AVIVA INVESTORS
HOUSE VIEW

ECONOMIC OUTLOOK
CHINA: STRUGGLING TO HIT THE TARGET

Q3, July 2016

AVIVA INVESTORS

CHINA: STRUGGLING TO HIT THE TARGET

– Growth stability is the main priority for policymakers

– Leverage will increase but not as extreme as previous years

– With leverage rising and reforms sidelined, credit markets will be the key risk in H2

Chinese policymakers are committed to the 6.5-7% growth target

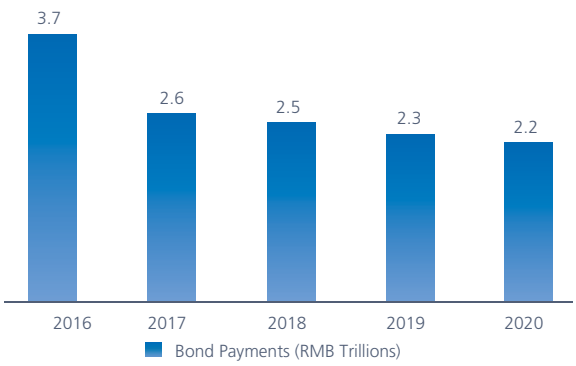
Heading into H2, the key task for Chinese policymakers is to achieve the 6.5-7% growth target. This will be quite challenging considering the recent data. The momentum since the end of Q1 appears to have slowed. It appears that policymakers are not willing to push the accelerator too much and risk generating even more excesses. Reforms may not be the government's main priority, but they linger in the shadows. Our view is that if growth falters, the government will provide the necessary stimulus to meet their objective. We remain concerned about the medium-term implications of the further expansion in credit. Total debt to GDP which is currently around 237% needs to stabilise rather than increase further. Risks to the banking sector also remain elevated, with the recent IMF WEO estimates suggest as much as 14% of corporate bank loans are vulnerable to default.

Credit concerns will be the key risk in the medium term

While growth may have stabilised, credit risk and the delay in structural and economic reforms are the key medium-term risks for the economy. The credit markets will be the main concern heading into the second half of the year. A rise in defaults among both private and state-owned enterprises (SOEs) has led to widening credit spreads. Since the start of April, there have been three distinct credit events and an additional three defaults since May bringing the total number of defaults to twenty. More are likely to emerge. The maturity schedule for this year is the highest compared to the next 5 years (Figure 1). An estimated RMB3.7bn is due to mature this year; RMB1.5bn is from overcapacity sectors (Figure 2). Their ability to get refinancing will be crucial which means policy rates will need to remain low. A policy rate cut or RRR cut cannot be ruled out. As long as these credit events do not lead to broader financial stability concerns, the realisation of credit risk should be viewed positively. It is a sign that the government is managing the moral hazard issue. But, the government will likely bail out an SOE deemed as systemically important.

Figure 1: Largest bond payments due this year

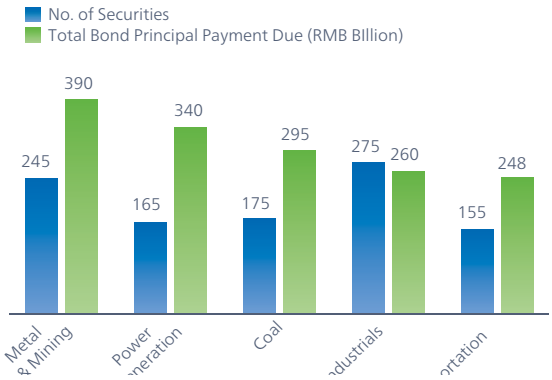
Credit markets are a risk given the payment schedule



Source: Bloomberg

Figure 2: Payments due are in the troubled sectors

Overcapacity industries have largest payments due



Source: Bloomberg

The concerns over the credit market highlight the need for reforms in these overcapacity sectors. However, reforms mean greater economic pain at the expense of growth which is a sacrifice the government is unwilling to make. The government will not completely abandon the reform, but will go about it at a much slower pace. At the recent World Economic Forum in Tianjin, the Chairman of the NDRC said that the central government is committed to implementing cuts in production of coal, iron and steel. It is estimated that these cuts would affect nearly 900,000 workers. By the end of May, the central government disbursed RMB27.64bn of the RMB100bn promised to help laid off workers. At the March NPC meeting, the government agreed to allocate funds to retraining and compensation for workers in these sectors. In the meantime, the ailing steel industry is becoming profitable again thanks to the recent bounce in prices. CISA reported on May 27 that 93 major steel companies in China recorded monthly profit of RMB 7.2bn in April, the second consecutive month of profits. Also, two large steel companies are set to merge to become the largest steel company in China. This should be seen a sign of supply side reforms.

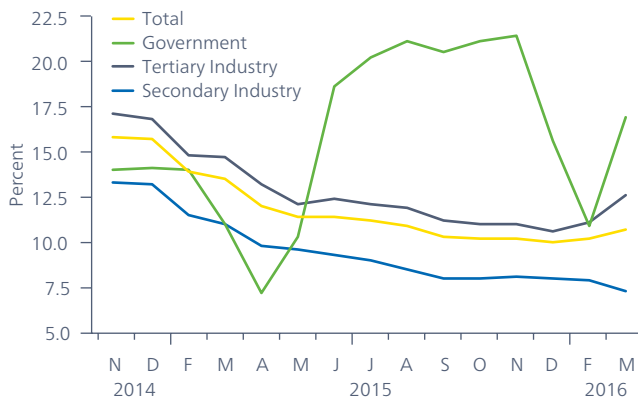
The focus on growth means supply side reforms will be delayed

To achieve its growth target, policymakers will have to forge ahead with investment spending. The government seems to be more willing to expand its own balance sheet. Fixed asset investment in May was weaker than April because of the weakness in manufacturing investment (Figure 3). Once again, this highlights the negative impact the overcapacity industries are having on the economy and the need for reforms. Infrastructure investment is holding up, and new project approvals are high although they have slowed since the start of the year to 32%y/y ytd in May versus. 41% y/y ytd in January-February (Figure 4). The government has the fiscal space to spend with a fiscal deficit of 3% and government debt to GDP of 57% (including general government debt plus off budget activity). In addition to infrastructure spending, they will need to allocate capital to more productive parts of the economy including the services sector, higher-end manufacturing, and research and development.

Government investment spending will be the key driver of growth

Figure 3: China FAI is rising in services and government sectors

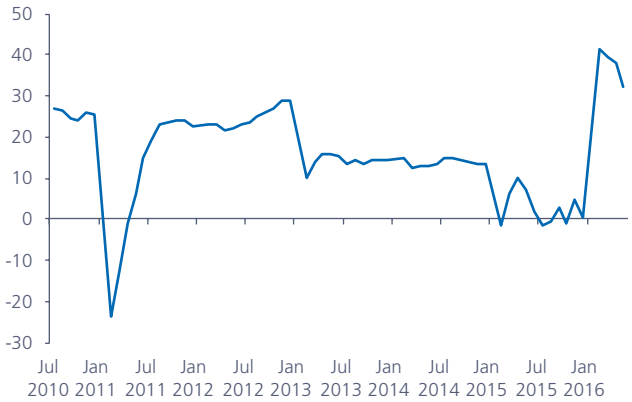
Government is boosting spending



Source: Macrobond

Figure 4: Number of newly approved projects has slowed

The impact of the recent fiscal impulse has slowed in Q2



Source: Bloomberg

Even though credit is increasing, inflation will remain subdued

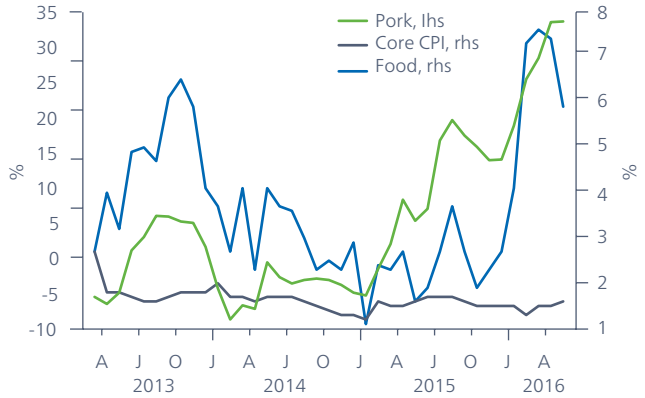
In the meantime, credit is rising. New loans in May nearly doubled from the previous month, but 60% of those new loans were for households rather than corporates. Household debt-to-GDP is only about 40%. Relaxation on house purchase restrictions in lower tier cities and mortgages has given a boost to the property sector. Tier 1 cities, especially Shanghai and Shenzhen, continue to be a concern for policymakers given the recent spike in prices. Restrictions will remain in those cities, to prevent overheating. PMIs and industrial production have been stable, but have not signalled a robust improvement in the economy. While inflation is rising, it is not a real threat. Rising pork prices have been the key driver. The underlying components of inflation remain subdued (Figure 5), but policymakers will need to prevent credit growth from rising too much for the sake of inflation and structural risks.

CNY depreciation has been mostly against the basket; a one-off devaluation against the USD is unlikely

With Fed hikes likely off the table this year, persistent USD strength may increase fears of CNY depreciation; however, we think the likelihood of significant CNY weakness is low given the surge of outflows seen at the beginning of the year. Outflows for now have been limited thanks to the capital account restrictions and CNY stability. However, CNY has depreciated nearly 7% against the CFETS basket since the beginning of December 2015. Over that same time period, CNY has fallen by about 4% against the USD (Figure 6). By maintaining a steady depreciation against the basket, the CNY maintains its competitiveness without sparking concerns of a depreciation policy. A one-off adjustment against the USD would have sparked those concerns. The PBoC recently noted that they could see USDCNY fall to 6.80 this year which is about 2.4% from the current level of 6.64 only if depreciation expectations are under control. The IMF argues that the CNY is broadly in line with fundamentals, and the goal is to achieve an effective float within the next couple of years. Progress on opening of the capital account is likely to be limited in the near term.

Figure 5: China CPI should remain subdued

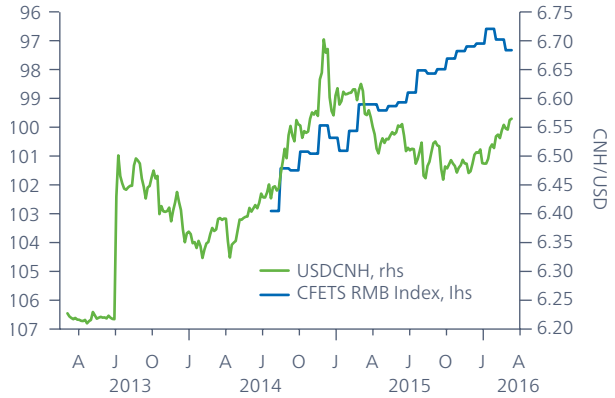
Pork prices are the key inflation driver



Source: Macrobond

Figure 6: RMB is slowly regaining its competitiveness

RMB is falling faster against the basket than the USD



Source: Macrobond

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