ShoreVest 新岸資本

China Debt Dynamics

It is now time for China to step-in and stimulate

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Summary and conclusion – now is the time for China to stimulate
A synchronized global slowdown is in underway in our view, and China is leading the pace with the recent downward inflection in economic data likely to deteriorate further in 2019. We believe it is now time for China to stimulate, and it could be increasingly significant as the year progresses.

From a chronological perspective, we expect the following stimulus measures to begin in earnest this year:

1. **Fiscal Stimulus** - local government fiscal programs (infrastructure) are likely to accelerate. Quotas for fiscal projects are already being relaxed to bring them forward in the year;
2. **Quantitative Easing** (market rates) – continued Required Reserve Ratio cuts (RRR; i.e., the percentage of bank deposits required to be kept on reserve at the central bank) are needed to suppress *market* interest rates, using the banking system as the conduit, through: (a) providing interbank liquidity; (b) purchasing municipal bonds to fund the fiscal stimulus, and; (c) funding a bond purchase program of government securities to keep risk free rates low;
3. **Monetary Easing** (policy rates) – cuts in *policy* interest rates, perhaps beginning as soon as the 2H19;
4. **Currency** – as a result of the above items, the RMB is likely to weaken in 2H19 (once the current US dollar weakness settles as crowded long-dollar positioning unwinds), allowing for currency transmission to help with exports.

A slowing economy naturally exposes NPLs; deal flow to remain strong
During the past two years, the flow of NPLs into the marketplace has been driven more by a regulatory push than from a slowdown in economic growth, in our view. But going forward, the slowing economy will likely expose overleveraged situations at an increased pace, driving the emergence of NPLs more so than from regulatory developments. In fact, depending on the significance of the slowdown, it is quite possible that authorities slow down the pace of regulatory enforcement, but not abandon it, as NPLs would emerge at an increased pace naturally as a result of a slowing economy. Our existing database remains robust and continues to grow, now with 672 portfolios with an asking price of US$88 billion.

A synchronized global slowing is underway
As we wrote in our last issue of China Debt Dynamics, the US' escalation of trade restrictions against China, and their pursuit of addressing trade imbalances globally, is causing disruptions to global trade flows and global growth in a material way. And unfortunately, this is happening at a time when global financial conditions are less supportive and/or deteriorating; namely that the US Federal reserve has already been shrinking its balance sheet and has hiked interest rates four times in the past year (the slowing effects of which are now transmitting through to the economy), BREXIT is dysfunctional and creating stress and uncertainty across the Eurozone, the ECB has ended its quantitative easing program, and the Chinese economy is inflecting downward as deleveraging initiatives are implemented at a time when excess capacity still exists. And to complicate things further, as we also have commented previously, the escalation of anti-China policies by the US to include more strategic topics such as investments into the US, intellectual property, etc. is a negative overhang that can last for quite a long time to come.

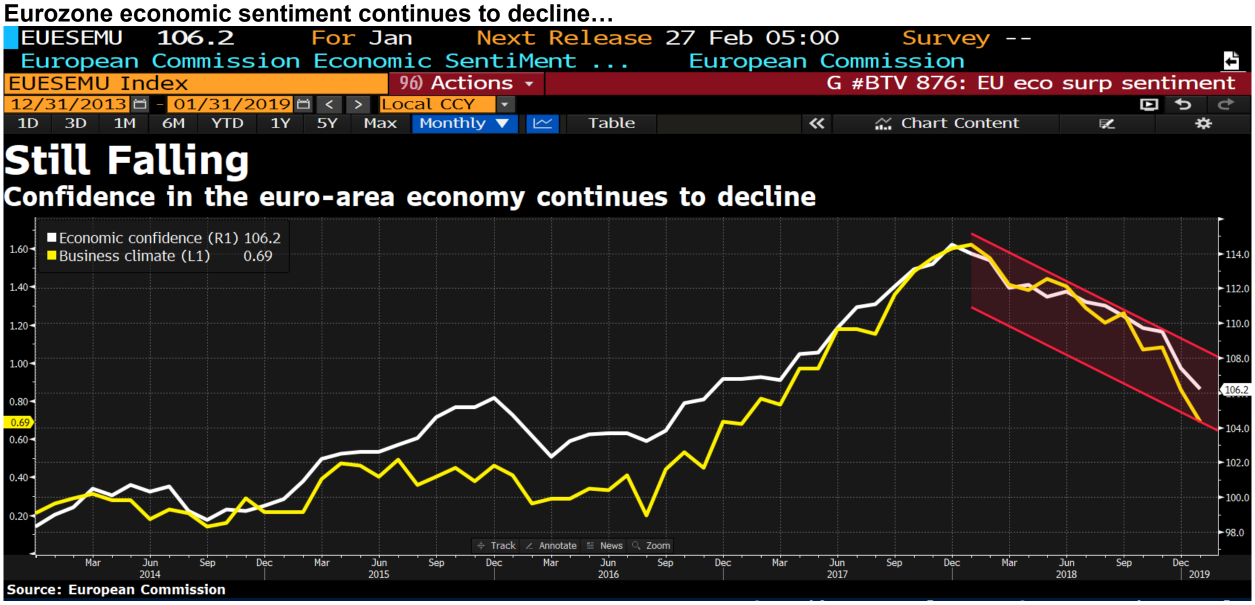
As a result, we believe global economic growth will slow further in 2019. Indeed, the IMF only a few weeks ago lowered their forecast for global growth for the second time in only three months, pointing to the slowdown in the Eurozone and in China as key drivers of the downward revisions. As but one example, they lowered the German growth outlook by 0.6% to 1.3% for 2019, which is a significant 33% downgrade. Virtually all key economic data reported globally in the last quarter is revealing the significance of the global slowdown.

Granted, China's economy would have continued slowing in coming years regardless of global economic conditions, given the significance of debt in the underlying economy and the Chinese authorities' intent on reducing overall leverage and address systemic risk that has built up from unregulated shadow liquidity and debt. But now, the confluence of these factors is creating a synchronized global slowdown such that external demand for China is under pressure at a time when domestic demand is also declining; the combined negative impacts of which do not seem to be fully appreciated by capital markets in our opinion.

Moreover, we have to believe that the combination of all of these factors is already modifying the behavior of C-suite executives to question their conviction in initiating new capex and investment. It is highly probable that the marginal propensity to invest is declining until the global economic landscape becomes more settled and more clear. This has the danger of creating a negative feedback loop and a self-fulfilling prophecy whereby the more geopolitics are disruptive, and the further the global economy slows, the more executives are unlikely to invest in the expansion of their businesses, which then results in even more economic slowing.

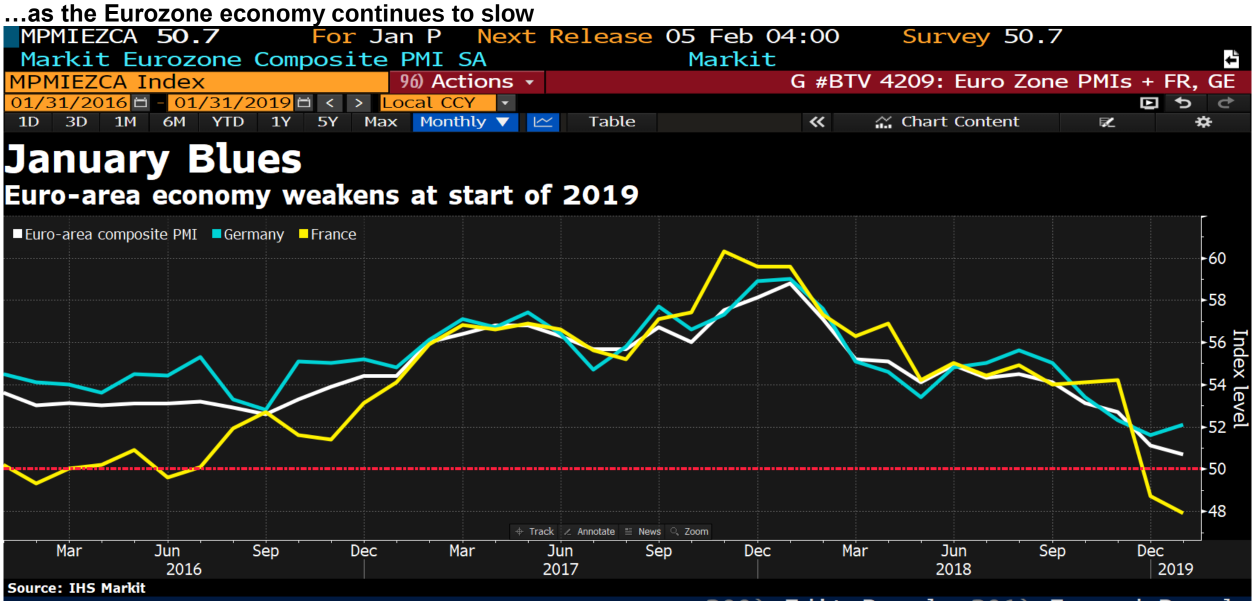
China needs to step in and stimulate, and they need to do it soon.

Eurozone economic sentiment continues to decline…



Source: Bloomberg

…as the Eurozone economy continues to slow



Source: Bloomberg

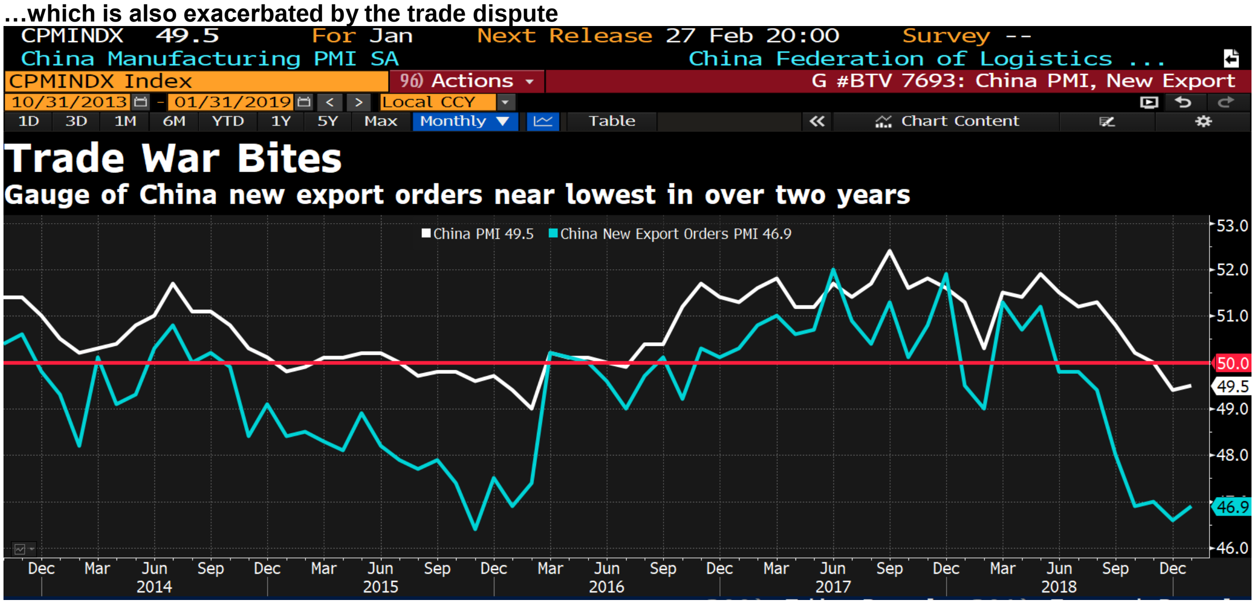
…And the US is heading for a slowdown

Source: Bloomberg

…so external demand is slowing, resulting in Chinese exporters and small firms suffering

Source: Bloomberg

…which is also exacerbated by the trade dispute



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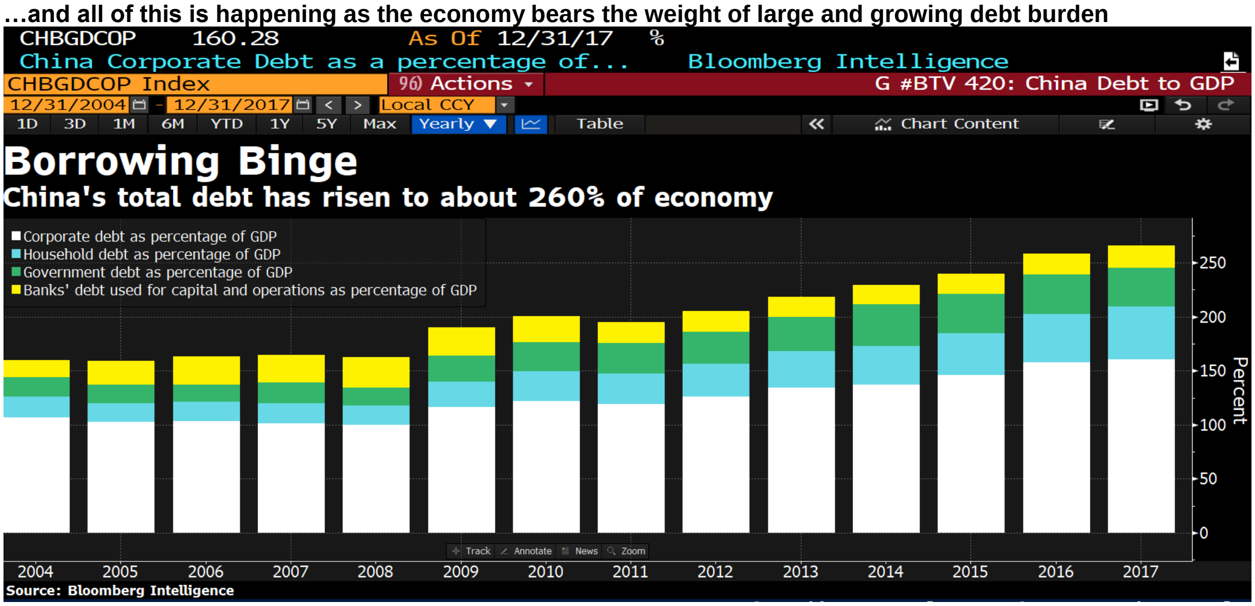
…and all of this is happening as the economy bears the weight of large and growing debt burden



Source: Bloomberg

So, what can China do? Stimulate. And soon.

Having said all of the above, there are some mitigating factors. The good news is that the starting point for China is one from which they have room to maneuver. We have always maintained that China would introduce multiple forms of stimulus should the economy inflect downward further. China is entering this slowdown having not yet stimulated (unlike, say, the Eurozone for example), providing them with firepower across multiple levers that can be pulled. The toolbox is full. For instance, policy interest rates are still relatively high, there has been very little quantitative and fiscal stimulus to date, and the RRR remains at a significantly high level.

As mentioned earlier, we expect a sequencing of initiatives this year, including fiscal stimulus, quantitative easing, monetary easing, and currency transmission (i.e., weakening).

Fiscal programs are already being moved forward

Just since the beginning of December, according to a South China Morning Post article, China has approved US$160 billion of infrastructure projects compared to just US$15.6 billion in the comparable period last year in an effort to front-load the stimulative impact of fiscal spending. So how will this be funded? Let’s turn our attention to the RRR cuts.

The RRR is key, but not in the way most think

As we have written previously, the cuts thus far in the RRR have not in-and-of themselves been stimulative in our view. Rather, they have intentionally been enacted to replace bad liquidity (i.e., shadow interbank liquidity) with proper liquidity, as authorities de-leverage and de-risk the system. Moreover. the deleveraging campaign has also resulted in a tightening in credit availability. So, the combined impact has been a net-tightening in overall financial conditions as far as we can tell. Meaning that RRR cuts thus far have not created net stimulus, contrary to most market commentators’ views. But we believe that’s about to change.

First a bit of context. The RRR is currently 14%. Meaning that 14% of deposits in the Chinese banking system (US$3.8 trillion) are “locked-up” as they are required to be kept on reserve at the central bank (and therefore cannot be placed into the interbank market, used to purchase bonds, or lent out, etc.). Prior to the credit boom which started in 2009, the RRR was 6%. The RRR in most countries globally is 0-2%. In fact, in Japan and in the Eurozone, should a bank place excess deposits on reserve at the central bank, they are *charged* an interest rate (i.e., negative interest rate policies).

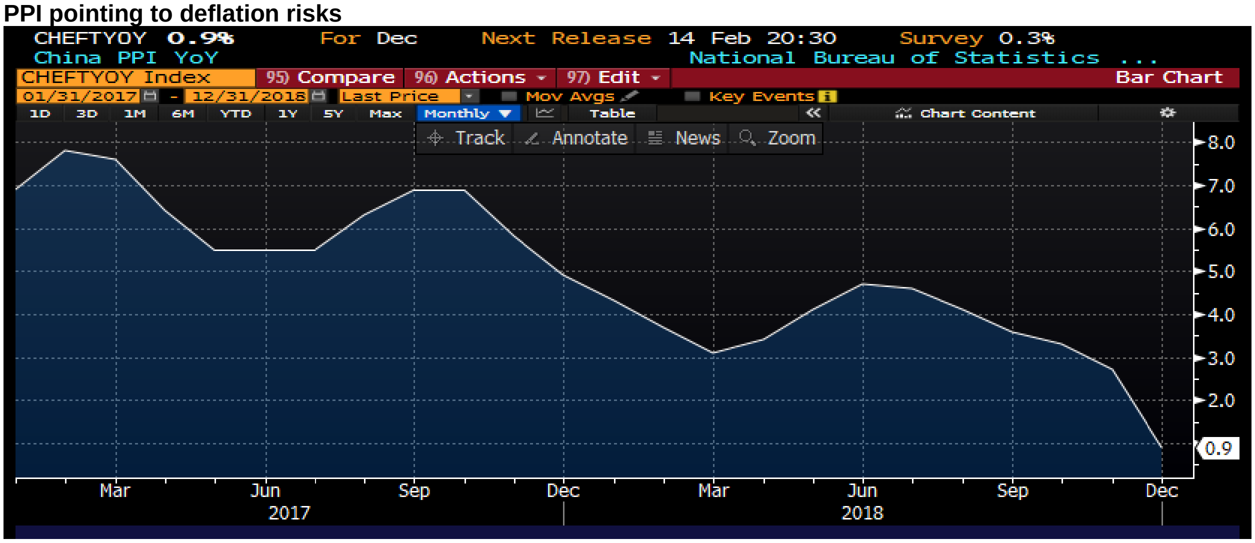
Cuts in RRR to fund fiscal stimulus and “encourage” quantitative easing to lower *market* interest rates

It should be evident that a 14% RRR is inconsistent with a deteriorating Chinese (and global) economic environment. This provides China a rather hefty arsenal of liquidity. For illustration, should the RRR be reduced back to the pre-credit boom level of 6% (although we believe it will end up lower than this level before all is said and done), some US$2.2trillion in liquidity will be released back onto banks’ balance sheets (equivalent to 16% of GDP), which, in our view, will be for three intended purposes as a form of quantitative easing and fiscal stimulus:

(a) Interbank Liquidity – placed into the interbank market to continue to replace bad liquidity with good liquidity as authorities continue to rid the banking system of systemically risky shadow interbank liquidity and ultimately lower interbank market rates;
(b) Municipal Bond Purchases – use the banks as funding sources to purchase municipal bonds which then fund the

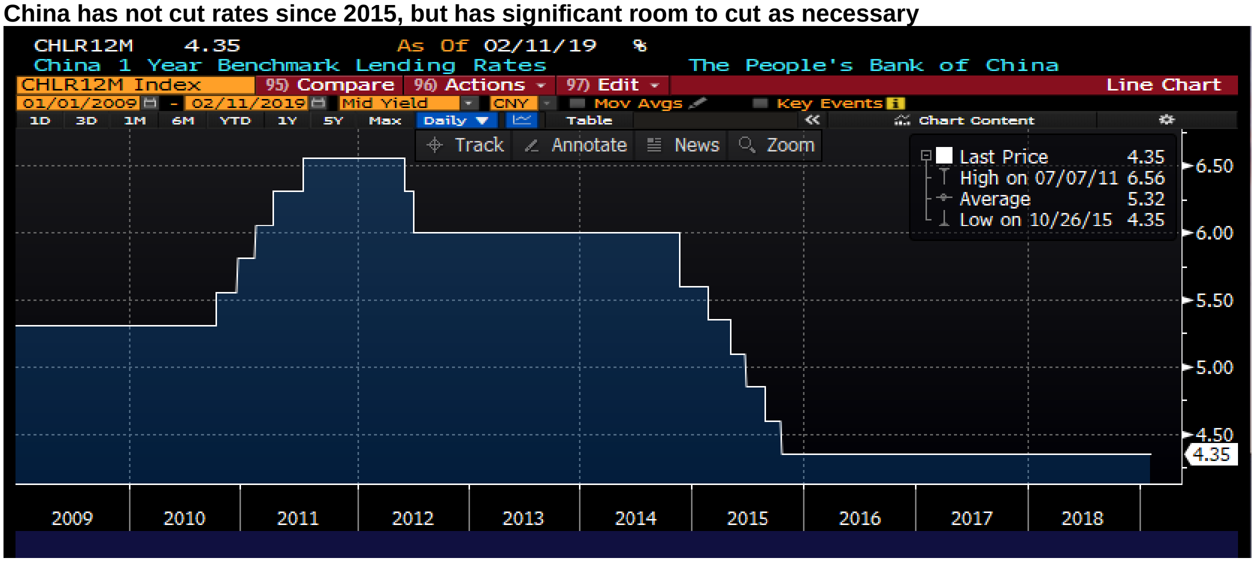
fiscal stimulus projects, and;
(c) Asset Purchase Program – encourage the banks to engage in a bond purchase program of government securities to keep risk free rates low.

Monetary easing at some point to lower *policy* interest rates and the real cost of borrowing
As the economy continues to slow and the Producer Price Index (PPI) points to the risk of deflation, the *real* cost of borrowing rises. For a slowing economy with a massive debt burden such as the case in China, the real cost of borrowing is of paramount importance. As PPI is already declining materially, the real cost of borrowing is rising for Chinese corporates. With fourth quarter PPI coming in at only 0.9% versus a general range of 4-7% for the previous 24 months (see below), deflationary pressures are emerging and the real cost of borrowing is now 3.45%.

PPI pointing to deflation risks


Source: Bloomberg

The good news is that with the benchmark interest rate at 4.35%, the PBOC has plenty of room to cut as and when they decide it is necessary (as compared to -0-% in the Eurozone or even the US Fed Funds rate of 2.4% after four hikes last year). The PBOC last had a monetary easing cycle during 2015, with the last cut by 25bp in October 2015. Granted, the current 4.35% is an all time low in China, but the point is that the PBOC has a strong starting point that affords them significant room to cut.

China has not cut rates since 2015, but has significant room to cut as necessary


Source: Bloomberg

RMB likely to weaken as a result of stimulus
As we have written in the past, we do not believe the PBOC will "weaponize" the RMB by deliberately weakening significantly from the current level. The weakness relative to the USD during the second half of 2018 was from increased interest rate and growth differentials between the two countries. The US was showing a resurgence of economic growth

and was in a process of hiking rates. But with deteriorating global economic indicators, it now appears highly unlikely that the US Federal Reserve will hike rates anytime soon, so USD weakness quickly ensued during the first month of 2019. Going forward, and perhaps as soon as the second half of 2019, we believe it will be more about the Chinese economy and the RMB as stimulus is employed and a deliberate need to transmit the benefits of a weaker currency into the economy becomes necessary. Granted, this is likely only after some level of trade agreements are achieved between the US and China so as not to complicate that process further, but it will become increasingly necessary as the Chinese economy slows further, in our opinion.

Recent RMB strength vs. USD is more from USD weakness

Source: Bloomberg

What does all this mean for NPL flows?

During the last couple of years, the increased flow in NPLs was driven more from regulatory push than from economic slowdown. This year, we believe it will be far more driven by the economic slowdown rather than from regulatory developments. And given the significance of the downward inflection in the Chinese economy, and given the global synchronization of slowing growth, we would not be surprised if the Chinese authorities necessarily slow the pace of deleveraging initiatives and regulatory enforcement regarding improperly classified distressed debt. That is not to say that they will stop the process. Rather we believe authorities are wholly committed to deleveraging and reducing systemic risk in the system. But it is a balancing act and the risk of a policy mistake is real. Pace is very important and must be aligned against the pace of the economic slowdown. Regardless, we strongly believe the pace of the emergence of NPLs will remain high. The last couple of years was a regulatory push. The next couple of years is likely to be the realities of an economic slowdown. When a debt-burdened economy slows, overleveraged companies and misallocated credit tends to be revealed. We are now in that part of the cycle in China. Indeed, our database now has 672 portfolios with an asking price of US$88 billion.

The question has come up in discussions with investors that should the economy slow materially further, would it complicate our exits of loans with underlying real estate collateral or create the risk of loss? Importantly, we point out that we price a senior secured loan with enforceable collateral at about a third of the collateral's third-party appraised value. Meaning that we value collateral at liquidation value rather than market value, thereby pricing-in a significant margin of safety. This is a rough generalization and the actual pricing of a specific loan is highly dependent on whether the senior claim is valid, local market conditions for liquidity of that collateral, and whether the collateral can be enforced and sold within an acceptable timeframe, etc. So, the significant discount of our pricing of loans at liquidation value of the underlying collateral is critical in our underwriting process.

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