Orient Capital Research
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China Thoughts after Meetings in Australia

I just finished a series of meetings with investors in Australia. They are a beleaguered lot. Between the collapsing commodity bubble and rising housing prices much due to Chinese capital many Australians are feeling squeezed. Here are questions I was asked:

Capital Flight – How Big and How Long?

Everyone knows that Chinese capital flight has become a significant issue. China suffered a $95 billion outflow in August and that number is likely to increase. There are two issues. What are the sources of capital leaving the country? And how much control does SAFE really have? On the question of capital ownership, some anecdotes are telling. Former security czar Zhou Yongkang's 300-strong family had RMB90 billion in the banks when he was brought down. Independent analyst Jonathan Anderson believes that an estimated $1 trillion missing in China's accounts is money skimmed by local officials from purported local investments that ended up in the banks. By some estimates, 5% to 20% of the banks' 53.8 trillion yuan in personal deposits are owned by a 3% of the population. That's 2 trillion to 10 trillion for 40 million people. This is a lot of wealth controlled by very well-connected people who can pull strings to move it offshore.

New Controls

Recently, it appears the government is becoming worried. The State Administration of Foreign Exchange (SAFE) has started to enact controls. It is highly significant that in the past few weeks there have been a spate of new regulations on capital flows. Overseas credit card payments through China's Unionpay service have been reduced to 100,000 yuan in 2016 and daily cash limits. And most important, any forex purchase above $1 million must be vetted by the banks' Beijing headquarters. This is serious firepower. Can SAFE overcome the wave of cash backed by political support? SAFE's chairman Yi Gang is a well respected economist with a Phd from Illinois University who may have the power to enforce stricter rules. But there is some question whether the banks have the manpower to conduct the actual enforcement.

In April, our research showed that in the face of regulatory opposition, banks had switched from false trade invoices to false service payments for anything from consulting fees to bundled student fees. It's quite likely new channels will be discovered. There is a special list of state firms and large private companies that have more or less carte blanche access to foreign exchange. All told, the outflow is likely to become larger before it is halted and it may take more desperate measures – such as halting certain types of transactions altogether – before SAFE declares victory.

What the Chinese Think

The devaluation essentially replaced the stock market bubble as a source of growth. This is the view of Yu Yongding, an economist at the Chinese Academy of Social Sciences in Beijing and a former member of the PBOC's, during a speech at the Peterson Institute in Washington. "In the first quarter of 2015 China's capital account deficit is larger that than that of current account surplus" which is due to 1) the unwinding of carry trade; 2) the diversification of financial assets by households; 3) outbound foreign investment; and 4) capital flight."

What is the impact on global economies? There is some debate about the liquidity of China's foreign exchange. Newly released data shows a breakdown of 30% U.S. Treasuries, 11% other U.S. assets, and 16% U.S. assets held by other channels. Another 38% is in non-U.S. assets. Shares in major multinationals cannot be dumped without consequences to their price or symbolism of China exiting an asset category. In addition, these "other" assets are likely in property that cannot be rapidly liquidated.

What's the Likelihood of a "Hard Landing"?

I was asked many times about the potential for a hard landing and what flashpoints would be useful signals. One is a small but real threat of internal disarray in the Party. This is the argument made by Roderick Macfarquhar at Harvard. Political paralysis or a series of swift downfalls from top Party members would be the signal.

More realistically, the flashpoint for a crisis would occur within the population in the countryside and smaller Tier 3 and 4 cities. The urbanization policy, coupled with the 2009 Rmb4 trillion stimulus, pushed the housing boom to unsustainable limits. The IMF estimates that urbanization rose by 40% in the smaller cities in the past decade while housing construction rose by 80% -- a dangerous mismatch. While the stock market fiasco was a sideshow in terms of household wealth, property is not. Any sharp decline would immediately lead to a decline in consumer spending and a loss of confidence in the government. This is much more likely in the smaller cities, where the overbuild was higher and jobs are scarcer, than in the capital-rich and politically connected large urban areas.

Countryside Strife

This decline in rural/urban asset prices is being coupled with a fall in revenue from the local governments' chief source of income: land sales. These regions account for 60% of property construction – a major contributor to GDP. Thus a double negative for governments and consumers alike would have major consequences for the economy. This also could lead to political strife.

It's indicative that Q2 employment in construction fell 23.8% YoY, a deeper decline than in wholesale and retail trade (-9.8%), and industrial employment f(-7.7%.

The data for these trends is thin. We have data from Chinese surveys on local government debt, but not on revenue. Likewise, the data – from the National Bureau of Statistics and other sources such as Soufun – does not adequately capture local property transactions from the smaller cities. China's largest residential property developer, China Vanke Co Ltd, said its first-quarter core profit fell 58.9 percent, reflecting a slide in the property sector. This is significant.

We are currently monitoring local newspapers for signs of unrest, defaults, or falling property prices.

Will China Reform the State Sector?

My answer was flat out no. Why?

1) Despite all the talk of mixed ownership, there are too many vested interests in the state sector. Spin offs and other asset plays are an opportunity for graft.
2) Xi Jinping is enamored with the idea of state champions. He was in Shanghai when state automaker SAIC moved up the ranks and admired its success. This champions also suit his narrative of China challenging the U.S. globally.
3) The SOE's pay the lion's share of taxes – 70%. That's revenue Beijing can ill-afford to lose.
4) The argument about protecting employment is a red herring. Private firms account for more than 70% of employment 95% of new jobs, according to independent economist He Qinglian. But it is true in certain regions reforming the giant SOEs would put thousands out of work in a single town, which could lead to unrest.
5) The government is interested in selling off minority stakes but not major reforms.

Given the Gloom, Where to Invest in China?

Several themes arose from these discussions. First is ***Mass Luxury.*** China will suffer from capital flight at the top (among the 1%) and declining consumption in the broad lower tier. But the upper middle may well stay financially healthy. The larger cities are weighted toward two better-protected cohorts: state firms and multinationals. Xi Jinping clearly favors the continued strength of the national giants, which will continue to enjoy privileged access to capital. Meanwhile, many multinationals may protest a "buy China" bias but they still have maintained high profit margins since their entry under the WTO. Both of these trends translate to profitable incomes for the millions who work for them in Shangha, Beijing and other cities. This positive trend has been reflected in the earnings of mass luxury companies such as Nike, Apple and Mercedes.

The second theme is ***Foreign Assets.*** As discussed above, early indications suggest Beijing will have a difficult time in the near future restraining capital flight. This is good for overseas housing and corporate assets.

A third theme is disconnected from the economy – ***Healthcare.*** Beijing has begun targeting corruption among hospitals. This could be positive for equipment and healthcare companies that are able to escape the slings of accusations of illegality and benefit from the institution of more fair procurement policies. In addition, hospital roll-ups will concentrate profits in single conglomerates. Last, there are noises from Beijing about nationalizing healthcare – currently the purview of local governments – that would benefit healthcare spending.

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