

May 26<sup>th</sup> 2016

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# The Panda in the Room

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By Louis-Vincent Gave

# Whether the US\$ goes up, or down, remains most important question

## Two questions, four outcomes

US\$ rises

US\$ is stable or falls

EM bond yields rise

**Fear of bankruptcies:**

Buy the strongest balance sheets  
in the US

A rare outcome:

When EMs are in trouble the US\$  
tends to rise

EM bond yields are  
stable or fall

No obvious pattern

**Fear of missing out:**

Buy the weakest balance sheets in  
the EMs, as no one will go bust

**Between 2012 and 2015, markets were there... but are they now moving to here?**

# A dollar driven decision tree

Q1: Do you think the US\$ is done rising?



Buy US Stable  
Growth Stocks and  
US Treasuries



Q2: Does Chinese  
economy implode over  
the coming year?



Buy EM yields, EM  
Growth, Energy,  
Value stocks in DM

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**1- The 'panda in the room':  
what should we make of Chinese growth?**

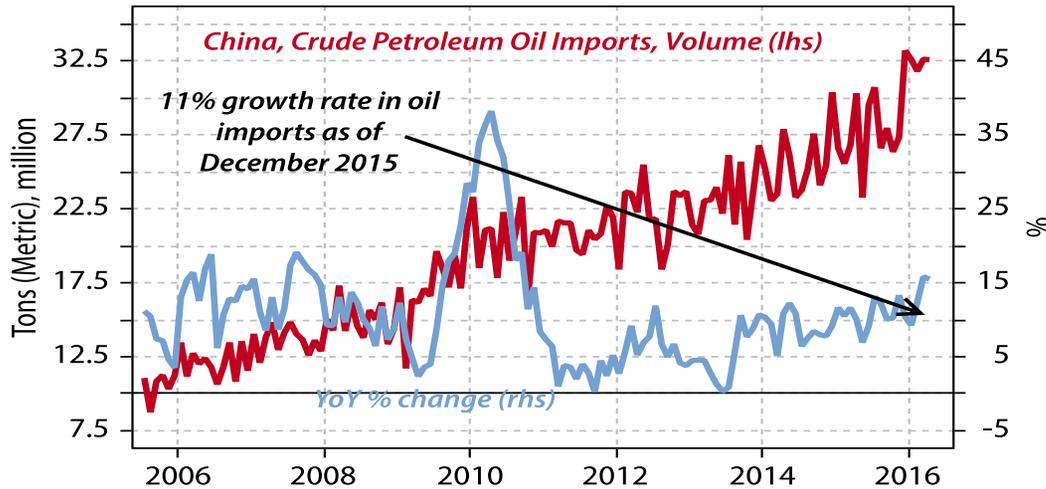
# The commodity markets are telling us that China is hurting

## The China driven boom and bust in commodities



# Or are they?

## Oil imports: 11% annual growth to new all time highs



✓ China's commodity imports (ex coal) are all making new all time highs.

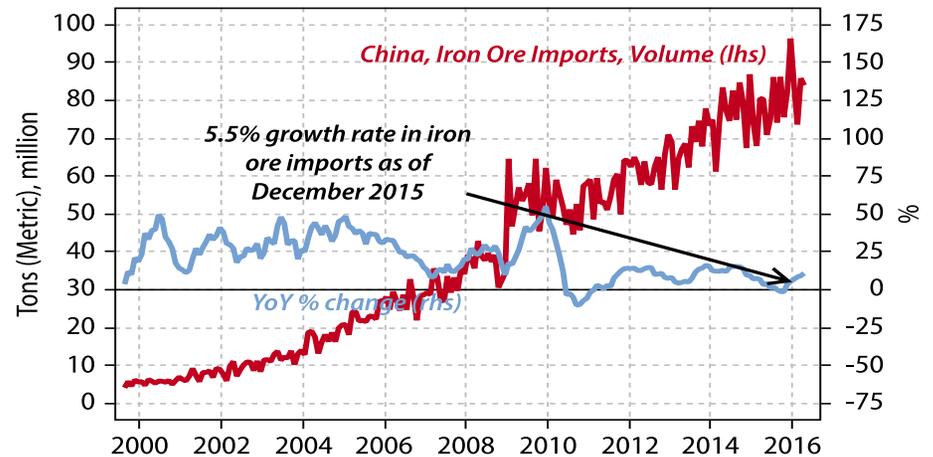
✓ Wait! What???

## Copper imports: 11% annual growth to new all time highs



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## Iron Ore imports: +5.5% YoY growth to new all time highs

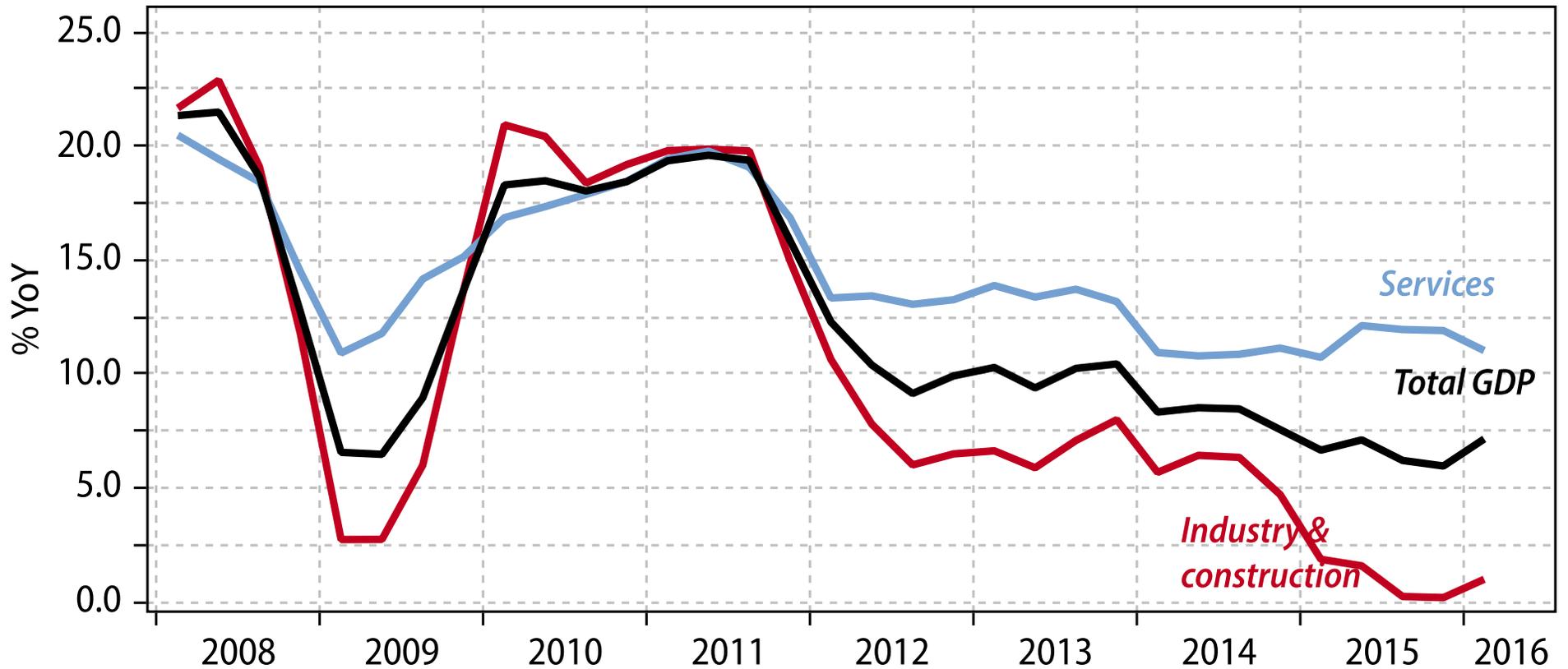


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# This is not to belittle the Chinese slowdown

## Services are humming away as industry slumps

Nominal change in value-added by sector

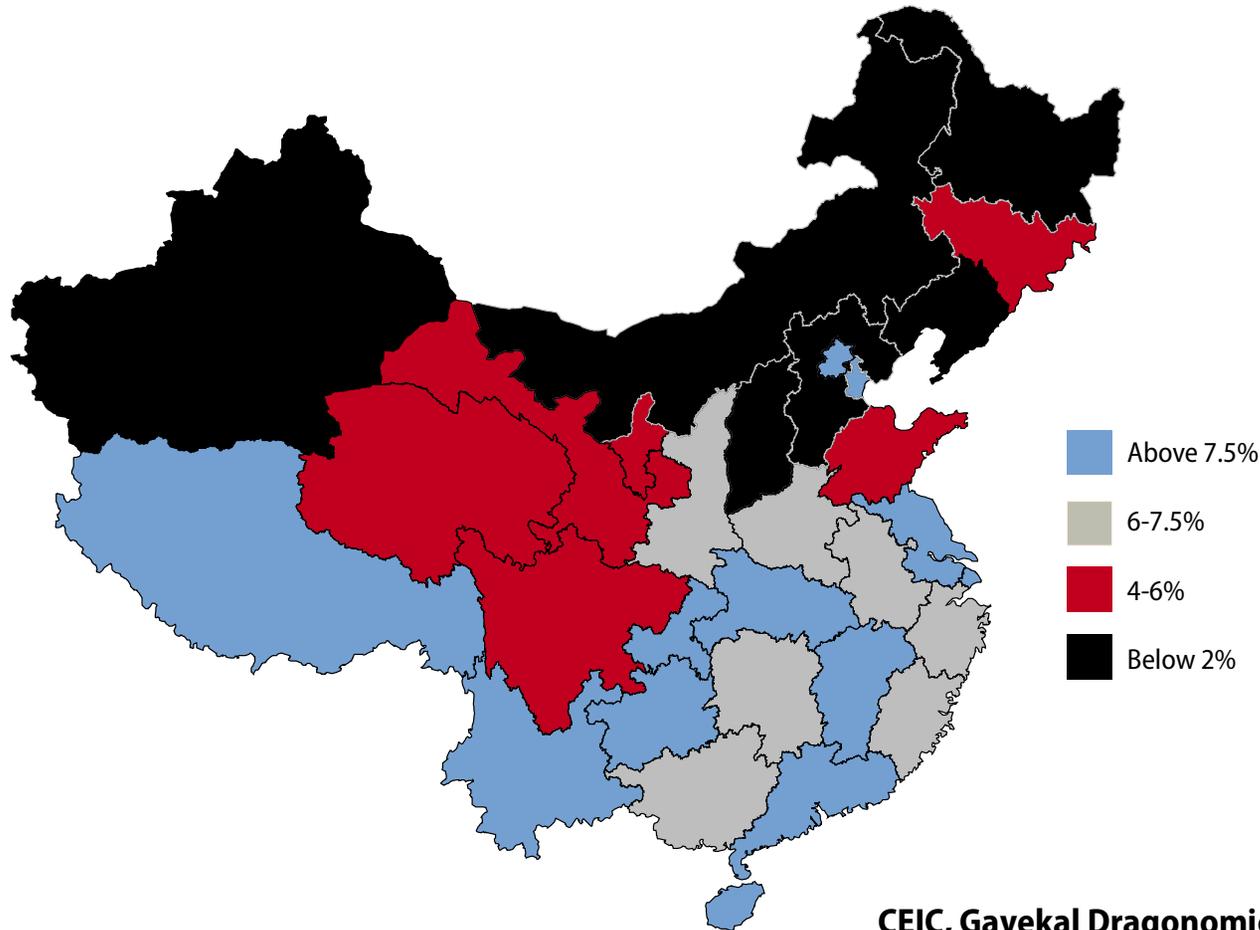


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# The disparity of growth is unprecedented for China

## China's northern and western provinces are the worst off

Provincial nominal GDP growth in the first half of 2015



The economic slowdown China has experienced since 2012 has been marked by an enormous regional disparity.

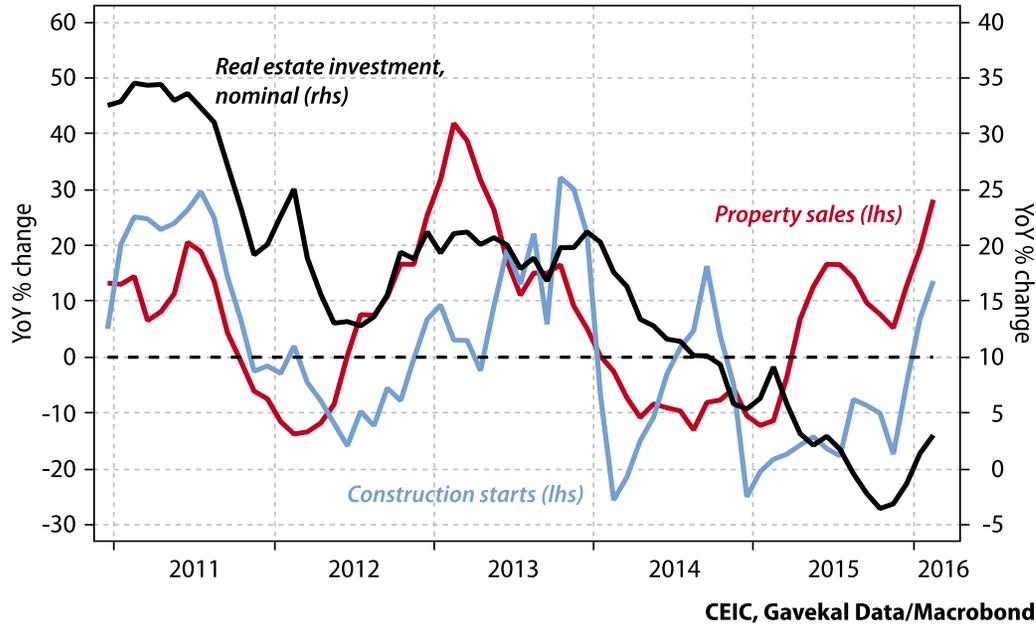
A group of northern provinces that are heavily reliant on mining and heavy industry are bearing the brunt of the slowdown. Three provinces had negative nominal GDP growth in the first half of 2015: the coal mining capital of Shanxi, and Liaoning and Heilongjiang in the northeast rust belt.

The wealthy centers of Beijing and Shanghai, as well as the coastal provinces, have been doing much better.

# The government is back to working the pump

## China's housing sales re-accelerated, and so did construction

Property indicators, 3mma



## Investment growth has stabilized recently as SOE spending picks up

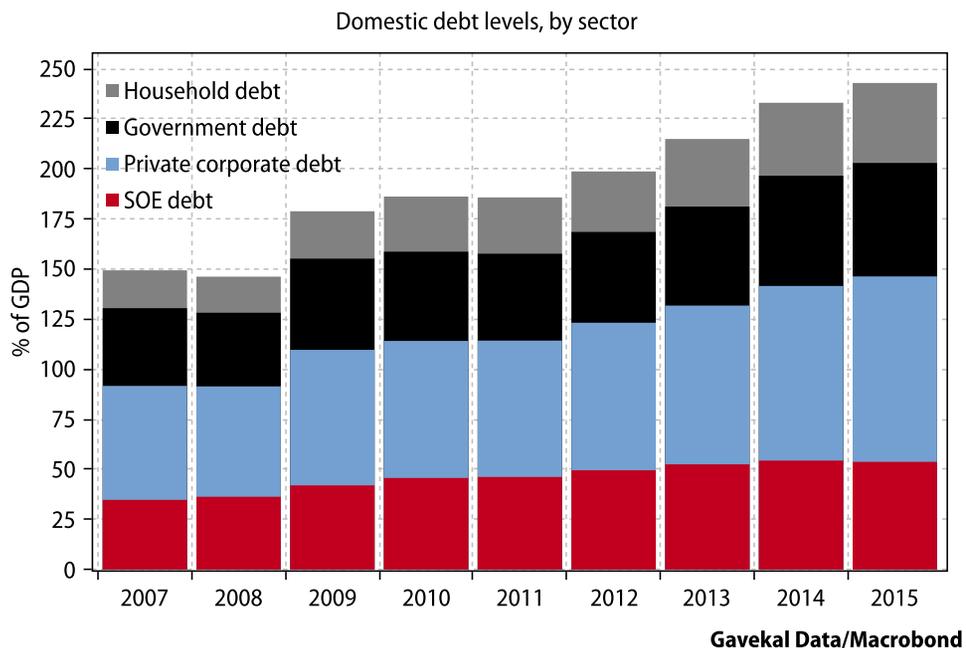
Fixed-asset investment by ownership of firm, 3mca



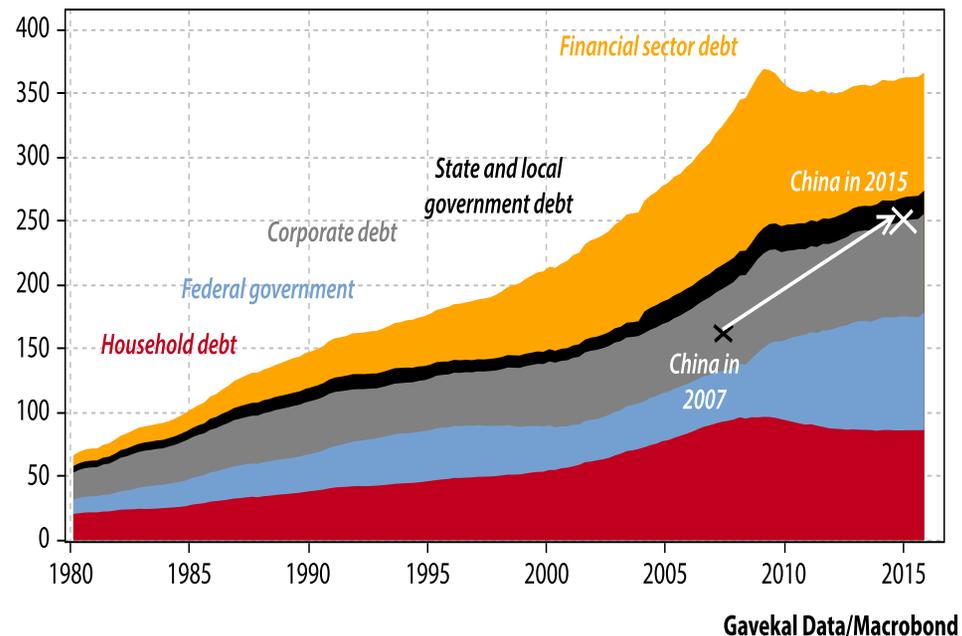
- This year's rebound in Chinese construction, property sales, and prices is possibly one of the least expected macro developments of 2016.
- Clearly, the government is back to working the pump. In the short term, this covers over the crack. In the longer term, it does raise serious sustainability questions.
- In the portfolio, we own **Guangdong Investments** (3%), **China Overseas Land** (2.2%), **CK Infrastructure** (2.9%), **Galaxy** (2.7%), **Sands China** (1.2%)...

# Begging the question of how long the debt increase can last?

China's national leverage has surged in recent years



The Evolution of US Debt (and China) as a % of GDP



- Chinese debt is a major concern amongst investors today. And while the level of overall debt still stands below the levels reached in the US, Japan, France etc... the genuine concern is the pace of growth in China's accumulation of debt. If nothing else, the rapid pace of debt growth would suggest capital misallocation on a grand scale.
- Another concern is that, unlike in the US or Japan, the growth in debt has not come from the government but from corporates – and now, with falling prices (PPI has been negative for 5 years) and weakening sales growth, the question of debt servicing is an open one.
- **So does China face a debt crisis?**

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## 2- Does China face a debt crisis?

# Two kinds of financial crisis

**Country runs large current account deficits for years**

Becomes dependent on the willingness of foreigners to fund its lifestyle

**Once foreigners want out (Argentina, Greece, Thailand...) the financial system implodes**



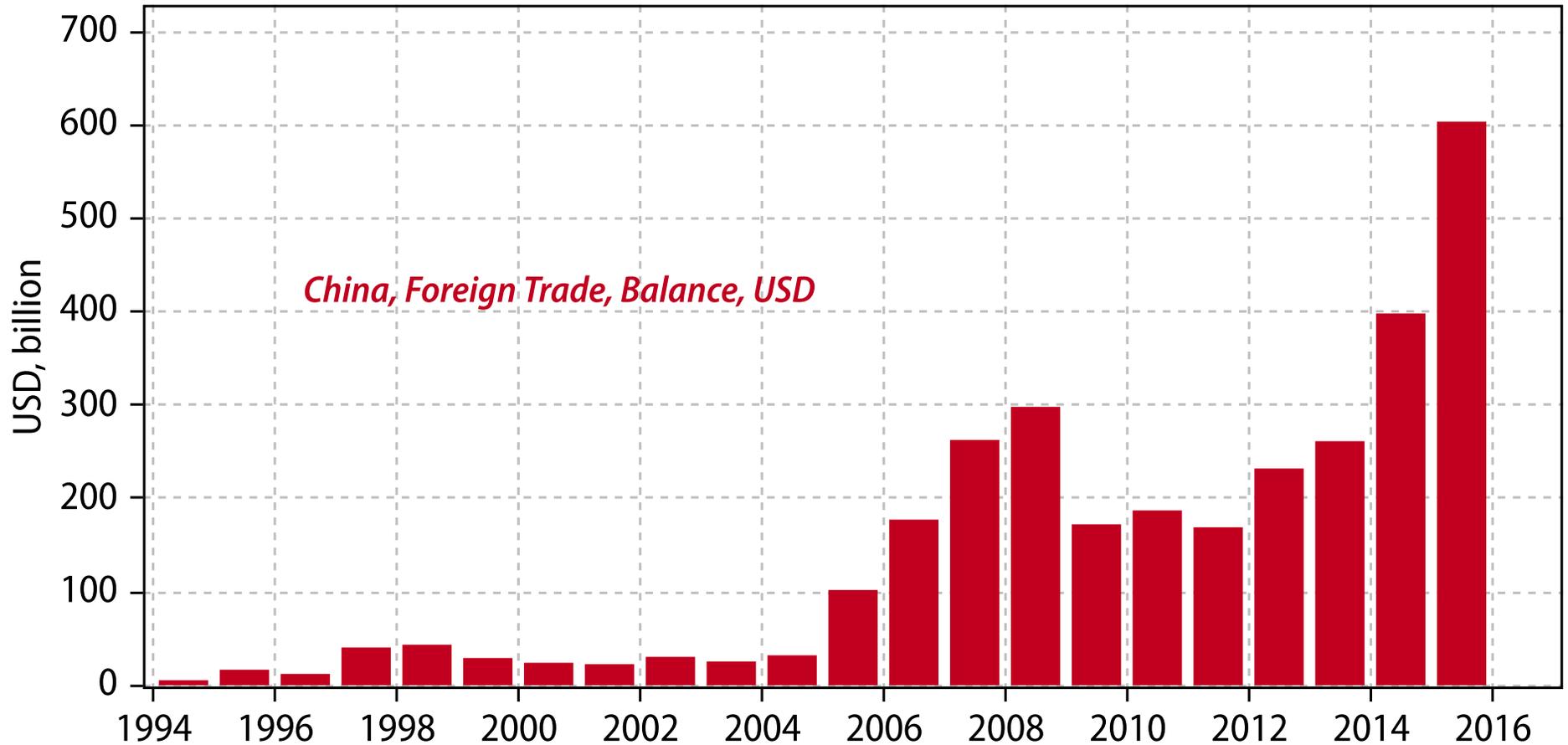
**Banks lean too far above their skins, usually by lending too much to real estate**

Bank outgrow their own equity and so borrow short (money markets) to lend long

**Money markets refuse to lend to banks and so banks need to raise equity quickly**

# Scenario 1 is impossible in China

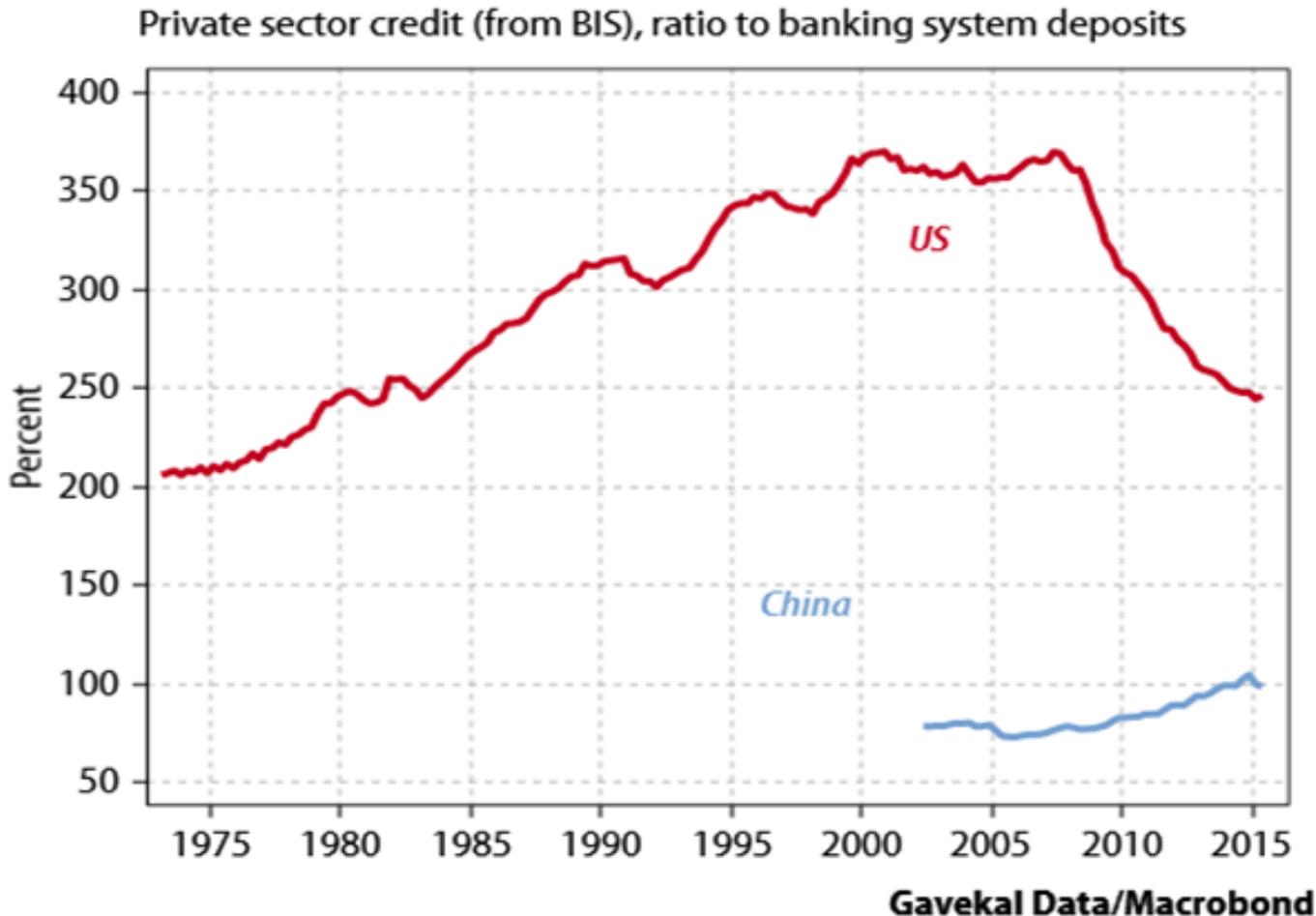
## China, Foreign Trade, Balance, USD



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# Scenario 2 is also unlikely

## The difference between the funding of US and Chinese credit

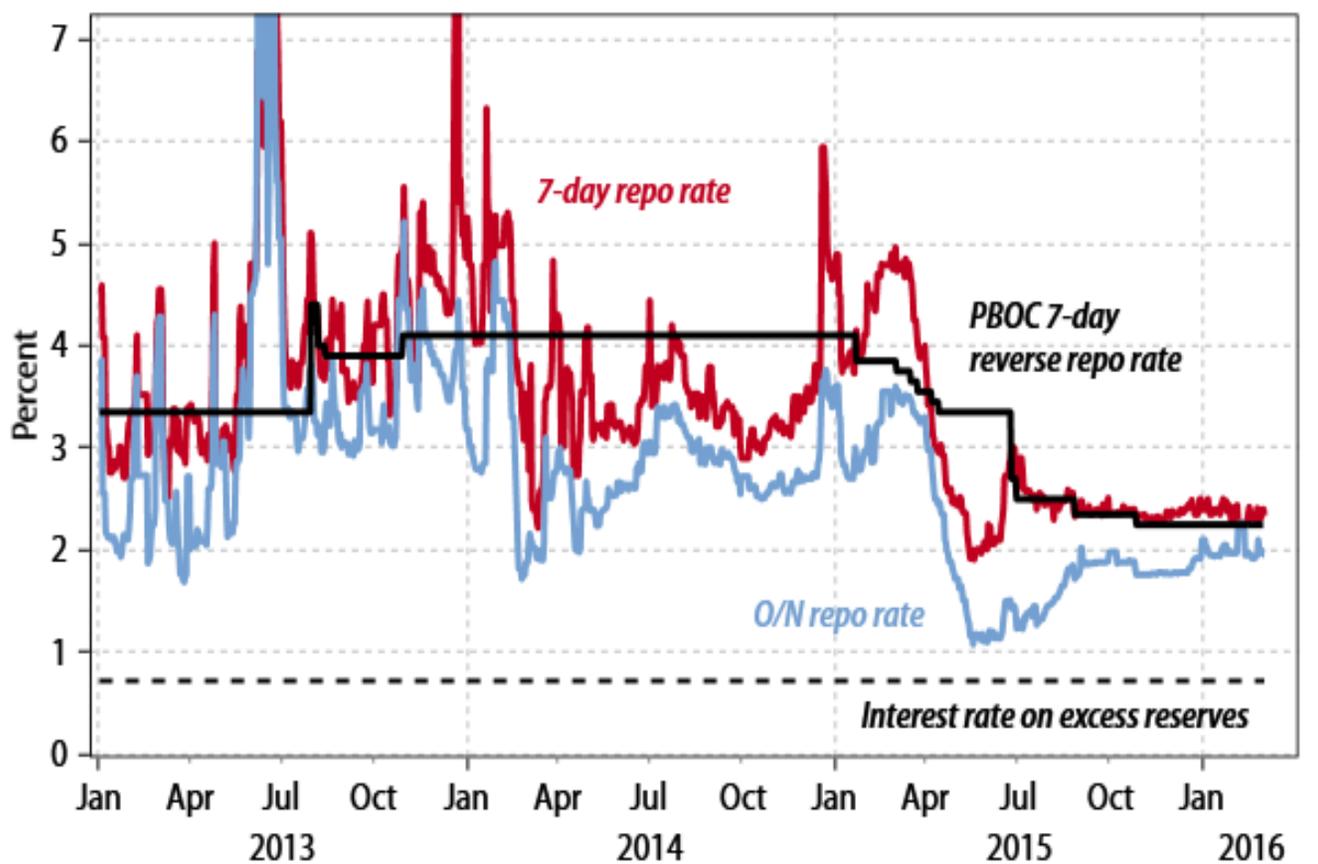


- In order to see a banking crisis in China, it will have to be that either the government triggered it (by ending regulatory forbearance).
- Or because panic depositors take their money out.
- But what would trigger such a panic in government owned and backed banks? As Charles often puts it, people change wives more often than they change banks...

# Instead, most likely scenario is to continue piling debt on

## With better guidance, interbank rates are more stable than ever

Policy and market rates in the emerging interest rate corridor



CEIC, Gavekal Data/Macrobond

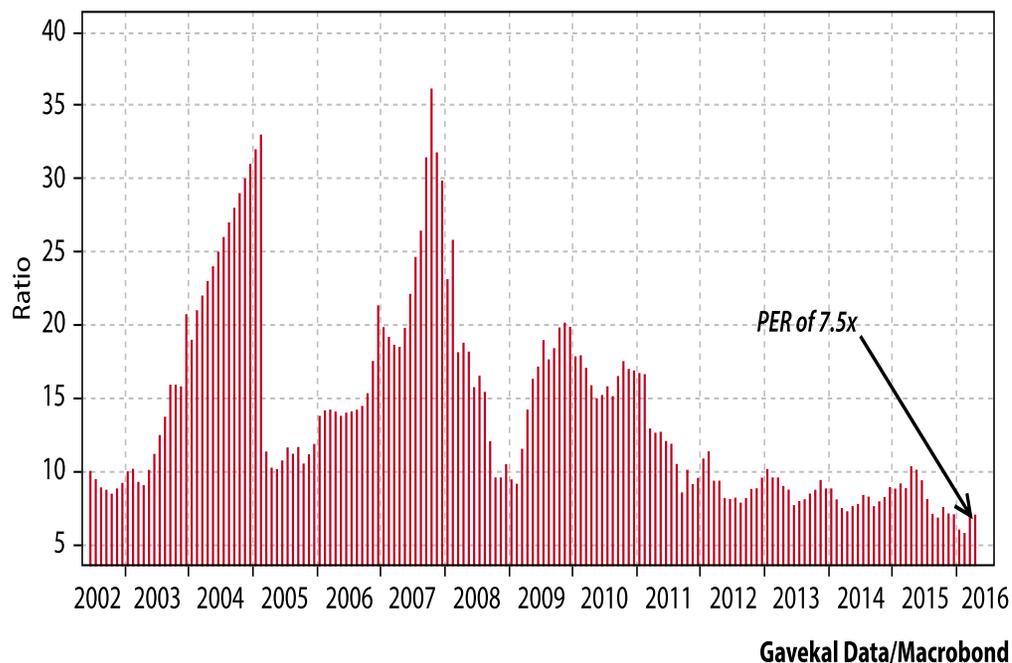
- While most foreign investors continue to worry that China is heading for an epic meltdown, the path of least resistance seems to be :
  - a) More debt accumulation
  - b) More zombie companies kept alive
  - c) More capital misallocation
  - d) Structurally weakening growth rate.
- In short, China would follow the path trail-blazed by Japan and now followed by every OECD economy.
- In this path, Chinese interest rates would go to zero, like everywhere else

# Is the 'short RMB' trade the new widow-maker?



# Low valuations and policy support = looking a gift horse in the mouth?

### H-Share Index PE Ratio

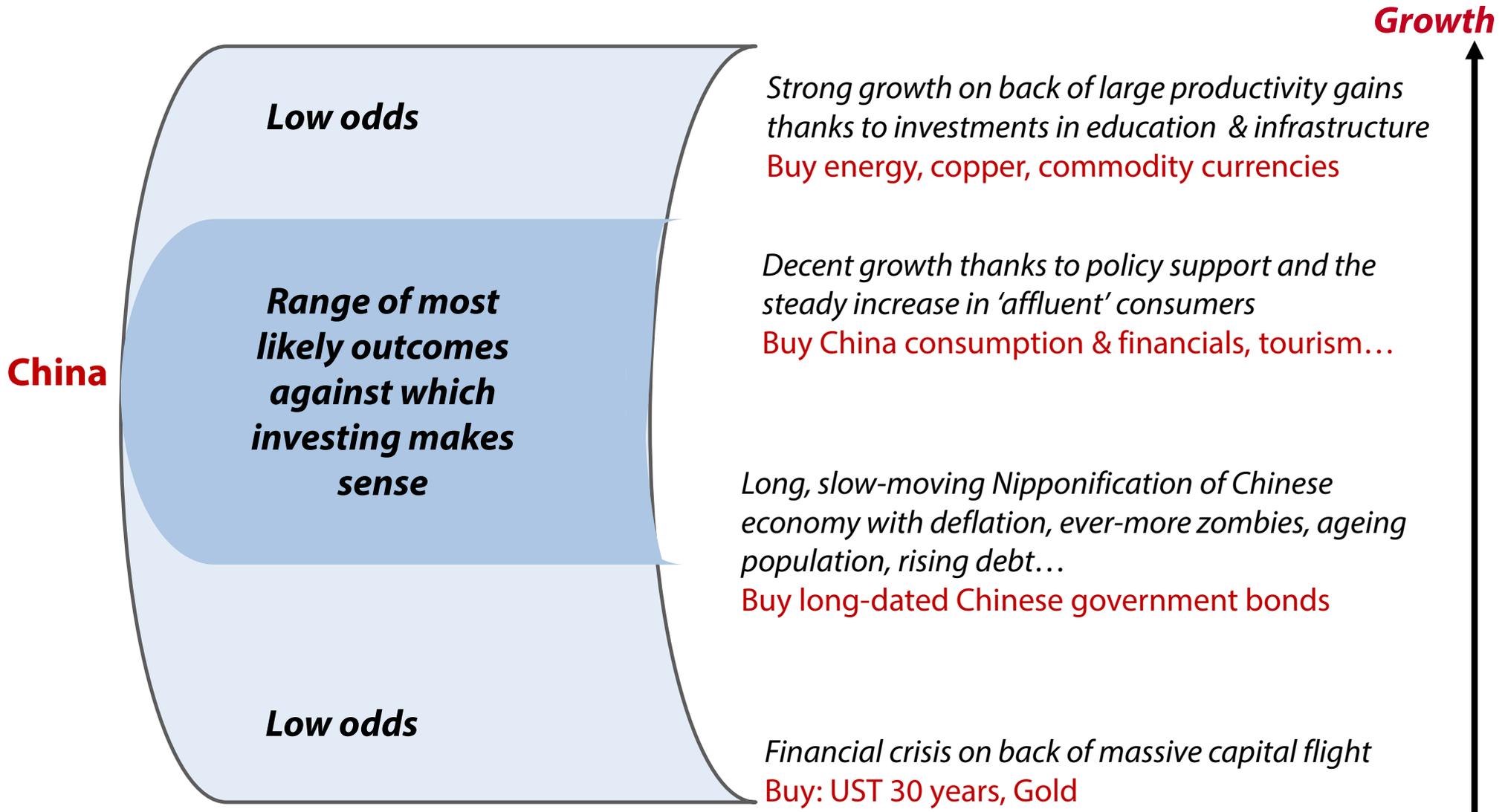


### Dividend Yield on H-Share Index & China Government Bond Yield



- PE ratios on H-shares are today about as low as they have ever been. Clearly the market is not pricing much growth opportunity out of China.
- At the same time, the difference between bond yields and dividend yields in China has never been this wide. Clearly, the market is pricing in many dividend cuts to come.
- This may of course happen... though in an environment of ever-easier monetary policies, and loosening of fiscal policies, dramatic dividend cuts would be unusual.

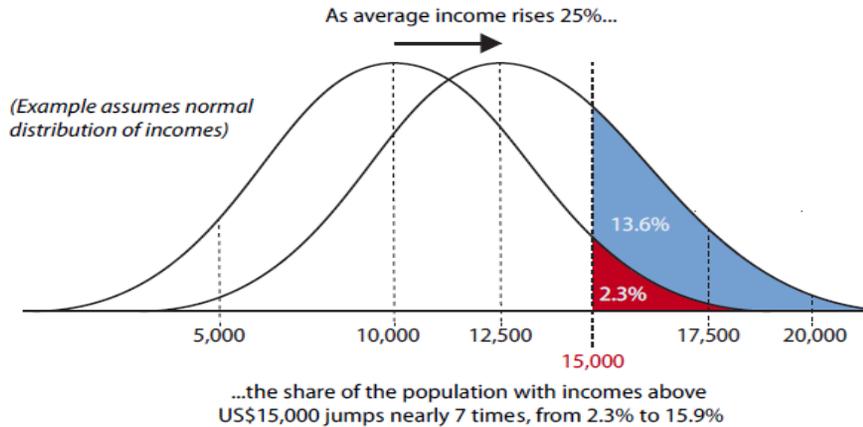
# The probable paths forward



# The acceleration phenomenon and the rise of the Chinese affluent consumer

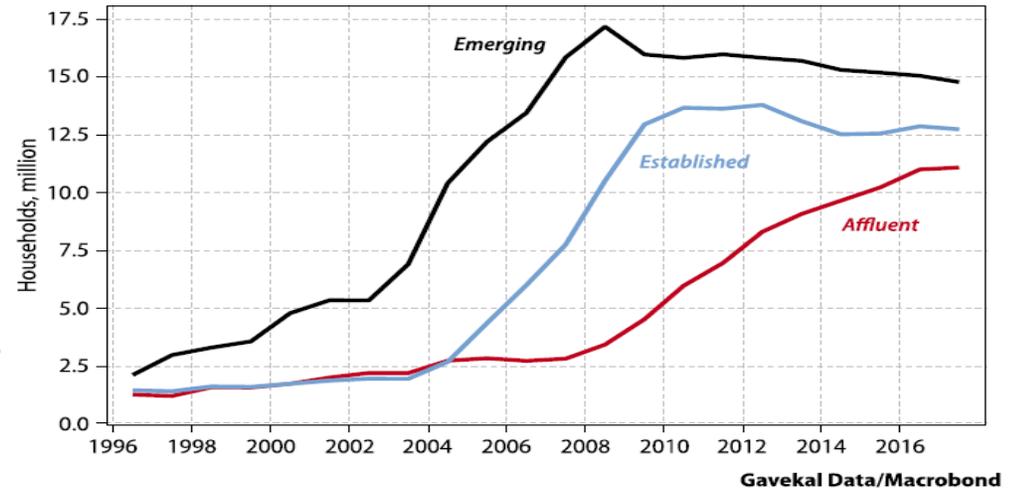
## Illustrating the acceleration phenomenon

Why growth in some markets can be much faster than total income growth



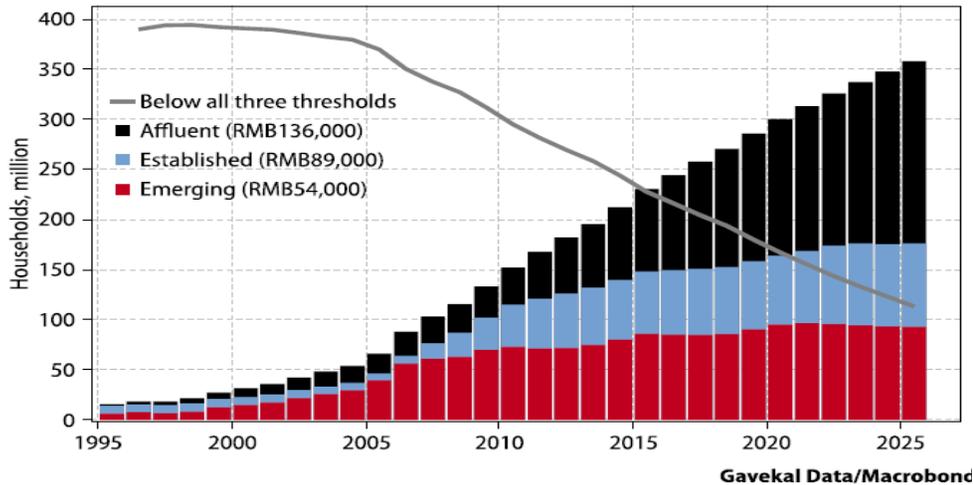
## The three waves of the acceleration phenomenon

Number of households crossing each income threshold, 5ycma



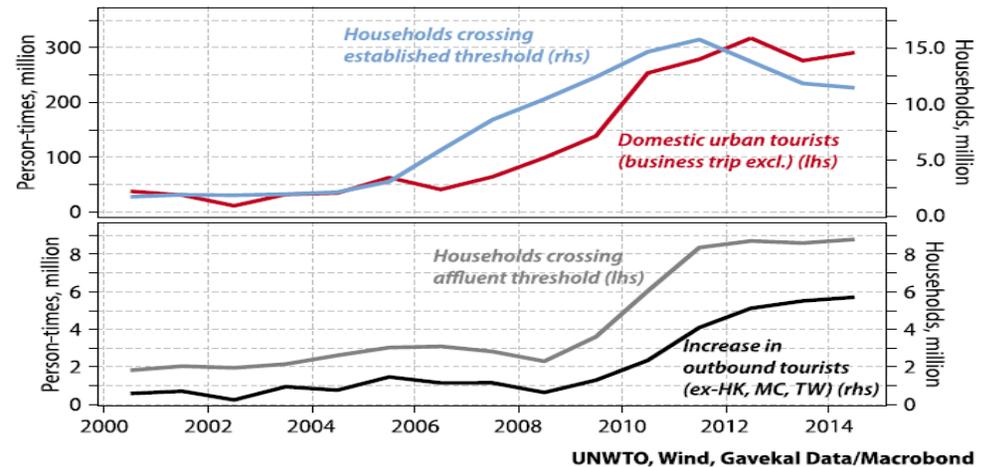
## Affluent households are now the fastest-growing consumer group

Number of households in each income group; projections for medium growth scenario



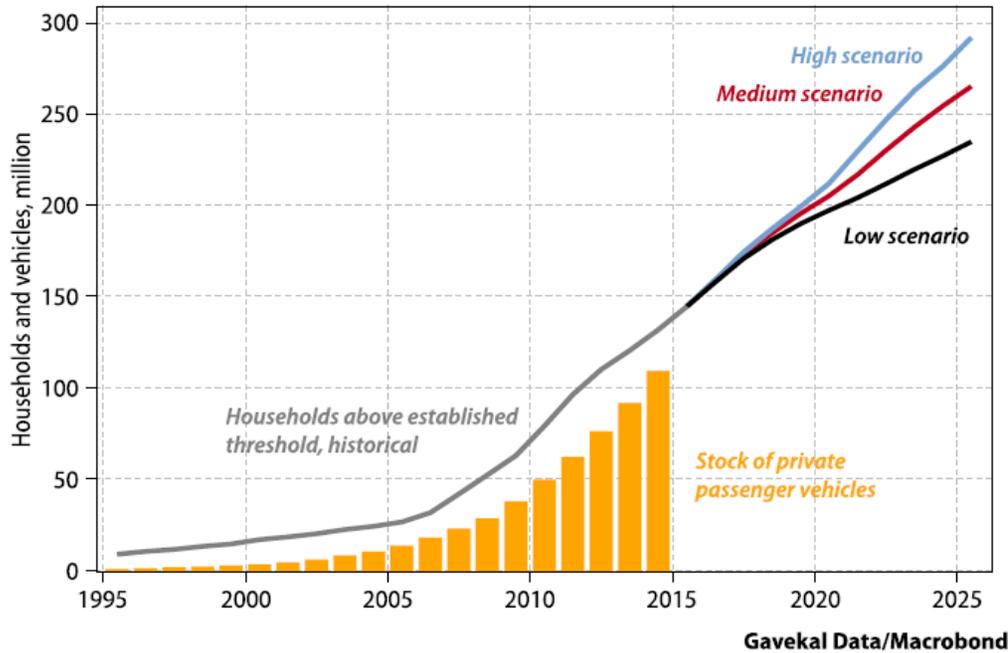
## Affluent households are driving the recent surge in overseas travel

Annual increase of tourist visits vs. households crossing thresholds, 3ycma

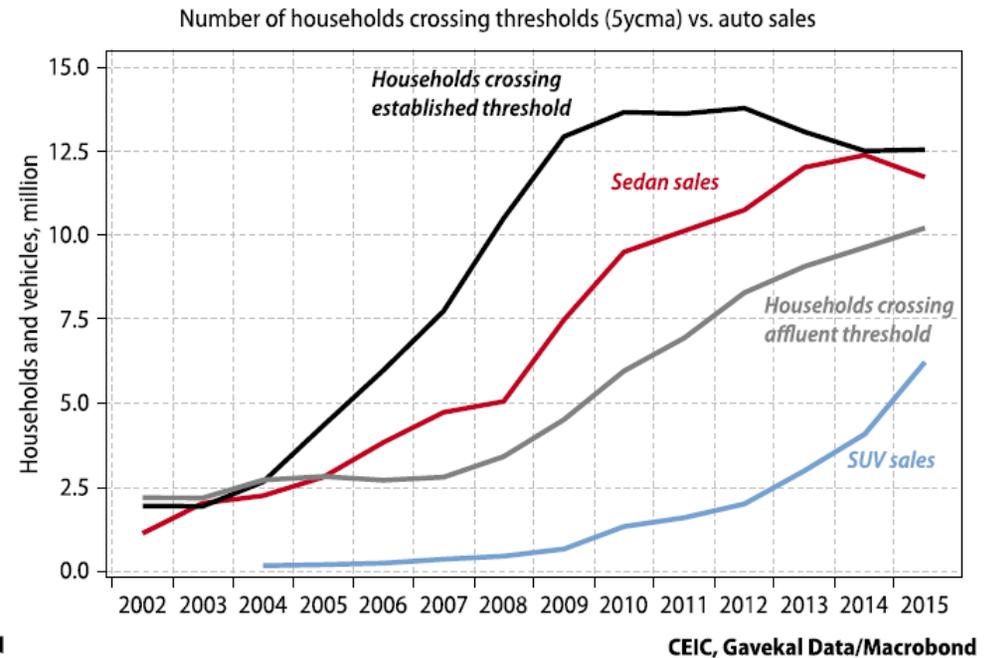


# Tourism, Autos, Financial Services, Tech... Where will affluent spend money?

The addressable market for passenger cars will rise 5-7% annually



Established households buy sedans, affluent households buy SUVs



- In markets like India or Indonesia, we are seeing households move from 'emerging' to 'established'. For example, did you know that, in the past two years, India has seen 150m new bank accounts opened? More 'established' consumers greater sedan sales, cell phones, sodas, fast-food etc...
- In markets like China, consumers are moving from established to affluent. This is terrific news for the sale of financial products, SUVs, e-commerce, tourism...

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### **3- So why all the negativity?**

# Slowdown has triggered a shift in perception of Chinese leadership

The Standing Committee of Politburo is off to Beidahe – summer 2015



# Xi Jin Ping has been very clear about his policy goals



## Anti-corruption drive

Put a third of Petrochina management in jail

*Stop paying 'wrong' price for commodities*

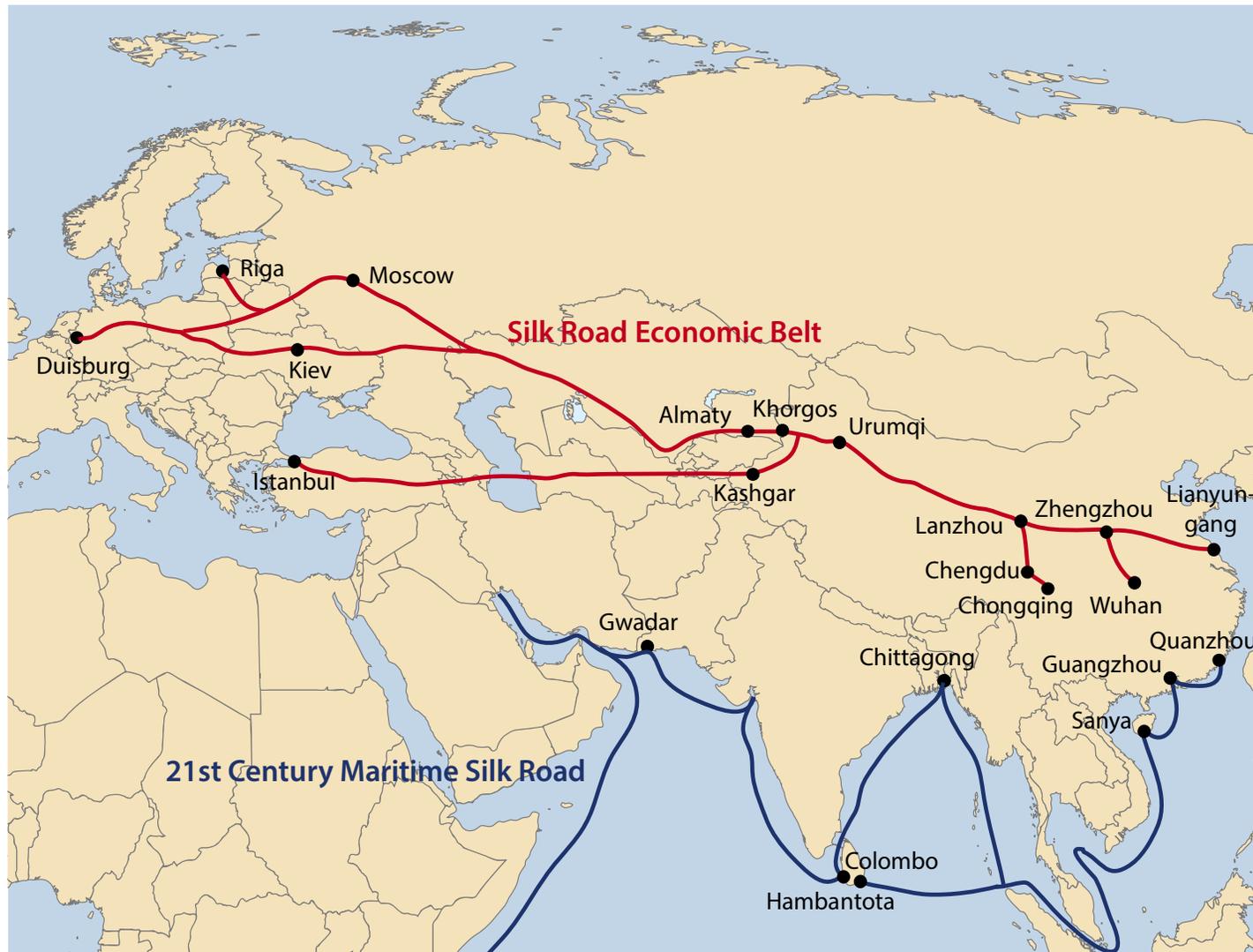
**Are those goals moving forward or backwards?**

## China Dream

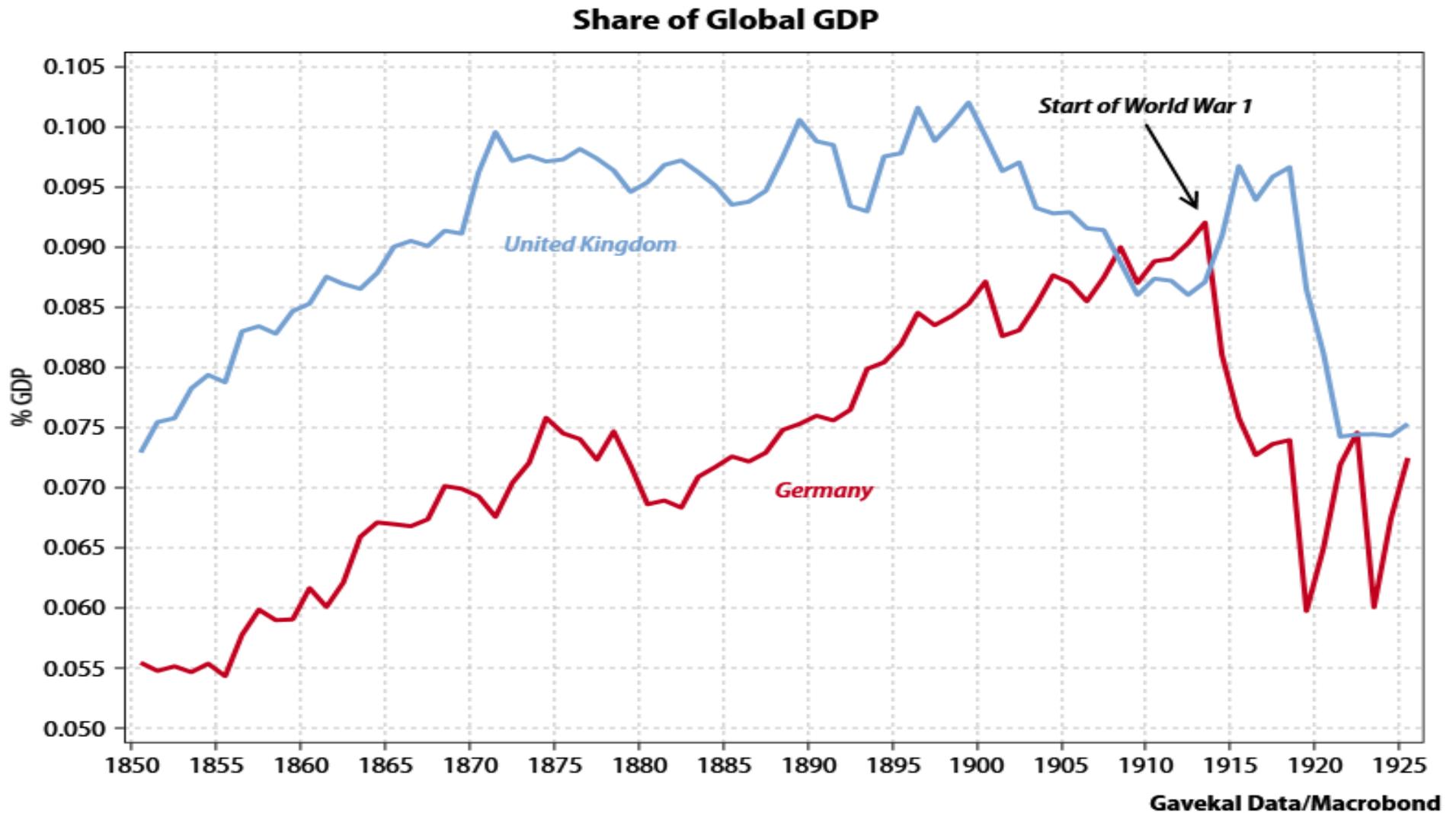
Establish China as genuine imperial power within Asia (OBOR, Silk Road, AIIB...)

*Avoid open conflict with USA*

# The real threat: will China overplay its hand?

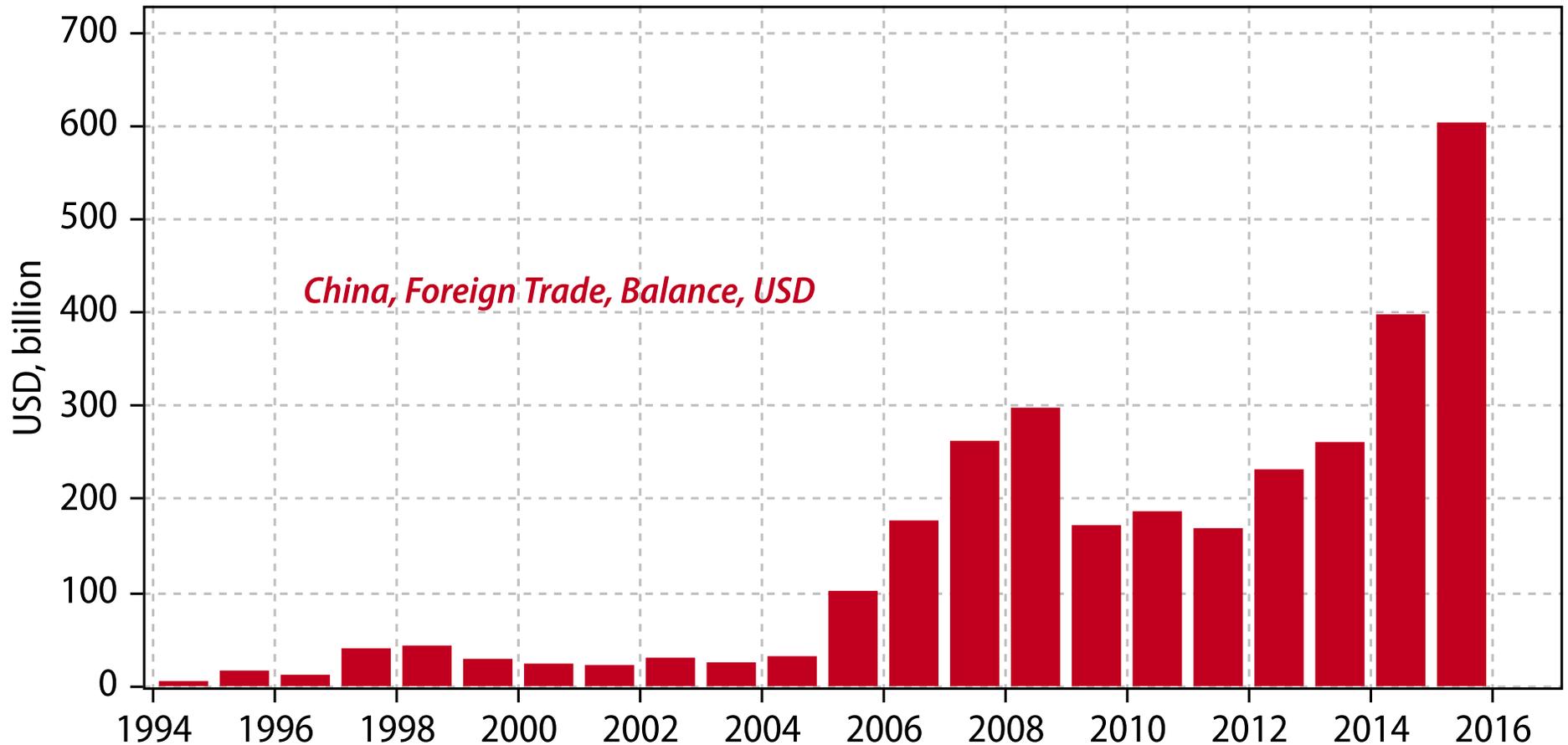


# History: if you want to eclipse leading power, do so discreetly



# Or perhaps China is just hiding its mercantilism better?

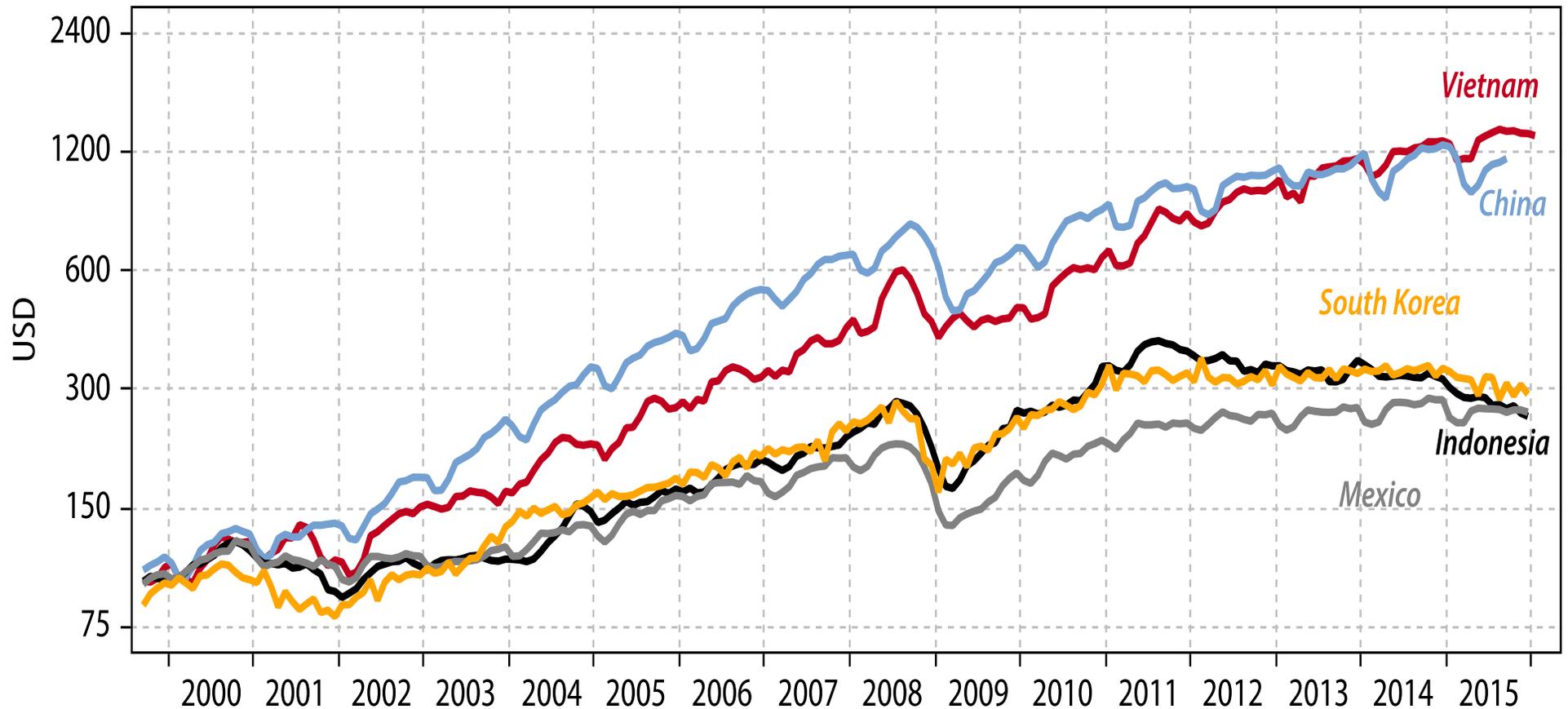
## China, Foreign Trade, Balance, USD



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# China has been eating everyone's lunch on the export front

## Growth in exports of various China competitors



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# How come China is getting so little grief for charts like these?

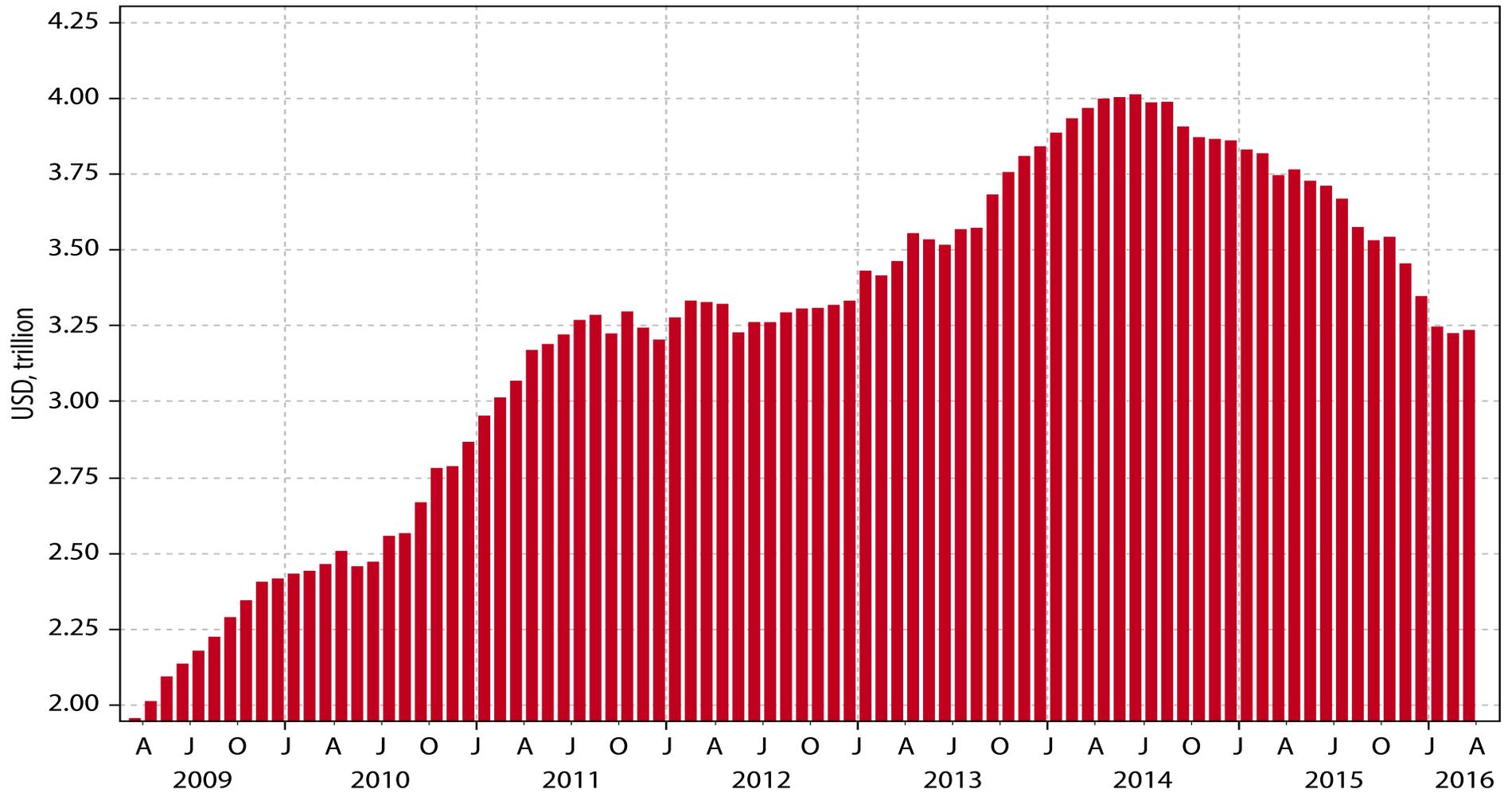
## China Export Metals & Metal Products, Products of Steel or Iron, Volume



Gavekal Data/Macrobond

# China is getting away with this because of RMB devaluation fears...

China Central Bank Reserves



Gavekal Data/Macrobond

# If capital flight was a problem, would every other SOE be allowed to export \$?

## Syngenta market cap



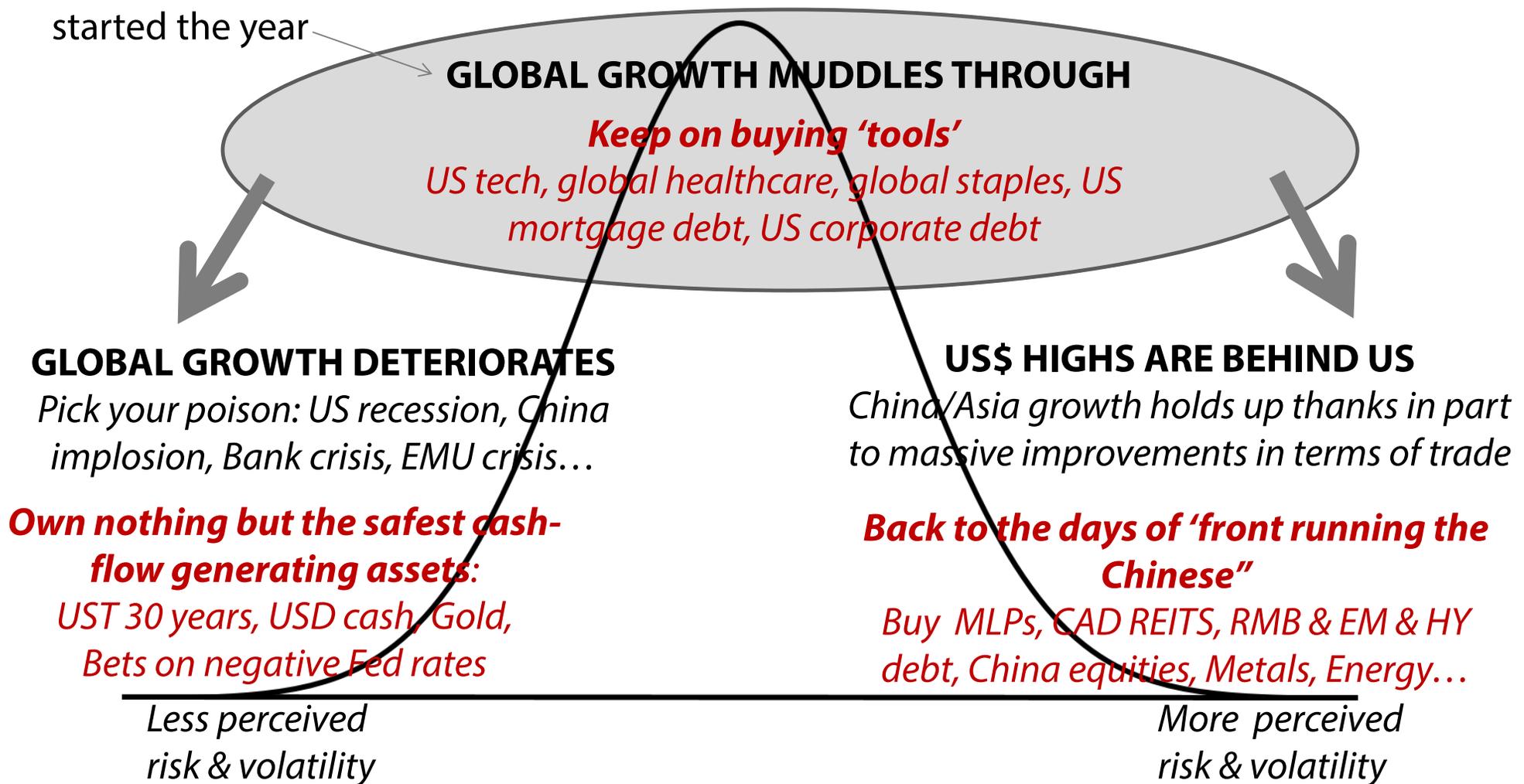
- Is it not odd that, in the midst of a panic on Chinese capital outflows, a large Chinese SOE gets the green light on a CHF 45bn purchase of Europe's leading agri-chemical company?
- Meanwhile, the Syngenta deal was not a one-off, but one of many, mostly SOE, deals for foreign assets.
- Or, like in the mid 2000s, is China recycling its massive trade surplus through the purchase of foreign assets (perhaps less visible, and more profitable, than UST accumulation)?
- **If so, are we back to the days of 'front running the Chinese'?**

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# Investment conclusions

# Playing the tails, or the consensus trade? We like a bar-bell approach

Where consensus started the year





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