China: Have We Reached Bottom Yet?

By Joseph Taylor, VP, Senior Sovereign Analyst

KEY TAKEAWAYS

- The Chinese government is simultaneously battling an economic slowdown, a bear market in equities and currency depreciation that may accelerate capital outflows.
- For those who still considered Chinese government policy unfailingly brilliant, the last few weeks have necessitated a rethink.
- Loan capacity is plentiful in China. The problem is loan demand. Businesses are sensibly refraining from borrowing because of overcapacity.
- China is searching for sustainable GDP growth of perhaps 4-5%; the adjustment period will be prolonged, and the GDP growth is likely to slip below that before bouncing back.
- We expect a sustained slowdown, and we suspect the market has not yet fully priced in an extended slowdown. Watch for more downdrafts in commodity markets and currencies.

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Currently, the Chinese government is taking its chances, attempting to manage three of the challenged nation's disparate battlefronts—a general economic slowdown, a bear market in equities, and a currency depreciation that may accelerate capital outflows—all at once.

Think of China's problematic economic strategy in military terms. No military strategist would willingly enter a two-front war; it is too difficult and costly. Napoleon's disastrous invasion of Russia in the 19th century while fighting the allied powers of Spain, Portugal and England is but one example of the perils of fighting two-front wars. A three-front war, such as China's, can be perilous in the extreme.

China's troubles don't end there. Its leadership's inconsistent reaction to the recent fall in equity markets and the currency depreciation has opened investors' eyes to the government's fallibility.

To give credit where credit is due, China has managed, according to the Chinese National Bureau of Statistics, unprecedented GDP growth of more than 9.4% over the last two decades. This remarkable growth was initially driven by mercantilist expansion during which the International Monetary Fund (IMF) estimates China increased its share of global exports from 2.9% (1995) to 12.7% (2014). However, since the global financial crisis, Chinese GDP growth has been dependent on debt expansion. The total credit-to-GDP more than doubled in the last five years and is still rising.

Today, China is searching for what it calls its "new normal"—sustainable GDP growth of perhaps 4-5%, according to our estimates. In the meantime, we believe the adjustment period will be prolonged, and the GDP growth is likely to slip far below this level before bouncing back.

WHAT THE PBOC DID

POLICY RATE CUTS:
The PBoC lowered both the one-year benchmark lending and deposit rates by 25 basis points, to 4.6% and 1.75%, respectively.

INTEREST RATE LIBERALIZATION:
The PBoC removed the interest rate limits on all deposits with a term longer than one year (the one-year deposit rate is not included). Now the only limit on interest rates is that the deposit rate on checking accounts and saving accounts (with a term of one-year or less) cannot be higher than 1.5 times the benchmark deposit rate.

GENERAL RRR CUT:
RRR of all financial institutions was lowered by 50 basis points.

Implementing a Sound Monetary Policy: Boasting or Self-Deception?

The People's Bank of China's (PBoC) recent moves to lower the required reserve ratio (RRR) and interest rates are relatively insignificant against the backdrop of the decelerating economy. Policymakers announced these moves mid-week rather than in the more typical weekend announcement, signaling a certain desperation. In its release, the PBoC didn't even try for a neutral tone to explain its actions. The Bank led with a self-congratulatory sentence about its "just right" management of monetary policy. Sounds a bit like Goldilocks's porridge. Read for yourself:

"PBC has continued to implement a sound monetary policy…it is neither too tight nor too loose, carried out pre-emptive adjustments and fine-tunings at the proper time and with appropriate strength." [1]

How Much of a Difference Will it Make? Probably Not Very Much

These changes alone will not do much to arrest the decelerating economy, in our view. The adjustment in the RRR increases liquidity in the banking system in the face of capital outflows. But the RRR cut will likely not lead to more lending and credit expansion.

There is already plentiful loan capacity available. The problem is loan demand. Businesses are sensibly refraining from borrowing because of the overcapacity in both the industrial plant and in construction. The services sector may not be slowing, but capital demands in that sector are not significant compared with heavy industry and construction.

Chaotic Government Policy: Not Very Inspiring

For those who still considered Chinese government policy unfailingly brilliant, the last few weeks have necessitated a rethink. The inconsistency in government policy regarding the stock market correction and the renminbi depreciation is instructive.

It is probably a reflection of the dissention among the leadership about what government policy should be. For a government that has prided itself as a perfectly tuned instrument gently guiding growth up and down, this incoherence reveals a hard truth.

The government appears unsure of what to do. First, the stock market intervention was panicky with a scatter shot of policies. The rock was just too hard to push up hill, and now the index has slipped well below the level it was when the intervention started. Though the government hasn't publically admitted as much, the domestic press is reporting that the government has ceased to purchase shares.[2]

[1] http://www.pbc.gov.cn/english/130721/2903582/index.html
[2] More regulatory adjustments are underway to slow the market correction, but according to The New York Times, the campaign has broadened in a sinister way. China has arrested (the government refers to it as taking "coercive measures") hundreds of journalists, brokers and bloggers related to the stock market crash. Anyone who is "fabricating and spreading fake information" is vulnerable. That is, anyone commenting negatively on the stock market slide appears to be at risk. This, in our view, is clearly an example of a shoot-the-messenger approach to receiving bad news.

The stock market had a kind of carnival atmosphere to it. *Step right up, get your shares—they're all going up, so borrow some more money and watch your assets grow.* Primarily high net worth individuals were players in the market, and their losses are unlikely to affect consumption in the economy.

The Currency Confusion: Seeking Equilibrium

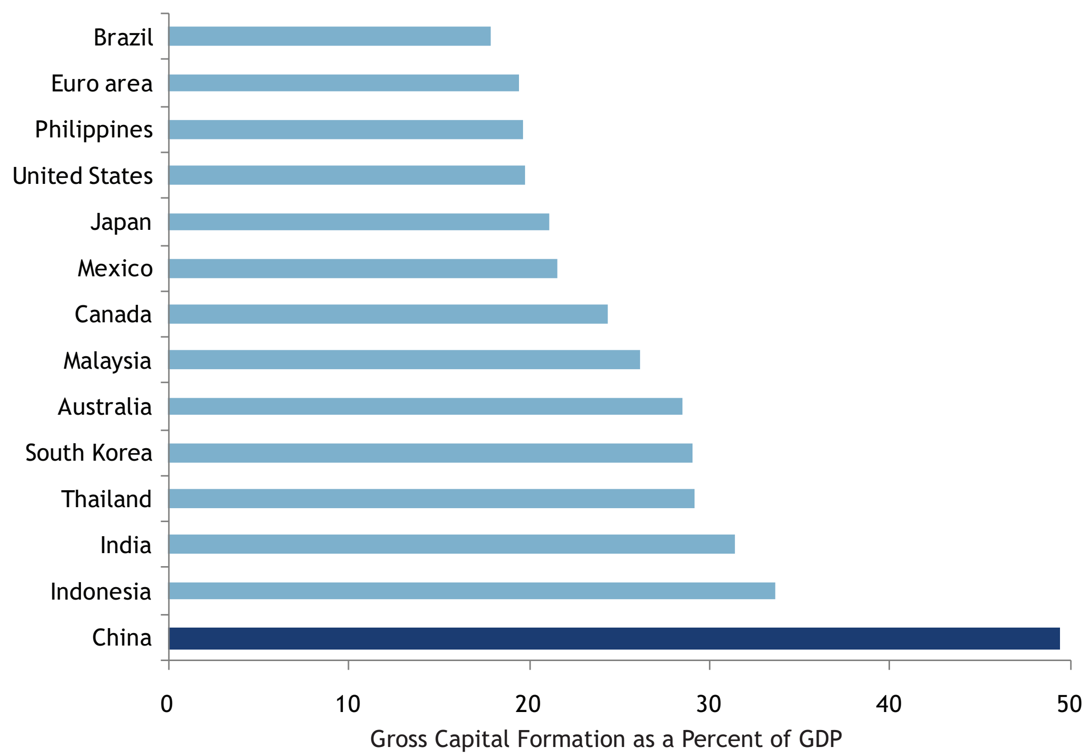
The currency depreciation that began on August 10 started out as a shift in policy toward a market orientation. We will let the market determine the appropriate currency valuation, government officials announced to great fanfare. Well, that policy lasted for about three days.

After letting the currency fall by roughly 3%, the PBoC abruptly changed course and has fervently locked the rate at 6.4 renminbi to the dollar. The market expects more depreciation —clearly reflected in the CNH market, the Hong Kong-based, off-shore renminbi market where the currency is trading at close to 6.5. The inconsistent policy has led economists to forecast for 2016 a spectacularly wide range of 6.2 to 7.1, which translates to an appreciation of approximately 3% or a depreciation of about 10%.

CHINA'S CAPITAL INVESTMENT IS OFF THE CHARTS

Gross Capital Formation as percent of GDP

Source: *UN data for 2012-2013.*



How much further will the PBoC manage down the currency? It depends on the extent to which China must deplete reserves to manage capital outflows, we think. We estimate outflows through July at about $309 billion. From peak reserves of $3.99 trillion in June 2014 to the most recent figure of $3.55 trillion (end of August 2015), the loss represents a drop of 10.9% of reserves.

China has ample reserves, but there may come a limit where its policymakers would prefer to "let go" of the currency as they did with the stock market. Where is renminbi equilibrium? We think the currency could fall to 6.75 within a year, but beyond that, the risks of accelerated capital flight, domestic companies' US-dollar-denominated debt exposure and general emerging market currency instability are just too great. That does not prevent some from forecasting a currency at 7.0 or higher.

Back to the Fundamentals: Has the Economy Found a Bottom?

In a word, no. The Chinese economy was drugged into growth through excess investment since the great financial crisis. At its peak, investment was 48% of GDP, an unprecedented level indicative of a massive misallocation of capital.

Working through that misallocation and deleveraging the debt will be a multi-year task. Investment (mostly construction) is slowing rapidly and that is driving declines in commodities, machinery, cement etc. There are no signs that construction has stabilized. The indicators are still falling.

Yes, housing sales in Tier 1 cities have grown fast in the last few months, and prices there are up. But Tier 1 cities represent only about 12% of the housing market in China. They do not reflect the overall construction pace in the economy, which is moribund. There is still excess inventory, lackluster pricing and slowing sales throughout the vast majority of the economy. Land sales, a forward-looking indicator of developer expectations, are down by 30% year to date. Developers are not betting on a turnaround.

Non-manufacturing PMI has held up nicely at (53.9), but according to Bloomberg, the most recent Caixin manufacturing PMI fell to its lowest level (47.3) since March 2009, the nadir of the great financial crisis. The rebalancing toward consumption is taking place, but it is a result of the swift decline in investment's contribution to GDP—not a swift increase in consumption's contribution to GDP, which has stayed about the same. The Chinese economy has not stabilized; it is still slowing and these last moves by the PBoC will have only a marginal impact.

How Much More Pain in the External Markets? Watch for More Downdrafts

Commodity markets, commodity currencies and Asian currencies have all made large corrections since the beginning of the year.

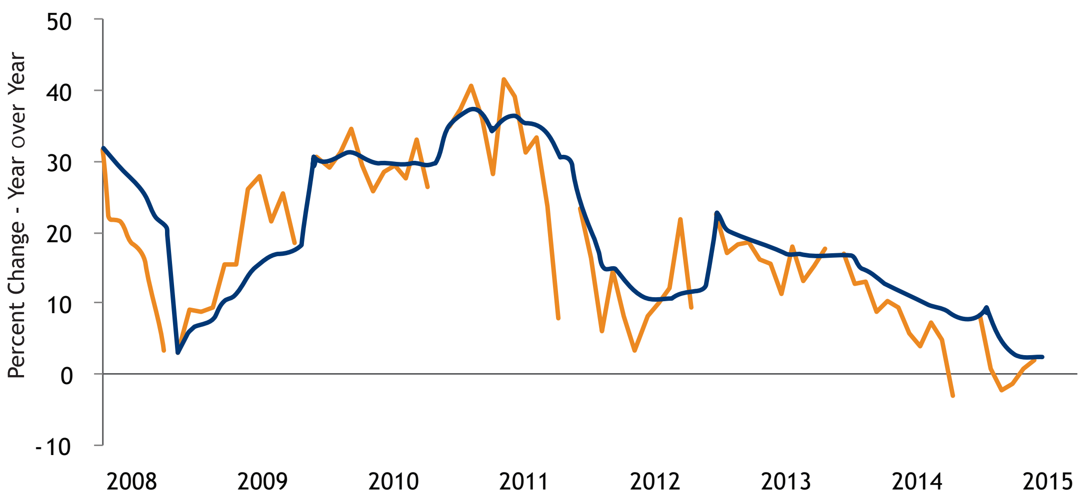
Are these corrections "sufficient"? That depends largely on whether these new levels reflect a sustained slowdown in the Chinese economy. We expect a sustained slowdown, and we suspect the market has not yet fully priced in an extended slowdown. Watch for more downdrafts.

INVESTMENT (MOSTLY CONSTRUCTION) IS SLOWING RAPIDLY

Source: *China National Bureau of Statistics, Haver Analytics, as of 8/18/2015.*

Fixed Investment: Residential Construction

Percent year-over-year (removing year-to-date aggregation)

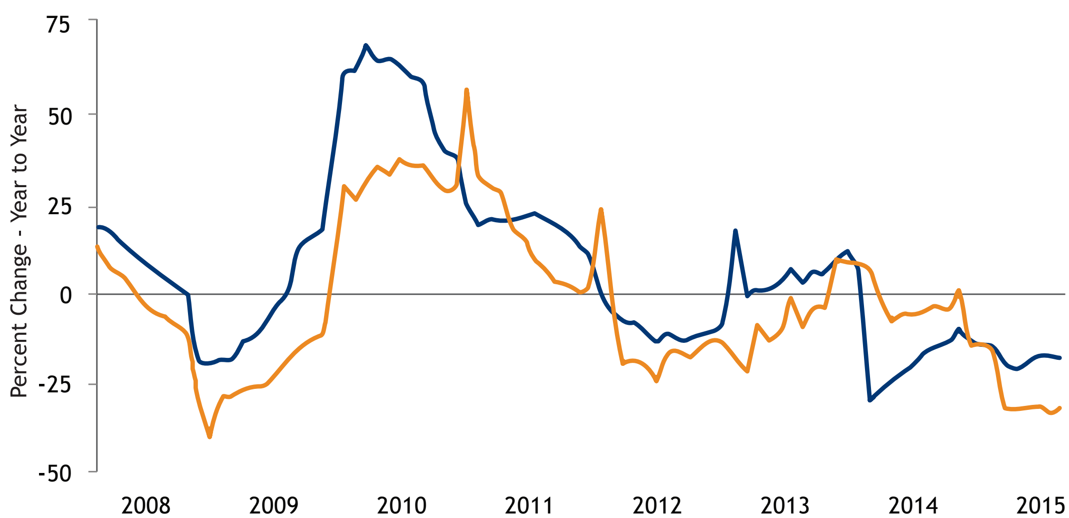


NEWLY STARTED CONSTRUCTION & LAND ACQUISITION IN CHINA

Source: *China National Bureau of Statistics, Haver Analytics, as of 8/12/2015.*

Newly Started Construction: Residential Buildings

Acquisition of Land by Real Estate Developers



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