China : Investment Opportunity or Impending Disaster

We do not believe that China is a “bubble” ready to burst and take down large parts of the world’s financial system. Neither do we believe that China represents a compelling investment opportunity. Ironically, both of these beliefs are grounded in the same set of circumstances; essentially, that China has a “surplus” of savings. China is the world’s biggest creditor, as evidenced by its $4 trillion stockpile of international reserves. It internally finances all its own capital needs. As its long standing current account surplus would suggest, China’s relatively closed financial system does not allow significantly large amounts of portfolio capital flows. In other words, China does not rely on foreign capital and is not vulnerable to capital flight. Overall debt to GDP is moderate and, at the central government level, it is very low. Whereas debt in the private sector has been growing very rapidly over the past few years, most of this debt is still in the form of bank loans at state controlled banks. If there is a credit crisis, the central government has the tools and capacity to control it. It can absorb bad debts, recapitalize banks, and manage credit crunch induced asset price and GDP declines. In summary, China is an excellent credit risk with currently low systematic vulnerabilities in the financial system. We will address why we use the word “currently” later.

Notwithstanding some investor claims of impending financial disaster, the market believes China is an excellent credit and consequently, its hard currency debt, as well as the debt of almost all large Chinese issuers trade at extremely tight credit spreads. It is worth noting that the Chinese government issues relatively little hard currency debt, the vast majority of issuance is in Remimbi. Corporate hard currency debt is more prevalent and approximately 60% of this is issued by state owned enterprises. These issues generally trade as if they were state guaranteed even though there is no explicit support. The lion’s share of non-state owned enterprise debt is issued by property development concerns and, to a lesser extent, mining and natural resource companies. As one would expect this latter group of companies offers wider credit spreads and in some cases, significantly wider. However, all of these issuers benefit from the tendency of Chinese corporations and high net worth individuals to invest their considerable hard currency assets in the bonds of Chinese issuers. Brokers commonly estimate that 60-70% of all Chinese issuance is owned by Chinese investors. Not only does this tend to make spreads tight, it also hinders short sellers. Many naïve short sellers have initiated short China positions only to discover that bonds never widen, only tighten, and that the borrow on the bonds is precarious. When this occasionally is not the case, it is only because the Chinese investor base knows something about the issuer that is not publicly known and not widely disseminated outside of China.

This description of hard currency Chinese bonds suggests a market with very low returns and occasional higher yielding opportunities that one should approach with extreme caution. In other words, when compared with other markets, Chinese bonds offer relatively little return for the risk being taken. The main reason for this is China’s enormous savings rate. China’s savings rate is 41%, the highest in the world. When China’s economy was relatively small, the total amount of savings did not make much of an impact on the world economy and could be productively employed in developing China’s woefully underdeveloped industrial base. Twenty-five years later this industrial base is highly developed, particularly for exports, and China is now the world’s second largest economy. A 41% savings rate for the world’s second largest economy is a lot of savings. These savings are having a hard time finding a home, in other words borrowers.

As previously discussed, China does not permit the free flow of capital. The original intent of this system was to channel China’s savings to industrial development in China and insulate the system from the ebb and flow of international investor sentiment. The system has largely accomplished this objective. Now there is a tremendous amount of savings chasing a limited array of investment opportunities. The system was intended to favor borrowers (industrial development) over savers and state control banks over non state controlled public markets. While public markets are slowly developing, the state controlled banks are predominant. In addition, there is shadow banking which we will discuss later.

We view the Chinese local currency market’s structure as similar to the hard currency market. There are government obligations and obligations of entities believed to enjoy government support such as bonds of state owned enterprises and bank deposits. These obligations offer relatively low rates of return. Investment options that offer higher rates of return should be treated with extreme caution because Chinese accounting transparency is low, corporate governance is poor, and the Chinese legal system which the creditors ultimately rely upon to protect their interest, is opaque and politically directed. It’s reasonable to assume because of these characteristics one is not being compensated for the risk. Combining these characteristics with the pool of captive savings desperately seeking higher returns, it’s reasonable to assume that returns may not be commensurate with the risk.

Even with this challenging backdrop, it is possible to make a case for Chinese local investment by international investors. Real rates, even on safer Chinese assets, are higher than in many developed markets. The currency could reasonably be expected to appreciate over time and China is the world’s second largest economy and arguably the world’s best credit. However, we would still advise against the higher yielding riskier segments of the market. As is the case with all higher yielding assets, investors might collect higher returns for some period of time but this attracts an ever greater number of investors and sets the stage for big losses. If one were to insist on investing in this segment we would recommend a locally based investment advisor with strong political connections.

Having stated our position on current risks and opportunities in China we view that systematic risk is increasing. This view is based on the fact that the non-state controlled public market portion of credit markets (shadow banking) is growing as a share of the total credit supply. While many people view this change as favorable, less state control clearly increases the short term risk of credit induced panics. Banks and trust companies have offered a plethora of products which offer yield starved savers high returns and keep assets off their balance sheets. These products are technically not guaranteed by the sponsors and investors bear the risk.

Although we think that China’s government still retains enough control to avoid a severe disruption of credit markets, our current sanguine view of the situation rests more on the belief that the Chinese government will not tighten credit enough to provoke a crisis. We believe that almost all modern credit crises start with government efforts to reign in credit growth. This occurs through some combination of interest rate rises and/or tighter restrictions on lending. Notwithstanding recent government rhetoric of a crackdown on shadow banking and runaway credit growth, we do not believe the government will tighten credit in a meaningful way. Growth is lower than the government has hoped for and inflation has dropped dramatically from 6% to in 2011 to 2% now. The government doesn’t want either of these figures to drop much more. Every time they seriously try to restrict credit both statistics weaken. When these statistics weaken, Chinese officials loosen credit again. There doesn’t seem to be the political will for a serious crackdown on credit. On the other hand, the longer shadow banking grows at such high rates, the more painful the contraction will be when it comes.

In the aftermath of the 2008 financial crisis demand for Chinese exports declined dramatically. This led to a reduction in China’s current account surplus from 6% of GDP to approximately 2% currently. As previously discussed, current account surpluses effectively export local savings to the rest of the world. If Chinese savings which previously had been used by the rest of the world were not used within China GDP would have declined. That is why China’s government undertook massive investment projects and encouraged others to take on debt to do so. These measures successfully avoided a recession. However, over the past few years the government has become increasingly concerned about credit growth. The primary reason for this concern is that unlike prior to the crisis; debt to GDP levels for the economy has been rising dramatically. The reasons for this are fairly straight forward. First, since the current account surplus has shrunk a greater share of domestic savings must be used internally to avoid a contraction in GDP. Therefore, the rate of credit growth has accelerated. Second, this decline in exports along with a naturally declining rate of return on increasing amounts of domestic investment has reduced the rate of real growth. Finally, this slower growth rate coupled with a smaller current account surplus that needs to be sterilized in China’s managed currency regime has led to lower inflation. Chinese credit is growing faster while GDP is growing more slowly. This trend has accelerated since 2012 when the government started to abandon its official stimulus program. Although central government debt to GDP levels have been relatively stable over the past few years, since 2012 private sector borrowing has exploded going from 120% of GDP to nearly 200%. Clearly this cannot go on indefinitely. Whereas there is an argument that a sovereign’s capacity to issue debt in its own currency is unlimited, there is definitely a limit for the private sector.

The Chinese government understands that this situation cannot continue. That is why they are trying to reign in credit growth. What’s troubling though is that they don’t clearly seem to understand that clamping down on credit growth alone is not only insufficient but counterproductive. In a society that insists on saving half of its income reigning in credit growth alone leads to recession, deflation, and ultimately depression. Ironically these conditions cause people to save more and make matters worse. Absent an increase in the current account surplus, which effectively exports this surplus savings problem to the rest of the world, the only solution is to save less and consume more. However, this requires a complete reorientation of the economy. As Michael Pettis explains in his book with the somewhat sensational title “Avoiding the Fall”, shifting from an export led economy to a domestic consumption led economy will be painful. If China’s leadership is not willing to take this short term pain, credit growth will turn into a bubble that will explode in a very painful way.

The implications of this situation for the rest of the world are unclear. Since China has followed the Japanese model, the Japanese experience may be relevant. Japan also went through a rapid export focused industrialization process which was funded by a high domestic savings rate. They also experienced high growth rates and large current account surpluses over many years. However, declining rates of return on marginal investment coupled with the need to invest an immense pool of savings led to rapidly increasing debt to GDP levels, asset price increases, and ultimately the lost decade. Even the demographic challenges of Japan and China two decades later are similar. What we saw in Japan was that a credit induced contraction in a big surplus savings nation can be moderately disruptive to the world economy as it reduces its external investment and pulls the marginal bid away from certain assets such as trophy real estate. In this case, China’s relatively closed financial system means that they are not as big a player in as many financial markets as Japan was. More importantly, since both Japan and China’s biggest impact has been on exports, their relative importance to worldwide aggregate demand is smaller than the relative sizes of their economies. Consequently Japan went through its lost decade with relatively little impact on worldwide aggregate demand. We suspect this would also be the case with China. A Chinese contraction would perhaps have a severe impact on many commodity prices and luxury goods but the overall impact would be limited. That being said, commodity producers have been disproportionately large issuers of debt over the past decade and the world economy is more fragile than it was during Japan’s lost decade. Although we believe the most recent round of China bears are still too early, we nevertheless believe that China will represent a fault line for the next round of credit related seismic activity.