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See The Chinese Forest Through The Trees

The Bears say that China is a mess. The latest round of stimulus won't work because past rounds haven't worked. Look at the massive spending on infrastructure and new "ghost" cities since the financial panic that hasn't produced real returns or benefit. How will more infrastructure spending help? **They can't see the forest through the trees.**

Over the past three decades, provincial and local municipal officials advanced by delivering higher growth. How they attained this growth was far less important (if it even mattered at all) than actually achieving growth to help the leadership in Beijing hit its announced economic growth target. Consequently, there was little, if any, accountability for how the money was spent or whether net economic benefit was generated—only that economic activity rose through the construction activity of whatever project was implemented, which was usually financed by land sales. The legacy of this lack of oversight is the relative stagnation in many third and fourth tier cities—some of them giving rise to the now popularized term "ghost cities".

On the other hand, bulls (we count ourselves among them) counter that accountability for spending by local and provincial officials is being rapidly enforced by Beijing. This is a BIG DIFFERENCE with a spotlight being placed on the efficient use of capital to look at economic value added over the life of the project. Access to capital and financing is changing for government entities. One way that Beijing is facilitating this is by expanding the municipal bond market. A rating process that encompasses financial analysis of issuer/project cash flow to service debt will eventually ensure that better use of capital generates higher returns on investment in the future. Beijing will enforce greater oversight, which also means that market forces will begin to determine the suitability and cost of new projects. Beijing is approving refinancing some local government debt into bonds, including raising funds via the nascent municipal bond market to complete unfinished private projects that can be either reabsorbed by the government directly or through new hybrid securities.

For the sake of argument, let's say that the bears are right and China has a hard landing. But how does that happen in an environment of accommodative monetary policy? Wouldn't Beijing exhaust all its options first in order to avoid just such an event? **China has still has ample monetary and fiscal tools at its disposal.**

China's real rate of interest is still among the highest in the world. Even after this month's 25 basis point cut in the benchmark lending rate by the People's Bank of China (PBoC) to 5.1%, it remains far above the country's 1.5% annual inflation rate. The central bank could continue to lower interest rates to 2% or less so long as inflation stays around current levels and three straight years of monthly declines in the producer price index indicate that upward pressure on CPI remains elusive. Should the PBoC feel the need to do so, it could even follow the lead of the European Central Bank and push real rates down into negative territory. Credit expansion by China's banking system is constrained by one of the world's highest reserve requirement ratios (RRR) at 18.5%. **Although domestic loan demand has been trending below expectations, further reductions in the RRR in conjunction with new monetary and fiscal policy initiatives could lead to resurgent economic activity. We believe that China has at least two more years to pursue aggressive stimulative monetary policy given the current state of the global economy and generally accommodative monetary policy enacted by most central banks. In our view, it will be at least that long before accommodative global monetary policy transitions to a tightening cycle. Meanwhile, the world is awash in rising central bank driven liquidity.**

The large scale experiments with quantitative easing by central banks have demonstrated that it takes a huge press of money over time to impact the real economy. To the chagrin of central bankers, the leakage into financial assets has not created a virtuous circle of investment to propel economic growth higher, despite forcing investors further out the risk curve and propelling valuations higher.

Beijing can't be too unhappy with the money that has spilled into the stock market. After all, China's capital controls limit the investment options for the average Chinese investor. Stimulus enacted by The People's Bank of China will continue pushing investors into riskier assets just as it has for central banks elsewhere. The wealth effect complements their goal of shifting the engine of growth toward consumption as the past three decades of investment-led growth is de-emphasized. What does worry Beijing is the speed at which equities have been rising since last summer. The leadership can recognize a bubble as well as anyone in the west. The leadership wants sustained growth in assets that can be managed (or so they believe). It's an extremely difficult balancing act. Regulatory tools such as adjusting margin maintenance requirements can let some air out of the balloon but they only slow the market's ascent for a while. Too heavy a hand and the regulators risk reaching a tipping point. **We believe that the real worry isn't so much apprehension that the market could crash in and of itself but that the subsequent loss of confidence in the economy (and by extension government policy) given the preponderance of retail investors in the stock market spills over into the real economy to form a negative feedback loop that could lead to social unrest—the biggest fear by far of the communist party leadership.**

Adding to bankers' misery is a recently issued central government directive ordering them to continue funding any local government project started before the end of last year and that any projects that are unable to repay existing loans should have their debt renegotiated and extended. Local government balance sheets are stressed as municipal revenues are declining in large part due to land sales falling on average by around 30%. Without new sources of revenue or financing, municipal spending is destined to decline.

In the meantime, banks have initially been resistant to the forthcoming wave of new municipal bond offerings to refinance existing debt. Their reluctance can be traced to the terms that include lower rates of interest offered on the new bonds compared to the existing loans that they're replacing. This puts added stress on bank profits already under pressure from falling interest rates and rising non-performing loans. Yet this last point contains some irony since banks would in most cases likely improve their position through senior creditor status as bondholders.

Skeptics will point to this as an act of desperation by a government faced with intractable financial problems. We view the situation as not nearly as dire and more manageable that many would believe. The central government is simply forestalling defaults [that we all knew were coming] until a more robust newly created mechanism is in place to absorb the impaired debt. Liberalization of the financial system is a process, not the wave of a magic wand.

These efforts should not be misconstrued as a reverse bailout for the private sector to bailout bankrupt local government entities. In our view, it's an issue of timing for Beijing to jump start China's nascent municipal bond market that currently totals just about 400 billion yuan. While market acceptance of Beijing's financing plan has not been immediate that is hardly the same as saying that the debt swap/refinancing plan won't be accepted. Nonetheless, it still wouldn't surprise us if the central bank winds up absorbing a significant amount of the municipal bad debt regardless of what is currently being implemented.

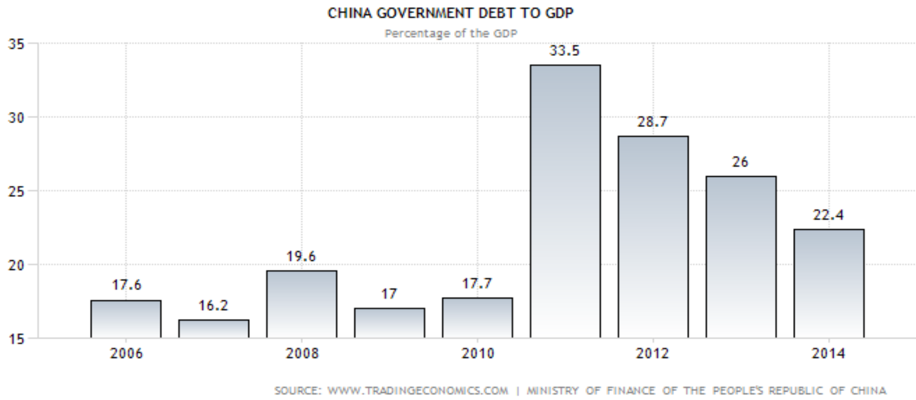
Beijing is injecting the concept of moral hazard into the country's financial system—dispelling the belief [that was always a myth] that the central government would implicitly bail out the debtholders of all types. Lenders are still shaking off the bucket of cold water thrown on them by the People's Bank of China. This really shouldn't have come as a surprise. Quite a lot of Premier Li Keqiang's comments subsequent to the publication of the Third Plenum objectives have been preparing people for the consequences of one's actions.

All this will increase the pressure on Beijing to enact even more fiscal and monetary stimulus and Beijing is wasting little time doing so. Earlier this week, China's National Development Reform Commission accelerated approval for 250 billion yuan ($40 billion) of rail and subway projects in an effort to offset slowing local government spending. (We see this as partially driven by the initial lukewarm reception for refinancing local government debt with new municipal bond issues.) **There's more to come as Beijing now intends to increase spending this year by 10.6%, thereby creating the largest budget deficit since 2009. However, the deficit will likely amount to just 2.7% of GDP (up from last year's 2.1%), which pales by comparison to those borne by the United States and most European nations.**

Beijing's debt replacement program finally got out of the starting gate last Monday when Jiangsu Province successfully completed a 52.2 billion yuan ($8.4 billion) bond offering. Proceeds will be used to replace debt maturing this year, which should cut interest expense in half. The appeal of the bonds was enhanced by last week's announcement by Beijing that banks could use these new bonds as collateral for new borrowing from the central bank. Many more bond offerings are being readied for the market since we estimate that this first offering only represents about 0.2% of total local government debt outstanding.

Local governments are also benefiting from the rally in Chinese stocks since almost 1,000 of state-owned enterprises (SOEs) are listed. The market capitalization of these companies has more than doubled, on average, over the past twelve months. The potential exists for secondary offerings for local government entities to raise funds. Also, since these SOEs are highly leveraged, they can sell shares to directly reduce their own corporate debt, which is acknowledged to be of growing concern. As they strengthen their balance sheets, the listed SOEs will likely become more active participants in Beijing's plan to restructure much of the corporate landscape. Beijing also has another vested interest in sustaining the market's bull run as a source of funding for small companies. Among the Third Plenum reforms is a call for a supportive environment to stimulate the creation of small businesses

Skeptics might argue [not without some validity we admit] that all we're really expounding is another version of the greater fool theory. Although we acknowledge that this could all end badly, total financial collapse is not fait accompli and isn't even yet on the distant horizon. New loans and bond issuance will have a higher standard for approval—it's not just more of the same. More efficient use of capital will mitigate financial risk. China's central bank has more than sufficient monetary and fiscal resources to stimulate economic growth for years. We've used the following chart before. Debt to GDP compares extremely favorably to most countries. As we've also previously pointed out, many would argue that the "real" number needs to be adjusted higher due to the "implicit" guarantee believed to exist for the central government to cover the debts of local governments. **This means that even if we assume that ALL local debt is refinanced and absorbed by the PBoC, China's public debt to GDP ratio would be just about 55%—still the envy of many countries.**



Finally, the International Monetary Fund now believes that China's currency, the renminbi, is fairly valued—opening the door for inclusion in the IMF's supplementary foreign exchange reserves for Special Drawing Rights (SDRs). As recently as May 14th, an IMF spokesman reiterated during a press conference that they are consulting with China on resolving the lack of convertibility that has been the principal impediment for inclusion. While the issue of whether the renminbi is "freely usable" remains, it has nonetheless become one of the top five currencies traded in the world. An initial review should be released next week with a final decision made in November. **If the renminbi is included in exchange reserves for SDRs, asset managers indexed to global indices would be forced to increase China exposure in order to match allocations to revised index weightings regardless of valuation. Those purchases are likely to be made at higher valuations and push shares prices even higher as foreign buyers return to the market in size.**

We continue to reiterate our long-term contrarian call to buy China; adding to 'A' Share exposure on pullbacks. Despite more than doubling over the past year, the Shanghai Exchange Composite Index still remains 35% below its record closing high of 6,124 on October 16, 2007 and continues to outperform the S&P 500.

Our preferred vehicle has been the Deutsche X-trackers Harvest CSI 300 China A-Shares ETF (ASHR), which consists of the 300 largest and most liquid China A shares that is breaking out to a new high after several weeks of consolidation.

Those investors more risk adverse but still desirous to play the liquidity-driven China rally should look at Hong Kong. The recently expanded Shanghai-Hong Kong Stock Connect program allows mainland China investors to buy less expensive Hong Kong listed shares while settling via the exchange and clearing house in their home market. Conversely, it provides Hong Kong and other foreign investors similar access to China 'A' shares.

While recognizing the steeper the ascent, the deeper the correction; we reiterate that we believe the greater risk for investors is one of not participating and missing out on China's continued bull run.

There's much more room to run.

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