SPOTLIGHT: CHINA

China tightens modestly: What pitfalls and opportunities does this present?

Spotlight | February 2017

China has tightened its monetary policy very modestly to curtail the growth of corporate leverage and more effectively price risk in money markets. Growth is unlikely to be impacted; it is sliding from 6.8% last year to 6.5% as stimulus abates. Similarly, the renminbi will continue to depreciate above 7.00 to the US dollar. For fixed income markets, long-dated onshore bond yields will rise and require investors to be selective in their exposure. Offshore issuance should increase as international rates are lower. In equities, higher yields and spreads make insurance and banks the beneficiaries. Infrastructure, property and consumer finance appear to be the sectors most at risk of a setback.

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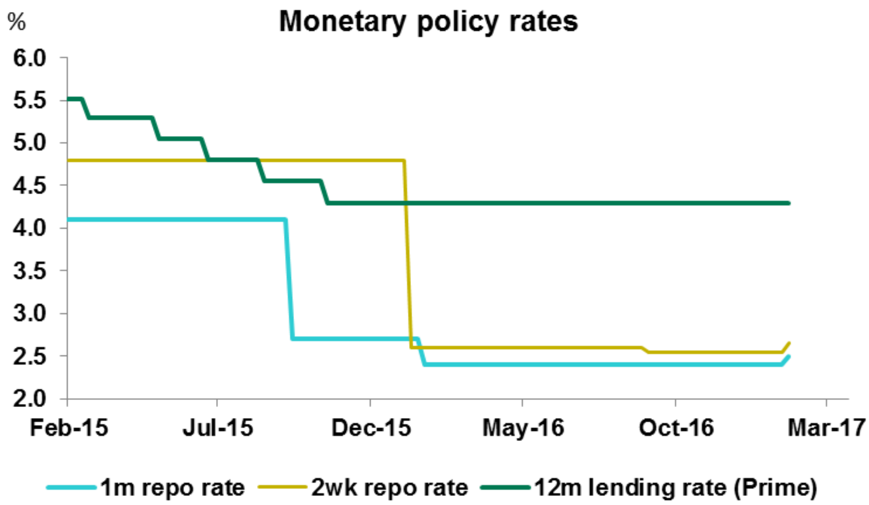
Key points

- *On Friday 3 February 2017 the Peoples' Bank of China (PBoC) increased money-market interest rates for the first time in many years. This was aimed at moving administered interest rates closer to market-based rates without changing the benchmark lending rate. The era of rate cuts is at – or very close to – an end. China's policy bias is no longer towards easing.*
- *The impact will not slow the descent in GDP growth from 6.8% last year to 6.5% in 2017. Stimulation, if desired, could come from increases in funding available for banks to lend. Beijing will probably continue to allow USDCNH to rise (expected to breach 7.00). Beijing can also be expected to tighten rules on moving funds offshore ahead of the ruling party's conference in the autumn.*
- *These changes will introduce some opportunities for investors. Local currency bond yields will rise at longer maturities and possibly prompt more USD-denominated bond issuance. In equities, monetary tightening is bad for infrastructure but good for life insurance companies and the net interest margins of large state banks.*

The central bank wants to rein in credit growth

Over the last two weeks China has tightened its monetary policy only modestly, giving additional notice that the period of monetary policy loosening in Asia is at an end; in many countries interest rates have either bottomed out or are very close to that point. The decision by the US Federal Reserve (Fed) to start raising interest rates, together with the rebound in commodity prices, has quashed the opportunity to lower interest rates further.

Marginal tightening of monetary policy



Source: Bloomberg Finance L.P.

This is evidenced, for example, by Bank Indonesia's rate cuts throughout 2016. Korea's inflation rate surged to 2% and will abruptly halt further loosening by the Bank of Korea (BoK). Better than expected data from Australia suggests that the Reserve Bank of Australia's (RBA) rate cut cycle is now also over. This week's statement by RBA acknowledged this. Only the Bank of Japan (BoJ), and perhaps the Reserve Bank of India (RBI), remain candidates for looser policy.

Why tighten when growth is slowing?

Capital continues to exit, putting pressure on the renminbi

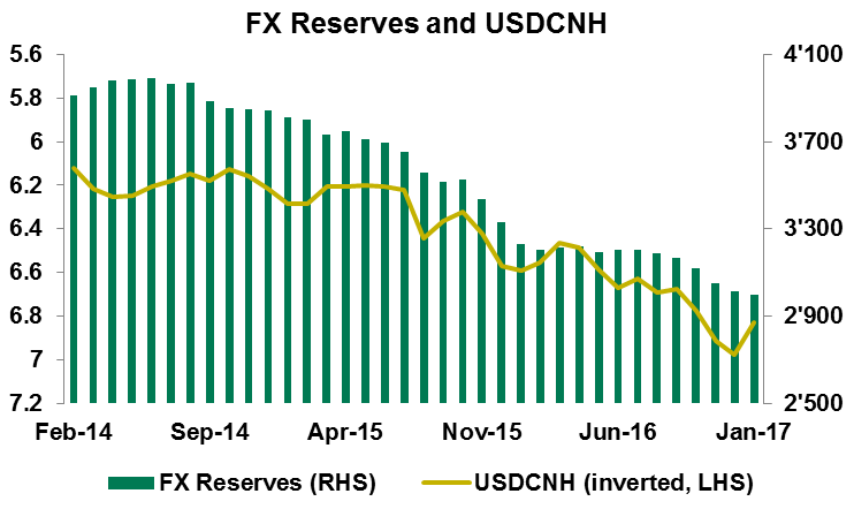
A combination of falling international reserves and higher US interest rates has forced PBoC's hand. China's ability to depreciate the renminbi (CNH) slowly without causing a panic in financial markets has been undermined by figures showing capital continuing to leave the country. Rising international bond yields have increased returns from offshore investments, making the job of maintaining a credible policy that much harder.

The reserve requirement ratio (RRR) can be lowered at a later date

The PBoC has opted to tighten policy modestly, ration credit and restrict terms to bad borrowers, and so allow the recent rise in inflation back above 2% to keep interest rates flat. If needs be, the reserve requirement ratio (RRR) – the quantity of bank reserves that cannot be lent to households and corporates – can be lowered at a later date.

For the PBoC to do nothing would probably see capital flight increase again as the Fed gears up to raise US interest rates. The potential impact of not tightening would be a much faster tightening of Chinese policy at a later date and a more abrupt slowdown in growth ahead of this autumn's 19th Party Congress. With corporate debt currently valued at roughly 230% of gross domestic product (GDP), there is every reason to reduce leverage, albeit gently.

FX reserves and currency depreciation



Source: Bloomberg Finance L.P.

GDP, FX impact

The impact on GDP growth, for now, is minimal and does not change our view that growth will fall from 6.8% in 2016 to around 6.5% this year. However, China's growth rate is not collapsing. Private sector wage growth has been solid over the last two years and retail spending, whether online or in stores, continues to grow at 10% per annum.

China's growth rate is not collapsing. Retail spending is strong

Property market activity received a sizeable boost after the ill-fated change of currency policy in mid-2015, but recent measures to rein in price appreciation will probably lead to slower growth later this year. This should be offset to some degree by increased international trade as the growth of G7 countries increases global demand.

We see USDCNH breaching 7.00 (from 6.87 today), and possibly moving towards 7.2 as the pace of US tightening picks ups (UBP thinks that the US central bank could raise interest rates three times this year). The pace of depreciation will be modest to avoid accusations of 'currency manipulation' by Washington. From current levels, this equates to a drop of only 5%.

Fixed Income

With a higher interest rate in the domestic market, we expect USD offshore borrowing from Chinese issuers to increase. Beijing made some comments in January to encourage banks (especially the large state-owned banks) to issue US-denominated bonds offshore. This is also in response to a firm demand for Chinese credit amongst international investors.

The impact on higher-quality Chinese issuers with low leverage will be minimal

We also expect more supply from the Chinese property sector seeking opportunities presented by lower offshore borrowing costs. For higher-quality Chinese issuers with low leverage, the impact from this tightening policy will be minimal. Nevertheless, the need for corporates to reduce their debt burden implies that investors should be selective, particular on property-related corporates.

The impact on the offshore 'dim sum' bond market could be larger (Dim Sum bonds are listed outside China but are denominated in renminbi). With higher onshore yields, local currency bonds are likely to decline in price, with investors expecting higher interest rates. Investors will probably demand a higher premium for offshore renminbi (CNH) bonds.

Equities

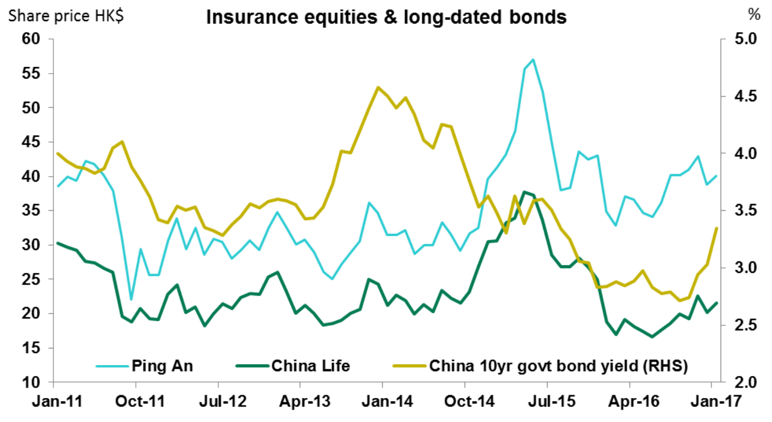
The insurance sector will probably be a key beneficiary as long-dated bond yields rise, boosting returns and improving financial solvency ratios. Given the rally in this sector since the US presidential election, the preferred strategy is to look for selective opportunities rather than buying the sector as a whole.

The impact on the banking sector will be size dependent. It benefits the state-owned banks' net interest margin but hurts smaller banks' return on wealth management products (WMP). WMPs are off balance sheet investment vehicles that banks have offered to depositors to enhance yield. Many of these products have been invested in low quality corporate credit and the premium that banks have to charge for poor quality lending has been increased by 1%.

Insurance and segments of the banks will be beneficiaries

Finally, a tighter monetary policy will benefit China's financial markets if it leads to renewed, but slow, deleveraging.

Rising yields improve insurance solvency ratios



Source: Bloomberg Finance L.P.

For companies listed on the Hang Seng H-share index or on China's A-share index, Friday's measures are a challenge for infrastructure projects; new projects were expected to offset the slowdown in property investments after the introduction late last year of a purchase quota and other restrictive policies on financing for large cities (Tier 2), and metropolises such as Beijing and Shanghai (Tier 1). Housing loan growth may be impacted by tighter policy. Similarly, sentiment in industrials and utilities may dip given the potential for slower project execution.

Historically, a tightening of monetary policy also dampens motor financing and automobile sales, but given that the benchmark lending rate was not increased, any slowdown in 2017 will most likely come from lower car-purchase tax rebates compared to 2016.

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