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Investment Publications Highlights

CAMBRIDGE ASSOCIATES LLC

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"Risks Rising of a Temporary Hard Landing"

Jian Chang, Barclays, July 5, 2013

The latest developments in China suggest that risks to the country's GDP growth are skewed to the downside, argues Barclays' Jian Chang. Recent stress in the banking system and news about disappointing industrial growth herald a shift to 7% growth from the 9% to 10% of years past. With the new Chinese government unlikely to implement another round of stimulus programs, the risk that China's economy will face a "hard landing" is increasing. Possible triggers for a sharp, temporary slowdown include frictions from structural reform, heightened stress on banks, and significant capital outflows.

Since posting 9.8% annualized GDP growth during first quarter 2011, China's economy has drifted slowly toward the 7.5% number most recently reported for second quarter 2013. The massive credit creation that carried China through the global financial crisis has led to high levels of leverage and industrial overcapacity. Investors should consequently expect a slowdown in China's potential GDP growth rate to 7%. A June spike in Chinese interbank lending rates is just one sign that the short-term risks to this forecast are to the downside.

Several factors suggest that a temporary "hard landing," in which economic expansion drops sharply due to a collapse in investment growth, is becoming increasingly likely. First, the Chinese economy lacks clearly identifiable growth drivers. Although stimulus programs during the financial crisis expanded industrial capacity, year-over-year growth in industrial activity has fallen to 9%—down from 20% in 2010—as overcapacity issues become more acute. Little progress has been made in shifting away from the economy's reliance on this type of investment-led growth.

Another major risk to growth is the increase in leverage in China's financial system and the accompanying threat of rising non-performing loans. Over the last two years, measures of system-wide debt have increased from approximately 125%–150% of GDP to 200%–225%. Particularly troubling aspects of this lending include the facts that (1) many banks lack sound liquidity and market risk management practices, and (2) much of the new financing has gone to cover interest payments or to roll over or refinance existing debt. Concerns that the rise in debt has also fueled a widespread property bubble raise further questions about the availability of productive new investment opportunities going forward.

The third risk to growth is the policy approach of China's new leadership, which took over in March 2013. While the central government appears committed to market-oriented reforms that are likely positive for long-term growth, its plans to avoid stimulus and encourage deleveraging may create pressure on asset prices and the exchange rate, thus risking convulsions in shorter-term growth.

Investors should keep an eye on three potential catalysts for a hard landing. The first is friction arising as the central government liberalizes certain prices (such as interest rates) and cuts the subsidies to state-owned enterprises (SOEs) that have helped fund overcapacity. Reduced transfers to SOEs may cause rising defaults or increased financial stress for certain borrowers. A second potential trigger is a liquidity squeeze amid any deleveraging or reduction in credit growth leading to increased stress on banks. A third potential tail-risk scenario is a large outflow of capital amid increasing expectations of Chinese yuan depreciation. This would trigger a disorderly sell-off in the domestic property market.

"Bank WMPs, Tunneling, and Shadow Banking"

Ting Lu and Xiaojia Zhi, BofA Merrill Lynch, April 8, 2013

Concerns about rapid growth in China's "shadow banking" sector and the rising riskiness of "wealth management products" (WMPs) have led some commentators to predict a sharp slowdown in the country's growth or, at worst, a banking crisis. Ting Lu and Xiaojia Zhi of BofA Merrill Lynch commented on recent regulations introduced by Chinese banking authorities, concluding that they might cause a minor near-term drag on liquidity, but that they will ultimately help to restore investor confidence in China's financial system. They believe that the risks of a financial crisis are overstated and expect economic growth to remain relatively high.

Slowing growth in China and a dramatic rise in credit issuance have caused concern among investors about the size of the country's "shadow banking," or informal lending, sector. Moreover, banks have been investing proceeds from WMPs, term deposits that promise customers high yields in exchange for a predetermined lock-up, in increasingly risky assets. New rules issued by China's banking regulator, the China Banking Regulatory Commission (CBRC), will have little impact on overall credit supply, and should help China maintain its strong growth in the coming years.

At the end of March, the CBRC announced rules governing banks' investments of WMP proceeds. Banks are now not allowed to invest more than 35% of WMP balances in assets not generally tradable in major equity and bond markets. Moreover, such "non-standard" assets may not account for more than 4% of a bank's overall assets. The guidelines represent a shift from the banks' holdings today; the non-standard investments currently account for 44% of WMP assets. Investors responded to the CBRC's announcement by selling off Chinese financial stocks, fearing that the new measures would hit the sector's earnings and tighten overall credit, dealing a blow to economic growth.

While the reforms are needed to bring discipline to China's banking sector, they will have little impact on overall credit. Most crucially, the CBRC did not cap overall growth of WMPs, so the sector will likely comply with the rules largely by increasing investment in publicly traded assets from new WMP issuance. The development of securitization in China will also help alleviate some of the negative impacts of the new CBRC rules on credit supply, although growth in this market should certainly not go unchecked or unregulated. Banks have a ten-month window to comply with the new standard. Overall, the effect should be one of restoring confidence in China's financial system. The current administration has demonstrated that it is serious about banking reforms.

Commonly cited risks to China's growth outlook, including the size of the shadow banking system, have been overstated. China's non-bank financiers serve as "tunnels" through which banks can move assets off balance sheets to bypass regulations. The funding source of this shadow banking activity has mainly been bank WMPs. Proceeds from the WMP deposits are "tunneled" by various institutions, including trust and securities companies, to end borrowers. While some observers estimate the size of all shadow banking activity at between RMB15 trillion and RMB30 trillion, some of these estimates appear to double-count assets and liabilities. A more conservative estimate would put the size of China's shadow banking system around RMB11 trillion. Descriptions

of China's WMPs and their interconnections with property developers and local government financing vehicles as "Ponzi schemes" are similarly hyperbolic. Calculations suggest that 30% of WMPs are exposed to these two categories of borrowers.

There are many obstacles that policymakers and regulators will have to overcome in the near future as they crack down on shadow banking practices, but there are reasons for investors to be encouraged. The new CBRC rules officially give birth to China's money market funds and advance the development of the country's debt capital markets. Although there might be short-term pain for investors over the misunderstood liquidity "crunch" in China, there are reasons to be optimistic regarding the country's long-term growth outlook and the stability of its financial sector. Whether regulators can keep up with financial innovations aimed at circumventing existing rules remains to be seen. ■