

Investment Insights

UBS Asset Management

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At the heart of the global macroeconomic and markets outlook for 2018 lie prospects for China. And at the heart of the outlook for China lies the country's high and rising debt to GDP ratio. Recent policy initiatives suggest that the debt issue is finally being taken seriously. Can the Chinese authorities navigate the fine line between a hard landing if the deleveraging is too severe or creating an even larger debt bubble if it is not severe enough?

Investment Insights addresses a major concern for investors globally and explores the key themes in Chinese equities and Chinese bonds against this backdrop.

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China: the deleveraging tightrope

Erin Browne, Bin Shi, Hayden Briscoe

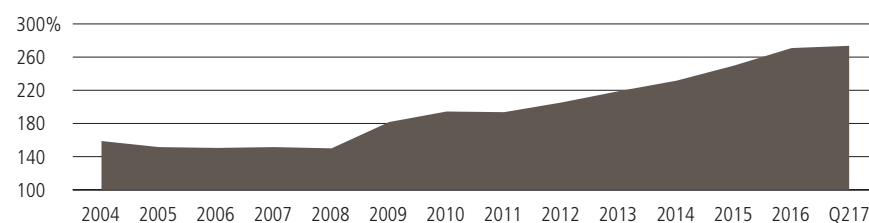
In a country where every nuance of public statements from senior figures is carefully considered, it is very hard to dismiss as careless hyperbole the recent warning of Zhou Xiaochuan, chairman of the People's Bank of China (PBoC), the Chinese central bank, that China faces "a Minsky moment".

Significantly, the warning about the potentially severe consequences of excessive optimism and the build-up of debt within China came at the country's high profile National Party Conference (NPC) in October. Given the context and unusual frankness of the comments, Xiaochuan's assessment was, in our view, as clear an indication as investors get in China that the authorities are serious in addressing the issue of high debt levels.

This has not always been the case. Conflicting political and economic interests have historically resulted in inconsistent policy objectives and a familiar boom/bust cyclical narrative. In particular, an explicit and somewhat arbitrary growth target for GDP effectively encouraged significant debt-financed investment at local government level.

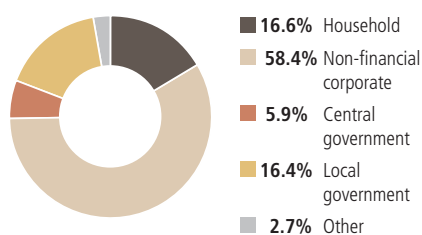
But times are changing. And while a relatively steady growth rate is still important as China builds towards the 100th anniversary of the founding of Communist Party in 2021, the omission of specific GDP growth targets in Premier Xi Jinping's keynote NPC address was, in our view, particularly notable. We see the omission as further compelling evidence of the shift in China's policy priorities towards the quality and sustainability of growth, rather than just the pace of growth. With Xi's position not merely secure but emboldened, the Chinese premier now has a clear mandate to build further on deleveraging progress to-date.

China's Debt: Total Non-Financial Debt as % of GDP



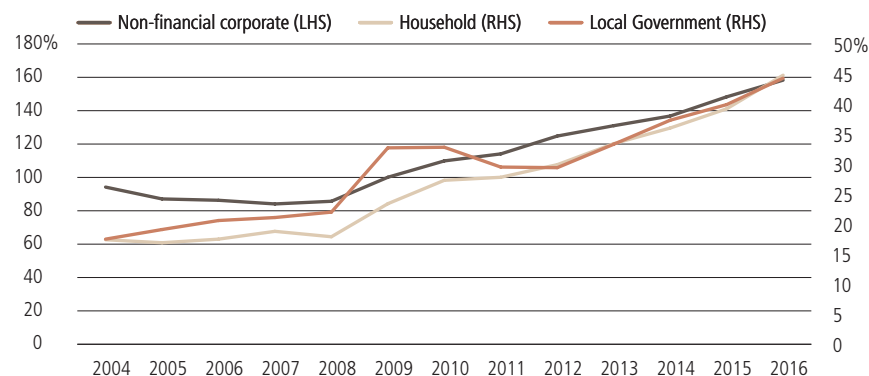
Source: CEIC, UBS Estimates

China Non-Financial Debt by Sector



Source: CEIC, UBS Estimates as at December 31, 2016

Debt as a % of GDP of Key Non-Financial China Sectors



Source: CEIC, UBS Estimates as at December 31, 2016

The corporate sector accounts for just under 60% of all debt in China—roughly 160% of GDP. This ratio is among the highest in the world and is significantly higher than that of Korea, US, UK, the EU or Japan.

How serious an issue is China's debt?

A series of policy initiatives both before and particularly subsequent to the financial crisis encouraged debt-financed investment and the building of industrial capacity where none was really needed. Since the financial crisis, China's debt has consistently grown significantly faster than GDP.

Estimates¹ of China's debt to GDP ratio, the key measure of a country's overall leverage relative to the size of the economy, stand at around 270% (as at end-June 2017). The figure has risen steeply since 2008. Higher than developed nations including Germany and the United States, China's debt to GDP ratio is particularly elevated by emerging country standards.

China now faces two related debt issues. First, a debt pile relative to GDP that increasingly threatens both short- and long-term economic stability. Second, capital inefficiency that is holding back the economy after a number of years in which an increasing amount of new credit has gone towards debt servicing costs and investment in 'old economy' sectors.

Where is all the debt?

We focus on what we believe are the three key areas of leverage within the Chinese economy:

Corporate Debt The corporate sector accounts for just under 60% of all debt in China—roughly 160% of GDP. This ratio is among the highest in the world and is significantly higher than that of Korea, US, UK, the EU or Japan.

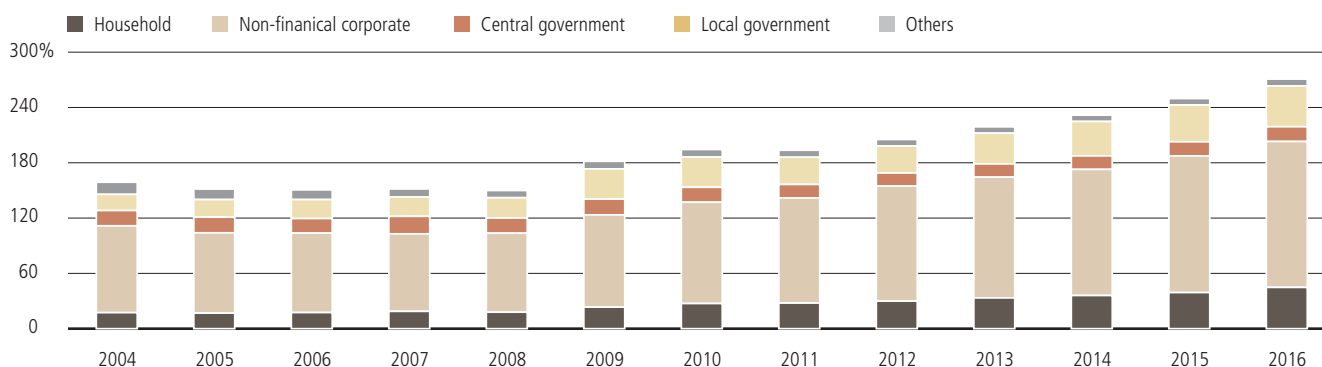
Since 2008, corporate debt as a percentage of GDP has nearly doubled. There are no official figures on the amount of debt in China's State Owned Enterprises (SOEs), the government-owned businesses that remain at the heart of the Chinese economy. However, recent UBS estimates¹ suggest that over 60% of all corporate debt (or around 100% of GDP) is SOE-related.

Local Government Debt While Local Government accounts for around 16% of all debt in China and 44% of GDP, many observers point to it as the most likely source of defaults. Mixing policy and commercial imperatives, China's local governments borrowed heavily to meet growth targets, circumventing rules designed to curb excessive debt by using dedicated Financing Vehicles and by borrowing from the shadow banking sector.

Household Debt The pace of growth in household debt is accelerating. At similar levels of GDP to the Local Government sector, household debt in China still has room to grow without prompting concern, but at some point debt servicing will clearly curtail consumption growth.

¹ China deleveraging—where are we? UBS, October 2017

China: Debt as % of GDP by Sector



Source: CEIC, UBS Estimates

What about China's shadow banking sector?

There has been a lot of comment about systemic risks to China from the scale and stability of the financial sector's off-balance sheet assets. In tandem with lending from non-financial institutions these assets are what is referred to as 'shadow credit', and their existence reflects the sector's desire and ability to avoid tighter regulation and higher reserve requirements on traditional deposit and lending activities.

Precise estimates about the size of the shadow banking sector vary widely, but few doubt that the sector has played a key role in providing debt to the wider Chinese economy.

Concerns about liquidity issues in the shadow banking sector are focused in particular on higher risk funding areas such as asset backed securities and wealth management products (WMPs).

In late November the PBoC moved to address some of these concerns, announcing widespread changes that significantly tighten the standards affecting some USD15 trn of wealth management products. The new rules ban guaranteed return products, prohibit capital pooling across asset management products, limit leverage and force providers to put aside 10% of management fees against potential losses.

How serious are the authorities in dealing with the debt issue?

In 2017, while China's economy has slowed, it has not slowed as much as many forecast at the start of the year. Signs of stress have generally been absent. This has led some to believe that China is not tackling the debt with the seriousness it should. We believe this view is mistaken. First, the improving external demand environment has played an important role in supporting the Chinese economy via better than

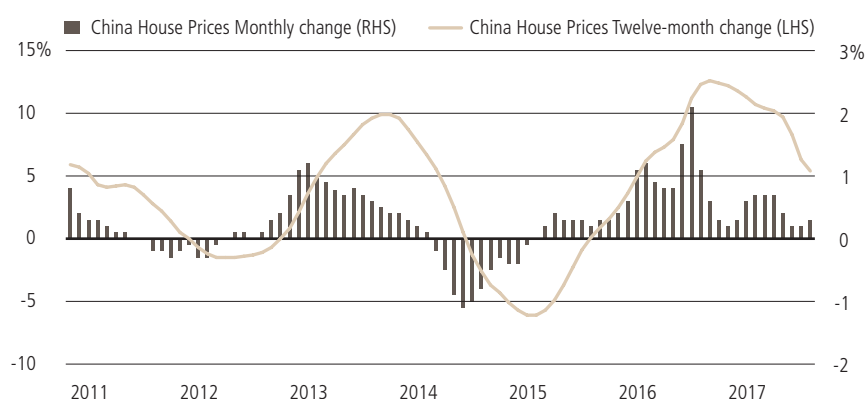
expected profits and by reducing the disinflationary pressures of excess capacity in manufacturing. With lead indicators for global demand strengthening, we believe that the external environment will continue to support the Chinese economy.

Moreover, there has been significant action to-date in terms of reform and deleveraging. On the supply side of the economy there has been a welcome ratcheting up of environmental standards and the reduction in capacity across heavy polluting industries including steel and iron ore.

We take the recent tightening of regulations regarding WMPs as further proof positive of the authorities' determination to address the debt issue. WMPs acted as an important source of funding for shadow banking activities and are now under the strict supervision of the China Banking Regulatory Commission. That the move follows new restrictions on negotiable certificates of deposit and money market funds shows that the deleveraging campaign is broad-based and unlikely to change in the short-term.

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China House Prices



Source: Datastream, UBS Asset Management as at November 2017

The housing market is clearly slowing, while measures of money supply, fixed asset investment and new credit growth reveal a marked cooling as liquidity conditions tighten, money market rates increase and bond yields rise.

Elsewhere, China has already progressed initiatives designed to address the significant debt on SOE balance sheets. Given the large proportion of China's overall debt in SOEs—and longstanding issues with SOE productivity and profitability—successful reform of the SOEs lies at the very heart of addressing China's broader debt problems.

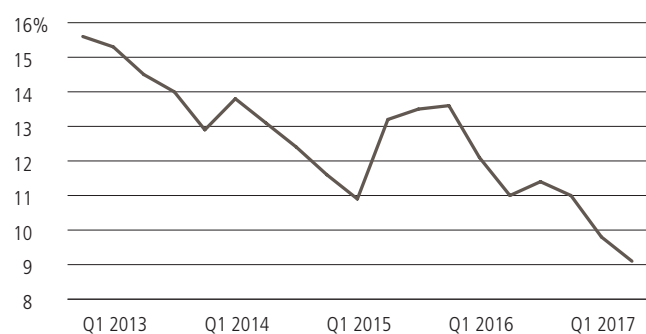
These initiatives include new incentive schemes for SOEs to address poor

corporate governance and low productivity, as well as a pilot mixed-ownership structure which involves the introduction of private equity capital to reduce debt.

Meanwhile, stringent personal penalties for local government officials caught attempting to circumvent tighter regulations on local government financing vehicles are now helping to slow the breakneck pace of residential construction.

The impact of these policies is already evident. At the end of June, total non-financial debt as a percentage of GDP had increased only marginally from the start of the year. The housing market is clearly slowing, while measures of money supply, fixed asset investment and new credit growth reveal a marked cooling as liquidity conditions tighten, money market rates increase and bond yields rise.

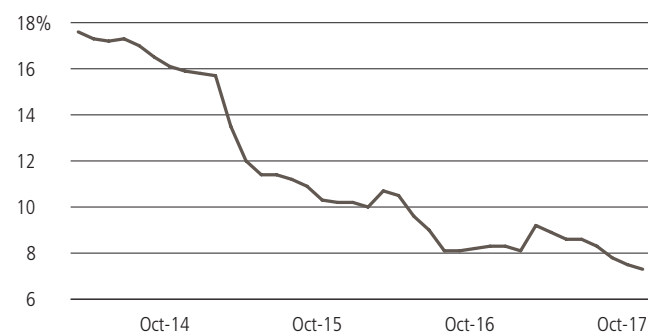
China M2 Money Supply Growth (% YoY)



Source: CEIC, UBS as at November 2017

M2 = M1 liquid assets (cash, current account deposits) + 'near cash' equivalents: short-term deposits and money market funds

China Fixed Asset Investment (% Change, YoY)



Source: CEIC, UBS as at November 2017

Fixed Asset Investment (FAI) is expenditure by the government and business sectors on buildings, engineering construction and machinery and equipment. FAI comprises three broad categories: residential structures, non-residential structures, and machinery and equipment

What is the outlook for Chinese growth in 2018?

The pace of growth in the Chinese economy will slow in 2018 as the deleveraging process continues. This reflects the impact of tightening policies already in place and in particular the impact of deleveraging policies on infrastructure spend (due to the tightening in local government finance), a slowing housing market and property construction. But we do not believe that the effect of deleveraging policies to date will prompt a hard landing for the Chinese economy.

Our base case is that consumer spending remains resilient. But for an economy that is seeking to increasingly rely on consumption growth going forward, a sharp correction in house prices is clearly a risk both to consumer spending and to the wider economy given how significant a role residential construction plays.

But overall we believe that the process of deleveraging will be relatively gradual and well managed. What gives us a degree of confidence that China can avoid a liquidity-driven hard landing is

the belief that the PBoC has both a deeper understanding of bank liquidity needs and a broader toolkit to measure liquidity and to adjust it should it prove necessary. China's one party political system also makes adjusting policy a straightforward process.

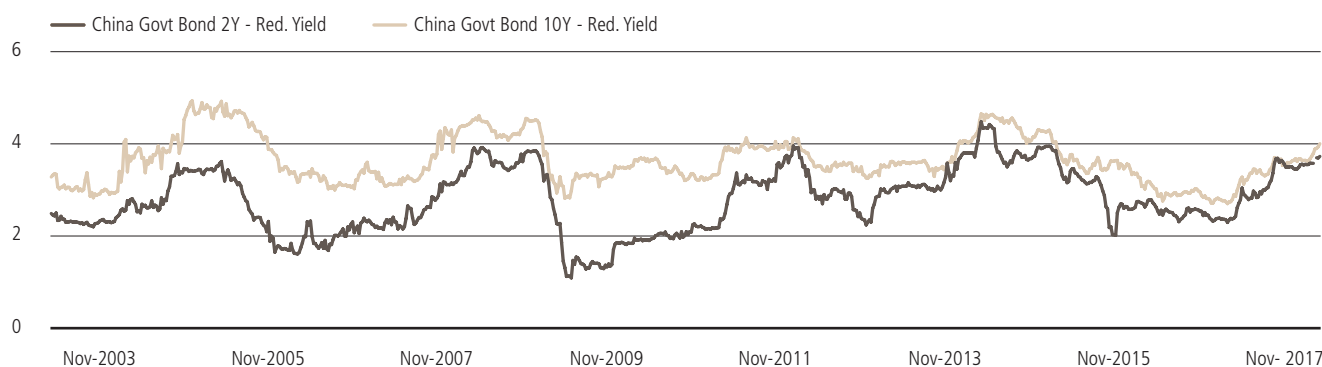
A good example of the PBoC's more nuanced approach was the cut in the Reserve Requirement Ratio in late September for banks that meet specific criteria on lending to micro enterprises. Not a big deal in itself, but a small move that simultaneously reduced risks to the

economy while ensuring new credit is deployed more efficiently in higher value activity.

Given the Chinese economy's historic volatility, a degree of scepticism is perhaps understandable with regard to the authorities' ability to navigate the deleveraging process successfully without provoking a hard landing. But in our view, the progress to-date and the very noticeable shift in rhetoric and policy focus all bode well for the future. Perhaps it's time to give credit where credit's due.

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China Govt Bond Yields



Source: Datastream, UBS Asset Management as at November 2017

China equity market, key themes:

Bin Shi, Managing Director, China Equities

- In our view, a less volatile economic backdrop means Chinese equities deserve a higher multiple. Coming into 2017, some investors were concerned about a hard landing scenario—something we never thought was likely. Looking at this year's performance of the economy and the equity market, we think that we are proven to be correct. A lot of the companies were rerated.
- Balance sheet trends within the listed equity universe have already improved meaningfully in 2017 as Chinese companies continue to deliver strong earnings growth. Only a small part of the listed equity universe is highly leveraged and the debt is focused in a handful of SOEs where overcapacity is an overhang.
- Beneath the slowdown figures are seismic structural shifts that are, in the main, broadly insulated from the deleveraging process. In general, companies in the new economy were not highly geared in the first place and have solid balance sheets, strong earnings and cash flow. The deleveraging process might have some impact on the cost of financing going forward but we do not expect the impact to be significant.
- China is not an isolated market. If the external global demand backdrop slowed significantly, China would be impacted. However, the majority of our holdings are driven mainly by internal demand and external impacts to Chinese company fundamentals will not be huge.
- We think that China as well as the overall EM will continue to do well in 2018.

China bond markets, key themes:

Hayden Briscoe, Head of Fixed Income, Asia Pacific

- China's slowdown and the shift in the government's attitude are creating compelling opportunities for fixed income investors.
- In particular, the steady rise in domestic bond yields during the past year represents an attractive entry point in our view.
- The opening of quota-free access to China's Interbank Market (CIBM) plus the launch of China's Bond Connect system allow overseas investors to fully allocate to China's domestic markets.
- Short rates will likely remain elevated as credit creation slows and tighter macro prudential measures plug the leaky holes in the unregulated lending markets.
- On a comparative basis, yields on Chinese government bonds look attractive compared to options in the US, UK, Japan, and Germany
- We favour adding longer-duration bonds in the 3.9% to 4% range, which will position investors to benefit from high nominal and real income, plus the potential for capital appreciation as China's economy slows.

Further reading

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