Income & Fixed Interest Newsletter

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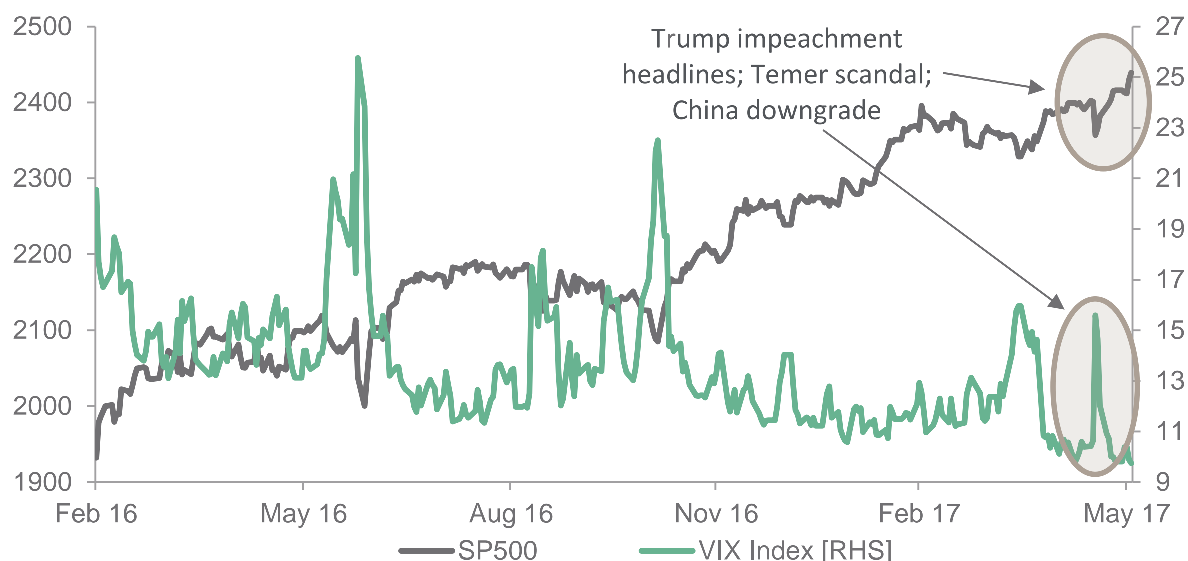
Another fake break?

This month President Trump faced increasing political problems, President Temer was swept up in another Brazilian corruption saga, North Korea lobbed more missiles in their relentless ‘testing’, and China’s credit ratings were downgraded by Moody’s. After a solid start to the month, markets started to suffer a crisis of confidence, wondering if this was finally the big break out of the range. But if you followed the old adage “sell in May and go away”, you would have had to rush back half way through the month to reboard the FOMO Express. Following a brief dip in equity markets and a short and sharp spike in volatility, the S&P 500 continued its march towards all-time highs, and the VIX fell back into ‘whatever’ territory. The bears felt cheated, the buy-the-dippers felt like geniuses, and the unloved middle are left to wonder why, in a world of so many uncertainties, of lofty asset valuations, and of central banks determined (for one reason or another) to “taper” and “normalise”, is there so much complacency in the market?

We had a decent month on the funds with all flagship funds outperforming their respective benchmarks. In last month’s Newsletter I went very deep into the intricacies of Chinese financial plumbing and we got feedback that I lost a few people on the journey, so this month I wanted to step back and take a big picture view. In this note I aim to pull together our current thoughts on China and, given the growth inflection point looks to be clearly behind us, investigate what they mean for the rest of the world’s economies and markets.

Chart 1: All aboard the risk train



Source: Bloomberg

Perhaps to say that there is complacency in the market is too broad a generalisation, it just seems like there are just so many contradictions out there currently. Equities and fixed income markets are saying very different things; while the S&P 500 and VIX are very sanguine, US bonds are rallying which tells of a much more concerning picture, but even here volatility is falling. As sentiment and expectations continue to gyrate between extremes, the underlying economic data is still playing out in much the way that we had anticipated. I would argue that it is not so much the economic data that have been volatile and unpredictable, but rather the pendulum swings in market moods, coupled with headline grabbing political dramas, which have led to the kind of fake breaks that we saw in May. I have written over the last couple of newsletters about the unwind of the Trumpflation trade, and it seems like this has now been pretty much all priced out.

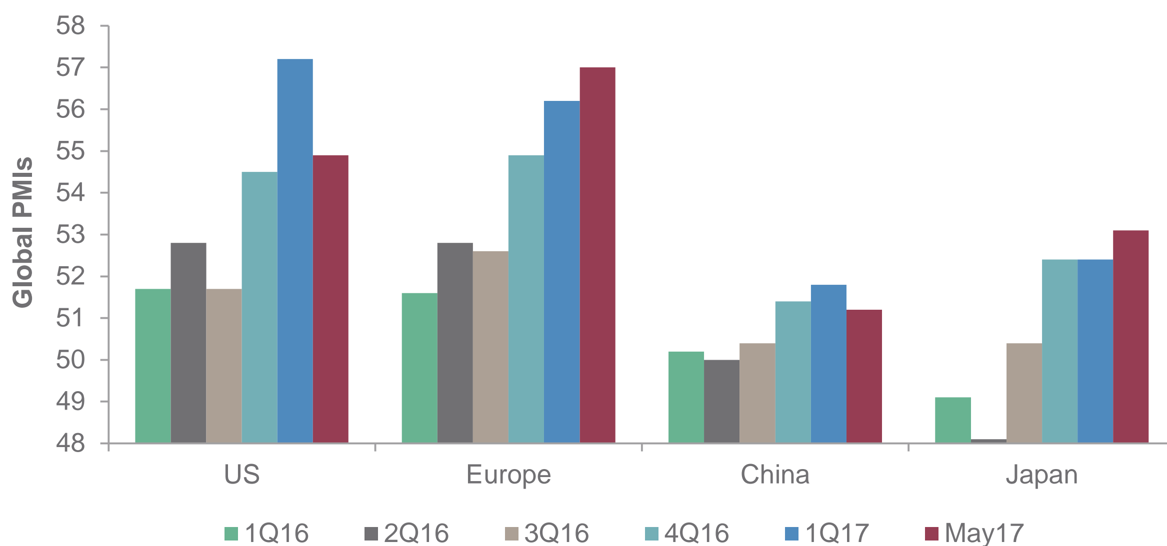
Chart 2: Greenback back down

Source: Bloomberg

Nevertheless, these are indeed some very confused times for markets, and to complicate matters further, global growth is not in synch. US data continues to disappoint versus high expectations (set by some very strong soft data prints that I wrote about in previous Newsletters), but more importantly the positive Q1 momentum seen out of EM and Asia has begun to wane (as China's policy tightening starts to bite). European and Japanese data look to be on fire, apart from the one indicator that everyone cares about the most, inflation.

But the GFC has altered the way that the market perceives the balance of risks (the behavioural finance term is pain memory): we now have a tendency to overestimate long term volatility ("it's all going to crap"), hence placing a heavier weight on downside risks. Also, with the economic green shoots in Europe and Japan being *so green*, we don't know if we can trust them yet, or if they can gather enough momentum to offset the potential drag from China and the US.

Chart 3: Crucially, the inflection point has been passed in China



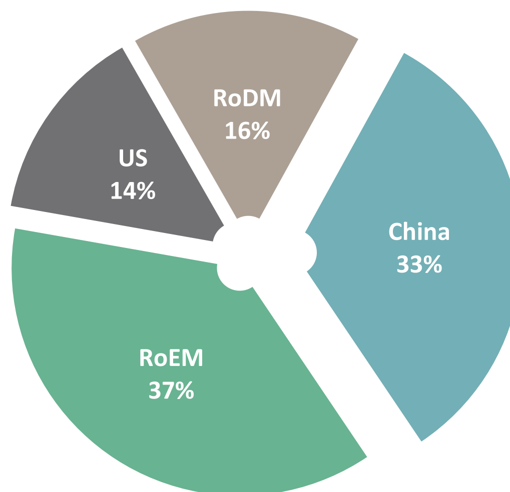
Source: Bloomberg

The central country

The latter point is an important one, and regular readers will be familiar with our long-held view that the reflation theme had its epicentre in China's most recent wave of credit stimulus, which began in late 2015. The lack of synchronicity of current global economic cycles means that there are push and pull dynamics at play between the emerging economies ("EMs") and developed ones ("DMs"). If you think the distortive effects of extraordinary monetary policy make it difficult to gauge where we are in the US cycle, it is infinitely harder to discern where China might be in its cycle, let alone to trace the would-be impact on the rest of the world. But with China now contributing to over 30% of global GDP growth, various economic

reforms currently underway, and the potential for a more introvert US economy led by an increasingly isolated president, we need to face the new reality which may well have China at its centre. As it so happens, the Chinese characters for China are *zhong guo* 中国, which translate to "the country at the centre". Whilst perhaps not quite the intended meaning of the original name, China's growing importance and interconnectivity to the rest of the world places it closer to the centre than ever before.

Chart 4: Look who's the big dog now



Source: IMF

As an example of the aforementioned market mood swings, sentiment on China has swung towards concern in recent weeks as the latest set of economic data started to disappoint versus some fairly high expectations. Along with the moody (market) sentiment, Moody's (the rating agency) decided to downgrade its long term local and foreign currency issuer ratings on China by one notch to A1 from Aa3. This leaves S&P now the only ratings house to still have an AA- rating on the country.

Whilst the timing may have taken the market by surprise, the action itself left no meaningful dent on Chinese asset prices. The reasons cited for the downgrade were related to concerns on the China debt problem - a concern widely shared by the market (ourselves included), and already warned about over a year ago when Moody's placed its then Aa3 rating on negative outlook.

Other ratings sure to be negatively affected by this downgrade include those of the big five banks, core SOEs and strategically important Chinese blue chips, and local government financing vehicles (LGFVs), as they are all tied, in one way or another, to the sovereign credit rating. Yet broader financing costs are unlikely to suffer meaningfully because the

majority of financing is raised domestically, and Chinese corporate reliance on external debt funding has reduced materially since its peak in 2014. For domestic investors, their decisions to invest in Chinese sovereign and corporate bonds depend more on the ratings from domestic rating agencies, rather than on those from Moody's.

The price of high growth

So if credit markets don't care about the China downgrade, then why does it matter to the rest of us? We think it matters insofar as it places more pressure on China's leadership to pursue a more concerted effort on economic reform. The concept of reform as applied to China is a complicated one, and I won't be exploring the semantics here. Simply put, the harnessing of market forces within a socialist framework has resulted in extraordinary growth for China in the last two decades, but the resulting imbalances and inefficiencies of such a growth model now need to be tackled. Rising inequality and corruption have accompanied this period of phenomenal growth and it is inevitable that within a socialist economy, political pressures have been mounting from the left. Since the GFC, each time that growth has faltered, the Chinese authorities have come to the rescue by pumping credit to the 'old economy' (SOEs, manufacturing and commodities-intensive industries) which by default, crowds out the 'new economy' (private sector consumer-focused businesses, services and tech).

This is currently being reflected in the recent divergence between the official and unofficial Chinese PMI data. But de facto socialist allocation of credit and resources results in lost efficiency and productivity, and unprofitable ("zombie") SOEs have been propped up by enormous piles of debt. Meanwhile, financial sector regulation has been haphazard at best, and growing leverage within the financial system has become commingled with rising corporate leverage. The systemic risk stemming from all of this has clearly got President Xi worried, and hence the decision to begin policy tightening alongside a regulatory-led hawkish PBoC this year.

Reform or regress?

There is no doubt that continued economic reforms are necessary, but *how* this broader process of reform takes place is every bit as important as whether it takes place at all. Broadly speaking, we see two paths toward reform. The first path is the one that seems to make sense to most. This path sees President Xi consolidating his power at the 19th National Party Congress later this year, and moving forward with a much harder line on reform in 2018, including SOE reform that will necessitate rising corporate default rates.

Such a path of reform would likely mean a sharp growth correction in 2018 and even 2019. And whilst such a slowdown would be painful (both within and outside of China), it would be temporary, and pave the way for improving trend growth in the long term. Seen in this light, the current monetary tightening should be viewed as a positive, insofar as it aims to allow credit to flow to the real economy, rather than being trapped in the virtual economy 脱虚向实. The optimist's version of this path of reform is that there need not even be a trade-off between short-term pain and long-term gain, and that the omnipotent leadership can engineer a reform of the SOEs whilst still supporting the growth of the new economy.

The second path of reform is murkier, and involves some sort of SOE reform that doesn't really deal with the problems of bad debt and zombie companies, but rather continues to socialise these problems. Seen in this light, the supply-side reforms in the coal and steel sectors last year become more worrying. When reforms seek to raise prices in order to save unprofitable producers from default, these same reforms become a mechanism by which the new economy pays for the sins of the old economy. Similarly, recent regulatory and financial measures can be seen in a different light. The alphabet soup of money-market tools that better allow the PBoC to target its control over both the price and quantity of liquidity may be a necessary step to contain rising financial leverage. The tightened capital controls on cross-border RMB flows may have been a necessary circuit breaker to stymie the overwhelming pressure of outflows from 2016. But together with the new fixings introduced in May for both the currency and short-term interest rates, these measures are all nevertheless a move away from the influence of free market forces.

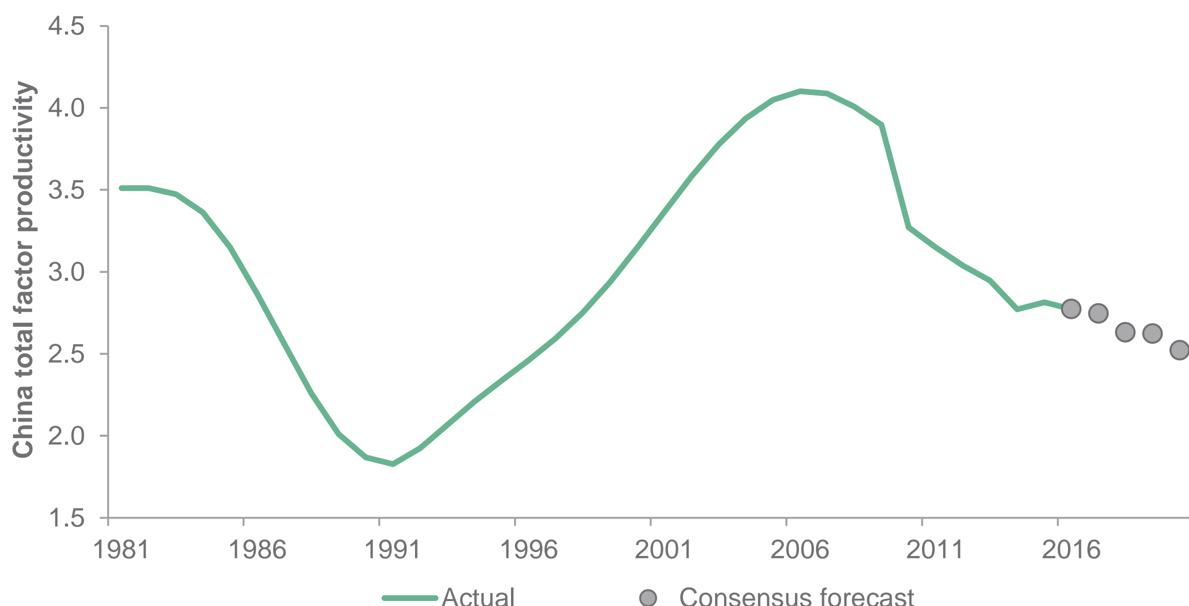
Socialism with Chinese characteristics

"Socialism with Chinese characteristics" has been the central ideology of the Communist Party since Deng Xiaoping was its leader. The common defence against leftist hardliners during the earlier stages of reform was that China was in the "primary stage of socialism" during which capitalism needed to be harnessed in order to address the underdeveloped productive forces of the economy. Over the years, many in the West have interpreted the ideology instead as "capitalism with Chinese characteristics", but if the ultimate goal was (and will always be) a highly planned socialist system, with the heavy hand of the state being felt through every strand of the economy, the West may need to rethink its interpretation.

If reforms are to mean a digging-in of socialism's heels, the economic outcomes will look very different. The broader implications would actually be bullish for the near term. Old economy China continues to fire on all cylinders, the growing middle class don't yet feel the weight of the burden they will ultimately have to bear, the economy continues to hum along

with a 6%-handle on growth, and the world hums along with it. But the longer-term prospects become much bleaker, with productivity continuing to be eroded as China's bad debt problem gets socialised and control remains centralised. There will be a greater likelihood of growth accidents, against which the credit stimulus machine will have diminished fire power. And if the positive spill over effects were so large and far-reaching during the ride up these last 20 years, we would be right to fear some stomach-churning moments on the ride back down. Furthermore, if the primary stage of socialism involved China's displacement of much of the developed world's manufacturing industries, what kind of havoc should we expect from the second stage of socialism? Regardless of your interpretation of reform, China is likely to remain "the central country" for some time to come.

Chart 5: Chinese TFP…..going tfffffppp



Source: Bloomberg

The need for speed

Reforms aside, the current consensus is that this year's leadership reshuffle provides a 'policy put', and that Chinese growth will end up at or around the 6.5% mark. Whilst we agree that one can be comfortable with Chinese growth in the near term, we are less convinced on the idea that there is meticulous policy coordination behind the current policy and liquidity tightening. The five-year plan in 2015 reiterated China's previous commitment to double the size of the economy by 2020 (to $12tn, from its 2010 GDP), and the credit stimulus implemented in late 2015 (when "true growth" likely had a 5% or even 4% handle on it) was a demonstration that China stands true to this commitment. The goal of a $12tn economy necessitates that any slowdown in growth below 6% be avoided.

Whilst we have likely seen the peak in PPI, PMI and GDP growth for now, we are careful not to over-interpret a turn in the momentum of the data to mean an imminent crash. After all, if the market expects 6.5% growth for 2017, and Q1 growth came in at 6.9%, then by construction, the market must already be expecting growth to slow in subsequent quarters, so is the market double-counting its concern? More likely, as is consistent with aforementioned mood swings, the market has swung to a much more pessimistic expectation of closer to 6% than 6.5%. Granted, the developed world would go gaga over a growth print of 6%, and if 6% can be sustained, it is still a healthy pace of expansion for the Chinese economy. But the worry is that this would imply a hefty growth shock in H2, which in turn would imply that the slowdown had momentum and 6% would be unsustainable without another rabbit being pulled out of the hat. This is certainly a (fluffy) tail risk outcome that could result from a policy mistake, but the current turn in data in and of itself fails to warrant such near term pessimism.

(Back) Channels of influence

The downside risks to the Chinese growth picture matter not only for investment decisions with regard to Chinese assets, but arguably even more so outside of China. In fact, one of the most painful consensus mistakes so far this year has been to bet against the RMB. Just as we have all learned that “you don’t fight the Fed”, it is becoming apparent that this likely applies to the PBoC also. Moreover, what may be healthy for China may not be healthy for the rest of the world.

Without a doubt, China’s impact on EMs outweighs that on DMs, and the main channel through which this influence can be seen is commodities. China’s share of global commodity imports has been rising since the GFC, and is now at a point where commodity exporters and manufacturing exporters send equally large shares of their exports to China. Unsurprisingly, bulk and base metals exporters have the highest dependence on Chinese demand, making EMs such as Brazil and Peru more vulnerable to a China slowdown risk. To this end, Australia is the most EM of the DMs. Iron ore and copper suffered the worst reactions this month to growing China concerns. Another trade channel is, of course, manufacturing exporters, although the mix of manufactured products demanded by China has changed significantly over the last decade, with China now competing in the manufacturing of higher tech and higher value-add goods. This means that the small open economies in the Asian supply chain are most sensitive to Chinese growth risks, including Taiwan, Singapore and Korea. The sensitivities are large and immediate, as was witnessed in the first four months of this year, where Asian trade data surprised significantly to the

upside, and with growth momentum now coming off its peak in China, we expect that to transmit into weaker trade growth momentum for the region in Q2.

A more subtle channel of influence that China has over other EMs is its ability to become a substitute for external financing - especially important to the hard-core EMs who have things that China want (natural resources), and for whom the international doors are often too quick to close. Existing recipients of Chinese funding include Brazil, Argentina, Venezuela and Ecuador. Another financial channel of influence is through Chinese FDI flows, which are particularly apparent in the ASEANS, as well as in Africa, as China pursues the (One?) Belt and (One?) Road initiative. The financial and trade channels of influence are overlapping, in that if strong trade-led momentum is able to ignite domestic growth momentum, FDI and external financing provide the fuel to keep that momentum alive.

EM's growing dependence on China may make it easier to explain why the market doesn't care as much as it perhaps once would have done about the accusations against President Temer, or North Korean missile headlines. Of course, the disruption of political stability affects investor sentiment in Brazil, but the fate of the current economic improvement hangs as much (if not more) on the health of Chinese commodities import demand as it does on the outcome for Temer. Similarly, as disturbing and terrifying as it must be to live next to North Korea, South Korea has been riding on the coattails of the Chinese rebound. Coupled with the passing of its own impeachment saga, South Korea has been enjoying the strongest and longest rebound in consumer confidence since 2009.

Chart 6: The key rate in the world right now

Source: Bloomberg

For DMs, China's most significant channel of influence is through its currency. China began operating a managed float foreign exchange regime in 2005, and until 2013 the RMB was managed within a fairly narrow band versus a daily fixing against the US dollar. In fact, until 2014, the only way the markets had known RMB weakness was as a pause in its steady appreciation. In August 2015, with a move that shocked the markets, China devalued its currency by more than 3% over three consecutive days of deliberately weaker currency fixings versus the US Dollar. The move was likely provoked by very weak growth domestically, complicated by softness in the Japanese Yen and Korean Won which were hindering China's export competitiveness at the time. The move raised concerns over currency wars throughout EM, as well as questions over the real health of the Chinese economy. 2016 then saw the RMB depreciate nearly 8% from peak to trough against the US dollar.

While this may all seem a bit 'so what?', Yuan depreciation has a deflationary impact on the rest of the world in a number of ways. First of all, a weaker RMB coupled with a stronger USD raises the prices of commodity imports for China, which may dampen Chinese demand (the commodities channel). Second of all, and the aim of the 2015 devaluation move, the cost of Chinese exports fall as the currency devaluation has made them more competitive, and trading partner margins are squeezed as they are forced to lower prices in response. Third and most important of all to the US economy, currency devaluation in an EM economy often inadvertently invites speculative attack on the currency, as well as prompting capital flight from within the economy. A typical course of central bank action during a currency crisis is to try to defend its currency via the use of foreign exchange reserves (market forces-biased), which is what China chose to do through much of 2016, until the market started noticing how quickly they were burning through those reserves. More importantly, China held the majority of its foreign currency reserves in US Treasuries, and had been the largest holder of US Treasuries from September 2008 until December 2016. China's crown was lost to Japan after almost a year of selling treasuries to defend the RMB. When the largest holder of US Treasuries sells down a quarter of its foreign reserves, treasury yields head north, and US financial conditions start to bite, and everyone takes notice. In short, China has the ability to hold the global reflation trade hostage via its currency.

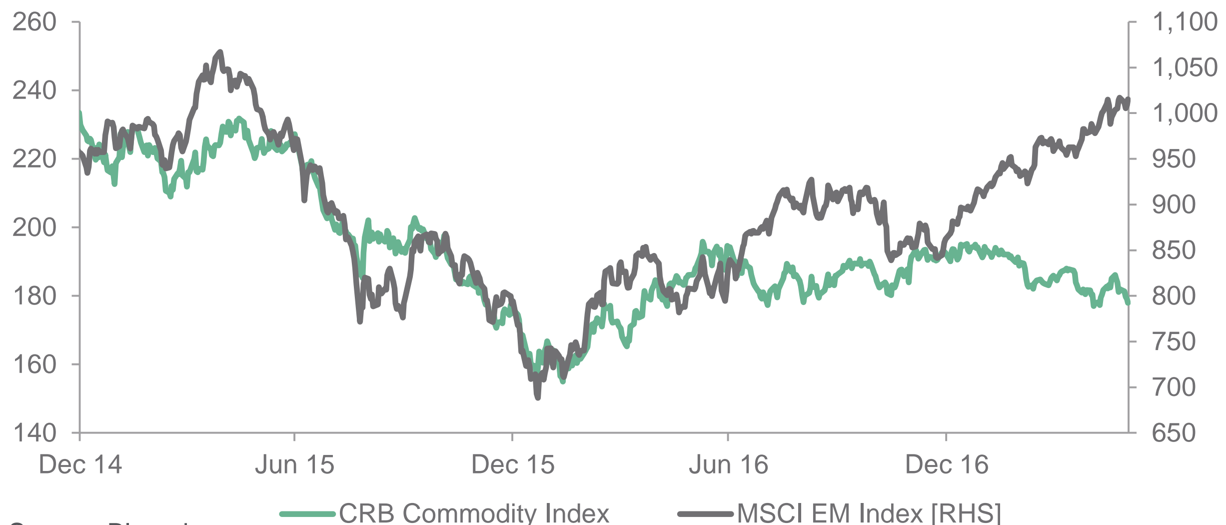
Chart 7: The big dog wags its tail

Source: Bloomberg

Take that

The currency channel is precisely what is different this time. As we entered 2017 and markets remained convinced about continued RMB depreciation, China decided to screw with market forces and reserve depletion, and reverted to old-school EM ways: sealing its currency borders. As often with EMs, rules are made to be broken, but the authorities also cracked down hard on the circumventors (import over-invoicing, offshore spending by corporates), and since February this year, outflows have practically stopped and reserves have stabilised just above the $3tn mark. The absence of currency volatility, however it was achieved, has been crucial to the breakdown in correlations between commodity prices and other global risk assets.

Chart 8: A clear break



Source: Bloomberg

Pandas no more

Even as we continue to caution against the downside risks to the Chinese growth story, it is important to highlight that not all is black and white. The China model has no predecessors. Those who draw parallels between China and Japan are missing the incredibly strong role that the Chinese consumer plays in today's economy, as well as China's role in the largely overlooked tech cycle. The strength of political support behind the Chinese tech sector is observable from the designation of the new city of Xiong'an as the new China tech hub, not to mention the sheer scale of demand that will stem from the building of this city. There is a chance going forward that technology can be the X-factor that alters the trajectory of Chinese productivity.

As we inch closer to the Congress in October/November, Chinese leaders will continue to walk the tightrope, balancing stability against financial deleveraging. President Xi has amassed the most political capital of any Chinese leader since Deng Xiaoping, and we expect to see him make some important changes this year. Whilst both President Xi and Premier Li have reputations for being pro-reform, they likely differ on which path that reform should take. EM experiences remind us that not all reformist leaders who are perceived to be market friendly at the outset turn out to be so friendly in the end (eg Erdogan). The recently celebrated Dragon Boat Festival 端午节 reminds us that the sidelining of influential officials in the pursuit of "a greater good" is just part and parcel of Chinese history.

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