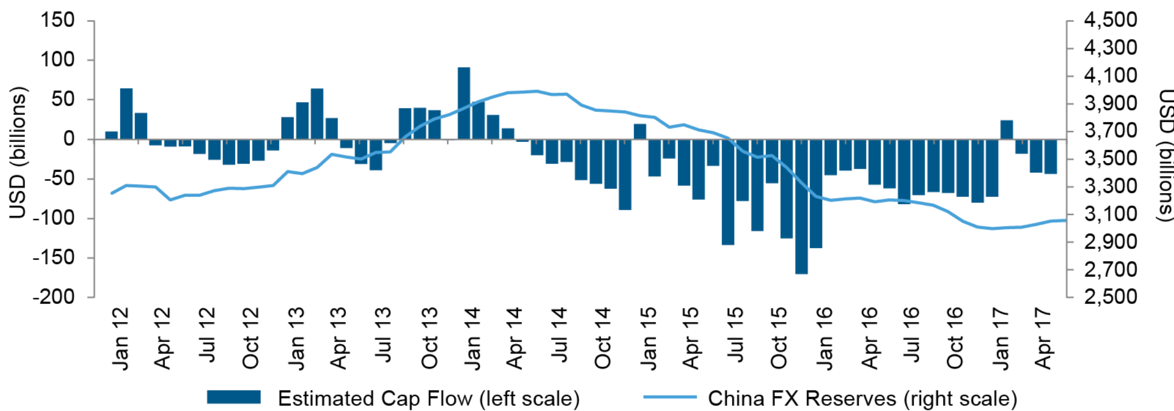
Fundamentally, with tightened capital controls, we think the CNY should remain relatively firm on a trade-weighted basis, buffeted by China's large trade surpluses, relatively high economic growth and interest differentials to developed currencies. The CNY's bi-lateral direction versus the USD will be largely dependent on broad USD trends, particularly versus the EUR, given the eurozone is China's second-largest trading partner (and second-largest weight in CFETS, at 16.3%). With relatively attractive bond yields of 3.5% to 4.0%, we expect the Chinese yuan to be an outperformer in developed Asia local currencies on a total return basis.

Since capital outflows peaked in December 2016, the State Administration for Foreign Exchange has gradually tightened controls on capital outflows including making it onerous for individuals to convert their CNY (limit of US$50,000) to foreign currencies. In mid-June, the CBRC asked banks to conduct risk analysis and check loans to large private companies including Dalian Wanda, HNA Group, Fosun and Anbang Insurance which were active in large offshore acquisitions. Recent data show that capital outflows have stabilized around US$40 billion per month but some studies suggest the impetus for Chinese companies and individuals to move funds overseas remain strong – slowed only by tighter capital controls (Exhibit 5).

Exhibit 5: Tighter Capital Controls and a Stable CNY Have Helped Stem Capital Outflows



Source: Bloomberg. As of 30 Jun 17.

However, it is worth noting that the Chinese USD hoard is extremely large and well in excess of their liabilities. According to IMF data from December 2016, China's net foreign assets, excluding PBoC FX reserves, stood at around US$3.4 trillion, including onshore FX deposits of US$780 billion and offshore FX deposits and portfolio investments of US$532 billion. While we are mindful that the Chinese love affair with offshore assets may represent prudent diversification, in our assessment, a substantial amount of speculative USD demand is in play as well.

OPPORTUNITIES AND RISKS FOR FIXED-INCOME INVESTORS

Less than 2% of China's US$9 trillion bond market (third-largest in the world) is currently owned by foreigners. The latest program aimed at enticing more foreign money into the local bond market is "bond-connect." This is modeled on the existing "stock-connect" plan, and would allow foreign investors to buy onshore Chinese bonds via Hong Kong. Bond-connect should be a more flexible and convenient channel than the existing programs (e.g., QFII, RQFII and CIBM) because the Hong Kong Monetary Authority (HKMA) will act as a custodian via its Central Moneymarkets Unit (CMU), so foreign investors do not have to set up trading accounts with onshore Chinese market makers. In addition, the bond-connect program should ease some foreign investors' concerns that in a crisis, China may impose capital controls to prevent them from repatriating funds. Hong Kong's commitment to free capital mobility has a long track record, credibility and the free operation of the stock-connect program has set a strong precedent.

China's onshore bond market has gone through a significant adjustment in yields – CGB bond yields have risen 50 – 60 bps YTD as the authorities' tightened liquidity to combat excessive leverage. For the foreign investor, the combination of higher China bond yields, potential bond index inclusion, currency stability (including SDR status)

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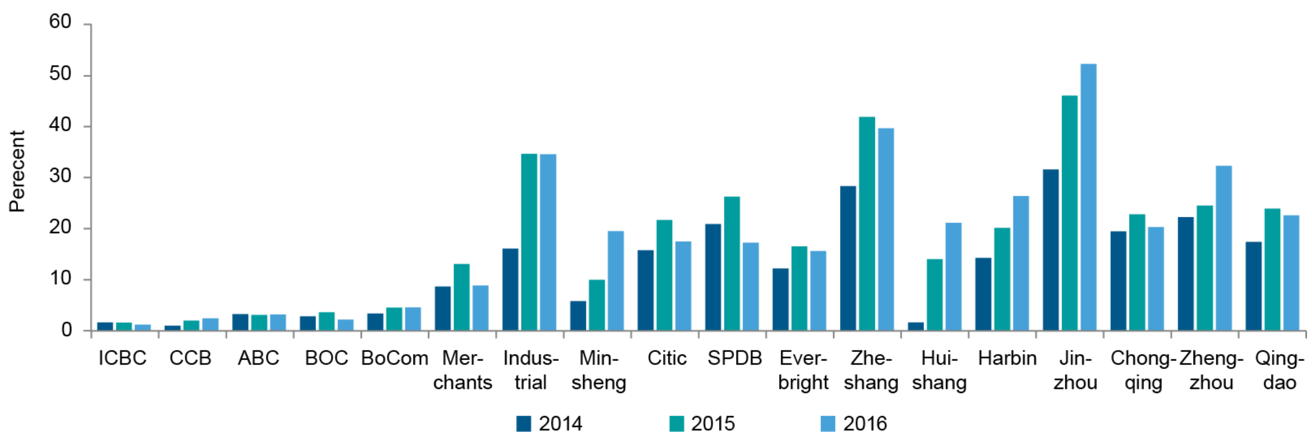
and new innovative programs to easily invest in the huge onshore bond market could make the next six months an attractive time to invest in China bonds, starting with CGBs and policy financial bonds (PFBs), issued by policy banks.

For investors that remain cautious of China, we believe that macro trades betting on a replay of the "Lehman-style" meltdown in China are unlikely to be profitable. As we have explained earlier, Chinese authorities have sufficient policy tools to manage the magnitude and pace of deleveraging without sending the economy into a tailspin. That stated, President Xi is pursuing an aggressive and wide-ranging deleveraging program which may weed out weaker and more highly leveraged private companies and less strategic SOEs. Therefore, strategies focusing on the avoidance of micro idiosyncratic risk will be more fruitful than a bearish China macro overlay like shorting the CNY/CNH. To illustrate, Exhibit 6 shows that the balance sheet holdings of Wealth Management Products (WMP) vary widely among Chinese banks.

Exhibit 6: Chinese Banks – Investment Receivables (% of Total Assets)



Source: Company Reports, Nomura. As of Sep 16.

The major Chinese banks have 2% – 3% of WMP on their balance sheets while for smaller and regional banks, WMP can be as high as 40% – 50% of balance sheet. Therefore, it is not useful to generalize regarding Chinese banks' exposure to WMPs and suggest a systemic risk. The emphasis in our credit strategies has been on judicious credit selection and hence, our core holdings are in bonds issued by China policy banks, the five major banks and their leasing subsidiaries, while avoiding the highly exposed regional banks.

USD-denominated bonds issued by Chinese Tier-1 SOEs (e.g., Sinopec and State Grid) offer a pickup of 30 – 60 bps over similarly rated global credits due to concerns by some global investors over the supply pipeline and transparency. However, bonds by these SOEs and strong investment-grade Chinese issuers are well supported by captive demand from Chinese bank treasury, exporters and high net worth individuals with large offshore USD holdings. Our credit preference has been for centrally owned, strategically important SOEs and strong investment-grade private companies while avoiding most high-yield private issuers. To underline the micro idiosyncratic risk of Chinese high-yield issuers, prices of bonds issued by companies such as Dalian Wanda, HNA Group and Fosun dropped by more than 10 points in mid-June after the news that they were singled out by CBRC for large offshore acquisitions.

Chinese investors have substantial USD holdings, well in excess of their liabilities due to widespread expectations of a stronger USD and capital flight. If this mindset changes (albeit slowly) over a period of CNY/CNH stability or appreciation, pent-up demand coupled with recent moves to include Chinese "A" shares and China bonds in mainstream indices could drive the CNY/CNH significantly stronger. With relatively attractive bond yields of 3.5% to 4.0%, we expect the Chinese yuan to be an outperformer (on a total return basis) relative to other developed Asia local currencies.

From a risk perspective, we are cognizant that the fixed-income investment opportunities that we have highlighted in China rest strongly on Western Asset's central scenario of benign global interest rates, Fed balance sheet reduction and US President Donald Trump politics. As attention

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switches from the economy to politics as we approach the 19th Party Conference this fall, questions vary from how President Xi will manage the Standing Committee transitions, with five out of the seven members expected to retire this year, to his intentions after 2022 when his second term ends. Also, in the background remains the delicate issue of North Korea, which presents a “known-unknown” geopolitical risk of immense negative impact if a large-scale military conflict were to breakout in the Korean peninsula. While we do not expect any major unsettling outcomes from the Party Conference, we remain concerned about the North Korean situation and will watch warily, feeling confident only in that no one knows how this will play out.

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