How to gauge the strength of the coming stimulus & market direction

Investment Strategy

13 August 2018

To follow the money

- **The big debates:** there are two major debates in the market, the outcome of which may decide market direction over the next few months: 1) whether the US will roll out the 25% tariff on US$200bn of Chinese goods (After tariffs on US$200bn goods, what China may do?, Jul 11); and 2) how strong China's stimulus will be (Helen Qiao, Politburo meeting focused on growth stability, Jul 31). We stay cautious on the equity market as we believe that, compared to market expectations, the risk of tariffs could be higher and the strength of the stimulus, weaker (State Council fine-tuning, a false dawn?, Jul 25). Our note focuses on stimulus.
- **Stimulus, watch local government spending:** we believe that, for this round of stimulus, China may primarily rely on local government infrastructure spending, rather than housing market or loose monetary policy (What policy easing might turn around the negative market sentiment, Jul 21).
- **Funding holds the key:** as such spending is mostly funded by local governments' debt, it's how sharply that the State Council, the Ministry of Finance (MoF), and various financial regulators open up their debt channels that matters the most.
- **Actions speak louder than words:** it's been our experience over the past decade or so that policies of various departments may not always be completely in sync with the State Council's announcement, e.g., the fairly weak stimulus during 2013-14. So far, pro-growth signals from MoF and the financial regulators are mixed at best (MoF effectively said no major stimulus, Aug 3).
- **Local governments' true debt likely much higher than common market perception.** This could explain MoF's reluctance for the locals to take on more debt. Table 1 lists the key funding channels for them, other than land sales (which showed a sharp decline over the past month or so): bank loans (largely assumed by local government funding vehicles, or LGFVs, and local SOEs), muni & LGFV bonds, entrust and trust loans, public-private partnership (PPP), government sponsored industry fund (GSIF), services procurement, build-transfer (BT) & accounts payable. As most of these channels are opaque, our exercise involves our best estimates (key assumptions inside). Based on our estimates, bank loans account for approximately 45% of locals' debt funding; bonds, 20%; other shadow banking tools, 30%; the others, 5%.
- **Key things to watch to gauge stimulus**: so far, our channel checks show that bank loan remains reasonably tight and a majority of shadow banking activities are still under tight control. Bonds seem to be the preferred channel this time (Channel check: policy loosening, the impact on local government financing, Aug 6). In addition, there are media reports that trust companies have been asked to speed up funding to local governments. At this stage, other than bonds, we expect debt growth over the next few months to be moderate. However, should bank and trust loans surge as well, our thesis could be too cautious. In addition, we should also monitor if MoF and the National Development & Reform Commission (NDRC) decide to increase PPP & GSIF project rollout again (the two items are still treated as equity in most official accounts although they are more debt in nature in our view).

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Timestamp: 12 August 2018 08:23PM EDT

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If our estimates are roughly right, the local governments need to almost double their debt taking in the 2H vs. 1H (RMB4.9tn) for their total debt growth in 2018 to be meaningful YoY.

Table 1: Local government debt balance – a comprehensive list (RMB bn)

	Bank loan	Shantytown loan	LGFV bond	Muni bond	Entrust loan	Trust loan	PPP	GSIF	Services purchase	BT & payables	Total	Growth
2007	6,520	-	0	-	480	124	-	-	-	19	7,144	
2008	7,513	-	14	-	620	229	-	-	-	31	8,408	1,264
2009	9,991	-	194	200	842	375	-	-	-	52	11,653	3,246
2010	11,245	-	379	400	1,214	503	-	-	-	93	13,834	2,181
2011	12,338	-	678	600	1,471	571	-	-	-	136	15,795	1,960
2012	14,018	217	1,460	650	1,723	1,000	-	-	-	201	19,270	3,475
2013	15,319	295	2,285	862	2,407	1,611	-	4	-	277	23,059	3,789
2014	17,288	636	3,915	1,162	3,110	1,783	-	108	-	352	28,355	5,296
2015	19,270	1,306	5,034	1,605	3,670	1,818	-	786	167	390	34,046	5,691
2016	21,129	2,126	6,500	2,513	4,398	2,092	3,232	1,900	511	431	44,832	10,786
2017	23,797	2,700	7,025	3,876	4,657	2,844	6,667	3,500	1,562	626	57,254	12,422
1H18	25,557	3,161	7,208	4,073	4,388	2,785	8,696	3,600	2,219	704	62,390	4,936
% of total	41%	5%	12%	7%	7%	4%	14%	5%	4%	1%	100%	

Source: CEIC

Our key assumptions:

Our assumptions are largely based on our channel checks and our sampling of key financial products, e.g., the 100 largest trust products.

Bank loan: we assume that 50% of construction loan and utilities loan, and 100% of transport, environmental, and public administration loans are local government related.

Entrust loan & Trust loan: 1/3 of their balance in the reported total social financing (TSF) is local government related.

Muni bonds: we exclude the swap related bonds from the muni bond balance here. By 1H18, Rmb11.8tr muni bonds were issued to replace, or swap for, a part of the debt taken on by the local government during the 2008-2010 round of government stimulus. As a result, debt growth during 2015-2017, when the swap program was implemented, could be higher than the numbers in Table 1.

BT & payables: we use listed construction companies' long-term receivables as a proxy. For the non-current part of their long-term receivables, we assume 100% are de facto lending to local governments; for the current part, we assume 25%. As their 2Q financials are not out yet, we have used their 1Q balance in Table 1. As listed contractors are a portion of the total industry, our estimate here could be underestimating the true extent of BT and local government payables.

PPP: we use the invested project size in MoF's and NDRC's PPP project databases as a proxy. NDRC's data is incomplete, so we estimate the missing periods' numbers by assuming that they grew in line with MoF's.

GSIF: No official data on this. We use the target size data from Qingke, a 3rd party consulting firm, and assume that about 1/3 of target size are paid in.

Government services purchase: 1) We have official data until 2016. For 2017 and 1H18, we assume that the size grew at the same speed as GSIF's, as both were lightly regulated until late 2017. We also assume that 50% of services purchase is debt in nature.

There may be considerable overlaps among the various items in Table 1. For example, some GSIFs might have invested in PPP, or some bank loans might have ended up in GSIFs. As a result, our estimates should be viewed as a very rough proxy. Nevertheless, we believe that ours paints a truer picture of local government debt situation than the official account and most estimates on the street.

Our expectation is that local government's total debt growth in the 2H will disappoint the market. This means that stimulus strength will likely be weaker than the market's expectation. Together with the higher chance of the US tariffs, we expect the market to weaken further in the ensuing months.

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