The View From The Outer

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EVANS & PARTNERS

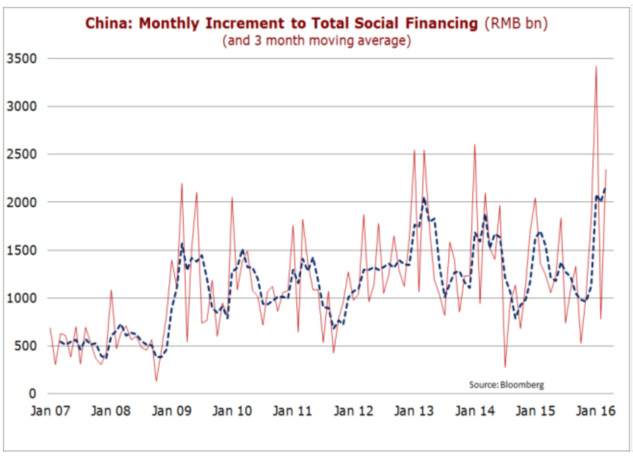
China's March Q credit surge: Australian equity implications

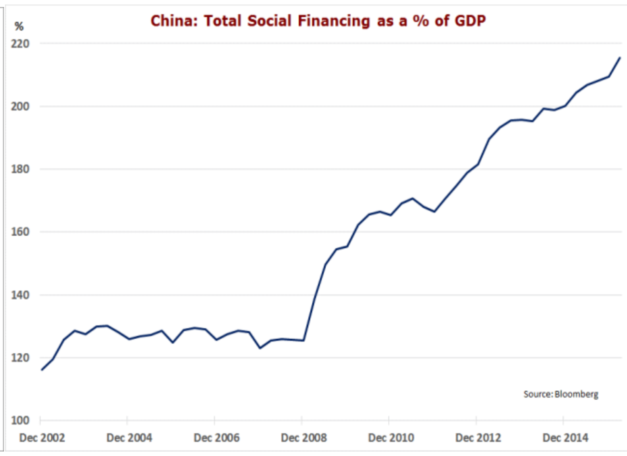
China's March Q credit surge: Policy easing in China has gained traction. Six interest rate reductions between November 2014 and October 2015, together with reductions in banks' Reserve Ratio Requirements and some fiscal support, have seen China's property market and heavy industries step up a gear. The monetary impetus is clear from the acceleration in the broader credit aggregate, Total Social Financing (see chart below). The critical question for Australian investors is, from a policy perspective, does this reflect a desire to return to the so-called "old growth model" (that is, infrastructure/property/capex/export driven)? In our view no.

We do not see this as a sustainable, viable longer term option for three reasons:
1) The rapid increase in the debt/GDP ratio post December 2008 led to diminishing marginal returns and excess capacity. We do not see this being repeated from current debt levels. Non-performing loans have also been increasing;
2) China's real effective exchange rate has appreciated strongly over the last ten to fifteen years, and particularly from mid-2014 to end 2015 as it largely tracked the US Dollar higher. This has significantly impacted competiveness; and
3) The recent massive rebound in China's basic domestic materials prices such as rebar steel (which rose circa 65% from the lows in January 2016) looks grossly overdone and brings with it the seeds of its own undoing. In the case of steel, which is in global oversupply, it is bringing back previously mothballed higher cost Chinese production, while exports can also presumably be diverted back into the domestic market.

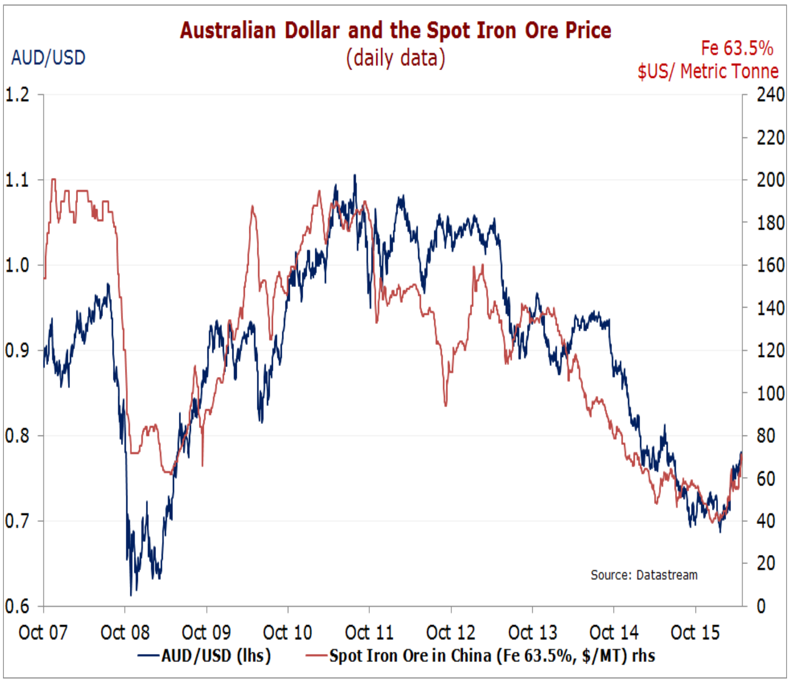
Simply put we believe the Authorities are trying to smooth the transition to a more consumption and services oriented economy rather than revert to the "old model." Indeed excesses in the property markets of Shenzhen (prices up over 60% in the last twelve months) and Shanghai are already being met by tighter regulations to try and choke back demand. Intra-month data suggests this appears to be effective. However to achieve this transition, the decline in the still substantial old industries cannot be too rapid or it undermines employment growth and the capacity of growth in the consumption and services sectors to pick up enough of the slack elsewhere.

Clearly this a difficult balancing act. While accepting global economic pessimism was overdone back in January / early February, commodity prices look way overdone now, even though there is clearly a risk that the March quarter China credit impulse continues to provide a "sugar hit" to the "old economy" industries in the short term.





Australian equity implications: The rise in commodity prices and the resources led recovery in the market from 12 February lows has (unsurprisingly) seen a strong rise in the Australian dollar, aided by favourable interest rate differentials and relative shifts in monetary policy expectations. (See chart of the Australian Dollar compared to the iron ore price below).

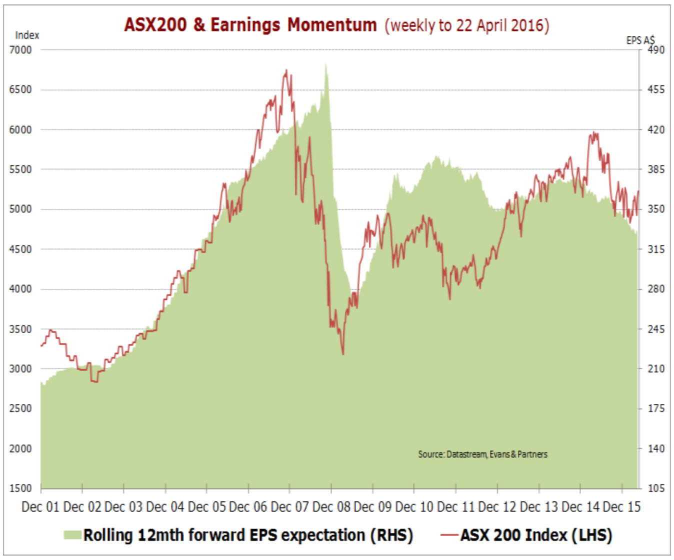


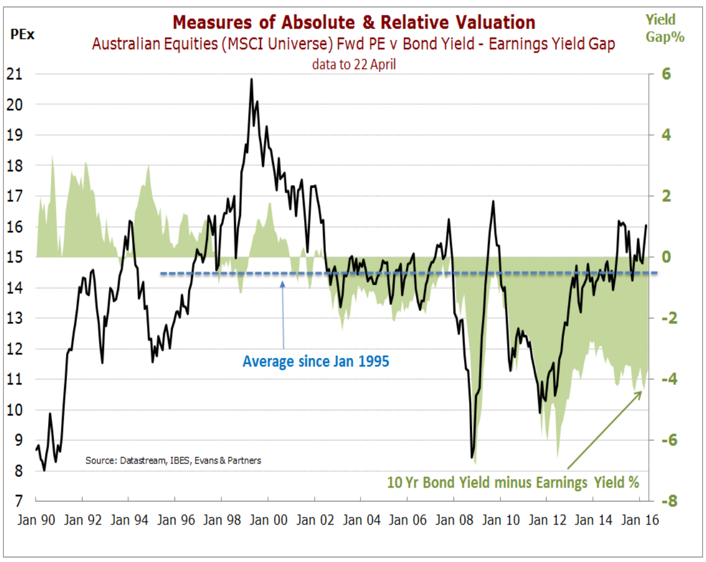
However, we expect these three factors that have driven the Australian dollar higher to be partially unwound. Over the balance of the year we expect commodity prices to weaken as China's credit impulse fades. From an interest rate differential perspective, we expect the RBA to be reducing Australia's cash rate by 0.25% while we still view the Fed as likely to tighten again by 0.25%. This points to a weaker Australian dollar, at least through the second half of the year.

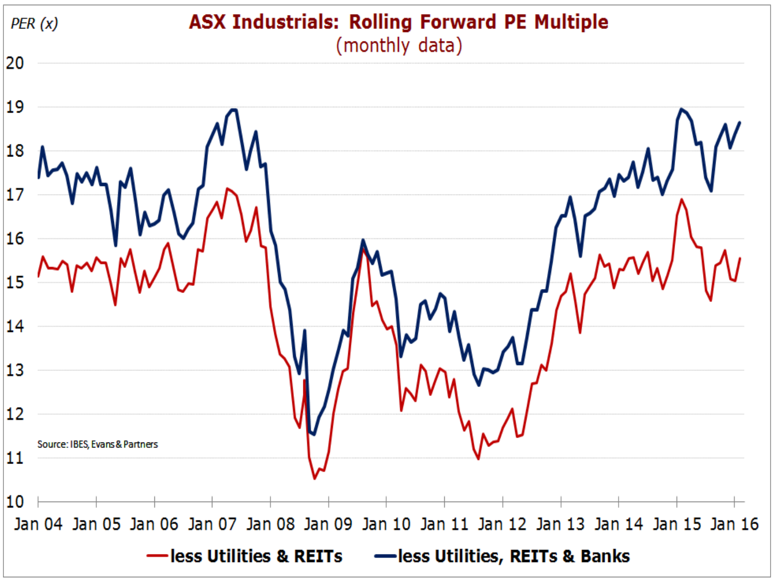
From an Australian equity market perspective, if sustained, the concomitant rise in the Australian dollar is strong enough and quick enough to lead to industrial earnings downgrade risks whilst also impacting competitiveness. As we have written previously, we are also expecting Australian economic growth to ease somewhat through the year (*The View From The Outer 18 March 2016*).

The Australian equity market has run ahead of earnings expectations, which have continued to be revised down (see the chart below left). Further, the major resource stocks are already trading on high 2017 consensus PE Ratios (PE's), suggesting optimism is already priced into this sector.

Interest rates are ultra-low and supportive of the yield trade, but the broader market's 12 month rolling forward PE is back at 16X; a level that makes us cautious from a valuation perspective. Only during the valuation bubble in the TMT boom/ dot com bubble (1999-2001) were PE's above this level for an extended period. (See chart below right). Of course the environment is different on every occasion, but as in March 2015 buying the market at over 16X consensus forward earnings leaves little in the way of a valuation buffer if equity risk premiums are re-appraised or earnings disappoint.







With respect to the Industrials (ex-Banks, REIT's and Utilities) valuations are becoming stretched. Twelve month Forward PE's are not far off the lofty heights seen in mid-2007 and March 2015. (See chart left). This leaves little scope to accommodate a potential disappointment.

What is the biggest risk to the above scenario? The most apparent risk is the longevity of the current credit impulse on the Chinese economy. How should one deal with this? We are always reluctant to chase a potential short term move which lacks underlying valuation support. While equity markets are not cheap in absolute terms, we prefer international equities from a relative valuation perspective; with a wider and more attractive opportunity set from which to choose.

From an asset allocation perspective: We therefore maintain our long standing overweight global equities/ underweight Australian equities view with the marginal additional equity investment dollar better placed offshore. If the weaker USD/ China credit surge environment supports commodity prices and global equity markets over the June quarter, you would participate in the upside but likely underperform Australian equities short term. However if (or as we expect when) commodities decline again, global equities are likely to prove a more defensive equities proposition than domestic equities, presumably further assisted by Australian dollar weakness.

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