view from the OUTER

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Why Trump is wrong on China

The slowdown in the Chinese economy has become a critical issue for investors. Not only is it important for the global macro outlook, but it is also becoming a major factor in the trade war between the US and China.

Trump apparently thinks the slowdown in the Chinese economy and the crash in the local stock market is due to the trade war, and hence wants to maintain the pressure, in expectation of a capitulation by China. However, the real cause is a deleveraging campaign that began in mid-2017 – well before the trade war started. Chinese exports to the US have actually jumped higher this year.

In recent months the tightening in credit has started to affect a broader range of sectors in the economy. It started with infrastructure spending and has now extended to the consumer and property sectors.

If the overwhelming cause of the weakness in the economy is tight credit, then the solution that China would use to reverse it is to ease credit. What is much less likely is that they would capitulate to Trump to try and stimulate the export sector.

Conclusion

The economic and market implications are:

- The Chinese economic downturn is driven by its long-term reform agenda and not the trade war. The slowdown to date is an expected consequence of tightening credit and the economy is not weak enough yet for a full reversal in the reform agenda although there has been some softening in rhetoric from officials since July and some mild policy easing in the form of cuts to reserve requirements. Overall, however, we expect credit to remain tight and for the economy to weaken further in the short term.
- Trump's misguided view that the trade war is causing pain in China may see the trade war get worse, before it gets better.
- Global and Chinese stock markets will probably get even cheaper in this scenario. This ultimately could represent a buying opportunity, but further escalation of the trade war could see more market weakness. We have been highlighting that several sectors of Asian markets already represent significant value, including Chinese internet and Asian technology stocks. Another sector is Chinese property developers, which are now trading at a 60% discount to net asset value (NAV).

Trump is wrong on China

The slowdown in the Chinese economy has become a critical issue for investors. Not only is it important for the global macro outlook, but it is also becoming a major factor in the trade war between the US and China.

The link with the trade war is that Trump, and the broader administration, are of the view that the slowdown in the Chinese economy and the crash in the local stock market have been caused by the trade war. The logic therefore is that China must be close to a pain threshold which will cause them to capitulate into a pro-US deal on trade and access for US companies into China. The US then is likely to hold its ground, cause more pain, and wait for China to buckle.

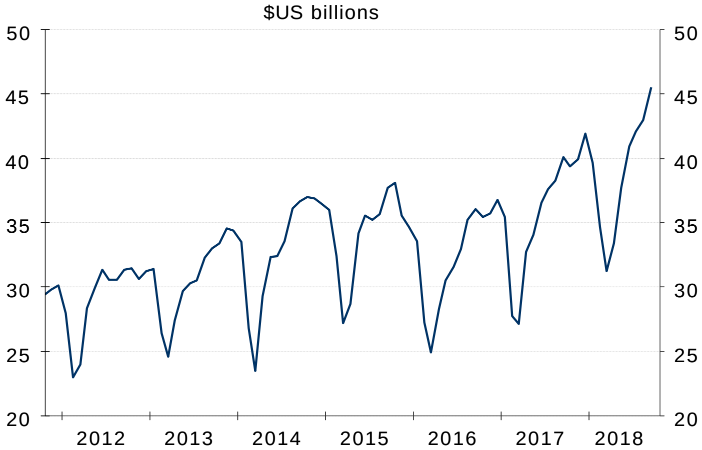
Chinese slowdown is not due to the trade war

It is fairly easy to disprove the notion that the trade war has had a material impact on the Chinese economy to date.

Firstly, Chinese exports to the US have actually jumped higher this year. This is probably due to the sharp fall in the Chinese currency and front-running of tariffs – i.e. companies buying more before the tariffs come into force.

Chinese exports to US

$US billions



Source: Thomson Reuters Datastream, Evans & Partners

Secondly, the economic slowdown has been led by a slump in infrastructure spending which commenced before the trade war rhetoric started. Infrastructure spending has very little to do with export performance. The next chart shows that the infrastructure slump started in the second half of 2017.

China Infrastructure

Annual change %

Source: Thomson Reuters Datastream, Evans & Partners

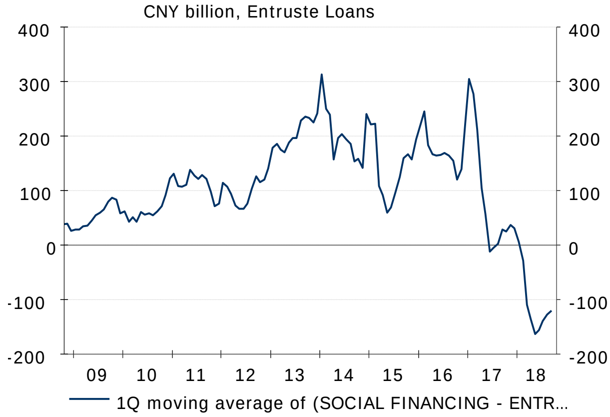
Deleveraging is the real story

The reality, which we have been highlighting all year, is that the slowdown is almost entirely due to an acceleration in economic reform, particularly the campaign to reduce debt in the economy. China commenced a new round of reform in mid-2017, with the principal aim of reducing financial risks. The shadow banking sector was effectively shut down from around May 2017. For an economy that had become so dependent on credit, this was always going to have consequences for activity.

The deleveraging campaign was officially endorsed at the National People's Congress last October and is intended to last for three years.

Chinese Shadow Loan Issuance

CNY billion, Entruste Loans



Source: Thomson Reuters Datastream, Evans & Partners

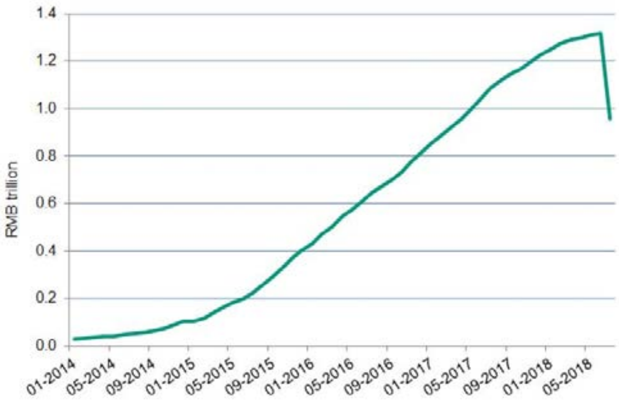
This had its first effect on the infrastructure sector because local governments –who sponsor most infrastructure projects – were large participants in the shadow banking sector.

Deleveraging effect is spreading

What has occurred in recent months is that the tightening in credit has extended to other parts of the economy, including the consumer and property sector.

Consumer spending has softened in recent months, as has been most evident in sales of big-ticket items such as appliances and autos[1]. The most likely cause of this has been the extension of the deleveraging campaign to consumer finance provided over the internet. This segment of the market had exploded higher since the sector was deregulated in 2015 and significant problems were emerging. This was a double hit to the consumer because much of this occurred on peer-to-peer (P2P) platforms where the source of the funds was other households. So some households lost funds from being lenders, while others have had spending plans curtailed because credit is no longer available.

Outstanding lending on Chinese P2P platforms

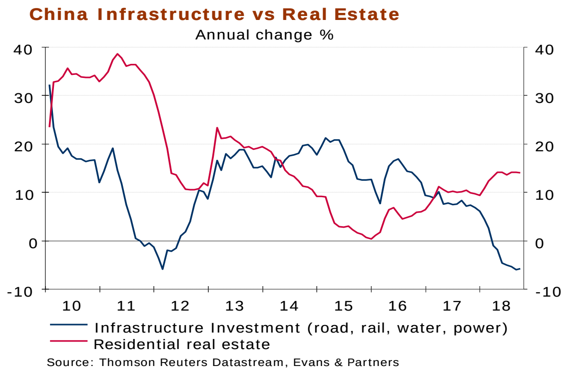


Source: China Internet Finance Association

More recently there are signs the property sector has also been affected. Sales have been weak recently and some developers have been cutting prices in order to raise cash, as finance has tightened. Even though sales have risen this year they have not kept pace with new builds and construction activity, resulting in a cash drag for developers. Over the past month developers have started reducing prices to encourage more sales and rebuild cash balances.

The other reason developers have been forced to cut prices is that offshore funding, through US dollar bond issuance in Hong Kong, has become more expensive. Yields on developer bonds have spiralled higher, from 5.5% to 7.5% recently, as shown in the next chart.

The property market is a critical area to watch going forward. Up until now it has been the strongest part of the economy and has been providing a significant offset to the weakness in the infrastructure sector. A material decline in construction will be felt by the commodity sector in particular.



[1] We discussed this in detail in *View from the outer: the Chinese consumer will spend again*, 18th October

How weak could China get?

Even though there has been a change in momentum in the Chinese economy and conditions are starting to weaken, Chinese policy-makers are probably not yet at the point where they will consider aggressive stimulus.

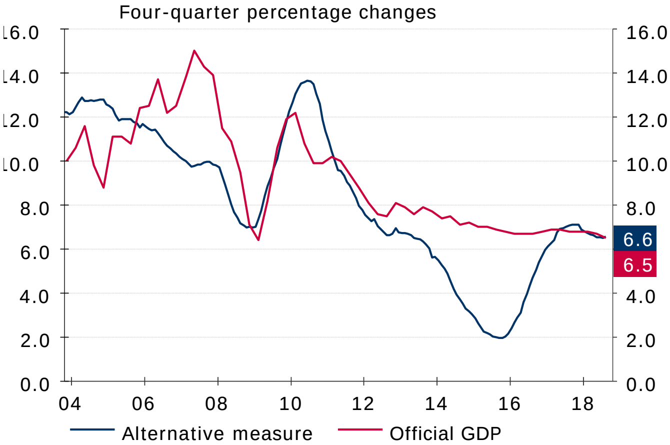
It is important to remember that the downturn was an expected consequence of a tightening in credit, and that the government thinks a reduction in dependence on debt is in the long-term best interests of the economy. Policy makers will be willing to pause the reform agenda if conditions deteriorate substantially, but it is not clear that we are at that point yet.

This situation is similar to the 2013-15 period. President Xi Jinping commenced his first set of reforms, shortly after his promotion to the top job in late 2012. Reforms were significant and were initially focussed on reducing corruption. By 2015, the impact on the economy was severe – and in early 2016 reforms were suspended and there was a substantial easing in credit conditions.

Alternative measures of Gross Domestic Product (GDP) are a good way to compare the 2015 episode to where we are now. These measures aggregate series such as power generation, trade, credit and freight movements. They are a good cross-check on the official data, which is generally considered to be of poor quality.

One of these measures, as prepared by Thomson Reuters, shows conditions were much more severe in 2015 than now. Policy makers did not respond aggressively to address the slide until 'alternative GDP' growth hit 2% in early 2016. The current level of growth is well above this at around 6.5%. Conditions may need to get much worse, before widespread stimulus occurs.

Chinese GDP and Alternative Measure



Source: Thomson Reuters Datastream, Evans & Partners

Importantly, if the overwhelming cause of the weakness in the economy is tight credit, then the solution that China would use to reverse it is to ease credit. What is much less likely in our view is that they would capitulate to Trump to try and stimulate the export sector. Hence Trump is likely wrong if he thinks China can be coerced into a deal.

Stock market weakness is due to pledged loan issue

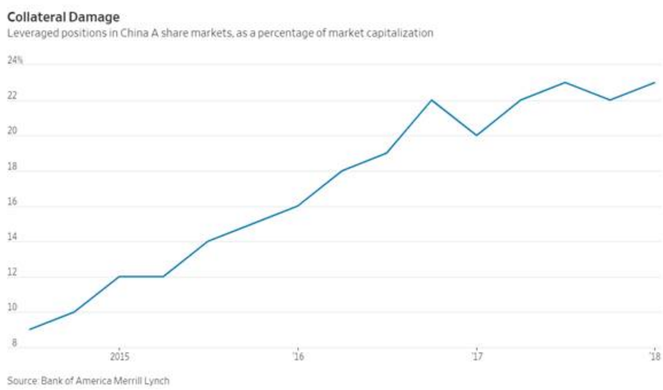
One reason why the economic weakness in China feels stronger than it is, might be that the stock market is crashing. However, this is more to do with the issue of 'pledged lending' than macro or earnings developments.

The main reason the Chinese stock market is under pressure is that company founders and large shareholders have been borrowing against the value of their shares in substantial numbers. This 'pledged lending' is different from 'margin lending' – instead of individuals borrowing to invest in shares, these are shareholders borrowing against the value of their own shares and using the funds for other purposes. Often up to 40% of shares are pledged.

The practice has been rampant since 2015, and now apparently 23% of shares have been collateralised in some way. With the recent falls in shares around 20% of that is near the forced liquidation line. This growing practice is also a by-product of the deleveraging campaign; many companies claim to have done it because it is the only way they can obtain working capital at a time when banks have no capacity to lend due to strict quotas.

The main plan that authorities have devised to combat this is to set up a fund to buy the shares of troubled companies off-market, so the firms in trouble can repay the loans. This in effect results in a public takeover of private firms. Importantly though, this should not be considered as a broad policy easing.

Pledged loans in Chinese A-shares

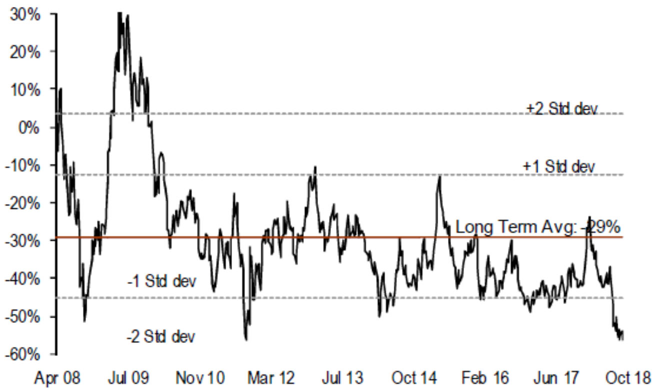


Conclusion

The important conclusions from this discussion which inform our market views are:

1. The Chinese economic downturn is driven by its long-term reform agenda and not the trade war. The slowdown to date is an expected consequence of tightening credit and the economy is not weak enough yet for a full reversal in the reform agenda although there has been some softening in rhetoric from officials since July and some mild policy easing in the form of cuts to reserve requirements. Overall, however, we expect credit to remain tight and for the economy to weaken further in the short term.
2. Trump's misguided view that the trade war is causing pain in China may see the trade war get worse, before it gets better.
3. Global and Chinese stock markets will probably get even cheaper in this scenario. This ultimately could be a buying opportunity, but further escalation of the trade war could see more market weakness. We have been highlighting that several sectors of Asian markets already represent significant value including Chinese internet and Asian technology stocks. Another sector is the Chinese property developers, which are now trading at a 60% discount to NAV.

Chinese developers discount to NAV



Source: JP Morgan

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