Income & Fixed Interest Newsletter

Vimal Gor

Global growth is ok(ish), but major economies are mixed…

April was a divergent month across economies and asset classes. Whilst the US economic picture continues to deteriorate, we believe a Fed hike in June is locked in, absent an exogenous shock. This is driven primarily by the continued strength in the employment picture. In contrast the economic data from Asia, and China in particular, is notably upbeat, a dynamic we think is likely to continue for the foreseeable future. European data was somewhere in the middle, not too strong or too weak, but pretty good for an economy which was facing a depression not so long ago.

Asset classes also showed this divergent theme. Bonds continued to unwind the bearish positioning and saw the US 10yr yield spike to a 2.16% low (from a high of 2.62% in March). Equities markets and credit markets continue to ride the liquidity wave and posted a strong month. We had a positive month with all of the flagship portfolios outperforming their respective benchmarks.

Jam tomorrow…

Over the last few months we have been questioning whether the global reflation trade is all its trumped up to be (pun intended). The optimistic theme has been run with hard by the market due to its bias to be optimistic after a disappointing 2014 and 2015 for the global economy. The upswing, kick started by an unprecedented expansion of credit in China, which rippled through every market, has been supported by enormous Quantitative Easing (QE) from both the European Central Bank and the Bank of Japan. In this newsletter I do a deep-dive on China to see what we can learn about its potential growth path from the way it's managing a number of increasingly conflicting financial market indicators.

The three liquidity factors above have driven risk markets strongly higher, pretty much ignoring the considerable amount of political risk that we've lived through and how much of it is on the horizon. Along with the market's strong up-move we've seen consumer confidence, business confidence and manufacturing surveys across the globe accelerating to levels we hadn't seen in years. This promise of continuing acceleration of GDP growth in 2017 was expected to push inflation higher than the oil rebound had already caused. Central bankers were taking note, with the Fed and the ECB talking about a better environment, seemingly looking to build on the confidence that was already permeating through the economy. With this optimism comes interest rate hikes, bringing with them higher bond yields. The optimism and continued QE would mean even higher equity markets and tighter credit spreads – further perpetuating the virtuous cycle.

It's not supposed to happen like this…

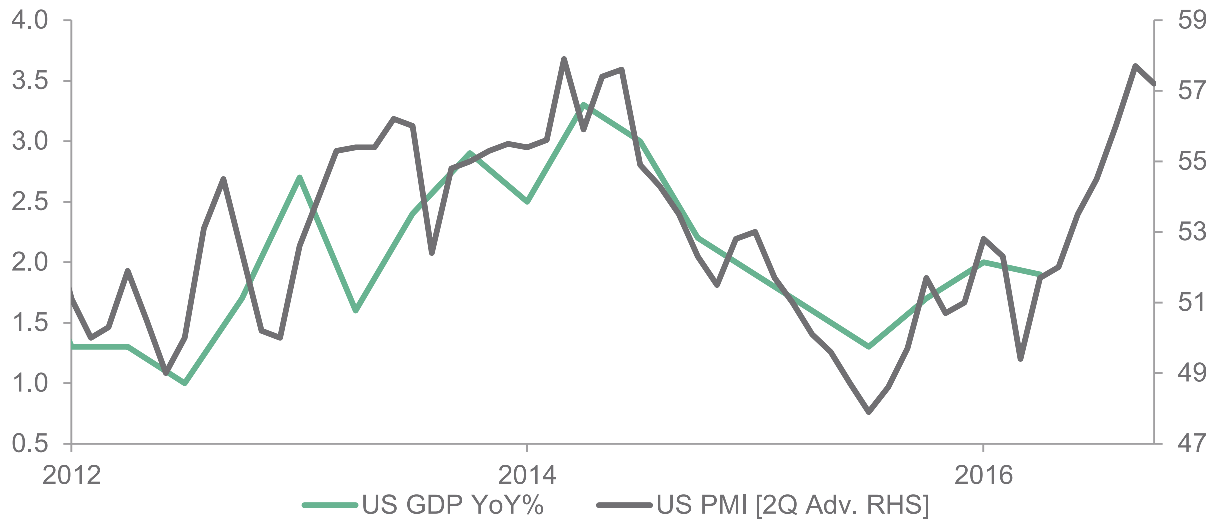
To be clear this is all well and good if growth follows through on its promise, but if it doesn't the thesis must change. So we are watching and waiting for the real economic data (the 'hard' data as I wrote about last month) to accelerate to meet with the forward looking surveys (the 'soft' data). Unfortunately a number of roadblocks towards achieving this were hit in late April and early May, denting the reflation story somewhat. The first is a quarterly US GDP growth outturn that was the worst recorded in three years, but more worrying is the second, which is that the 'soft' data looks to have peaked before growth has even started to accelerate.

The US first quarter advance GDP printed at 0.7% annualised, which was poor even for the traditionally depressed first quarter results. The Atlanta Fed "GDP Now" measure was a good lead on this print, with high consensus expectations showing that economists were clearly following the survey data. The big disappointment didn't really shift markets, which are following the usual trend of looking through to the second and third quarter in the US for the big uplift to growth. As always the work is cut out for those quarters as with such a low first quarter print, it makes the required numbers for the rest of the year even higher to hit the consensus 2.2% GDP growth expectations for CY2017. To be fair, the good result for construction does bode well for future quarters, but it is still a large step to a decent yearly growth rate.

As regards the soft data, one of the most watched macroeconomic indicators in the world, the US ISM manufacturing survey, has been pointing towards some big quarterly growth numbers for quite a while. Operating with a two quarter lag and using the correlation of the last few years, the uplift in this manufacturing survey is pointing towards US GDP running at

roughly 3. 5%. The problem is that the ISM index is already starting to turn down as at the last print in early May. This print corroborates with the regional manufacturing surveys so it is unlikely to be an aberration.

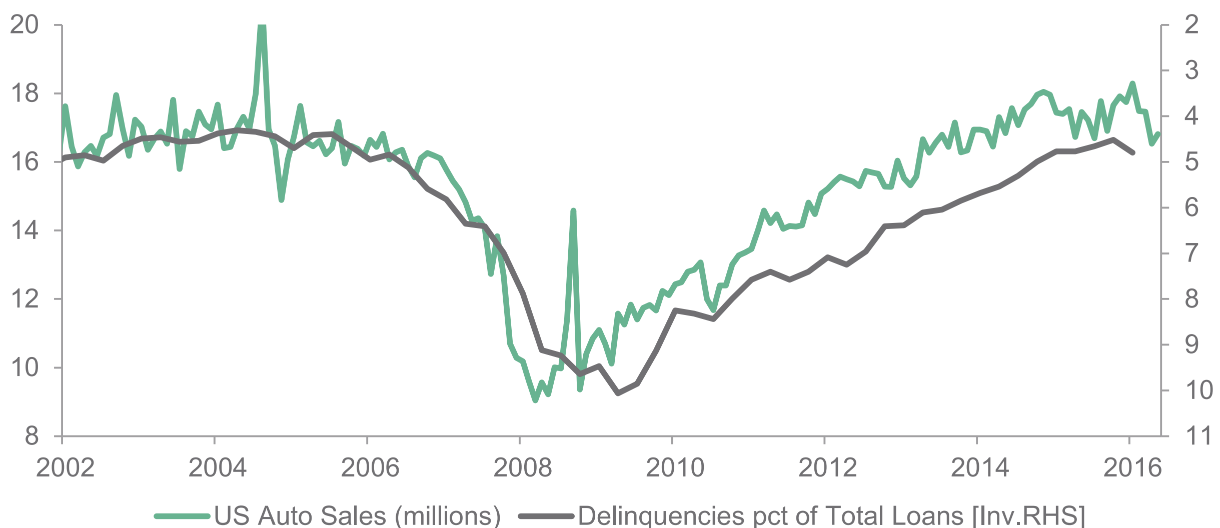
Chart 1: Wouldn't it be nice…



Source: Bloomberg

The new lower print points towards US GDP of just over 2.5%. While decent and above trend it is hardly a 'reflation'; yearly growth is running at 1.9% now and has averaged 2.2% over the last three years. This is where a helpful Trump administration could and should build on this base by encouraging investment through any mix of incentives, but the chance of that is looking bleaker by the day. The low first quarter GDP print was due to an incredibly weak consumer, which will likely bounce in the coming quarters. However the magnitude of the bounce is questionable given we've seen auto sales crash 8% already this year, following the trend higher in auto loan delinquencies and a bloodbath in retail.

Chart 2: Falling faster than the resale value of a yellow mini cooper

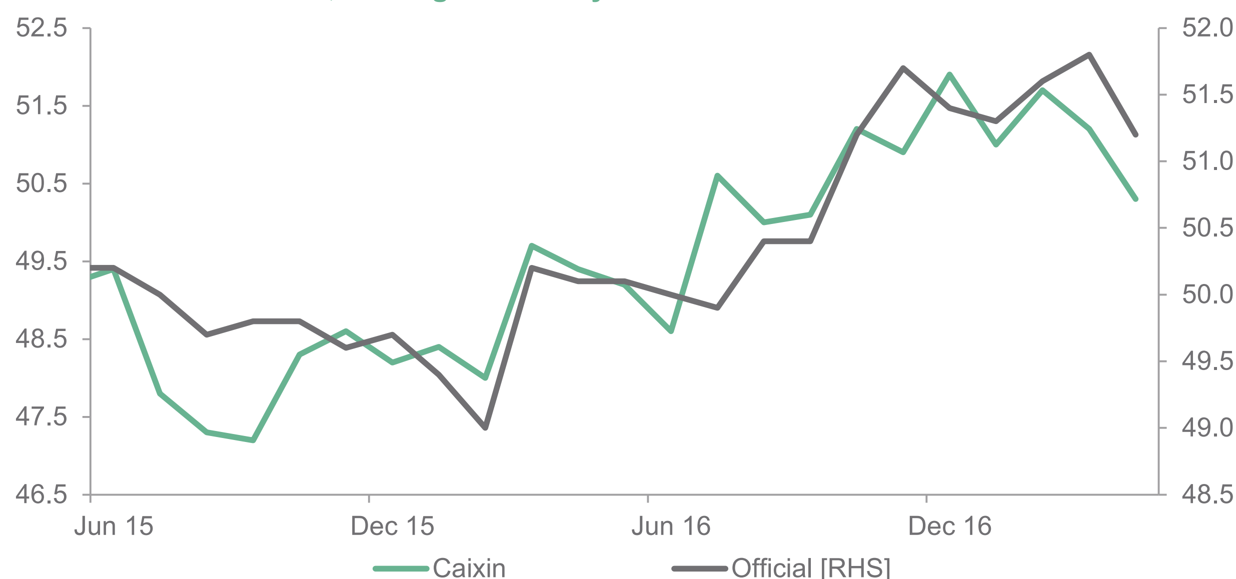


Source: Bloomberg

Given that most retail bankruptcies and hence store closures happen in the first part of the year after the last gasp that Christmas affords, 2017 is on track to have the most store closures since the GFC. A large part of the explanation is structural due to internet shopping, but store closures have very real effects on jobs and commercial property valuations, causing banks to pull back lending in that area. Stories like this aren't supportive of an economy that is trying to break free from the low-growth trap left behind by the GFC.

The fall in manufacturing surveys in the US doesn't happen in a vacuum however, and as I wrote about last month the manufacturing surveys of all the different regions are highly correlated as we live in the era of globalisation (much to the dismay of Mr Trump et. al.). The two main Chinese PMI figures have also come in on the low side for May, disappointing not only market expectations but with outright falls in the absolute level of each index.

Chart 3: Chinese PMI's, looking a bit sickly



Source: Bloomberg

China, at an inflection point?

I have written in the last couple of newsletters about the profile of growth in China, which has been slowing since about the turn of the year. The slower pace of credit growth has seen the contribution to GDP from infrastructure investment slow materially, which means we've probably already seen the top in GDP growth, after a fairly lofty 7.1% for the first quarter. That said, property and private investment in our opinion will pick up the baton in the second half of the year giving Chinese growth (and perhaps world growth) a second wind. This further investment will however require even more credit, even if it is credit that's going to better capitalised private companies over troublesome state owned enterprises. More credit means more leverage, and with the Chinese economy on its way to

300% debt to GDP ratio by 2019, this amount of leverage in an economy that doesn't have a fully developed financial system is going to result in some issues.

Huge debt means equally huge bank balance sheets. Huge bank balance sheets need to be funded, whether that is through bank deposits, long-term or short-term wholesale funding. The demand for funding from the market has skyrocketed since the GFC as bank loan growth has surpassed deposit growth since 2011, with the exception being one brief period during 2013 after there was a significant recovery in GDP growth from 7.5% to 8.1%. Unsurprisingly, this uplift in growth was from a burst in loan growth in the prior year. The cumulative funding gap to the banking sector increased by roughly 2% per year, leaving a 10% gap in funding, when total bank assets come in at just under $34 trillion. That is a very meaningful funding gap.

Chart 4: Mind the gap

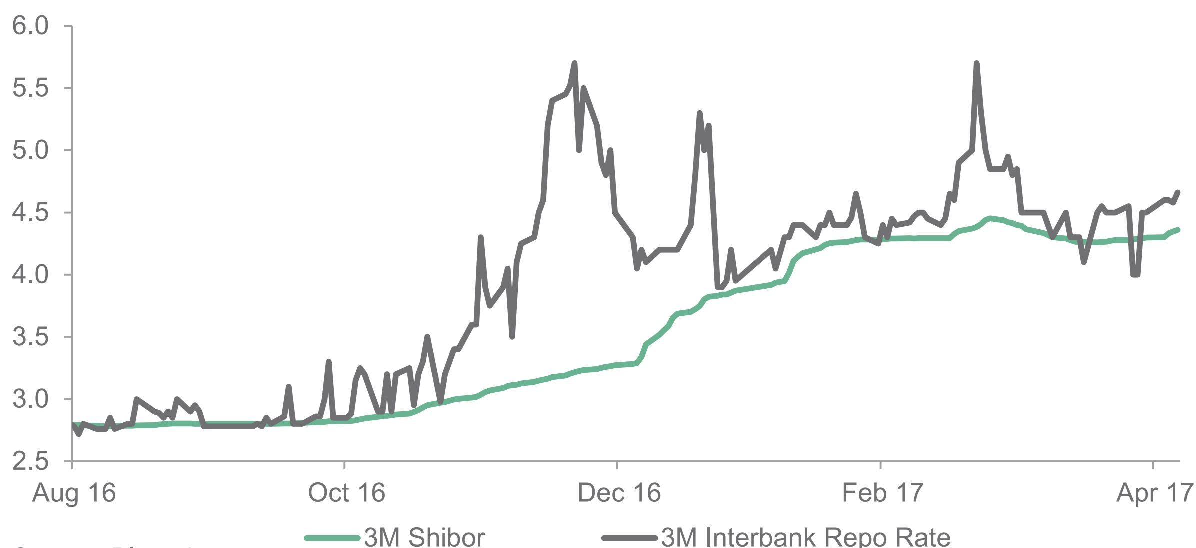
Source: Bloomberg

Scarily, the Chinese banking system is now the biggest in the world in USD terms ($34 trillion), overtaking the European banking system in late 2016, clocking in at nearly 3 times the size of its economy. For reference, the US banking system is only $7 trillion (only c.40% of the economy size). It also grew just under 35% over 2015 and 2016 in Yuan terms. Since China doesn't have a bond market the depth of either the US or Europe, it has to rely heavily on the banking system for credit creation. It also has Wealth Management Products (WMPs) that total roughly $4 trillion, which are off balance sheet and the source of higher return (and presumably higher risk) credit exposures with even more leverage.

More recently a surge in outflows of deposits by foreign corporations has placed further strain on funding for the banking system, causing 3 month interbank rates to rise significantly at the end of 2016, from a low of 2.80% to a steady 4.34%. This is a persistent rise of more

than 1.50%, doubling the PBOC's underlying deposit rate. Be in no doubt, a funding squeeze is currently in play, a result of a massive growth in loan assets at the same time as deposits have failed to grow at a fast enough pace to cover. A situation like this is guaranteed to happen when you are growing credit by more than the economy, forcing the banks to search elsewhere to fund the gap, and generally this search has to happen overseas. When you have to search too hard, rates have to rise to attract that capital. The greater the funding gap and the greater the perceived risk, the greater the premium required.

Chart 5: Chinese short-term rates



Source: Bloomberg

Developed market financial institutions are old hats at funding their expansions by reaching overseas. The Icelandic, Irish, Spanish and even Australian banks were the most successful at this strategy pre-GFC, growing their banking systems to many multiples of their respective economies. But this degree of rise in funding rates isn't something that happens in developed financial markets, even at the worst of times. During the worst of the GFC (September-October 2008), short-term funding rates for banks increased in magnitude significantly but this was solely due to the fact the financial system was in an existential crisis at the time, with investors not knowing if a bank would make it through the night.

At the worst of it, Australian bank short-term funding rates increased by only 0.3% and while the US experience was far worse (with rates exploding by 3% for some of the lower tier banks), this extraordinary period only lasted for less than a month. Further, these higher funding costs rarely hit the banks as they did most of their borrowing from central bank emergency facilities, rather than from the interbank market. In contrast, funding spreads in China have widened by emergency levels, and have maintained those levels for nearly six months now, while the banks are actually paying these elevated levels to source funding. Yet there is no panic or concern visible in wider markets about this funding

squeeze. If funding spreads blew out this much in the Australian market, the stability of our financial institutions would be questioned immediately.

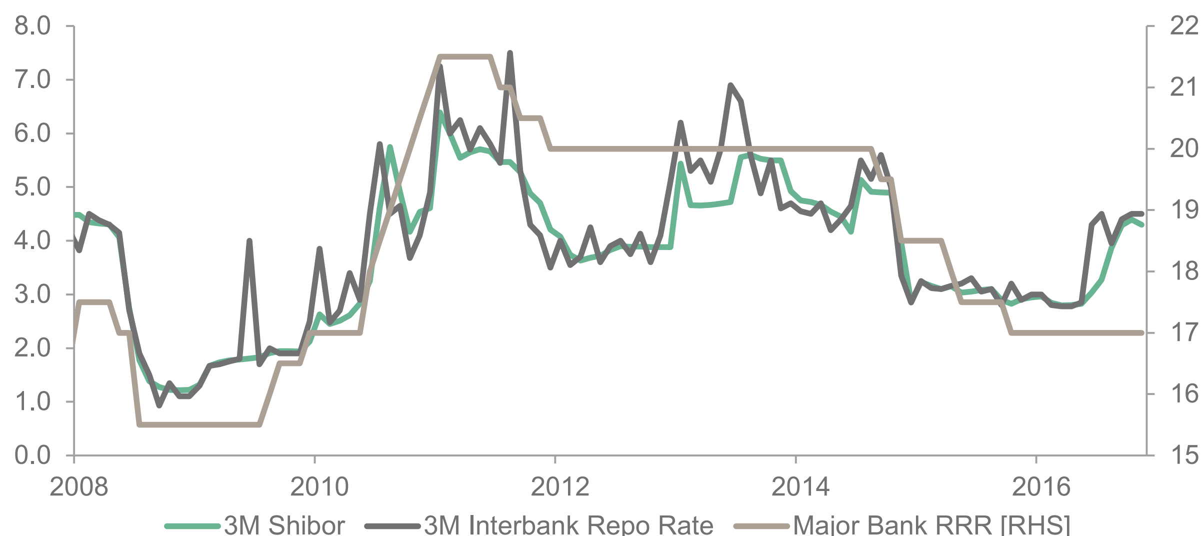
Chart 6: Australian stresses during the GFC

Source: Bloomberg

Left a bit, right a bit, left a bit, full steam ahead

However, it is unlikely that these pricing signals morph into a full-blown crisis. This is thanks to the control that the leadership and the PBOC have over all aspects of the financial system, as well as the distinct lack of ways to actually make a direct bet on the failure of a bank. The charts above show that it isn't the first time that this has happened either. Taking a longer term look at interbank funding rates shows that these rates can be highly volatile, with chart 7 below showing the spread to PBOC lending rates rather than the absolute borrowing rate. The chart also contains the Required Reserve Ratio (RRR). This is a ratio set by the PBOC which determines the reserves required to be kept at the central bank, and acts as a leverage limit on the banking system. Increasing the RRR should restrict the supply of credit to the economy, while reducing the RRR should encourage credit expansion. In the past this has been used to loosen monetary conditions when growth was waning, and as a tool to encourage economic reform by lifting the RRR. The fall in the RRR during 2015, a year of very poor economic growth, hinted at the leadership's desire to kickstart credit as a growth engine once again.

Chart 7: China rates and Reserve Requirements Ratios



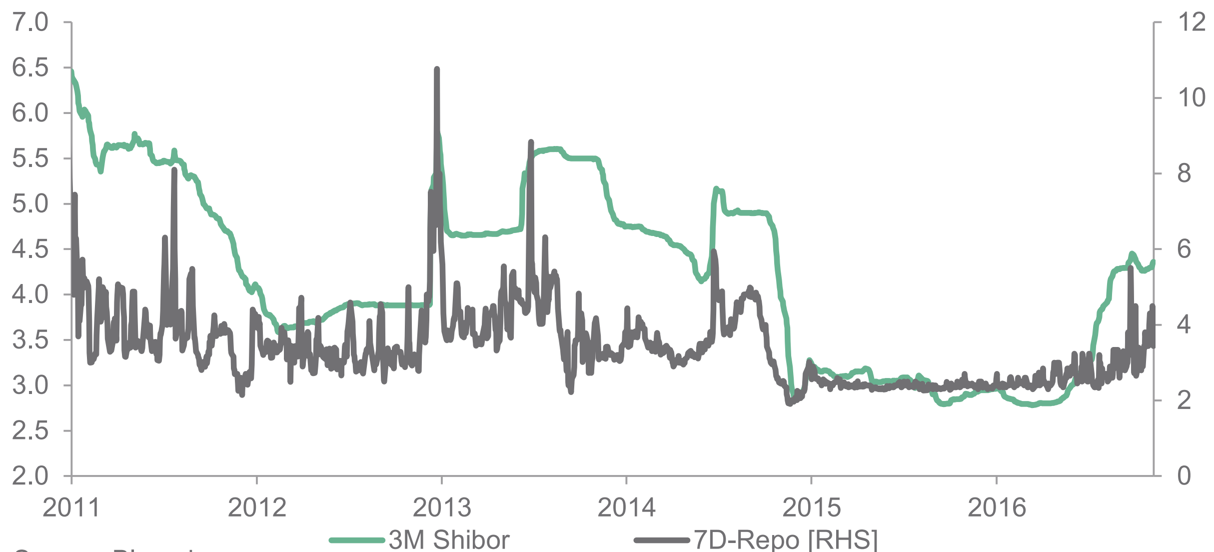
Source: Bloomberg

These moves to the RRR also resulted in lower funding costs, as captive liquidity was immediately released into the market. Its payback is only being felt now with the rise in funding costs causing a slowdown in credit growth. A further RRR cut by the PBOC may alleviate some of these issues, but other limits are now being bumped up against, such as loan-to-deposit ratios. Obviously these rules can be changed (and are highly likely to change in order to avert a disaster), but right now they dictate the constraints the banking system operates under. More importantly to the leadership, lowering the RRR sends mixed signals on the ultimate goal of economic reform and hence the option is being left off the table.

Without the option of fixing the problem permanently with the RRR, the PBOC have resorted to expanding their use of an alphabet soup of liquidity facilities. These are aimed at ironing out the hiccups in interbank liquidity and essentially providing emergency funding to the banks that need it because of short-term funding issues. Once again, if these facilities were being used as regularly as they are in China in any other developed market there would be mass panic with equity investors dumping stocks, bond investors would stop rolling their exposures and short-term money market rates would cause a wider reaching liquidity crisis in the banking system. However, the rules are different in China, with total trust in the leadership to continue to manipulate any market necessary being the primary factor.

The best measure of liquidity issues is the 7 day repo rate. The more volatile this indicator (i.e. the more that it spikes), the more likely the PBOC will have to intervene with open market operations or provide liquidity through any number of facilities.

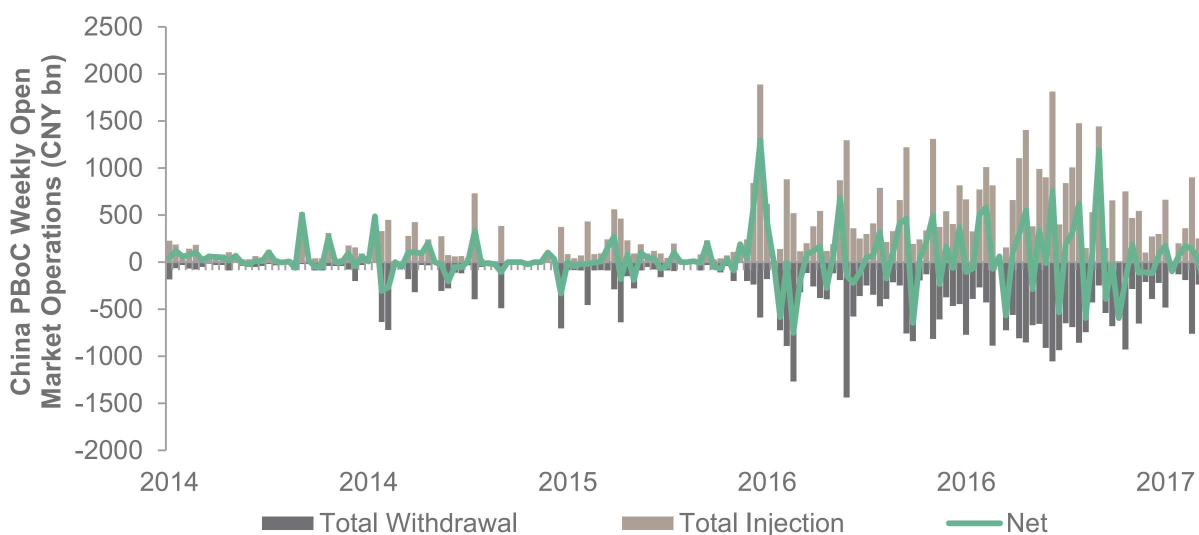
Chart 8: Back to the bad ol' days



Source: Bloomberg

2015 and 2016 both saw low volatility in the 7 day repo rate, the sign of a well-functioning market. Along with this there was a low funding rate for banks (once again shown above by the 3 month interbank lending rate), and this was all probably a function of the large reduction in the RRR over the whole of 2015, releasing liquidity and taking pressure off the banks. Once credit growth kicked off again in late 2015 and the RRR was not dropped any further, open market operations started again, picking up in intensity toward the end of 2016 when funding rates started to increase as shown in chart 9.

Chart 9: Chinese FOMO for OMO (sorry)



Source: Bloomberg

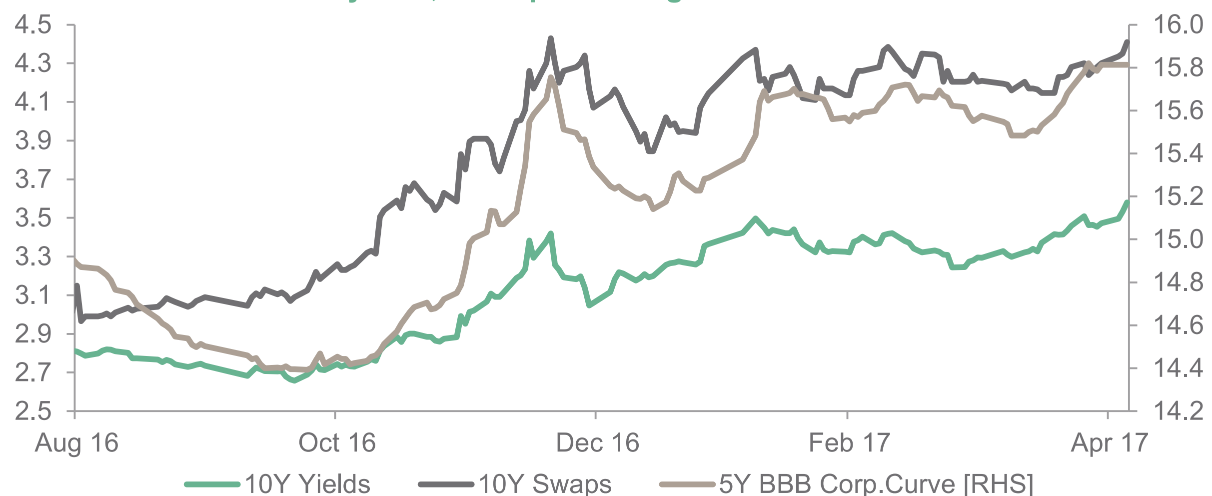
The narrative being spouted for this intervention has been one of reform, with China bulls putting forward these hiccups as a necessary evil when trying to reduce leverage in the system. Those Wealth Management Products (WMPs) I spoke about before are big buyers

of short-term paper of the banks, acting as a large funding source. To get the returns necessary for the higher returns promised with these products, leverage once again is the answer. Investing in bank and corporate bonds is done on a leveraged basis by lending out these securities to buy some more. This became such a widespread activity that it was feared that a small rise in interest rates would be enough to send some products bust just because of the degree of leverage. This already occurred in 2016 with stories of small financial institutions getting into trouble because of rising interest rates. In an attempt to curb this sort of behaviour, the PBOC has been allowing the market to suffer liquidity issues and restrict liquidity to non-bank institutions, leading to a bifurcation between bank and non-bank levels of stress.

The fact that it isn't so much the proper banking system affected by these frequent liquidity disruptions should mean that everything is fine, right? Well we would argue that while the banking system may not be clamouring for liquidity, their funding costs have most definitely been going up because while they may not be in the firing line of PBOC policy, their key investors are. Add this to deposit outflow and it's no wonder funding rates have jumped 1.5%.

The targeting of leveraged institutions has had effects on other asset classes too, namely government bonds and other corporate credit. Chinese 10-year government bonds have made new highs in yield while the US has the gone the other way, remaining as an outlier. We've seen the same being reflected in swap rates and corporate credit which is at new highs in outright interest rates and wides in spread terms as well. Not great news for an economy as indebted as this one. Rising interest rates reduce corporate profits and consumption and while this may be the market operating rationally in light of the huge increase in debt, it points towards far higher defaults in the future.

Chart 10: Chinese bond yields, underperforming the world



Source: Bloomberg

This is all a very bleak story, painting the picture of a financial system that would be on the precipice in the absence of a central bank that had so much power to patch over any issues. This is the last environment you'd expect a central bank to be hiking rates, especially given that inflation has collapsed to only 0.9% for the year, with only modest improvements in inflation from here expected. Sure, factory input prices have been rising aggressively but that is just because of commodity prices and that will turn very soon anyhow as we have seen the highs in commodities already. Despite this, the PBOC has been gradually raising interest rates over the year, with 20bps of hikes so far across a range of money market facilities and more expected. While inflation and the deleveraging story was cited, we think there are other issues forcing the PBOC's hand here.

Chart 11: Nothing to see here…

Source: Bloomberg

The reason that China will always find itself in a position where its hand is forced on rates is because they continue to try and manage the currency and avoid significant depreciation while having a leaky capital account which still enables individuals and corporates to get their money out of the country. The more the US raises interest rates, the more pressure is placed on the attraction of offshore locations for capital, making it harder to keep the currency stable. China has gone down two routes to ensure the currency doesn't devalue which is to raise interest rates and to further clamp down on the current account. A huge 7.1% economic growth rate in the first quarter certainly goes a long way to keep capital onshore as well, but when the environment does sour it will place more pressure on the PBOC to hike rates further to keep capital at home. Rising market interest rates have also helped to attract offshore funding for banks. Where else in the world can you get 4.3% for lending to a well rated bank for 3 months? This has all contributed to a result of zero capital outflows as per the official numbers in the last two months. A good story - for now.

Controlling the illusion or the illusion of control?

There is no doubt financial risks are rising in China. This is going to put further constraints on the ability of the leadership to reform the economy away from the 'old economy' of heavy industry towards consumption, as the noose of past debts tightens on the economy, siphoning more resources away just to service past debts. The issues with liquidity I have highlighted will place further strain on an already creaking system, struggling with a massive volume of debt.

Being bearish on the China story is getting old and multitudes of investors have been run over waiting for the big crash to happen: however, there is one difference this time around, and this is the reason we are becoming more cautious. For the first time in modern Chinese economic history, interest rate policy is been implemented like it is a real emerging market country, and this is deeply concerning. Throughout the last decade-and-a-half China has been classed as an emerging market, but it was seemingly big enough and dominant enough on the world stage that interest rate policy acted like a developed market. In this sense it was set for domestic growth and inflation reasons, not for external reasons. It seems now that the PBOC is hiking interest rates to manage the currency and capital outflows, rather than domestic inflation or financial system stability. All you have to do is ask Brazil or Thailand or Russia why having to do this can make life very difficult for the domestic economy.

Vimal Gor
Head of Income & Fixed Interest
BT Investment Management

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BT Investment Management's Income & Fixed Interest team of thirteen dedicated professionals, led by Vimal Gor, manage the #1 performing Australian composite bond fund of 2014 and 2011.

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