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Opportunities emerge as China slows

Why China's mini-cyclical slowdown is creating attractive fixed income opportunities | UBS Asset Management

Hayden Briscoe
Head of Fixed Income Asia Pacific

Highlights

- The policy-driven, mini-cyclical slowdown we expected for China is taking shape
- The Chinese government's deleveraging process is slowing economic growth
- China's growth slowdown will accelerate to the downside into 2018 and global markets will feel the impact
- But China's policies are addressing high debt levels and improving long-term growth prospects
- Despite the slowing economy, China's fixed income markets offer highly attractive opportunities
- Recent reforms mean investors can fully allocate to China's bond markets

China's government remains committed to deleveraging

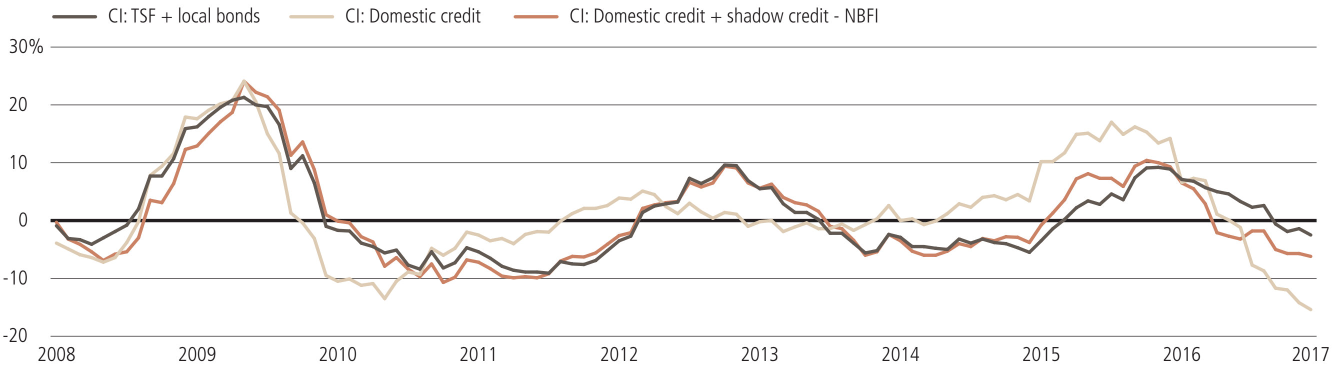
The policy-driven, mini-cyclical slowdown we expected for China is taking shape and will accelerate to the downside through 2018 and impact global markets, particularly those with strong trade linkages to China. However, the policies causing the slowdown are improving China's long-term prospects and opening attractive fixed income opportunities.

The slowdown is principally being driven by the government's commitment to deleveraging and strictly controlling credit growth.

Reducing financial risk and containing leverage is a top priority for the government and since mid-2016 regulators have employed a variety of tools to limit credit growth, including curbs on lending, controls on wealth management products, and increased oversight of local government debt issues.

That means liquidity in the economy has tightened significantly, with our measure of credit support showing that the contraction that began in October 2016 has not just continued, but upped pace through H1 2017 (see Exhibit 1 below).

Exhibit 1: UBS China Credit Impulse Growth (%/YoY), Jun 2008–Jun 2017



Source: UBS Securities Asia Limited, as at September 2017.
Note:
TSF = Total Social Financing, a measure used by the People's Bank of China to track credit and liquidity in the economy
Local bonds = Bonds issued by municipal, county, and/or provincial level government bodies in China
Domestic credit = Credit provided to domestic companies by China-based banks
Shadow credit = Credit flows outside of China's formal banking system

China's economy is feeling the impact of tighter credit

Tighter government policy is impacting China's key economic indicators, with fixed asset investment seeing a continued slowdown, plus weaker growth in industrial production (see Exhibit 2 on the right).

Continued restrictions on property sales, including stricter loan criteria, increased sales taxes, and curbs on second-home ownership, have slowed sales dramatically. Data from China's National Bureau of Statistics show that sales of new residential units declined 9% y-o-y in October 2017, compared with 35% y-o-y growth in October 2016 (see Exhibit 3 on the right).

Weaker demand for residential units, combined with tighter financing for developers, explains why real estate fixed asset investment growth slowed to 5.6% y-o-y in October (see Exhibit 3 below), compared to 8.1% y-o-y on average between January and September 2017.

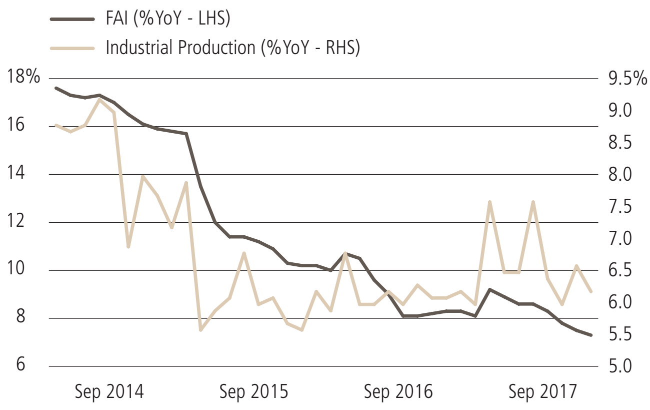
Slower growth in prospect
Consensus Bloomberg estimates forecast a 6.4% increase in GDP during 2018, compared to 6.8% expected in 2017.

Much will depend on how aggressively the government pursues deleveraging, and all indicators point to a continuation into 2018.

Our key takeaway from the October NPC meeting was that China's top leadership is more focused on the quality of economic growth rather than the quantity. This means that we wouldn't be surprised to see the government tolerate lower growth than the 6.5% target stipulated in the 13th Five Year Plan.

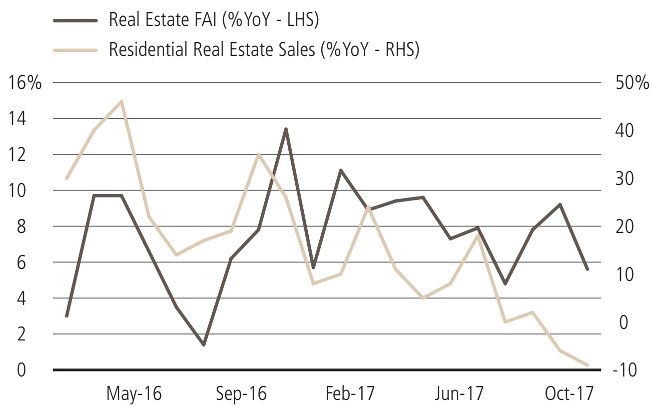
China's slowdown will impact China's trade partners, and particularly global markets with substantial trade ties to China. China's rebound in 2016 had boosted growth expectations and drove upward earnings revisions for energy and mining companies. However, slower growth in China will remove the momentum seen in 2016 and will impact growth prospects for economies outside China through 2018.

Exhibit 2: China Fixed Asset Investment YTD Growth & Industrial Production Growth (%/YoY), Feb 2014–Oct 2017



Source: Bloomberg

Exhibit 3: China Real Estate Fixed Asset Investment & Residential Real Estate Sales (%/YoY), Feb 2016–Oct 2017



Source: National Bureau of Statistics.

Long-term prospects are improving

But while the economy is seeing the impact of tighter policy, evidence is piling up that the measures are improving China's longer-term outlook.

China's debt load is at the heart of this. Rapid debt increases following the post-GFC stimulus saddled China with a huge debt burden estimated at around 270% of GDP at the end of 2016. Left untouched, these debts would load the industrial sector with a mountain of bad loans and excess capacity.

Early signs indicate success in stemming the flow of credit that has contributed to China's debt load. Growth in M2—a broad measure of the supply of money in China's economy—has slowed to an average of 9.86% y-o-y through 2017 which is a record low, and a marked decrease from 12.4% in 2016, and 12.5% in 2015, according to Bloomberg data.

The shadow banking sector is feeling the impact. Wealth management products (WMPs)—the core of the shadow banking sector and a major contributor to China's debt pile–have been put under strict supervision by the China Banking Regulatory Commission, causing the rate of growth to contract from mid-2017[1].

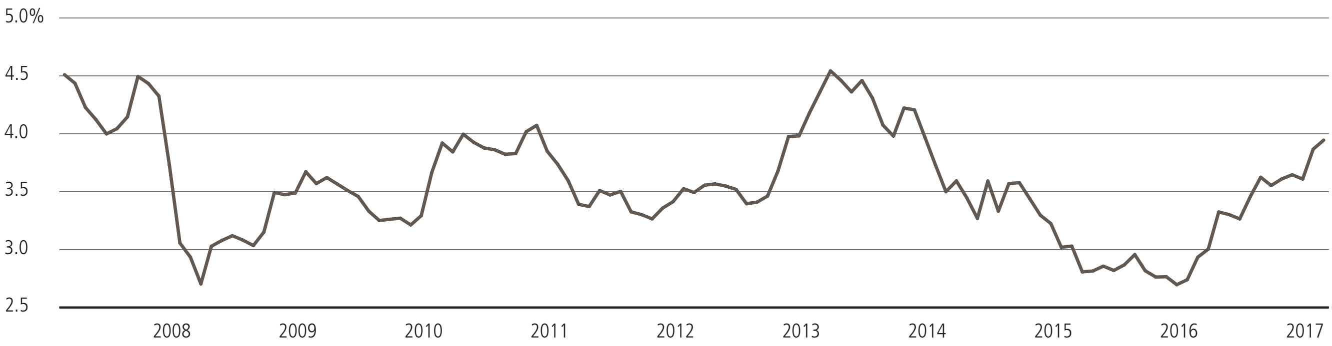
The government has stepped up forced closures of excess capacity and zombie companies in the industrial sector, according to recent news reports. Shanxi province, one of China's main industrial heartlands, recently announced the closure of 2.3 million tonnes of coal processing capacity[2] and Binzhou, a city in Shandong province, ordering the closure of 2.57 million tonnes of aluminium smelting capacity[3].

Fixed Income markets offer attractive yields

And while we are confident in the government's moves to rebalance the economy and expect deleveraging to continue, current trends in China's fixed income markets offer investors attractive opportunities.

Yields on 10-year Chinese government bonds are close to breaking the 4% barrier—their highest level since late 2014 (see Exhibit 4 below).

Exhibit 4: Nominal Yields on Chinese 10-yr government bonds (%), Nov 30, 2007–Nov 15, 2017



Source: Bloomberg. As of November 15th 2017.

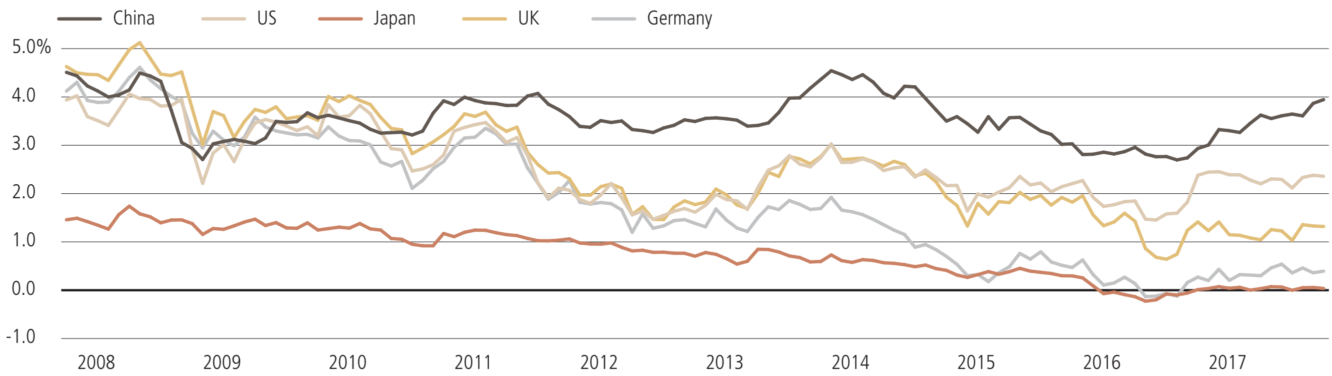
[1] Bloomberg: China Is Taking On the 'Original Sin' of Its Mountain of Debt https://www.bloomberg.com/news/articles/2017-08-08/china-is-taking-on-the-original-sin-of-its-mountain-of-debt
[2] http://finance.sina.com.cn/7x24/2017-10-14/doc-ifymuukv2024883.shtml
[3] Reuters: Key Chinese aluminium city to shut 2.57 mln T of capacity https://www.reuters.com/article/china-metals-aluminium/update-2-key-chinese-aluminium-city-to-shut-2-57-mln-t-of-capacity-for-winter-idUSL4N1MO3EK

The difference between now and 2013 is that the opening of quota-free access to China's Interbank Market (CIBM) plus the launch of China's Bond Connect system allows overseas investors to fully allocate to China's domestic markets.

This factor, combined with the growing attraction of yields at their current level, explain why total holdings of onshore bonds by overseas investors exceeded RMB 1 trillion at the end of September 2017[4].

On a comparative basis, yields on Chinese government bonds look attractive compared to options in the US, UK, Japan, and Germany (see Exhibit 5 below), and that's why we favor 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.

Exhibit 5: Nominal 10-year yields (%): an international comparison, Nov 30, 2007–Nov 15, 2017



Source: Bloomberg. As of November 15th 2017.

[4] Sina: http://news.sina.com.cn/o/2017-10-26/doc-ifynffnz2625347.shtml

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