CQS Strategy Perspectives

QE Chinese-Style

JUNE 2015

Introduction

In this edition of CQS Insights, we discuss why Yuan devaluation is unlikely, the arrival of Quantitative Easing with Chinese Characteristics and what this means for China's fixed income and equity markets.

Like many market participants we at CQS are keen China watchers. In many of my CQS Insights pieces I have highlighted the opportunities and challenges China presents, both from within and outside the country. There are two themes that I find particularly fascinating. First, from my many visits to China I am always impressed by how astute the Chinese leadership is. They are smart, understand the challenges and have thus far been able to navigate China's economic development effectively. Second is China's political cycle. As opposed to the short-term electoral cycle prevalent in the West, China's electoral cycle allows for Five Year consumption plans that enable long-term macroeconomic planning to be implemented. A fundamental tenet of 2011's Five Year plan was a drive to shift economic growth from being infrastructure-led to consumer-led. Part of this shift is reform of financial markets structures. Financial market structures, regulation and a legal infrastructure are being put in place to support this goal. These reforms are pushing China towards a more open economy with a goal of having a fully convertible currency.

The internationalization of the Yuan and capital account liberalisation is a central plank of China's economic planning. Remember for a currency to be a global reserve currency it needs to be investible. An important milestone in that process is the International Monetary Fund (IMF) meeting in October of this year when the IMF will consider whether the SDR basket needs to widen. The Chinese authorities expect the Renminbi to be included in the new weighting structure and are very cognizant that a significant devaluation may jeopardise that objective.

As pointed out in this piece:
"The importance of this policy goal has to be considered in the context of China's long-term strategic plan for greater involvement in leadership of the global economy." The establishment of the Asian Infrastructure Investment Bank is a case in point. Other examples of financial markets reform include the establishment of Shanghai/Hong Kong Connect last November (the combination has created a top three global exchange); the forthcoming Shenzen Hong Kong Stock connect, arguably as significant as Shanghai/Hong Kong for its own flows. Another example is the recent announcement in Hong Kong that the long awaited mutual fund recognition will take place allowing cross border fund sales between Hong Kong and the mainland. Financial reform is taking place.

In the attached piece we argue that currency devaluation would make all these critical reforms far more difficult to execute. Furthermore and additionally supporting the thesis that Yuan devaluation is unlikely, is that markets do not appear to appreciate how tight a monetary policy the People's Bank of China (PBoC) has been running since the 2010. He argues that what we are now seeing is Quantitative Easing (QE) with Chinese characteristics – QE Chinese-style – which should continue to benefit China's fixed income and equity markets.

Sir Michael Hintze, AM
CQS Founder, CEO and SIO

QE Chinese-Style

Summary

- We believe the Yuan will not be devalued
- Markets do not appear to appreciate how tight a monetary policy the PBoC has been running over the last 5 years and why there will be further rate cuts
- What we are now seeing is Quantitative Easing (QE) on Chinese terms
- China's fixed income and equity markets are likely to continue to benefit from lower rates

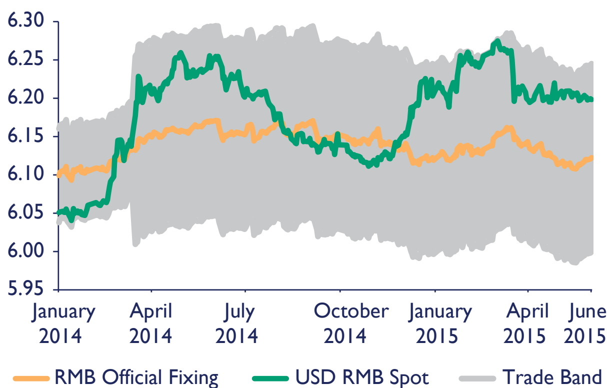
On the last day of the year in 1993 the PBOC devalued the Yuan by just under 50% from 5.76/$ to 8.62/$. The risk that they will do so again has risen substantially over the last year as the Chinese economy has slowed and many investors perceive the recent cuts in interest rates and FX band widening as a precursor to the event. We believe that this expectation is wrong as the core thesis behind a potential devaluation is the attribution of the entire slowdown in China's growth being due to structural issues; namely an overleveraged property sector and a slower than expected rebalancing of the economy away from investment to consumer-led growth. We believe this to be an incomplete analysis.

Growth and its rebalancing

Figure 2 below shows the breakdown of Chinese GDP by expenditure. What is immediately visible is that the dramatic investment-driven stimulus to growth that started in 2000, peaked in 2011, and is handing the baton over to consumption.

The problem is that while consumption has been growing, the overall rate of growth has not allowed the economy to maintain its prior growth rate. Some of this underperformance can be attributed to the structural headwinds that face the Chinese economy, however, what the market appears to have missed is the level of monetary tightness that the economy has been labouring under for the last five years.

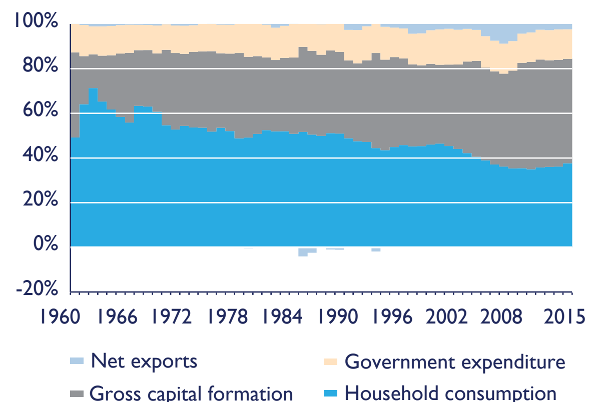
Figure 1: RMB and its Trading Band*



Source: Bloomberg, as at 2 June 2015.

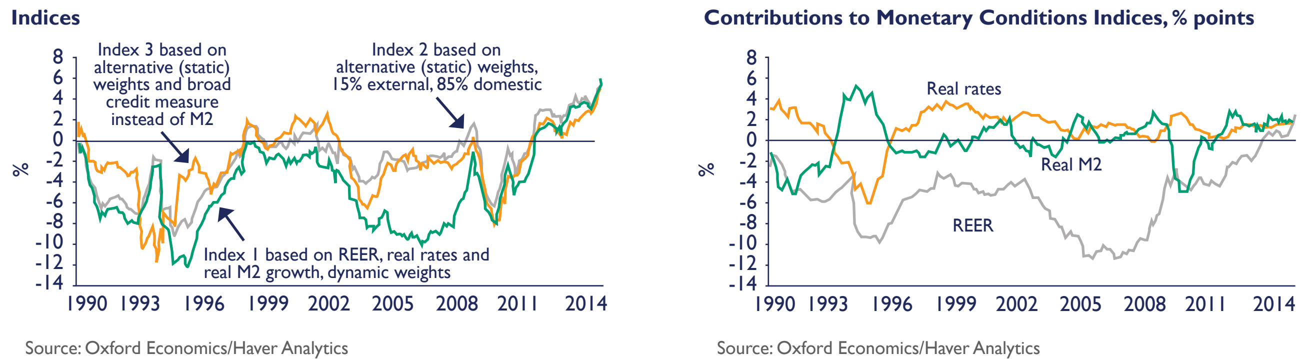
*The PBOC allows the spot value of the currency to trade within a band around its official fixing. Until 15 March 2015 the band was 1%. Since then, the authorities have expanded the band to 2%.

Figure 2: China GDP Split by Expenditure



Source: Aviate Global LLP, as of 1 June 2015

Figure 3: China: Monetary Conditions



Source: Oxford Economics/Haver Analytics

Source: Oxford Economics/Haver Analytics

Monetary Conditions

Monetary conditions were notably loose at the peak of the crisis in 2008/09 and then began a long period of substantial tightening. As can be seen in Figure 3 (above), 2014 saw a small easing of monetary conditions as the currency band widened, but that did not persist as sharp devaluations in the Yen and the Euro dragged the Yuan's Real Effective Exchange Rate (REER) higher and declining inflation saw real rates rise sharply. The current policy stance of cutting rates and the RRR[1] is aimed at reversing this tightening. This policy stance is aimed at unwinding the tightening due to Quantitative Easing (QE) policies elsewhere and falling inflation. Unfortunately the scale of the tightening means that three interest rate cuts and a cut in the RRR have not as yet been sufficient. Further rate cuts remain likely during the course of the next few months.

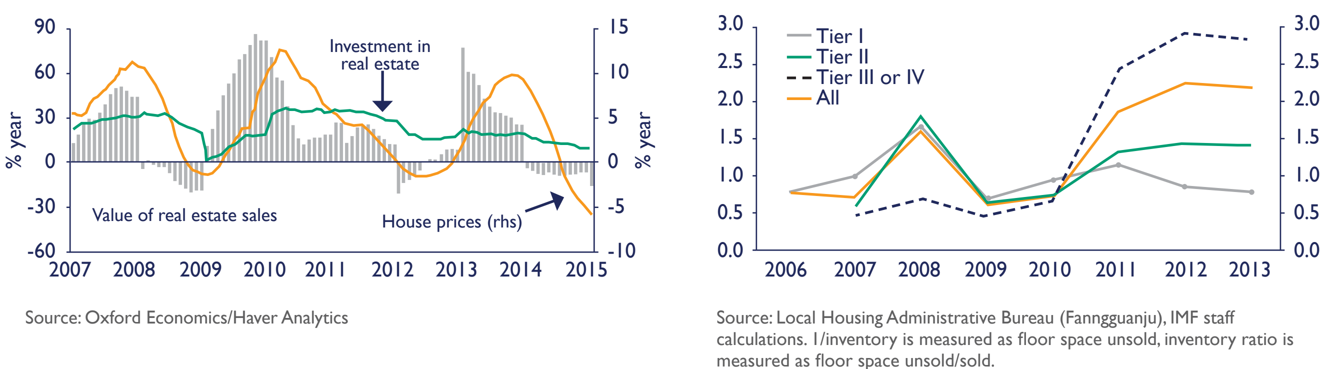
Headwinds from Property

Over the last five years real estate has become a key risk for the economy. The highly expansionary policy that followed the global financial crisis drove a pretty dramatic increase in house building. The authorities have sought to address the problem by trying to affect the micro structure of the market. They have at various times restricted access to financing for second properties as well as higher taxes, limits to ownership, etc., all of which had a very specific impacts on the sector.

As can be seen in the right hand chart in Figure 4 below, the main adjustment in both prices and quantities has to come from Tier 3 and 4 cities. The scale of the adjustment, even if confined to the smaller cities is substantial and the potential ripples could affect local authority financing and SOE (State-Owned Enterprises) profitability slowing the economy even further. The level of leverage and the scale of the adjustment suggest that official data on Non-Performing Loans (NPLs) at 1% is grossly underestimating the true level. The historical evidence from China itself also points to the official number being unrealistically low. The NPL ratio in the aftermath of the 1990's building boom was near 30% and much closer to the global norm.[2]

However, is it unlikely that any devaluation will provide a benefit to the property sector. Indeed, given the extent of the asset/liability mismatch most developers have on their balance sheet (RMB assets/HK dollar or US dollar liabilities), a devaluation has the potential to generate further corporate bankruptcies.

Figure 4: Over Investment in China Real Estate



Source: Oxford Economics/Haver Analytics

Source: Local Housing Administrative Bureau (Fangguanju), IMF staff calculations. 1/inventory is measured as floor space unsold, inventory ratio is measured as floor space unsold/sold.

Sources: [1]RRR: Reverse Repo Rate. The rate at which interbank funding is carried out by the PBOC. [2]Oxford Economics, Research Briefing, 20 March 2015.

Strategic Considerations

The argument for devaluation also misses the significant strategic considerations that currently drive Chinese economic policy.

The Chinese authorities have for some time made the internationalisation of the Yuan and capital account liberalisation a central plank of their economic plan. An important milestone in that process is the International Monetary Fund (IMF) meeting in October of this year when the IMF will consider whether the SDR basket needs to widen.[3] The Chinese authorities expect the Renminbi to be included in the new weighting structure and are very cognizant that a significant devaluation may jeopardise that objective. They are also equally sensitive to the view that any unnecessary volatility in the currency will result in a significant loss in confidence in the currency and cause systemic problems in the corporate sector because of private sector US dollar borrowing.

The importance of this policy goal has to be considered in the context of China's long-term strategic plan for greater leadership of the global economy. This strategic initiative also recognises that many internal reforms have to be executed alongside international initiatives such as the establishment of the Asian Infrastructure Investment Bank. This year alone proposals on rural land ownership reform and local authority finance reform have been outlined together with an announcement on SOEs which identified national champions as well as privatisation candidates. Currency devaluation would make all these critical reforms far more difficult to execute.

Conclusions

With the prospect of the Fed going into an interest raising cycle later this year or early in 2016, it is clear that the weight of central bank interventions is shifting to the east. The three largest economies in East Asia, China, Japan and South Korea have either committed themselves to, or are about to start, rapid monetary expansion.

This monetary expansion is likely to remain in place alongside weaker currencies until there is an unequivocal improvement in export demand or a recovery in commodity prices that substantially raises the risks of higher inflation. Our view is that Chinese authorities will meet the challenge with further rate cuts and a widening of the currency band to accompany the structural reform.

We believe a devaluation of the currency does not suit the country's strategic agenda. According to CQS' Head of Asia Investments, once global investors become less concerned about devaluation and that the internationalisation of the Renminbi is a matter of when and not if, the flows into the currency and fixed income assets denominated in CNY will likely drive further appreciation of these assets.

As for interest rate and RRR cuts, equity markets in China and Hong Kong should benefit as companies whose earnings are highly sensitive to the cost of capital and financing costs - such as real estate developers - should see a significant impact on their earnings.

Source: [3]The basket's weights and constituents are based on the value of the exports of goods and services and the country's capital contribution to the IMF.

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[1]Source: CQS, estimated as at 1 June 2015.

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