Orient Capital Research

March 24, 2017

Orient Capital Research
Andrew Collier, Managing Director
852-9530-4348
andrew@collierchina.com

Juilice Zhou, Analyst, Shanghai
Pat Chan, CFA, FRM Hong Kong

False Dawn in China's Economy

Analysts Jump too Quickly on News out of the National People's Congress

The economic news out of China recently has drawn glowing reviews from analysts and the press alike. China's property investment in the first two months rose 8.9 per cent from a year earlier. China's industrial output in January and February rose 6.3 per cent compared with the same period a year ago and fixed-asset investment strengthened to 8.9 per cent in the first two months.

Analysts said the data is a sign China is successfully modernizing its economy. One example from an economist in Hong Kong quoted in the South China Morning Post:

> "From what we can tell based on the first two months, the Chinese authorities are able to pursue the five key tasks without having a major negative effective on growth at least at this point," said ING chief Asia economist Tim Condon. The key tasks outlined by the government are **reducing production capacity** in some industries**, cutting stock levels, reducing debt, cost reductions** and the improvement of **economically underdeveloped areas.**

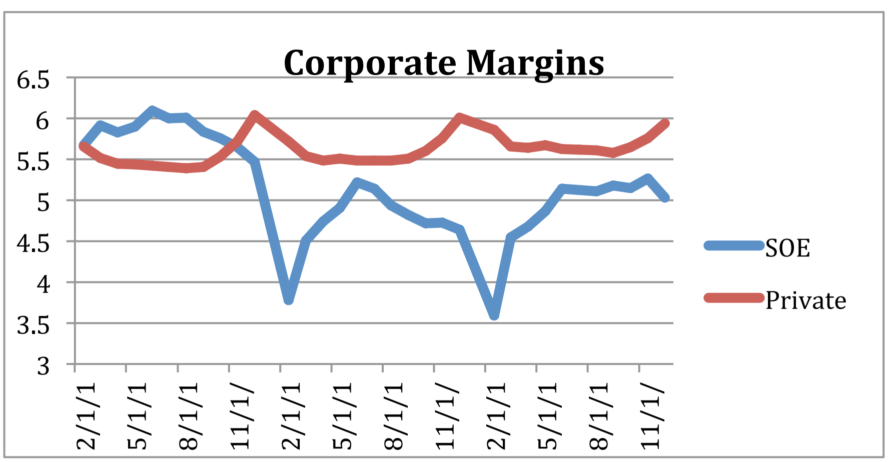
Not True….None of these things are happening.
However, we think this view is far too optimistic. To whit…

Declining **coal** output in 2016 came from a reduction in working hours per week – not capacity cutbacks. Coal producers were told to cut the number of working days from 330 to 276 days. As a result, from April to October, output slumped by more than 10% per month on a year-on-year basis.

Steel cutbacks have failed to be enacted because each province is reluctant to give up market share in one of their key industries, and a generator of employment. As of February, iron ore inventory at China's ports rose to a record 127 million metric tons. Steel production is at an all-time high at 67 Mln tonnes as of January 2017.

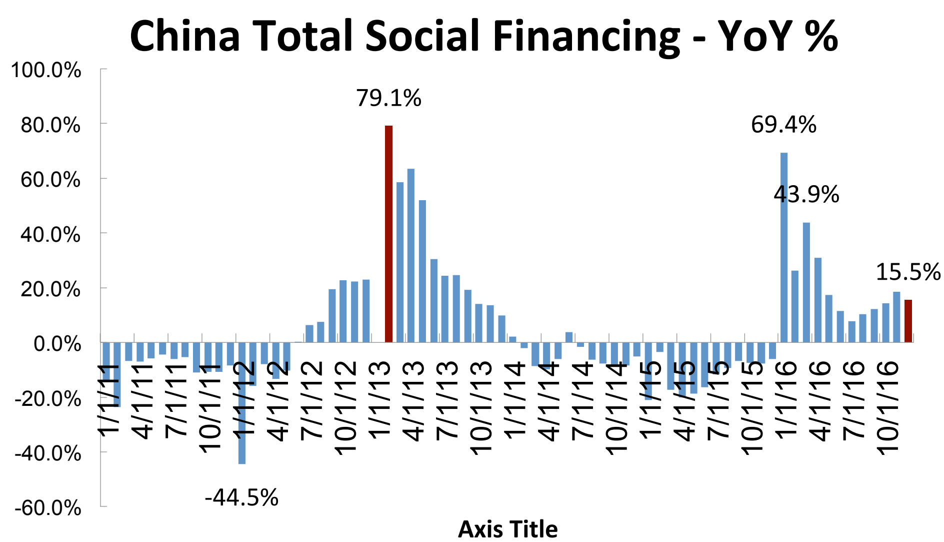
Nor has **debt reduction** occurred. Total debt as a percentage of GDP jumped 19 points in 2016, driven by an 11-point increase in corporate debt, among others.

Meanwhile, industrial restructuring, or **SOE reform**, hasn't resulted in meaningful cost reductions – at least as evident in corporate margins. They have risen slightly for private firms but have declined for state firms, where the restructuring is targeted.

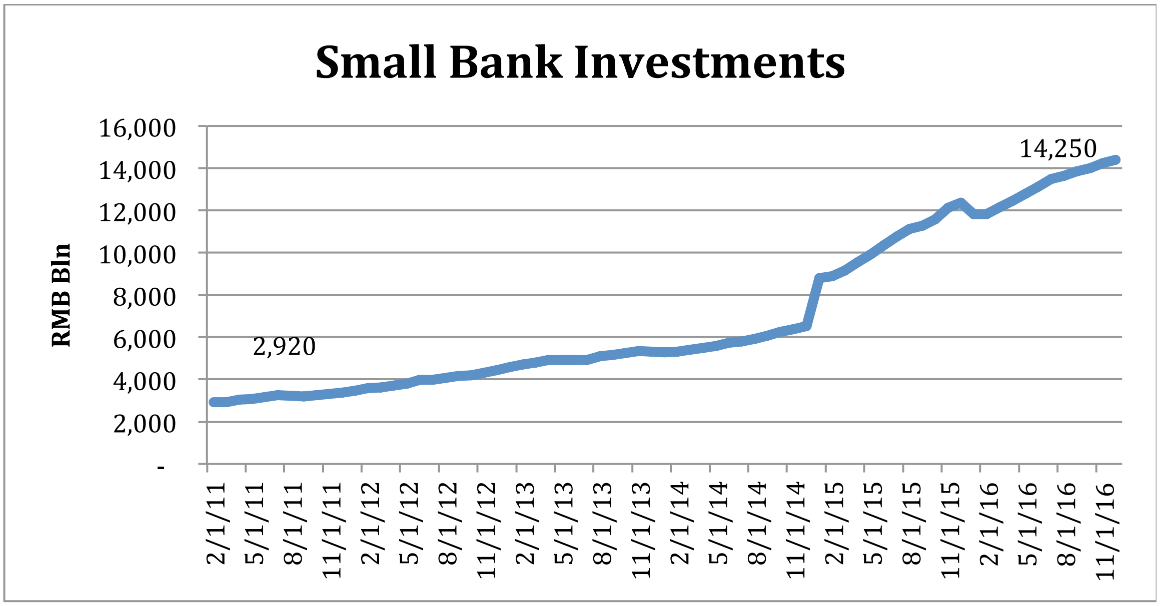


The Story – as always – is a Credit-driven Bubble

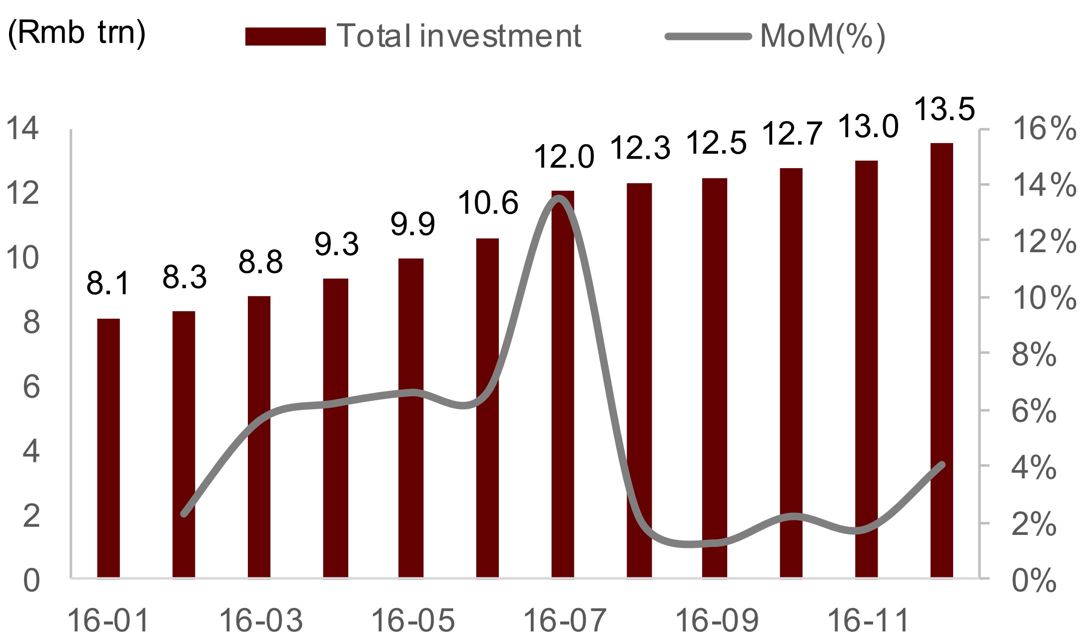
Total Social Financing, which includes some Shadow Banking such as Trusts, is growing at a healthy double-digit rate. But the real growth is in other areas not included in TSF for the simple reason that the leadership does not want to give the impression that it is continuing to expand the country's corporate and state debt, fueling the property bubble, and allowing profligate spending.



High Investments by the Smaller Banks. Credit is growing in the most risky areas. The chart below shows that the small banks have significantly increased their "investment" portfolio, a category not included in the restrained growth in TSF. Although the highest growth occurred in 2015, at over 80%, small bank investments cumulatively rose 16.5% in December 2016 YoY on a much larger base.



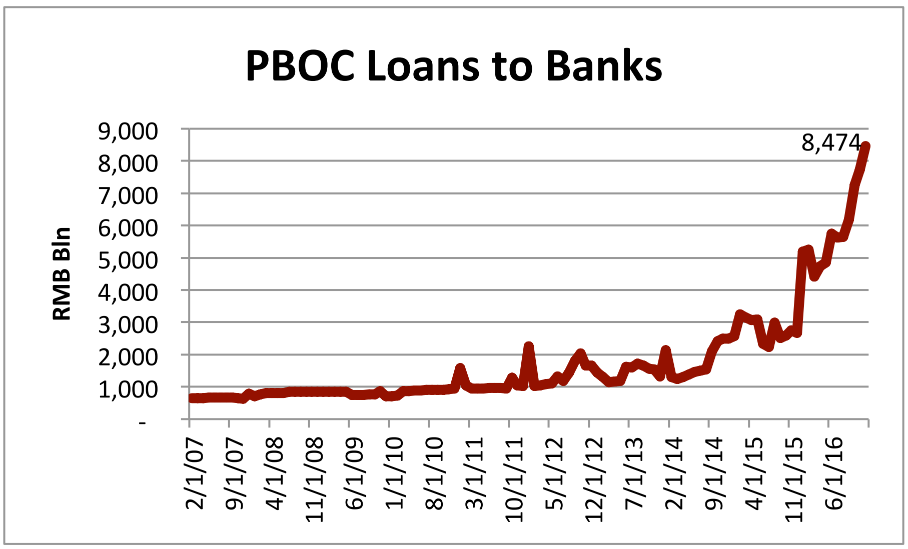
Private Capital for Fiscal Ends. Similarly, the new mantra among local bankers and government officials is Public-Private Partnerships, whereby private capital is used to invest in local government projects. This category continues to soar.



Weak Links – Smaller Banks. The growth in assets among small banks through WMPs and interbank borrowings make them highly vulnerable to bank runs. This could lead to defaults if this liquidity dries up, as I expect by 2018 as investors face defaults. As the Wall Street Journal pointed out this week:

On Monday, some small, rural banks failed to make good on short-term funds borrowed from other lenders, according to traders and banking executives. Late Tuesday, the PBOC injected an estimated 300 billion yuan ($43.6 billion) into the financial system via short-term funding facilities, the people said, in an apparent effort to prevent the defaults from evolving into a full-blown credit crunch.

Despite recent efforts to increase interbank interest rates, it's clear from the historical data that the PBOC has been assisting expansion of bank assets.



So don't let the official line cloud the real story under the covers, which remains a credit-driven bubble.

END