



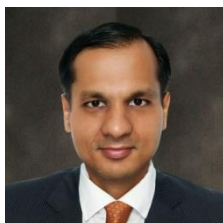
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China's Challenging Road Ahead

- *China's future growth rates are unlikely to match those from its recent past as potential growth is slowing and demand imbalances need to be redressed.*
- *We believe China has the tools to successfully manage this transition and avoid a hard landing. Therefore, we do not advocate broadly bearish positioning at this time.*
- *However, it is essential that both investors and Chinese authorities embrace the inevitability—and desirability—of slower future growth. If political hurdles further delay properly-sequenced structural reform, the risk of a hard landing could rise considerably.*
- *Despite the need for reform in the state owned enterprise (SOE) sector, we see opportunities in certain segments, such as oil and gas. Conversely, we are bearish on other sectors, such as property and banking.*

While China's growth rate has been slowing during the latest downturn and recovery, the country's importance to the global economy has continued to grow. Much of the developed world is closely monitoring China's economic transition in hopes that it might provide a steady, albeit more gradual, source of growth as these developed economies remain mired in a prolonged deleveraging process.

China's prior expansion has come at a cost after unsustainable credit growth resulted in overinvestment and excess capacity, both of which pose daunting challenges for the Chinese government as it tries to engineer a soft landing. In order to meet these challenges, several adjustments are necessary, including structural reform of the SOE sector, increased fiscal responsibility at the local government level (fiscal federalization), removal of implicit and explicit input subsidies that tilt the playing field in favor of inefficient SOEs, steps to boost competition, an easing of financial repression, and the eventual opening of the capital account.

We believe China's new leadership is committed to such reform, but execution will likely be slow and messy, due in part to opposition from entities with vested interests. This situation differs from China's prior growth wave, the benefits of which lifted all boats and generated broad political support.

Some markets have already priced in the risks related to the impending economic slowdown, and, going forward, investing in China will require a more nuanced analysis of sector and company fundamentals. In this paper, we provide our outlook for China's growth, followed by our views of the financial and real estate sectors before concluding with the consequent investment implications.

China's Growth Outlook—An Inevitable Slowdown

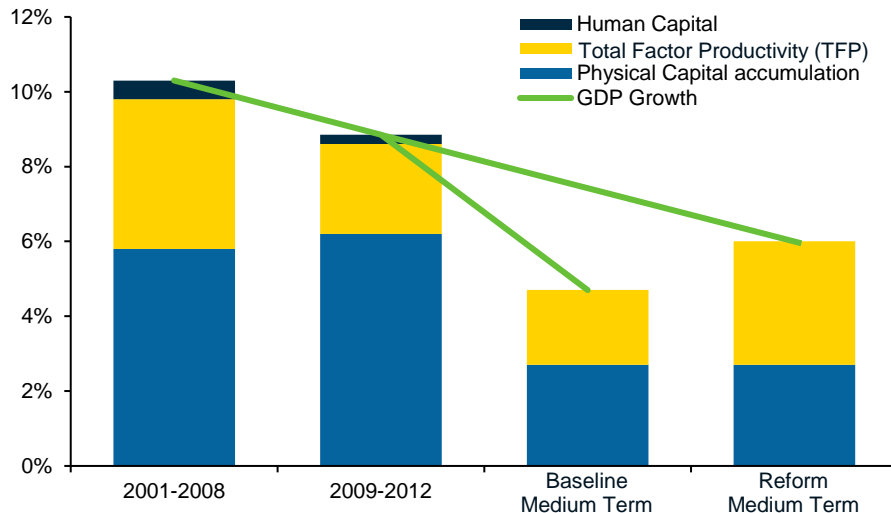
After two decades of rapid expansion, China's investment- and export-driven growth model is running into genuine constraints. China has become the world's largest exporter, and the scope for further growth in market share is thus limited.

Meanwhile, after the global financial crisis, the government implemented huge domestic stimulus measures through investment spending, which resulted in significant overinvestment and excess capacity in the manufacturing, infrastructure, and property sectors. The attendant debt accumulation from the stimulus has heightened financial stability concerns.

Although some observers have viewed China's slowdown as undesirable, we view it as the inevitable result of a likely deceleration in potential growth to between 5% and 6% over the coming years. Indeed, a slowdown is implied by all supply factors, as described in the following bullets and chart:

- We believe labor is unlikely to be a source of new growth as the working-age population is already shrinking, while the previously large pool of rural surplus labor has arguably been drained.
- Similarly, very high levels of investment have already resulted in a large capital stock and large-scale overcapacity in a number of sectors, thus limiting the potential growth from additional investment.
- This leaves growth in total factor productivity (TFP) as the main driver of future potential growth. However, given China's quick convergence to developed economies over the last two decades, much of the easy, "low-hanging" TFP gains (e.g., by introducing international best practices) have already been implemented. This makes future TFP growth in excess of the global production possibility frontier that much harder, unless long-standing structural inefficiencies (especially in SOEs) are tackled. While these reforms will be politically difficult, they are nevertheless essential to lift China's medium-term outlook.

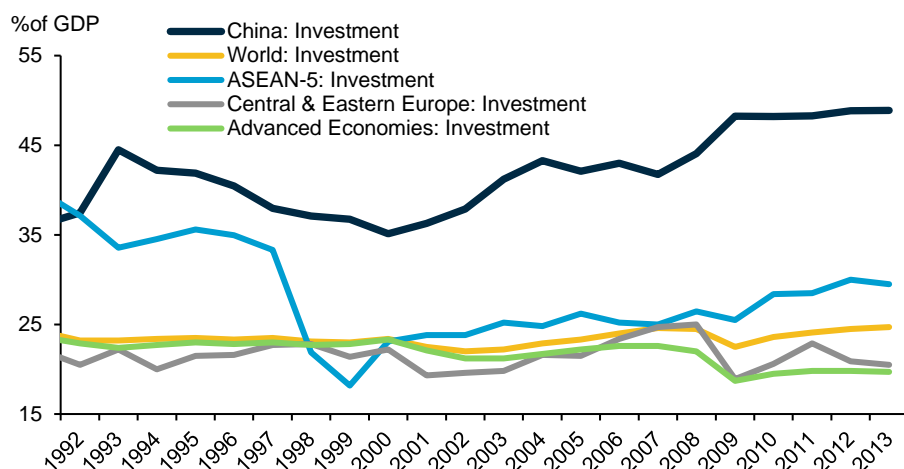
China's Impending Slowdown



Source: Haver Analytics, IMF, and Prudential Fixed Income as of April 2014.

Accepting these supply-side constraints will also allow China's authorities to eschew the recent unsustainable and largely ineffective bouts of demand stimulus and to proceed with the needed economic rebalancing. Clearly, investment-driven stimulus has reached historically unprecedented levels, as indicated in the following chart, and resulted in an unsustainable buildup of leverage. Furthermore, we believe that a rebound in the developed world's demand growth, even if enhanced by a depreciated exchange rate, will not facilitate a resumption of the prior Chinese export miracle. However, accepting a lower sustainable growth rate may enable Chinese authorities to phase out unsustainable stimulus measures and distribute a greater share of national income to consumers and wage earners, thereby raising economic welfare and gradually eliminating excess leverage and capacity.

China's Stimulus Policies have Fueled Further Investment



Source of charts: Haver Analytics, IMF, and Prudential Fixed Income as of April 2014.

As desirable and theoretically plausible as the case for rebalancing with reforms may be, it is politically difficult and presents unpleasant trade-offs. In broad terms, China faces an impossible trinity between maintenance of (I) high growth, (II) current economic structures, and (III) financial stability—where only two out of the three targets are jointly possible. Reform scenarios assume that targets (I) and (III) are pursued. Yet, the recent acceleration in credit growth and delays in structural reform highlight the risk of an outcome with conditions (I) and (II), in which case financial stability risks—the so-called hard-landing scenario—loom large.

The likelihood of a hard landing would also increase with improperly sequenced reforms, especially if financial and capital account liberalization (including interest-rate liberalization and further relaxation of external capital account restrictions) are executed ahead of SOE reform and development of an effective bankruptcy regime. In the past, such defective sequencing has led to financial and economic crises in other countries.

In summary, we sketch out three plausible scenarios for China's transition, the details of which are in the following table:

“Reform”: This assumes that, of the impossible trinity, the authorities pursue objectives (I) and (III), i.e. growth and financial stability. This entails meaningful and properly sequenced reform (SOE closures, defaults, etc.), rebalancing, and some support from a competitive exchange rate. Policies that help bring actual GDP growth down to potential and greatly reduce the risks of financial instability and an economic hard landing. This scenario corresponds to our central view with a 60% probability.

“Hard Landing”: This assumes the pursuit of objectives (I) and (II), i.e., growth with unchanged economic structure. The scenario is predicated on ill-sequenced financial sector reform; property and/or local government stress, resorting to weak FX, and renewed large-scale stimulus efforts reflected by a further increase in investment. As such, actual demand-led growth will continue to exceed potential growth in the near term, implying a further worsening of growth prospects in the medium term. While not our base case, this scenario becomes increasingly likely if key SOE reforms face further delay.

“No Reform”: This scenario assumes that structural reforms stall and that current economic structures are maintained, but that the authorities continue to pursue financial stability, i.e., objectives (II) and (III). The unreformed SOE sector would continue to overinvest, but the authorities would focus on containing the associated overheating with a deterioration of the external accounts and a dampening of consumption growth. Over time, these policies will also bring GDP into line with lower potential growth.

Three Illustrative Scenarios for China’s GDP: 2014-2016

| | 2006-2012 | 2013 | “Reform” | | | “Hard Landing” | | | “No Reform” | | |
|----------------------------|-----------|------|----------|------|------|----------------|------|------|-------------|-------|-------|
| | | | 2014 | 2015 | 2016 | 2014 | 2015 | 2016 | 2014 | 2015 | 2016 |
| (real % change) | | | | | | | | | | | |
| GDP | 10.6 | 7.7 | 6.9 | 5.9 | 5.5 | 5.1 | 4.8 | 1.7 | 7.1 | 6.2 | 4.1 |
| Consumption | 7.7 | 4.1 | 6.4 | 7.1 | 6.8 | 5.6 | 2.9 | 3.1 | 2.6 | 2.9 | 2.0 |
| Investment | 13.8 | 10.5 | 7.4 | 5.2 | 4.8 | 4.7 | 5.5 | 0.0 | 10.9 | 9.5 | 5.7 |
| Net Exports | 8.5 | 2.0 | 2.0 | 3.0 | 3.0 | 5.5 | 15.0 | 15.0 | -8.0 | -25.0 | -10.0 |
| (in % of GDP) ¹ | | | | | | | | | | | |
| Consumption | 44.1 | 38.7 | 38.6 | 39.0 | 39.5 | 38.9 | 38.2 | 38.8 | 37.1 | 35.9 | 35.2 |
| Investment | 49.9 | 58.4 | 58.6 | 58.3 | 57.9 | 58.2 | 58.6 | 57.6 | 60.4 | 62.3 | 63.3 |
| Net Exports | 6.0 | 2.9 | 2.8 | 2.7 | 2.6 | 2.9 | 3.2 | 3.6 | 2.5 | 1.8 | 1.5 |

Source: Prudential Fixed Income and International Financial Statistics (IFS), as of July 2014. For informational purposes only. There can be no assurances that these forecasts will be achieved.

To summarize our outlook, a few points are worth mentioning. First, the numbers in these scenarios are illustrative and come with a considerable confidence interval. Therefore, the bottom line is not to be precise to the decimal point, but to highlight the key trends within a framework that is consistent from a macroeconomic perspective. Second, having said this, we see a slowdown in all scenarios to China’s growth that is well below the levels from 2006-2012—numbers that China bulls still consider possible outcomes. Third, “rebalancing” is no growth panacea; relying on a greater contribution from consumption will not impart new momentum to the economy because consumption growth is already fairly rapid (reflecting the very large wage gains for Chinese workers). Fourth, sustainable growth may require a lowering of the investment share as depicted in our “Reform” case. And, fifth, China maintains a considerable scope to raise external demand via exchange rate depreciation, which it could use to soften the impact of a hard landing, though with considerable repercussions for global disinflation and potential for protectionist measures.

Banking Sector—Risks Abound

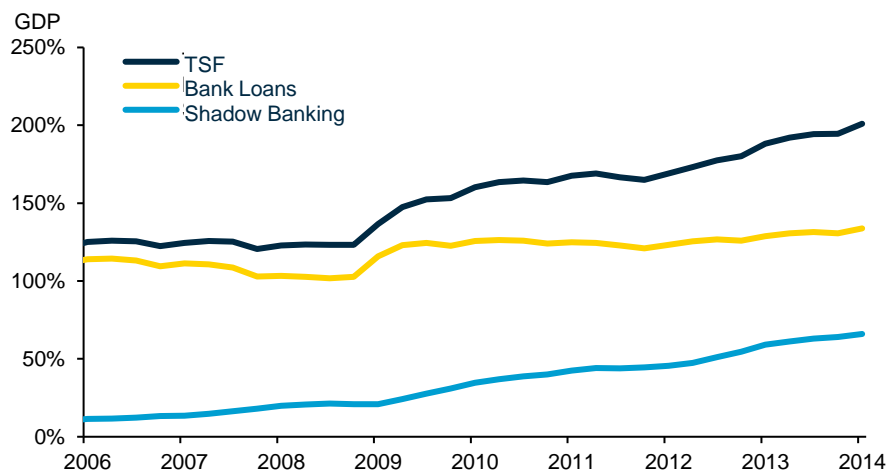
China’s banking sector has recorded a rapid build-up in leverage that has been accentuated by a lack of credit discipline and accurate loss recognition. Total social financing (TSF), which consists of bank loans and shadow banking activities, has increased from 140% of GDP in early 2009 to more than 200%, as depicted in the following chart.² The bulk of the increase in overall debt in the economy has come from corporations, and, as a result, concerns have mounted about over-levered sectors, including local governments at 14% of total loans, manufacturing at 18%, and real estate (excluding residential mortgages) at 6-8%.³

¹ Expenditure shares of constant price GDP. Historical nominal expenditure side GDP data are sourced from IFS, the historical discrepancy is allocated across expenditure components, which are then deflated by estimated component deflators.

² While the TSF concept is recognized to harbor significant shortcomings—for example the double counting of bank loans that are subsequently lent in the shadow banking system—the magnitude and speed of its rise are not impacted by any such data shortcomings, but are reflective of the underlying extent and speed of leverage accumulation.

³ Data are from Nomura as of the end of 2013.

Shadow Banking's Growing Presence in Total Social Financing (TSF)



Source: Haver Analytics, CEIC, as of March 2014.

When combined with a slowing economy, the recent surge in TSF presents direct and indirect risks to the banking sector. The risks may also be underappreciated given that the fastest growing banking channels, such as trust companies, wealth management companies, and internet lending, are informal or unregulated.

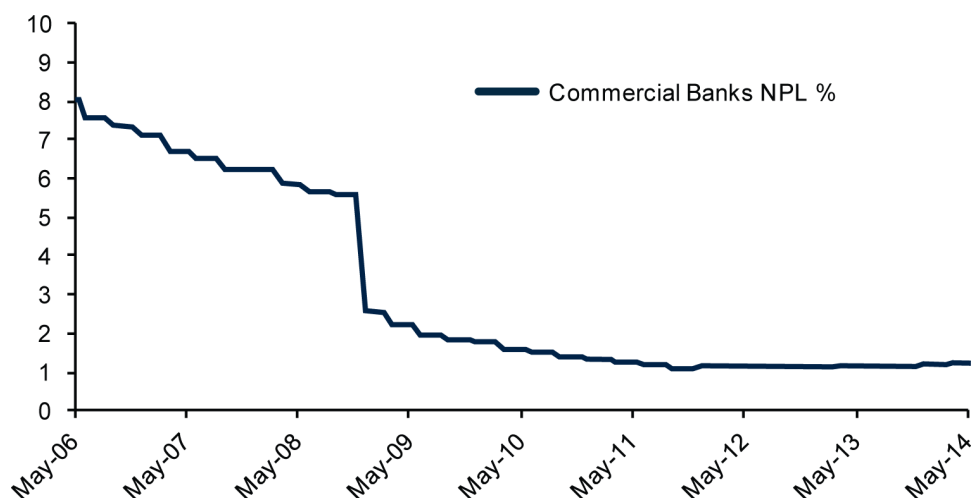
The increase in shadow banking activities has limited the growth in traditional banking to only 54% of the aggregate financing as of the first quarter of 2014, down from 70-80% a few years ago.⁴ However, many shadow lending arrangements remain affiliated with banks. For example, banks have direct and indirect reputational exposure from their distribution of higher yielding wealth management products (WMPs). Given limited investment choices and capped deposit rates, banks turned to such products in order to offer savers alternative investments, while reportedly providing insufficient education about the higher credit risks of WMPs.

Moreover, the substantial growth in lending has reduced banks' reported non-performing loans (NPLs) in two ways: i) the rapid growth in overall loans and ii) the refinancing activity that has supplanted what might otherwise become defaults (or "evergreening"). Thus, reported NPLs of commercial banks at 1.1%, as observed in the following chart, could overstate the sector's actual asset quality (the chart's drop in 2008 was the result of a significant liquidation by a single bank). In addition, we are concerned that the annual growth in bank loans has routinely exceeded deposit growth as reflected by a deterioration in loan-to-deposit ratios (despite these ratios having a regulatory cap) from 66% in 2009 to a reading of 70% as of mid-2014.⁵

⁴ Banking channel data are from CEIC.

⁵ CEIC.

The Low Rate of Commercial Banks' NPLs: An Inadequate Guide to the Future



Source: CEIC as of May 2014.

Prior periods of stress in the Chinese banking sector have equated to NPLs ranging in the mid to high single-digit percentages. Given the current size of the sector, we believe that a downturn consistent with historical percentages could equate to about \$1 trillion in NPLs—roughly in line with the scale of the U.S. sub-prime crisis. When the concerns of such a scenario are considered, recently reported Tier 1 ratios of 10% and capital adequacy ratios of 12% could turn out to be inadequate buffers for China's banking sector.⁶

While a significant increase in NPLs could threaten the solvency of certain banks, it is important to appreciate that banking problems do not have to be resolved through market mechanisms. For example, banks could write down their NPLs over time as their relatively high profitability, with net interest margins of 2.6%, and continued government support may allow the major institutions to replenish their capital from internal and external sources.⁷

China also has substantial resources to recapitalize a “good bank” and spin off a “bad bank” consisting of a portfolio of NPLs. Therefore, material financial instability is not part of our central view. Meanwhile banking reforms, including deposit rate liberalization, could present short-term pressure on profitability, and we expect these reforms will likely be introduced on a gradual basis. Regardless of the potential resolution, we believe an increase in bad loans of the magnitude previously described would likely increase volatility in banking sector spreads.

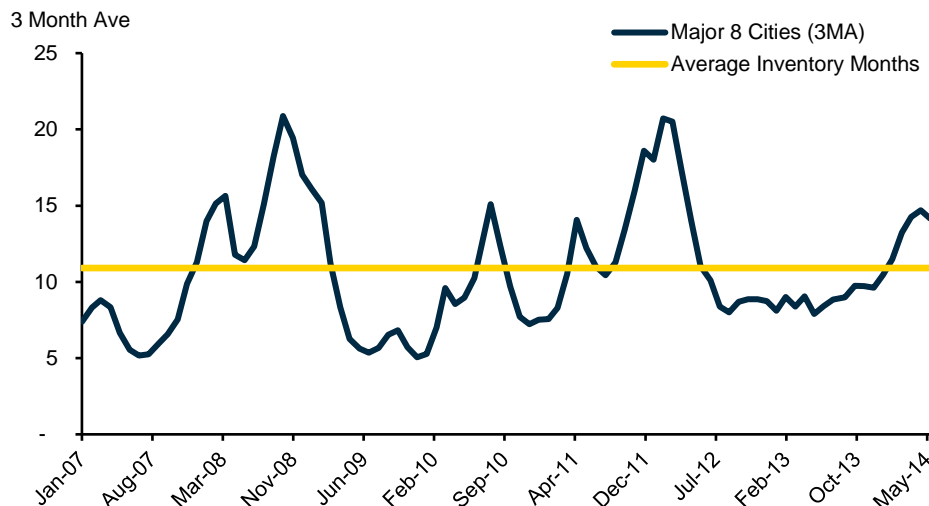
Property—A Deflating Bubble

China's property market has been a crucial driver of recent growth and employment as total funds invested in real estate amounted to 19% of nominal GDP in 2012.⁸ More recently, we have seen clear signs of market weaknesses with climbing inventory, falling prices, and declining total floor space sold—all of which point to a deflation in China's property bubble. Even so, the following chart shows recent inventories are still well above averages in eight major cities, indicating broad oversupply.

⁶ Data from CEIC as of 2013.

⁷ Net interest margin data are from CEIC.

⁸ Real estate investment data from the National Bureau of Statistics of China as of the end of 2012.

Inventories Again Surpass Averages

Source: Soufun as of May 2014.

With regard to prices, cities with declining house prices now outnumber those with price increases by a historically wide margin. It is a trend that could persist, as indicated by the following chart depicting that the average duration for each cycle of price increases and decreases ranges from 1.5 to 2.0 years. In another indication of the recent lethargy within the sector, measures of floor space started and sold tipped into negative territory in 2014 after a solid showing the prior year. However, further declines in floor space started could indicate an eventual stabilization in the sector should the trend continue.

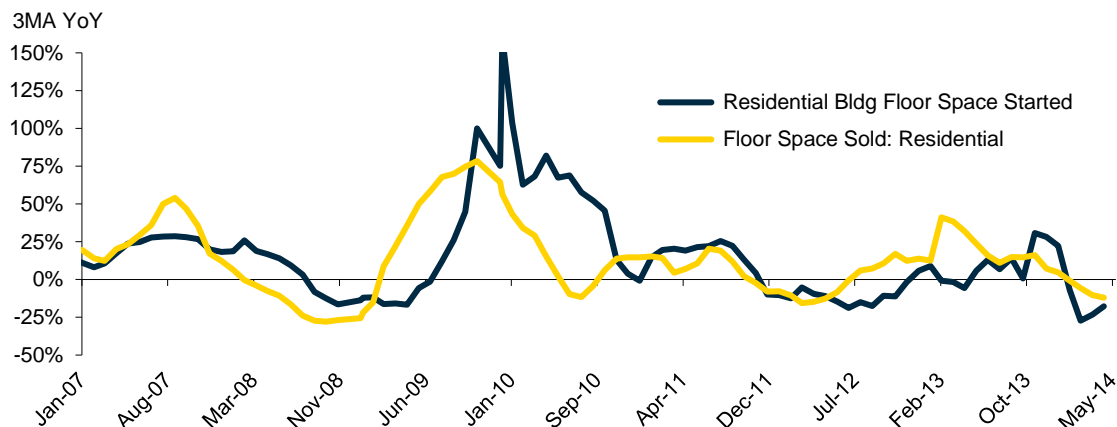
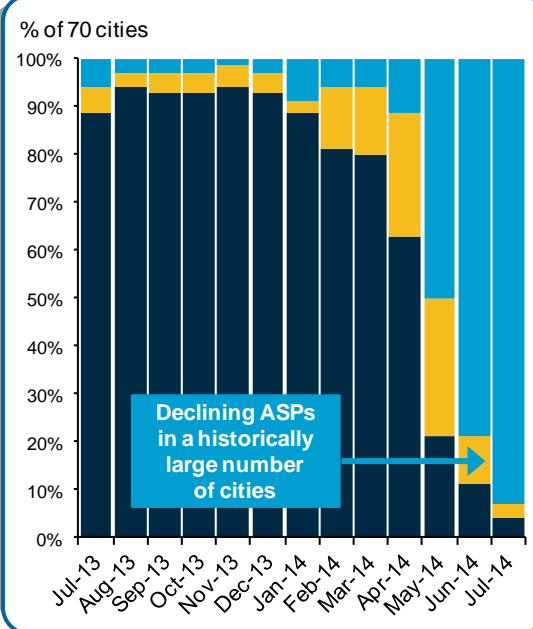
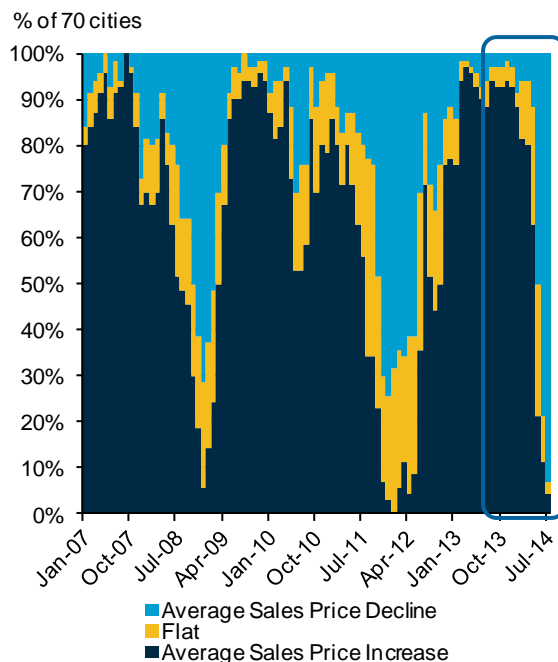
Not All Property Developers are the Same

While China's nationwide property market may be showing signs of weakness, large and well-capitalized developers may gain market share from smaller developers during a downturn. These larger developers tend to have access to the offshore loan and bond markets and can raise capital at much cheaper rates over longer tenors.

It already appears that stronger developers have gained market share as gross floor area sold by the top 50 developers accounted for 33.2% of nationwide sales in the first half of 2014, versus 26.2% in 2013 and 24.6% in 2012, according to Chinese Real Estate Information Corp. as of mid-2014.

Recent anecdotal observations of defaults on developer trust loans and halted projects due to financing difficulties highlight the scarcity of affordable credit to developers without strong banking relationships.

Average Property Prices on the Downtrend Amid Weakness on the Supply and Demand Sides

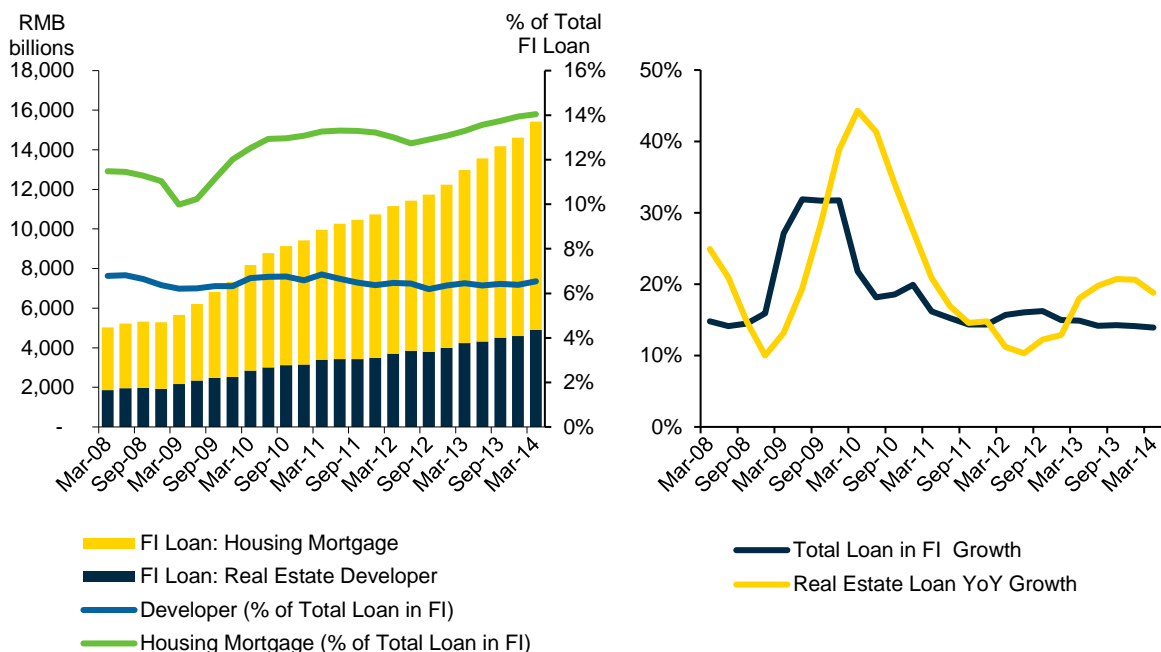


Sources: NBS and CEIC as of May 2014.

Given the importance of the property market to China's economy, the authorities have an incentive to support the sector considering its current level of stress, and some policy actions this year have already loosened restrictions on the demand side. For example, cities have been given more autonomy to lift home purchase restrictions by individuals who meet certain criteria, and reports indicate that banks have been told to expedite the mortgage process for first-time home buyers. In addition, policies were also expedited in order to accelerate the construction of low-income housing. These actions suggest the government is aiming for some stabilization of sales volumes, without the attendant inflation in average selling prices.

But the real property risk—which in our opinion remains a tail event, but one with increasing likelihood—is that Chinese authorities will provide too much stimulus to prop up growth, making the inevitable unwind of the bad investments all the more painful. This scenario could result in further stress in the banking system. As the following charts show, the property sector remains very active, with real estate loans, including mortgages and developer loans, accounting for over 21% of reported loans from financial institutions, which continue to experience faster growth in real estate loans relative to total loans.

Property Loans Exceed 20% of Loans from Financial Institutions, Growth Continues

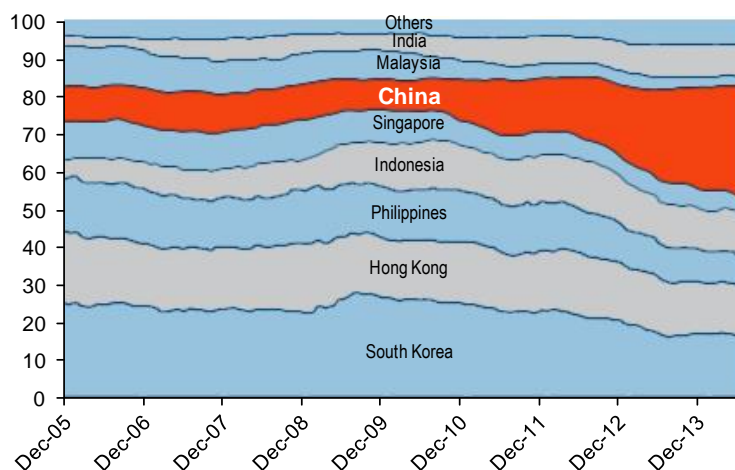


Sources: CEIC as of March 2014.

Investment Outlook

Asia's high savings rate and subsequent fixed income investments have contributed to the recent surge in issuance from China. With this increase, China has become the largest constituent to J.P. Morgan's Asia ex-Japan Credit Index (JACI), with an index weight of nearly 30% of the \$523 billion benchmark, as of June 30, 2014 and observed in the following chart.⁹

JACI Comp Market Cap by Country, 2005-2014



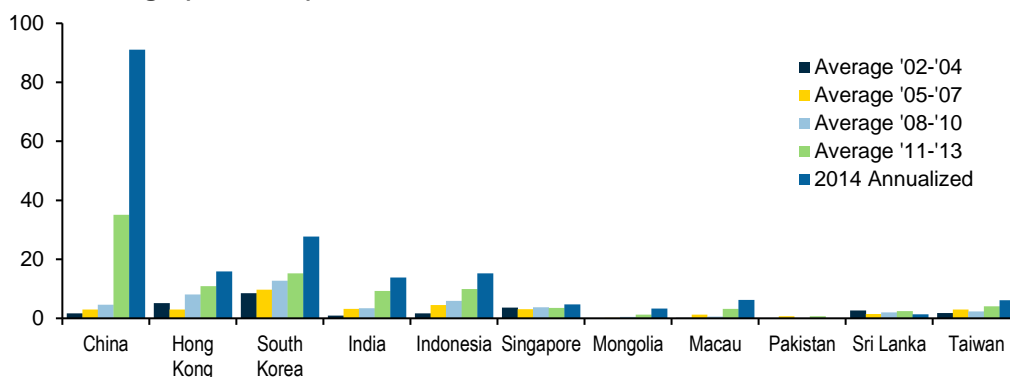
Source: J.P. Morgan as of 6/30/2014.

For 2014, issuance seems likely to exceed \$90 billion, nearly three times as high as during previous years, as depicted in the following chart. The market will likely continue to see debut issuers with more companies becoming reliant on the bond market for financing as many European banks continue to delever and scale

⁹ When Hong Kong is included, the combined contribution of China and Hong Kong to the JACI is approximately 42%.

back in the region. We expect further supply to potentially temper any outperformance in China credits for the remainder of the year, though intermittent policy easing initiatives may give the market some cause for outperformance, particularly among credits that are fundamentally healthy ([click here](#) for additional perspective on China's policy cycles).

China's Issuance Surge (\$ billions)



Source: J.P. Morgan as of 6/30/2014.

As previously indicated, the needed economic reforms will affect a broad swath of the Chinese economy, including the bond market. In no small measure, the attractiveness of bonds and other shadow-banking products also reflects the widespread expectations for official bailouts in case of payment difficulties. These expectations have recently been validated by several last-minute “white-knight” rescues of financial products that reportedly faced repayment difficulties. While avoiding systemic stress, these bailouts have nevertheless served to further propagate moral hazard. The authorities are aware of the problem, but investor expectations can probably be shifted only in the hard way, i.e., by incurring actual defaults. It is an open question how the wider bond markets would take such a shift in expectations.

The bulk of China's investment grade corporate market is concentrated in a few sectors, such as oil and gas SOEs, while high yield credits are concentrated in the real-estate development sector. A brief investment synopsis of certain sectors follows:

- We believe spreads are attractive for certain SOEs, which are strategically important, do not suffer from extreme overcapacity, and stand to gain from structural reform and economic rebalancing. Against this backdrop, we prefer large oil companies with credit spreads of over 100 bps to comparably rated U.S. oil companies as of Q3 2014.
- In the banking sector, the timing of a heightened loss recognition framework or other structural changes remains uncertain, and we do not believe the spread pickup in financials (also about 100 bps over comparable U.S. financials as of Q3 2014) is sufficient compensation for the inherent risks.
- Given the inherent risks in the property sector, we would avoid most property-related names. After undertaking detailed credit analysis, the few property names we favor tend to have well-located land banks, good access to credit, and prudent views towards land purchases.

With regard to Chinese interest rates, local rate markets do not parallel those in the developed world or those in many EM countries. Access to China's local rate markets is generally limited to the largest local organizations plus a few foreign institutions. Furthermore, given that financial markets remain underdeveloped and the monetary policy framework continues to evolve, the interbank market and front-end yields can experience sharp bouts of volatility. Offshore investors can access the Renminbi-denominated “Dim Sum” bond market, which has a limited selection of issuers, but is growing rapidly. Looking ahead, we

expect a gradual liberalization of local rates markets, ideally flanked by the development of a system of indirect monetary control by the Chinese central bank, that may also provide more opportunities for offshore entities to invest in local rates and regional authorities.

Forecasting China's currency is a challenge. A foremost consideration is that with some \$4 trillion in foreign exchange reserves and the ability to accumulate more, the authorities remain very much in control of the exchange rate.¹⁰ Apart from currency policy, a number of factors have the potential to move the Renminbi in either direction. If policy liberalization and structural reforms reduce the outlook for domestic growth beyond those felt to be politically acceptable, currency weakness may be viewed as an attractive way to generate export growth and help rebalance the economy. Moreover, greater opening of the capital account may present alternative investment opportunities abroad for a larger part of the Chinese population, which could also impart depreciation pressures. Alternatively, the push towards growth in consumer demand and the political interests to improve the Renminbi's standing as a reserve currency may benefit from currency appreciation. Given these opposing forces, we believe that investors are best served by remaining agnostic while exploiting tactical trading opportunities that will present themselves from time to time.

Given China's size, the investment implications from the country's economic transition do not stop at its borders. Indeed, investors in some commodity markets appear to be reacting quickly and strongly to potential and perceived developments in China, selling on the heels of growth concerns and buying on the hopes of stimulus measures. As reforms occur, past correlations and rules of thumb used to analyze developments in China in a broader global context will also need to be reassessed. These implications span from credit sector allocation (e.g. on global steel producers after removing implicit input subsidies in China) to Chinese asset classes (e.g. the rates market after the adoption of indirect instruments of monetary policy) all the way to developed market rates (e.g., if a renewed bout of Chinese currency weakness added another leg to global "lowflation" concerns). Rather than trying to keep an exhaustive account of China's potential reforms and their global implications—an impossible task anyway—investors may be better served by maintaining the flexibility to react to new developments.

Conclusion

Without question, China's economic transition represents a monumental challenge—it has become much more difficult for the world's largest exporter to simultaneously maintain rapid growth and financial stability.

Based on our ongoing analysis, however, we believe China has the tools to avoid a hard landing, and we would not advocate a bearish investment position on the basis of a hard landing scenario. Still, under a more consumer and domestically oriented economy, we believe it is unlikely that China will match its prior growth rates. For example, in our "Reform" scenario, we see China's GDP easing from 6.9% this year to 5.9% in 2015—still a brisk pace considering the continued lethargy in developed market economies.

Although we do not foresee a hard landing scenario in China over the near term, we still have strong sector views, such as our inclination to avoid most property developers and banks, while seeing value in certain SOE names.

While a slower growth rate may add to the political difficulty of the transition, we see China at a point where its reform agenda needs to be implemented without further delay. As more time passes without true reform, it may become more difficult to manage the transition without undue volatility. Furthermore, we view proper sequencing of reforms, such as first reforming the SOE sector and implementing an effective bankruptcy regime ahead of further financial liberalization, as essential for China's successful transition.

¹⁰ People's Bank of China as of June 2014.

Notice

Source(s) of data (unless otherwise noted): Prudential Fixed Income as of 8/25/2014.

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