Research Note
October 2014

China: Prepare for Stress

Investors should be prepared for increasing stress in China that will impact global markets and create opportunities

- There are several valid reasons why China may avoid a financial crisis or hard landing given the unique characteristics of the Chinese economy. However, investors should not be complacent.
- Our view is that the Chinese economy will slow more than the consensus expects as the authorities grapple with credit excesses and implement structural reforms. While China may indeed avoid a crisis, slowing growth and rising uncertainty will negatively impact global markets.
- Chinese policymakers can support the banking system and boost the economy via aggressive monetary easing, but the current administration seems reluctant to do so, heeding the lessons of Japan. China will be confronted with periodic flashpoints and a start-stop path of credit tightening, slowing growth, and defaults followed by policy easing and cyclical recovery.

We must boost our confidence, adapt to the new normal condition based on the characteristics of China's economic growth in the current phase and stay cool-minded.
–President Xi Jinping, as quoted by Xinhua News Agency, May 10, 2014

"Keep calm and carry on." That seems to be the message from China's leadership as they seek to assure citizens and investors alike that despite slowing growth the Chinese economy can weather any upcoming storm.

Our view is that investors should not be complacent. The Chinese economy will continue to slow as the authorities grapple with credit excesses and implement structural reforms. The next 12 months or so are particularly challenging, as maturities in the shadow banking system peak and the housing market weakens amid oversupply, adding to existing downward pressure on the economy. While China may indeed avoid a full-fledged financial crisis as policy-

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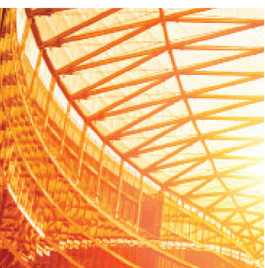


makers are forced to act, slowing growth and rising uncertainty will negatively impact global markets.

In this research note we discuss the issues facing the Chinese economy and why we think investors should prepare for stress. China must make the hard choice of taking economic pain now to be better placed over the long term, or run the risk of "turning Japanese" with even more dire consequences. We will also discuss where we might be wrong in our outlook and the investment implications of our view.

Can China Avoid a Crisis?

Recent months have seen much commentary debating whether China is heading for a financial crisis or a so-called hard landing.

The bears argue that the situation in China—slowing growth, soaring debt, cooling property prices, and rising defaults—seems eerily reminiscent of that in Asia and other emerging economies in the late 1990s and in the US economy heading into 2007. Too much debt has accumulated too quickly, which has historically resulted in some sort of financial accident.[1] China has seen private credit as a percentage of GDP rise by at least 80 ppts since 2008, reaching at least 210% of GDP by second quarter 2014 based on official data (Figure 1).[2]

While the level of debt isn't particularly extreme, the rate of increase is; according to Morgan Stanley, over the past 50 years there have been 33 cases of extreme "credit gaps" in developing economies (defined as an increase in credit to GDP greater than 40 ppts over a five-year period). Of these cases, 22 resulted in a credit crisis, while all suffered very sharp slowdowns in growth. Only five countries have had credit gaps similar to China's, and all of them have suffered some form of crisis.

More bullish observers cite the following reasons for believing China can avoid a crisis:

- Government policy has been a primary driver of the current growth slowdown and the authorities can "fine tune" the economy and prevent growth from slowing too sharply by easing monetary policy and applying fiscal stimulus.
- Restrictions on house purchases and financing for individuals and developers can be relaxed and the property market will rebound.
- Chinese households have low levels of debt, and the housing market is not highly levered.
- The debt problems are mostly in state-owned enterprises (SOEs) and the local government sector, which the government will not let default.

[1] Please see Moritz Schularick and Alan M. Taylor, "Credit Booms Gone Bust: Monetary Policy, Leverage Cycles and Financial Crises, 1870–2008," *American Economic Review* 102, no. 2 (April 2012): 1029–1061.

[2] This is based on the "Total Social Financing" data series produced by the People's Bank of China (PBOC), which includes bank loans and other forms of private lending such as trust loans, but excludes government debt. Other estimates of private credit in China result in even higher figures depending on estimates of local government debt and other forms of off–balance sheet lending.

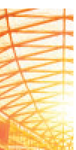
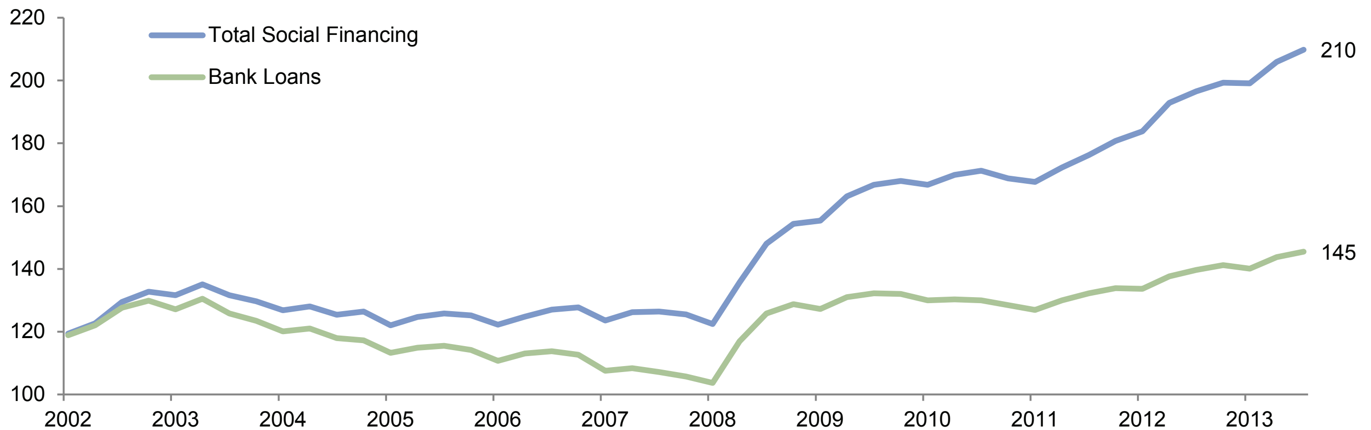


Figure 1. China Private Sector Credit as a Percent of GDP
Fourth Quarter 2002 – Second Quarter 2014 • Percent (%)



- The major state-owned banks are well capitalized and even if defaults rise, the government will not let them go under. There will not be a Lehman Brothers–type failure and panic.
- The Chinese central government has low debt and massive foreign currency reserves and therefore has the resources to bail out the financial system.
- China runs a current account surplus and is not reliant on foreign fund flows. China's closed capital account protects the financial system from outflows.
- The Chinese authorities have successfully steered the economy through many challenges and similar debt problems in the past, and have the ability to do so again.

Given these characteristics, many observers consider China to be quite different from most emerging markets—it lacks dependence on foreign capital flows, and the sheer size of its domestic economy allows it to drive its own growth. This makes comparisons with other Asian economies in the 1990s inappropriate and means there is little risk of a currency crisis.

More bullish commentators also see comparisons with the US housing and subprime boom as inappropriate because households are not overleveraged and neither is the banking sector (deposit-to-loan ratios are high). China's debt has gone toward assets that have some productive value (infrastructure and factories) and not toward consumption. China's banks are also less interconnected globally, so any financial panic will not echo through the global financial system thanks to the closed capital account.

Underpinning the "soft landing" view is a belief that the authorities have the tools, means, and ability to control or "contain" any financial fallout. In other words, a crisis cannot happen because the Chinese Communist Party will not let it happen.

Our View: Prepare for Stress

We agree that the structure of the Chinese economy is very different from that of a typical emerging market, and quite different from a market-driven developed economy. Many of the points advanced for why China can avoid a crisis or hard landing are valid.

However, in our opinion, much of the hard landing/crisis debate is somewhat irrelevant and misses an important point for investors — markets react negatively to uncertainty, and signs of economic stress in China will rattle global markets, even if a full-blown crisis is ultimately avoided. A "crisis" is a subjective term and only known after the fact.

Our view is that the Chinese economy will continue to slow and face periodic flashpoints as the authorities grapple with previous credit excesses and implement structural reforms. The next 12 months or so seem particularly challenging, and we see several reasons why investors should prepare for stress.

The New Leadership Is Reluctant to Stimulate the Economy. The current leadership is comfortable with, or at least fully acknowledges, the need for the Chinese economy to slow and reduce its reliance on investment-led (and therefore debt-driven) growth. The reform agenda announced last November emphasized the shift toward benefiting the household and service sectors at the expense of the SOE and industrial sectors. The leadership is reluctant to stimulate the economy lest it further aggravate current excesses. Economic conditions will likely need to deteriorate and financial stress escalate before policymakers feel compelled to step in.

June 2013 provides an example of how markets may need to panic first before the government steps in. The PBOC allowed interbank rates to surge as part of a crackdown on "shadow banking."[3] This triggered a mini-panic that saw Chinese equities tumble 20%, bank stocks get clobbered, and the Australian dollar and commodities fall 15%, while flows out of emerging markets equities accelerated. Following this adverse reaction, the PBOC stepped in to ease rates and the authorities announced they would expedite pre-approved plans for more low-cost housing and high-speed rail construction. In other words, the government would step in to soften the blow, but not enough to accelerate growth. This pattern has repeated so far in 2014: after rising interbank rates and slowing growth early in the year saw Chinese equities sell off, the authorities eased rates and announced other small projects to boost sentiment, all while reminding investors that they are comfortable with slower growth.

Underlying the central government's actions is a plan. The plan is to squeeze shadow banking credit channels in order to place assets and liabilities back onto regulated bank balance

[3] "Shadow banking" refers to lending and financing activity that takes place outside of the formal banking sector. This sector has grown rapidly over the past few years as loan quotas and caps on deposit and lending rates encouraged off–balance sheet lending.

sheets to better manage defaults and possible asset sales. At the same time, targeted, controlled defaults will occur in sectors with excess capacity (generally mining, metals, and construction).[4] These defaults will occur mostly in smaller private companies, not SOEs or local governments directly, although trusts funding these entities may default (and therefore place the burden on either banks or high-net-worth investors). Through various supply-side reforms and fiscal transfers the central government will seek to shore up local governments' finances by reducing reliance on land sales and shadow banking. Liberalization of the financial system will also slowly occur to encourage better risk-based lending and reduce the accumulation of further bad debts. Policymakers will use targeted fiscal spending as well to keep GDP growing at an acceptable rate to help "socialize" the credit losses via the state-owned banking sector and central government.

Policymakers take some comfort in their ability to achieve a smooth transition given their success in handling China's previous credit boom and bust in the 1990s. The rapid growth in the late 1980s and early 1990s also saw the accumulation of debts in the SOE sector that ultimately burst following the 1998 Asian crisis. By the early 2000s non-performing loans (NPLs) had reached 30% of bank assets by some estimates. To tackle this, the government set up four asset management companies (AMCs), one for each major bank, to dispose of the NPLs.

[4] Tim Hope et al., "Chinese Credit Problems Arise," Cambridge Associates Research Brief, April 8, 2014.

Effectively, the bad debts were removed from the banking system and transferred to the AMCs (often at close to 100 cents on the dollar), on the assumption that a growing Chinese economy would make the ultimate costs of the debt write-downs manageable. This strategy worked as growth in China boomed the following decade.

While China's policymakers have confidence in their ability to navigate the current challenges, rarely do things go according to plan, and the issues facing China today are more complex than 15 years ago.

Hidden Leverage in China Results in Underappreciated Linkages and Unintended Consequences. Of major concern is the scale and complexity of China's debt problems. While on some measures the size of bad debts relative to the size of Chinese economy is smaller than in the 1990s, this does not capture the off–balance sheet debt outside of the traditional banking system. Non-bank financing was negligible a decade ago. The fact that much of the riskiest debt exists outside the banking system in the form of trust products, wealth management products (WMPs), local government financing vehicles (LGFVs), and other forms of "shadow banking" means the government has less control over the financial system. The PBOC has recently cracked down on growing offshore leverage by Chinese companies betting on renminbi appreciation and on commodity-collateral financing deals, where imports of industrial metals (especially copper) have been pledged for loans. This type of leverage is not readily captured in official statistics.

Of similar concern is the growing level of receivables, bankers' acceptance notes, and inter-company loans on corporate balance sheets. Cash flow has turned negative for many companies as the business cycle has slowed and credit has tightened. Effectively, Chinese companies are finding it hard to pay their bills amid a liquidity squeeze, creating "triangular debt" where several firms owe each other. Many of these receivables, particularly in the construction and building equipment sectors, will need to be written off in part or in whole.

The inter-linkages in the Chinese financial system are most prominent in the WMP and trust lending sectors. Retail investors have piled into WMPs in search of yields greater than those offered by regulated bank deposits. Many of these products invest in money market–type instruments that are indeed safe and liquid. But there is also exposure to less liquid, longer maturity loans to trust companies, which themselves have invested in opaque higher-risk, high-yield loans to companies or local government projects. Given the maturity mismatch, WMPs must be continuously rolled over to generate liquidity and funding for trusts.[5] The risk is that a continued government clampdown on shadow banking and WMPs reduces funding for trust loans, triggering defaults, or that defaults in trust loans will ripple through WMPs, triggering retail investors to abandon the products, further exacerbating defaults.

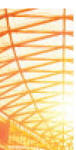
[5] Tim Hope et al., "A Matter of Trust(s): Chinese Banks' Wealth Management Products," Cambridge Associates Research Brief, May 16, 2014.

While retail deposits would likely return to the banking system (and thus not necessarily trigger a liquidity squeeze for banks), losses would eventually need to be borne by the banks and other investors, ultimately weighing on credit growth.

The reliance on new credit to roll over existing debts is the key issue facing China, and partly explains why a large increase in debt-to-GDP has failed to boost growth—new debt is not being put to productive use.

Trust loan defaults are likely to be a source of stress over the next 12 months. Public data put the total size of the trust industry assets at RMB 11.1 trillion ($1.8 trillion), or 19% of GDP. Yet these figures are acknowledged not to be truly comprehensive. Based on the public data, the end of 2014 and early 2015 will see the peak in trust maturities, and therefore a likely spike in defaults. Credit Suisse estimates that ¥1.5 trillion in trust assets will need to be rolled over in first quarter 2015, while Haitong Securities estimates that RMB 5.8 trillion in principal ($943 billion) and RMB 0.5 trillion in interest payments ($81 billion) will come due in 2015. While 2014 was supposed to see the peak in trust maturities, many have been rolled over from this year into 2015, creating even more of a financing burden in 2015.

While the Chinese government has done an admirable job trying to shed light on the debt exposures, the opaqueness of the system creates its own issues of uncertainty. The true size of the debt problems is unknown; estimates of potential bad loans range from under 10% of GDP to over 30%. And while bad debts can be

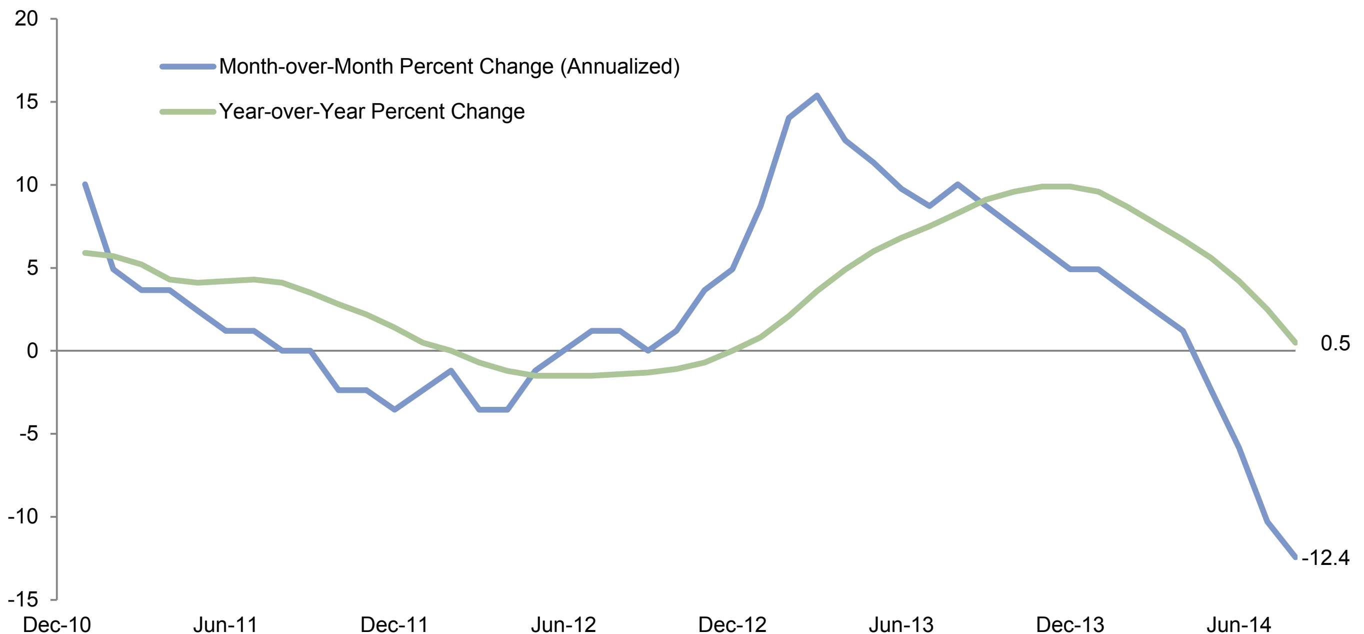


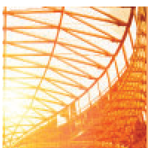
rolled over for an extended period, lack of clarity on how the government will tackle the debt issues, and how the losses will ultimately be borne, will continue to weigh on the financial system.

The Weakening Property Market Will Weigh on Growth. Further complicating the debt situation is the weakening property market. Property is often used as the collateral for loans, both official and unofficial, and anecdotally single properties are being pledged multiple times for different loans. The issue isn't the household sector; most households have limited leverage and mortgages require high down payments. The concern is highly leveraged entities such as property developers and local governments that rely on property sales for revenues.

The past few years have seen an oversupply of residential housing units in many areas of China, amid a mismatch in supply and demand for affordable housing and high-end housing stock. Oversupply is forcing developers to cut prices to boost volumes (Figure 2). The risk is that falling property prices become self-fulfilling, in that lower prices condition homebuyers to wait for lower prices, further squeezing developers that have halted new housing construction. Given estimates that housing construction and related activities account for 25% of Chinese GDP, a prolonged housing slump would have serious growth implications. While several local governments have eased restrictions on property (and banks have been told to increase mortgage

Figure 2. New House Prices
December 31, 2010 – August 31, 2014 • Percent (%)





lending), many expect the central government to allow further price declines to improve affordability and the supply/demand balance. Even if restrictions are lifted, meaningful new construction is unlikely to occur given current imbalances. Uncertainty over the property market could be a key trigger of stress.

Financial Liberalization Is a Double-Edged Sword. China's control over the banking system and capping of lending rates allows it to control defaults. The closed capital account keeps money within the system, which protects banks from deposits moving overseas, but creates trapped excess savings chasing yield. Misallocation of trapped domestic savings is an important source of excess investment and debt. Opening of the capital account is needed to move to a truly liberalized, competitive financial system, but doing so could provide a mechanism for a liquidity crunch and capital flight. A too-rapid opening of the capital account could easily trigger a financial crisis in China, making financial and capital account liberalization likely to be implemented very slowly until the debt issues are resolved.

FX Reserves Cannot Readily Be Deployed. Many commentators cite China's $4 trillion in FX reserves as the ultimate reason not to worry about a financial crisis—China has more than enough money to pay off bad debts. However, this appealing logic misunderstands the nature of FX reserves, which are to support a currency amid capital outflows. Every dollar in FX reserves corresponds to a liability on the central bank's balance sheet that reflects a capital inflow. For instance, if China were to open its capital account and funds were to flow out of the country, the PBOC would have to spend down its reserves to prevent a sharp decline in the currency. If China decided to draw down its reserves to bail out its banking system, this implies selling US dollars and euros to purchase renminbi, which would put upward pressure on the currency, potentially hurting growth. It would also represent a *de facto* draining of liquidity from the banking sector, which could increase stress. While some portion of China's FX reserves exceeds currency management needs and could be deployed domestically, the full $4 trillion is not available to spend.

Growth May Slow Sharply Even If a Credit Crisis Is Avoided. Even if a financial crisis is avoided as the banking system writes down bad debts and is supported by injections from the central government, Chinese economic growth may continue to slow, as excess capacity and investment are weighing on much of China's corporate sector at the same time that China's structural growth rate is naturally slowing due to peaking demographics and the diminishing returns from capital investment and urbanization.

At only 38% of GDP, consumption cannot replace investment as the driver of the economy in the near term (Figure 3). Notably, consumption has been growing briskly for years—China does not underspend, it overinvests! Slowing investment will continue to weigh on GDP growth, making consensus estimates of 7%

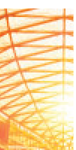
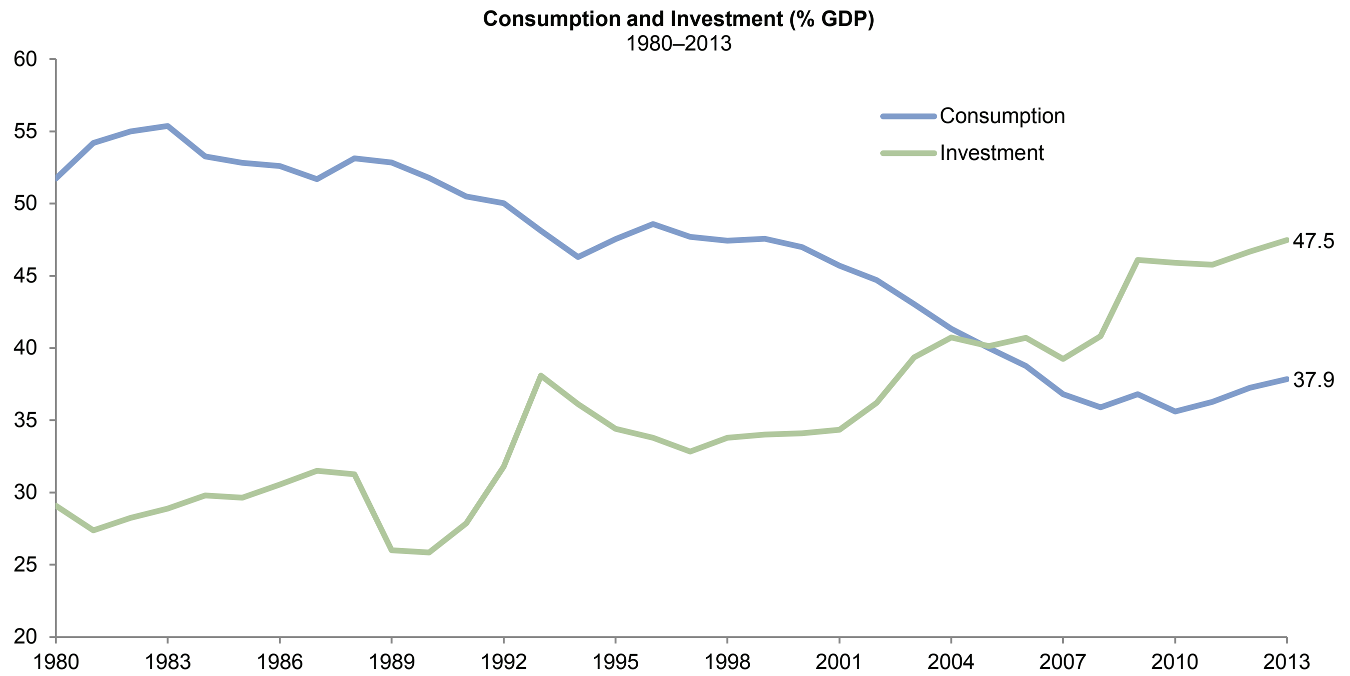
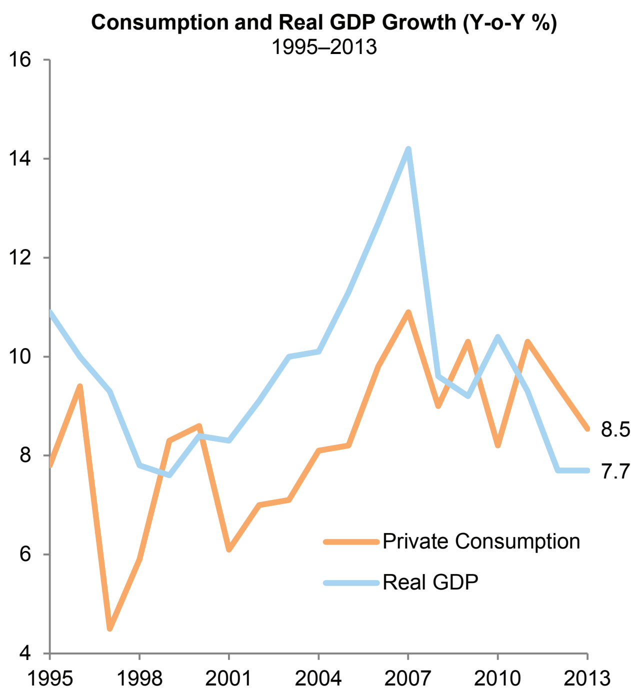
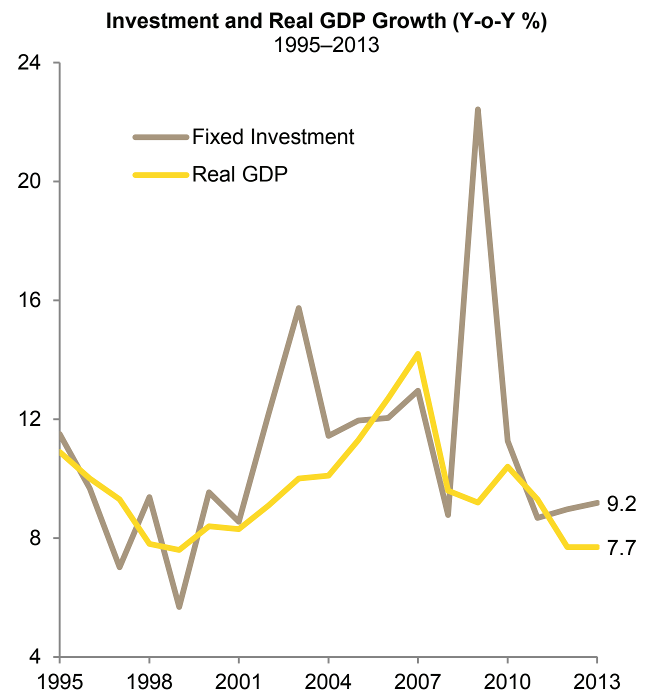
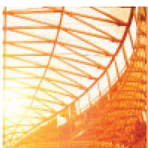


Figure 3. China Consumption and Investment









GDP growth over the next few years difficult to achieve. Indeed, 7% may be the new growth ceiling, rather than floor. According to Morgan Stanley, GDP growth typically slows to more than half its previous pace in the five years following an extreme credit surge, with a median growth differential of -5 ppts for emerging markets economies.[6] Thus Chinese real GDP growth of under 5% over the next few years is possible amid a steady decline in investment. While this sounds drastic, it is more a reflection that previous growth was overstated, and such an outcome could still coincide with resilient consumption growth and rising living standards, which is ultimately what the authorities want to achieve. Recall that until just recently it was widely believed (and promulgated by officials) that unemployment and social strife would quickly rise if GDP growth fell below 8%. Yet a rapid rise in unemployment has yet to occur despite GDP growth approaching 7%.

Some commentators argue that official statistics understate consumption and that it is a much larger part of the economy. This is undoubtedly true, given the large "grey economy" in China. However, this suggests that the possibility for continued strong growth in consumption may also be overstated and less able to offset investment demand in the near term.

[6] Steven Quattry, "The Overlooked Risk of Credit Booms," *Morgan Stanley Investment Management Journal* 4, no. 1 (January 2014): 3–20.

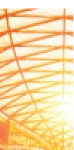
Lessons from Japan

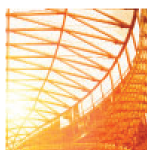
If the growth outlook deteriorates along the lines we have just outlined, wouldn't Chinese policymakers simply ease policy and stimulate to avoid such a slump? This is possible, if not probable. But by doing so, China runs the risk of "turning Japanese."

In our opinion Japan's post-bubble experience is the best lens through which to view China today. Over the 1980s and early 1990s the Japanese economy suffered from excess investment, an overleveraged corporate sector, a property bubble, and a banking system based more on relationships than credit quality. Policymakers (especially the Ministry of Finance and Ministry of International Trade and Industry) were widely perceived to control the economy and banking system, and were believed to be able to ensure that Japan would avoid a financial crisis.

And Japan did largely avoid a financial crisis after its bubble popped in 1989. Over the next decade a few small financial institutions went bust, NPLs rose, and big banks were forced to merge (especially in 2001), but there were no widespread defaults. Debts were simply rolled over to support "zombie companies" and maintain employment levels while government spending increased to offset retrenchment in the corporate and household sector. Instead of a financial crisis, Japan suffered a growth crisis, which continues today.

The main lesson from Japan is that while a financial crisis can be circumvented by avoiding or delaying debt write-downs and restructuring,





the cost is a steady decline in growth along with an economy and asset markets reliant on stimulus. While "social stability" is maintained, vitality is sapped from the economy. The risk for China is that unlike Japan, its economy and households are relatively underdeveloped. Thus, while an affluent Japan has been able to tolerate a stagnant economy for two decades (as real living standards have been maintained amid deflation), China's population may not be so patient.

China's leadership has studied Japan and realizes this dilemma, which is partly why they seem willing to force through reforms and take the pain now. Taking the pain now could lead to a more rapid recovery for China, which has some important advantages over Japan. First, China is less developed, so it still has scope to "grow" out of current problems before falling to Japan-like growth rates. Second, the domestic economy (and population) is larger than Japan, and thus is less reliant on external demand to absorb excess capacity. Finally, Chinese policymakers have been much more proactive today than Japanese policymakers were in the early 1990s. The downside is that China's imbalances are arguably bigger than what Japan faced, and the population more restless.

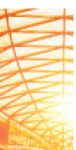
A Start-Stop Approach. Given the political realities, the temptation will be strong to try to mitigate the pain of economic reform. Chinese policymakers will most likely adopt a "start-stop" approach toward the economy, allowing growth to slow and losses to emerge, while periodically applying temporary stimulus to boost growth enough to keep employment steady. If the economy recovers and debt begins to rise, the brakes will be applied again until the deleveraging and restructuring cycle is complete. Arguably employment indicators will be more important for investors to watch than growth indicators.

The likelihood of this start-stop approach is a key reason for investors to prepare for stress, as it implies policymakers have a higher threshold for economic pain than the market expects. Taking some pain now and restructuring is preferable to dragging out the process and ignoring the lessons from Japan. But maintaining social stability will remain key for the Party and policymakers.

Where Could We Be Wrong?

Our views are based on the premise that the steps needed to slow credit growth and rebalance the Chinese economy will have unintended second- and third-order impacts that will create stress in the Chinese economy and slow growth more sharply than expected as well as negatively impact global markets, even if a full-fledged financial crisis is avoided.

Where could we be wrong? First, there is always the issue of timing. In recent months, actions have been taken to boost liquidity in the banking system and extend the wall of trust maturities. Chinese policymakers could be more sensitive to growth and willing to backtrack on the reform agenda and act aggressively to stimulate the



economy. Such action could trigger a powerful rally in China-sensitive assets. Of course, aggressive stimulus may in fact worsen structural issues, bringing into question how long-lasting such a rally would be, and increasing the risk of a Japan-like outcome.

Second, markets could also be adequately priced for stress in China. The biggest shocks come from risks that are unexpected or "unknown unknowns," and the issues in China are well known. While we still view markets as overly complacent, the impact from slowing growth and stress in China could be relatively mild or short lived, making global markets and China-sensitive assets adequately priced for the risks.

Finally, debt risks in China could be overstated, and sufficient firewalls could be in place to prevent any real spillover to growth from targeted defaults. Everything could go according to plan, as policymakers retain control over the economy. Yet this begs the question, how did the current problems grow so large if policymakers are always in control?

The deleveraging and reform process China must undertake is very complex and will take several years to accomplish. While a full-fledged financial crisis can certainly be avoided, accidents and periodic stress along the way cannot.

Implications for Investors

There are several implications for investors if our views are correct.

Markets Are Still Under-Discounting China Risks. While global volatility has risen, Chinese credit default swaps and other credit spreads remain below the spike seen last June amid the interbank rate scare and well below 2011 levels when fears of a Chinese hard landing last rocked the credit markets (Figure 4). Thus it is difficult to argue that financial markets have fully priced in a renewed "China-scare."

Industrial Commodity Prices Remain at Risk. Industrial metals are extremely vulnerable to a slump in Chinese investment. With China accounting for 50% of global demand for many industrial commodities, no other source can offset a substantial fall in Chinese imports. Recent demand has been distorted by commodity-collateral financing deals, the unwinding of which may dump more supply onto global markets. While prices for iron ore, copper, nickel, etc., have already weakened substantially from their 2011 highs, they are unlikely to have over-discounted a Chinese hard landing. The same can be said for the Australian dollar. While the Australian dollar has weakened recently, the currency remains overvalued by most metrics, and Australian exports are still heavily geared to China.

The impact on other commodity prices is less clear. Energy prices (oil and natural gas) are less reliant on China, while agriculture prices could remain supported by Chinese consumer demand.

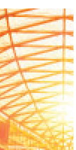
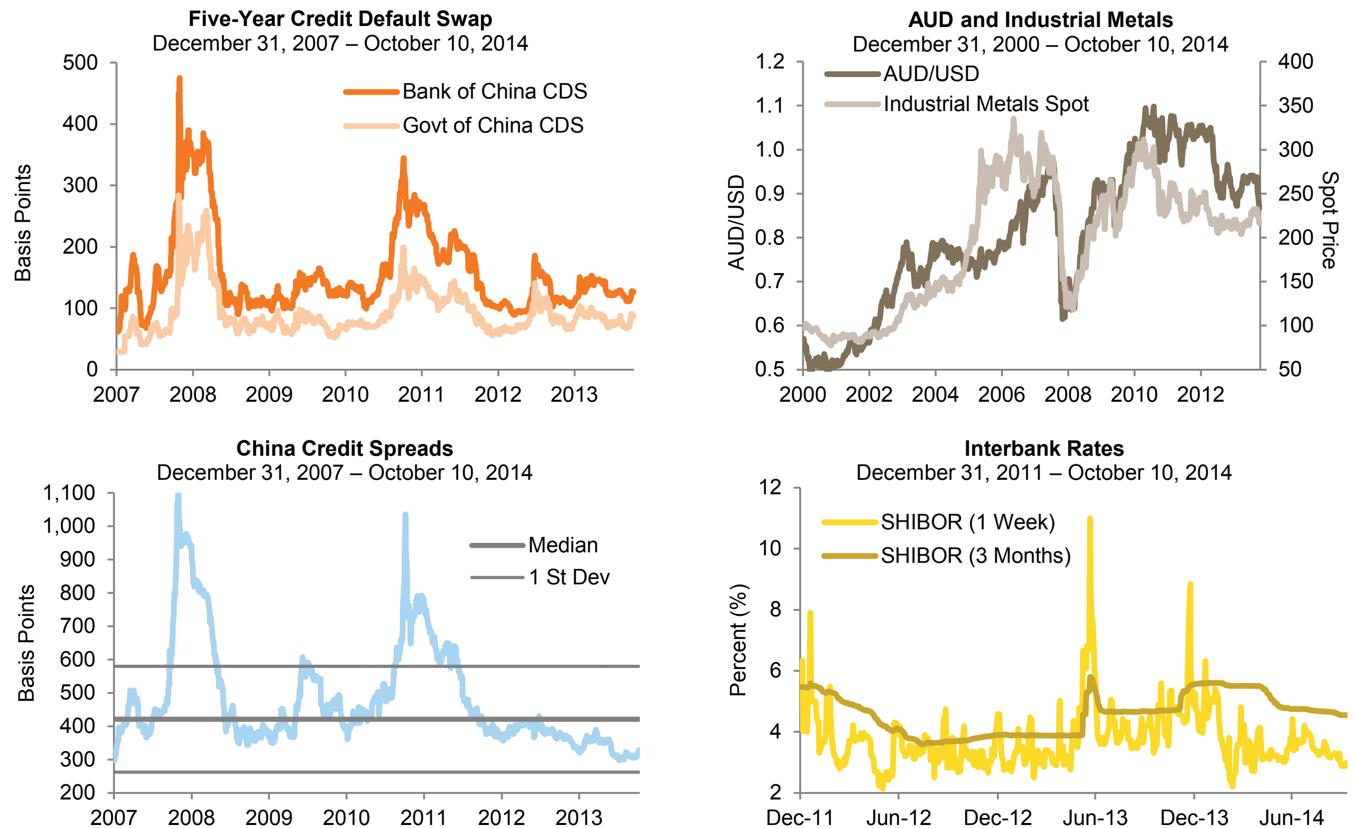


Figure 4. China Stress Indicators



Gold and precious metals could benefit from the market volatility. Still, given the risk-on and growth-sensitive nature of commodities, a China scare will negatively impact commodity markets.

Chinese and Broader Emerging Markets Equities Will Remain Under Pressure.

While valuations for emerging markets equities are low, they are not at recessionary or crisis lows. A renewed China scare would trigger additional selling and investor capitulation.[7]

[7] Celia Dallas and Aaron Costello, "Emerging Markets: Navigating Through Rough Waters," Cambridge Associates Market Commentary, February 2014.

Chinese equities offer near-record low valuations, but this is largely due to the financial and industrial sectors, which may be value traps in the near term. The longer the uncertainty over how China will deal with its debt issues, the longer the overhang over Chinese and broader emerging markets equities.

While the near-term headwinds for emerging markets and Chinese equities remain, valuations offer long-term upside and any panic-driven sell-off would represent a good entry point, including exposure to cyclical sectors. The valuation gap between investment plays and

consumption plays (and in China especially SOEs and private sector companies) is already extreme. At some point valuations will over-discount the headwinds, and relative valuations can narrow even amid slower growth, especially amid periodic rallies driven by stimulus, as Japan's post-bubble market has demonstrated.[8]

The RMB Will Remain Weak. While a sharp devaluation of the renminbi is unlikely given FX reserves and a closed capital account, the steady appreciation seen over the past few years will be halted. The PBOC has signaled to the market to expect more currency volatility, while any gradual opening of the current account may see net outflows from China that cap RMB upside.[9] A flat to modestly weak renminbi is a form of monetary easing needed to help offset weak investment demand.

China Will Be a Deflationary Force in the Global Economy. Slowing growth in China and easing commodity prices will continue to be a deflationary force in the global economy. A weak renminbi will also reduce import price inflation for China's trade partners. This is in contrast to recent concerns that China would begin to export *inflation* as the renminbi, wages, and demand for commodities rose.

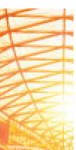
Global Bond Yields Will Remain Low. The deflationary forces from China will keep global bond yields low, both via lower growth and inflation and rising risk aversion. A China scare could also halt or reverse any potential Federal Reserve tightening cycle, similar to 1998 when the Fed proactively cut rates to provide additional liquidity to US and global markets amid stress in emerging markets.

Capital Will Continue to Flow Back to Developed Markets. A China slump will likely accelerate capital flows back to developed markets, analogous to the aftermath of the 1998 Asian financial crisis. Fund flows from Asia to developed markets may continue even absent a China crisis, as the gradual opening of China's capital account sees domestic institutions diversify globally, while other institutions in Asia do the same. Chinese investor diversification will be a major theme over the coming years.

Credit Market Dislocations and Distressed Opportunities Will Emerge. Stress in China will create dislocations in Asian credit markets, resulting in increased "special situation" and distressed debt opportunities. While traditional fixed income markets (investment-grade and high-yield bonds) are not yet showing stress, opportunities currently exist in providing alternative, private equity–like financing to private enterprises across Asia as banks tighten lending.

In China specifically, private capital will be required to deal with NPL and SOE asset disposal, with the Chinese government already promoting "mixed ownership" as a vehicle for

[8] For more on the possibility of the Chinese equity market turning Japanese, please see our companion research note: Aaron Costello et al., "Chinese Equities: A Question of Timing," Cambridge Associates Research Note, October 2014.
[9] Aaron Costello et al., "Escalator Up, Elevator Down? Recent RMB Weakness," Cambridge Associates Research Brief, March 27, 2014.



SOE reform. Changes in Chinese bankruptcy laws will also help potential NPL disposals, and the major AMCs have already begun fund raising and working with foreign investors on select deals.

Opportunities Remain to Invest in the Next Phase of China's Growth. Despite the negative outlook for China's investment-driven growth model, opportunities remain to invest in the next phase of China's economic development, which will be centered on improving the quality of life for citizens. As discussed earlier, Chinese consumption can continue to grow despite an overall slowdown in GDP growth.

The government is encouraging investment in sectors such as clean energy, education, food safety, and health care. Additional investment is needed in logistics and technology to improve the efficiency of the service sector, which will remain the key driver of employment growth.

Many of these opportunities are better accessed through private rather than public markets and require longer time horizons. While valuations for many health care and consumer-related investments are far from cheap, these sectors have structural tailwinds. Still, valuations matter and investors need to choose opportunities carefully, especially in the frothy Chinese Internet stocks and late-stage venture space, which we view as unattractive. Any turmoil in Chinese financial markets will create opportunities for investors to gain exposure to "new China" sectors at lower valuations.

Conclusion

Much like the United States in 2007, the cracks in China's "subprime debt" are now showing and policymakers are reassuring everyone that financial stress can be "contained." This is rarely, if ever, the case. While China's immense size and relatively closed economy give it advantages over other emerging economies and even the United States, the country will not be immune from the negative impacts of deleveraging and excess debt. Growth in China will continue to slow.

Policymakers can support the banking system and boost the economy via aggressive monetary easing, but the current administration in China seems reluctant to do so, heeding the lessons of Japan. China will likely be confronted with periodic flashpoints and a start-stop path of credit tightening, slowing growth, and defaults followed by policy easing and cyclical recovery. The next such flashpoint could occur over the next 12 months as maturities in the shadow banking system peak and the housing market weakens amid oversupply, testing the resolve of policymakers. This does not mean a financial crisis is imminent or inevitable. Rather, odds are increasing that markets will react negatively amid rising uncertainty over China, even if a crisis is ultimately avoided. The timing and magnitude of any macro risk event is always uncertain, and the economic adjustment facing China will take years to play through. Policymakers may instead decide to act proactively and aggressively to boost growth in the near term. But investors should not fall into complacency, and should be prepared for increasing stress in China that will impact global markets and create opportunities. ■

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Exhibit Notes

China Private Sector Credit to GDP
Source: Thomson Reuters Datastream.
Notes: Total social financing (TSF) is the broadest offical measure of private credit in China and includes bank loans and off–balance sheet banking activities such as trust loans, entrusted loans, and bankers' bills. The gap between TSF and bank loans is a proxy for "shadow banking" in China. These figures do not include central government debt.

New House Prices
Source: Thomson Reuters Datastream.
Notes: Index based on the price indexes of newly constructed residential buildings in 70 large and medium cities published by the National Bureau of Statistics of China. The index uses a weighted average calculation, with weights based on the population of the 70 cities.

China Consumption and Investment
Source: Thomson Reuters Datastream.

China Stress Indicators
Sources: BofA Merrill Lynch, MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

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