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Will China's consumer market become the next credit bubble?

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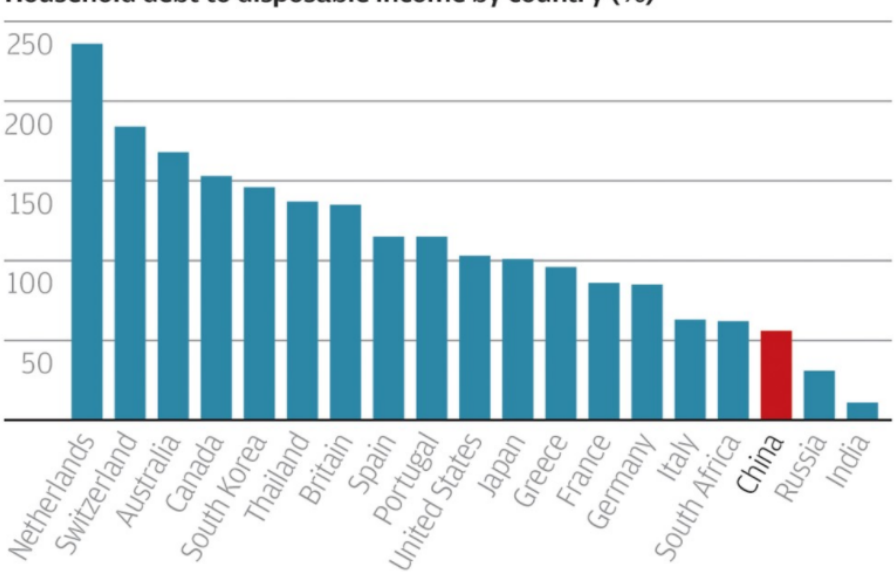
In a broad sense, economies globally are undergoing a rolling process of deflating their credit excesses. During this process in almost every major economy, bubbles tend to form and spill over from one segment to another, in an attempt to keep growth percolating. We believe China will be no different.

About 45 per cent of China's gross domestic product (GDP) is in the industrial economy, which after a credit-fueled growth, is now suffering from debt-laden excess capacity. This is the current focus of deleveraging, and is the primary source of increasing non-performing loans, about which we have been writing in past columns. But 39 per cent of GDP is private household consumption, which has very little leverage. That's about to change.

To offset the negative impacts on economic growth from deflating the industrial economy, we fully expect China to adopt the approach of letting bubbles spill from one segment to another, which most other major global economies have employed. This will quicken the rebalancing of the economy to a more domestic, consumption-driven growth model.

Household debt to disposable income by country (%)



Note: Latest available data - Switzerland is as of 2012; Canada, Portugal, Italy, South Africa and China are as of 2014; The rest are as of 2013

Sources: BIS, United Nations Statistics Division, Bot, NESDB

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So, although consumption is already growing, prepare for it to accelerate from here. And the fuel is likely to be the rapid development of the consumer finance industry.

While the positive medium-term, global implications of turbo-charging the Chinese consumer are enormous, they come with a health warning.

Just as in many other economies which have leveraged-up their consumers, it would not surprise us if in the next three-to-five years from now, we are grappling with a Chinese consumer credit predicament. But we have quite a way to go before that develops, so for now, let’s consider how this process is likely to unfold.

First, a recap of this shifting in China’s bubbles. The credit impulse that began in 2009 was China’s version of fiscal stimulus, using bank lending as the conduit. And it was targeted toward infrastructure investment, which led to a buildup in excess capacity in the industrial sector (e.g., steel, cement, etc.), which then resulted in a corporate credit bubble.

Indeed, China’s debt creation has been excessive, and far higher than other countries in recent credit bubbles. For context, in the five years between early 2009 and 2014 (when GDP growth started to slow), China’s private sector debt grew by 139 per cent of GDP. This compares with the US at 58 per cent of GDP or even Spain at 116 per cent between 2002-2007.

The result is that the stock of corporate debt is too high. Corporate credit in China is now at 171 per cent of GDP, which is the highest we can find globally, and is the source of the current non-performing loan cycle. By comparison, France’s corporate debt is at 125 per cent of GDP, Portugal is at 116 per cent, and even South Korea, which is widely seen as having high debt levels, is at 106 per cent.

In the early days of deflating this corporate credit bubble, authorities tried to rotate into the equity market in 2015 to provide a marketplace to recapitalize over-leveraged companies.

A bubble in the stock market quickly formed, with the A-share market rising by 63 per cent in the first half of 2015, at least partially driven by leverage (margin financing). In the summer of 2015, a meltdown in the equity market ensued, with the major stock index dropping 45 per cent in two months.

Authorities then turned to the bond market for multiple reasons, including refinancing maturing bank loans to diffuse credit risk away from the banks, and thereby reduce concentration, or systemic risk, as well as to “amend and extend” corporate debt, which means extending debt maturities to better align with borrowers’ cash flows.

Structurally, this was a positive capital markets development, but this rapid expansion formed a bond bubble. In 2016, over US$4.9 trillion in new bonds were issued, bringing the total market to US$8.8 trillion, making China the third-largest bond market in the world behind Japan’s US$9 trillion. Despite this rapid supply of bonds, AA-rated corporate bond yields dropped by 20 per cent in the first 10 months of the year to very tight spreads.

The only segment left that is not over-leveraged is the Chinese consumer market. In fact, household leverage is extremely low. Household debt-to-GDP ratio is only 40 per cent, among the lowest in the world. For comparison, the US is at 79 per cent while Australia is at 124 per cent.

The consumer market has the capacity to service higher debt. Household debt-to-disposable income is 56 per cent, which is also among the lowest in the world. For context, the US peaked at 123 per cent, and Australia is now at a worrying 168 per cent.

China could double its household debt ratios and still be "average" in a global context. Admittedly, this is a multi-year process, but with an US$11 trillion economy, this implies an additional US$4 trillion in purchasing power in today's terms.

This is a staggering number and has powerful global implications. For context, the fourth-largest economy in the world is Germany with a GDP of US$3.5 trillion.

We expect the initial mode of consumer finance to be point-of-sale vendor financing, rather than a rapid increase in residential mortgages, given the concerning rise in residential property prices.

As such, the biggest near-term beneficiaries from a leveraged consumption boom are likely the providers of this credit in the form of consumer credit companies, and the providers of "white goods" such as household appliances and consumer electronics, as well as the entire global supply chain to manufacture these products.

Other areas will include education, travel and leisure, cosmetics, etc. The providers of consumer data analytics will be in high demand to develop infrastructure.

Over the medium term, this should be good for the stock market, as same-store sales growth begins to accelerate at consumption-related companies, and then financial intermediaries such as brokers and asset managers will benefit as the positive wealth effect kicks in.

But be careful, if the rest of the world is anything to go by, consumer finance could grow too much, too fast in coming years, and then an ensuing bubble could form, and a consumer bad-debt cycle would surely follow.

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After credit-fuelled excesses consumer finance may be next

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