

MyConsultant

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China's defaults and financial liberalisation

The core of the global financial system has been struck by huge blows over the past several years. The collapse of Lehman Brothers almost brought about the same to the system itself and the sovereign debt and banking system crisis in Europe almost led to a break-up of the Eurozone. However, Australia has been relatively insulated from these events due to China's fantastic growth, and that has increasingly made China central to our prosperity and financial stability.

China had its first corporate default in early March 2014 when the Shanghai Chaori Solar Energy Science & Technology Company failed to make an interest payment. Some commentators have called this a 'Bear Stearns' moment for the Chinese financial system – i.e. a forerunner to a greater Lehman Brothers-like event. While this appears to be overly dramatic, the Cassandras have been right over the past several years – it would be negligent to dismiss them altogether. In addition, the Chinese authorities have signalled their intention to further reform their financial system. Lending rates from the formal banking sector have recently been liberalised, and the trading band for the Renminbi (RMB) in offshore markets (CNH) has been widened from 1 to 2%.

As Australian-based investors, we should be particularly sensitive to these issues.

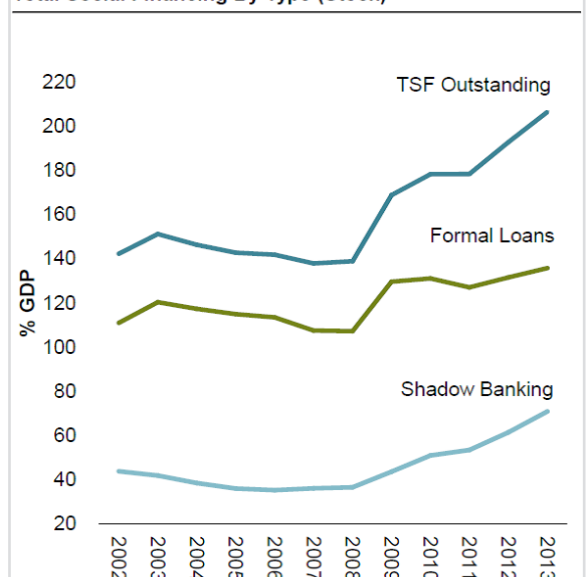
Shadow Banking and Defaults

China's accession to the World Trade Organisation (WTO) at the turn of the century allowed its export-driven model to work wonders for its economic development – income and prosperity soared. However, with the collapse of Lehman Brothers and the advent of the Global Financial Crisis (GFC), China could no longer

rely on this foreign income to drive its economy. Furthermore, China had become too large for the world to absorb its ever increasing supply.

As a result, the Chinese economy turned to borrowing as its primary source of growth – it filled the exports-growth hole with investment. In 2008, this was largely funded by the state-owned banks (i.e. formal loans), but the shadow banking system also started to grow and it has since been the persistent source of credit growth.

Total Social Financing By Type (Stock)



Source: AllianceBernstein

The shadow banking sector is not necessarily untoward or illegal. Previously, the formal banking sector had to lend at a set rate, which meant that the banks could not differentiate between credit risks and were thus compelled to only lend to the most creditworthy borrowers. The shadow banking system flourished in this policy setting as it could provide credit at different rates of interest and thus facilitated greater credit provision to riskier entities. In a sense, it can be seen as a step in the deregulation of the financial system. The China Banking Regulatory Commission (CBRC) monitors the aggregate of the formal and shadow banking loans through a concept known as 'Total Social Financing' (TSF), which is shown in the chart on the previous page.

The official estimates of the shadow banking

system puts it at around 70% of GDP. To put this into perspective, the US equivalent was around 150% of GDP prior to the GFC. Therefore, in aggregate, this is not a great concern; however, the pace of credit creation is. It is unsustainable at current rates and has greater potential for misallocation of capital. It appears that such misallocation has occurred in the Private and State-Owned Non-Financial Corporate Sectors, particularly materials, along with some Local Governments that are quite closely linked to the property sector. They all appear to be particularly vulnerable and the household sector has exposure through their investments in wealth management products (WMPs). We should expect to see further defaults, but only if the Chinese authorities want to see further defaults – 'nothing is unintended in China'.

China appears to have the wherewithal to ensure any deleveraging process is controlled and thus avoid contagion or crisis. The Chinese largely owe this debt to themselves, it is denominated in RMB, which means the authorities can 'monetise' the debt – i.e. by substantially loosening monetary policy and providing liquidity. China's Current Account Surplus has declined, but still remains positive, and it has an enormously strong balance sheet. It is a net creditor to the tune of around 40% of GDP. Thus, it has the scope to transfer wealth to secure important entities. It may do this by establishing 'bad banks' as it did with many Non-Performing Loans just prior to its accession to the WTO.

However, the authorities will also want to avoid the problems of moral hazard. As such, they do

Financial Reform Process

We expect that China's financial liberalisation will involve the following steps – liberalisation of lending rates, cleaning up shadow banking, liberalisation of deposit rates, gradually increasing onshore investment through increases to various quotas, correcting Balance of Payment (BoP) imbalances, allowing full currency convertibility, allowing capital to flow freely, and then including equities and bonds in global indices.

- **Liberalising lending rates:** This has been done to an extent. The formal banking sector now has more freedom to set lending rates. State-Owned Enterprises (SOEs) will be the biggest losers because they will no longer have access to cheap capital; however, this should help make growth more sustainable as capital will be allocated to its most efficient use. Chinese companies may respond by issuing bonds in the USD market.
- **Cleaning up shadow banking:** This has begun with the 'Chaori' default, and we have spoken about this process. The authorities have begun to close down the inefficient channels of credit distribution, and this is also an opportunity for them to open up credit to underpenetrated areas, such as the household sector. The authorities appear likely to intervene to avoid contagion, but aim to ensure moral hazard issues do not emerge. It will hurt retail investors and banks to some extent. Because Chinese households hold only a small portion of their wealth in WMPs, the clean-up process is unlikely to have a large negative impact on consumption.
- **Liberalising deposit rates:** This must be done prior to opening the capital account, otherwise the authorities risk capital flight. All else being equal, banking sector profitability will take a hit as they will be forced to compete for capital and will earn a lower spread between deposit rates and lending rates. The interbank lending market will provide a guide as to whether bank risk is rising materially due to this reform. Once deposit rates increase, retail investors will have a viable alternative to WMPs and online savings mechanisms (e.g. Alibaba), and the latter will likely be further regulated.
- **Gradually increasing onshore investment through quota increases:** Increasing quotas now will limit volatility in capital flows. An offsetting amount of domestic savings will have to be allowed to exit China (i.e. invest globally) to keep the capital account in balance.
- **Correcting BoP imbalances:** This must be done prior to allowing the RMB to float freely, otherwise it will appreciate dramatically. China is currently operating capital and current account surpluses, which is only possible due to the People's Bank of China (PBoC) accumulating FX reserves. FX reserves are a negative carry trade for China because they receive less interest on USD assets than they pay on their liabilities (i.e. domestic currency in circulation). This is a real economic cost to China that is getting too large to ignore. China is trying to invest as much as possible offshore through direct investments but there just is not enough foreign assets to buy.
- **Allowing full RMB convertibility:** This has begun with the widening of the trading band, and the float will be 'dirty' initially – i.e. the PBoC will occasionally intervene to change the value of the RMB. The PBoC is deliberately engineering some volatility, as the RMB trading volatility to date has been extremely low and it has largely been a one-way appreciation bet. Once allowed to float freely, China has plenty of reserves to protect against potential instability. The initial steps have created some speculative activity with iron ore and copper used as collateral in some cases.
- **Allowing capital to flow freely:** Any country can only control one of the exchange rate and the domestic interest rate when capital flows freely. China has restricted capital flows and hence has been able to control both rates. Once capital controls are relaxed, the RMB will have to be able to float freely and the investment quota increases discussed above should limit volatility in capital flows. The big unknown is how domestic savers will respond. If they are worried about corruption, too much money could flow out of China, but if they maintain a domestic bias to savings, not enough will flow out to offset portfolio inflows. The authorities have made a small step already: Multi-National Corporations (MMCs) can now move money between their Chinese and foreign entities at will, whereas they previously could only move retained earnings at designated periods.
- **Including equities and bonds in global indices:** China will represent a big portion of global equity indices and will be the third largest country in global bond indices. The aim will be to gradually allow investors to access more of the market via quota increases, and this will control the amount of capital flowing at one time. The authorities have already been working with other central banks, such as the RBA, to enhance their settlement and custody systems. Free capital flows are a pre-requisite as indices only include 'investable' securities.

not want to bail out everyone, and are likely to establish a process that enables defaults to occur and be worked out appropriately. The Shanghai Chaori Solar Energy Science & Technology Company default should be seen as the first step – it was intended, and may be seen as part of the reform process.

Short Term Impacts

China's potential growth rate is slowing as the growth of its working-age population slows, and the productivity benefits of further urbanisation are diminishing. Many analysts now project growth at around 7%. In the short to medium term, growth will be hampered by the extent and pace of deleveraging and reform; however, the authorities will ease this pressure by lowering domestic interest rates and providing greater liquidity.

We could see growth slow well below potential, and that would have a somewhat deflationary influence on the rest of the world. In particular, China's demand for commodities would be reduced, just as supply is being increased, and that would see commodity prices decline faster than currently expected. This would be an adverse shock for Australia, where the rebalancing from mining investment has only just begun. Australia is operationally levered to China, but also highly financially levered, which makes it particularly vulnerable to such a shock. These risks are partly why we remain cautious on domestic assets, along with the Australian Dollar (AUD).

Continued Development and the Global Impacts

With that said, Chinese demand will continue to be large over the medium to longer term. Even though China will grow less quickly, its size means that its economic force is enormous. The reforms should put its growth on a more stable path, and its policies will be less distortionary for the rest of the world.

The reforms will provide the Chinese with a market-driven price for savings and lending, and that will reduce the risk of misallocation and asset bubbles. China's savers have been punished through a prolonged period of financial repression where negative real deposit rates have forced them to seek alternatives to bank deposits. The search for alternatives has driven demand for WMPs and inflated real estate markets. Reforms will facilitate a greater shift to consumption, as households will receive a better return on their savings. These reforms will slowly fix the fundamental problems of too much reliance on housing and investment.

While the PBoC is trying to convince the market that the RMB is not a one-way bet, and there may well be some short term volatility – to the downside – the financial reforms should see the RMB appreciate over time due to favourable relative growth rates. Furthermore, China is the largest trading partner to 118 countries and while the RMB is still well behind the USD, it is now the second largest 'trade' currency. Still only a tiny fraction of central bank reserves are in RMB. This will change, creating a gigantic uneconomic buyer. The RBA recently initiated a position in the RMB, and it will be one of many. A higher RMB will enable China to import more, which will be great for the world's economy; however, China's appetite for operating a prolonged current account deficit will test the traditional reserve currency model.

Without the need to manage the RMB, the PBoC will not be recycling financial flows as much, and that means they will not accumulate reserves as quickly. This will see them buy less US Treasuries, and bonds of other countries into which the authorities have diversified in recent years. This is likely to place upward pressure on sovereign rates in these countries and downward pressure on their respective currencies.

Greater liberalisation of capital flows will see China more integrated into the world's financial system. Foreign investors will seek exposure

to China's strongly growing economy, and that is bullish for Chinese assets. Liberalisation will also mean greater outflows from China and for some smaller markets this could be quite disruptive. Ironically, those countries may have to implement their own capital controls. Hong Kong and Singapore have already restricted property purchases by Chinese residents – Australia and others could do the same.

Conclusion

Many observers have suggested that a crisis in China is a foregone conclusion, but the Chinese authorities have the fiscal and monetary tools to prevent the worst while it undergoes a deleveraging process. China's financial liberalisation should be seen in this context.

In the near term, we expect China's adjustment to have an adverse impact on Australia, and we remain cautious on domestic assets and the AUD. Beyond the medium term, China's reforms will enable it to grow more sustainably, with greater consumption and less reliance on housing and investment. The liberalisation process will also reduce the need for the PBoC to intervene in capital markets, reducing their distorting effects, and allowing the markets to trade in line with fundamentals. Longer term, this is bullish for China's assets, the RMB and those who export to China.

China has not restricted itself to financial liberalisation. It is slowly embracing factor price liberalisation across the economy: embarking on reforms to its energy, land, and labour markets. Some low hanging fruit has been picked thus far with the easing of the one child policy, but the pace of reform in other areas risks unrest. Pollution is now an urgent issue, and the Hukou system (city registration) reforms have slowed. Growth needs to stay high for the Communist Party to maintain stability and its authority. It is possible that addressing these issues could at times reduce the authorities' focus on financial system reform.

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