The Sydney Morning Herald

SE Business - Opinion & Analysis

HD **Bears scent blood but, for now, bulls hold the advantage**

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WC 971 words
PD 8 February 2014
SN The Sydney Morning Herald
SC SMHH
ED First
PG 9
LA English

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The volatile new year market contains two churches. Bulls see value emerging on conventional sums including price-earnings multiples. Bears are focusing more on what they believe is significant event risk in the markets.

The optimists got the upper hand towards the end of this week. Valuation bargain-hunters pushed prices higher as a crucial jobs report in the US reinforced the view that America's economy is not slowing down. The economic news from Europe also remained upbeat, and here the Reserve Bank lifted its growth forecasts.

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The bears are still looking for the next Black Swan event, however. Here are two candidates that haven't derailed the markets so far, but nevertheless can't be ignored.

China Credit Trust's 3 billion yuan ($548 million) spectacularly named "Credit equals Gold" product was distributed to investors by China (and the world's) biggest bank, Industrial and Commercial Bank of China (ICBC).

Credit equals Gold was far from golden. It had promised annual returns of about 10 per cent, but the money it raised was sunk into a Chinese coal mining company that imploded amid reports of shady dealings and lost mining licences. As its end-January repayment deadline approached and a possible default loomed, ICBC warned that it would not be in the business of bailing out investors.

That was food for the bears. Trust companies in China manage assets worth about 10 trillion yuan. They are one of the pillars of China's so-called "shadow banking" sector that the bears think could be the source of the next global market meltdown.

Just before Credit equals Gold's redemption deadline, ICBC announced that an unidentified investor would bail out the trust's investors at par. Beijing's hand in the bailout was assumed, but not confirmed.

The market's two churches saw the bailout differently, of course.

The bears said the rescue proved how dangerous a default would have been, and that it created a moral hazard - an incentive for even bigger risk-taking in the shadow banking sector, in the belief that a Beijing bailout was the back-stop.

"The bailout looks very much like the Bear Stearns moment," Bank of AmericaMerrill Lynch strategists Bin Gao and Ardash Sinha wrote after it occurred.

Global markets had continued to rise for a while after the rescue of that US investment bank in March 2008, but the securitised debt that sank Bear Stearns was everywhere in the global system, and almost cratered it six months later when Lehman Brothers also imploded.

The rescue of Credit equals Gold in China was accompanied by similar vapour trails, the Merrill duo wrote, including increased debt market volatility, falls in the value of higher-risk Chinese debt, increased stress on financial institutions and limited market insight into what was actually going on.

The bulls argued that Credit equals Gold's rescue showed Beijing could avoid a crisis.

What is called the shadow banking sector when China is being discussed is less hyperbolically called the non-bank financial (NBF) sector in the West, including Australia.

The Chinese government estimates that China's NBF sector holds assets equal to about 10 per cent of the country's banking system. JPMorgan thinks it is more, about 67 trillion yuan, but that is still only 30 per cent of the assets held by Chinese banks. The global average is about 50 per cent. Non-bank (shadow) assets in the US, measured the same way, are 170 per cent of the banking system, and the ratio in Europe is more than 50 per cent.

Is China's financial system safe? It depends ultimately on the quality of the debt the Chinese NBF sector and banks are holding. The shadow cast by China's "shadow banks" is at least not as big as it elsewhere, however.

The other Black Swan candidate is Turkey. It is financing a current account deficit that equalled a daunting 7.6 per cent of gross domestic product at the end of November, and its funding options are becoming tighter as the US Federal Reserve's tapering of quantitative easing restricts the global money supply.

Turkey's central bank more than doubled its one-week repurchase rate to 10 per cent and boosted its overnight lending rate from a little less than 8 per cent to 12 per cent at the end of last month to try to stop a run on the lira.

Turkey's banks are nominally well capitalised despite aggressive loan growth in recent years, but they are substantially foreign-funded, and are now in a vice.

Almost two-thirds of Turkey's $165 million short-term (payable within a year) foreign debt load is on the banks' balance sheets. The amount of lira they need to repay it rises as the currency falls, and interest rate increases that are sandbagging the lira will, if sustained, crush economic growth and flood their domestic loan books with bad debts. The possibility that Turkey is in a tailspin that leads to an IMF-led bailout cannot be discounted.

It's worth noting, however, that Turkey's problems are not causing serious contagion in the fragile southern European debt markets nearby. The yield on Spain's 10-year government bonds peaked at 7.6 per cent in mid-2012 as traders sold them down. It is now at 3.65 per cent. Italy's 10-year bond peaked at 7.4 per cent late in 2011, and is now 3.75 per cent. Even Greece looks pretty good. Its 10-year bond yield was off the scale during Europe's sovereign debt crisis. Now, it's 7.65 per cent.

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AN Document SMHH000020140207ea280004v

