FINANCIAL REVIEW

SE Companies and Markets

HD **Storm alert for investors**

BY Jonathan Shapiro
WC 1,499 words
PD 16 September 2014
SN The Australian Financial Review
SC AFNR
ED First
PG 19
LA English

LP

Economy China is preparing for financial crisis, says macro-consultant James Aitken.

Former US Treasury secretary Tim Geithner knows what financial crisis looks and feels like, having played a key role in the frantic scramble to rescue the US financial system after Lehman Brothers failed.

TD

But he also knows that investors stand to make a whole lot of money by partnering with governments that go "all-in" to restore stability.

That, says London-based macro-consultant James Aitken, is why Geithner's first trade at Warburg Pincus – a $US700 million investment in so-called Chinese "bad bank" Huarong Asset Management – provides a clue as to the near-term fate of China's financial system. "If you ask him, [Geithner] might tell you that in 2009 when a government and sovereign goes 'all-in', and offers you a stake when they are 'all-in', you should take it," Mr Aitken said.

China's "bad banks" were set up by the Chinese government to mop up the bad debts from the stressed lenders and stand to profit if they recover more than the price they pay.

In 2009, Geithner helped create the public-private investment process that worked with a group of eight US debt fund managers to buy up to $500 billion of "toxic" assets from stressed US banks – a tie up that proved highly lucrative for the managers.

James Aitken, the elder brother of high-profile stockbrokers Charlie and Angus, has been consulting to some of the world's largest investment funds and policymakers via his firm Aitken Advisers since leaving UBS in 2008. Before that he worked at insurer AIG at its infamous derivatives unit.

Mr Aitken is considered an expert on the inner workings of the global financial system and in recent years has focused his efforts on understanding China's finance system and its impact on global finance.Not all in China is as it appears

In China, all is not as it appears, says Mr Aitken, whose analysis Notes from a Small Island is despatched to his exclusive and still growing list of the world's most sophisticated investors and policymakers.

"People are getting 'head faked' by the slowdown in credit growth but total lending is well higher," he said.

Credit is being channelled through alternative sources, such as the bad banks and new vehicles modelled on those used by the Federal Reserve.

Another bad bank, Cinda Asset Management – which is now publicly listed and therefore discloses activities – has reported a sharp rise in loans to non-financial corporations, emerging as a source of credit for businesses.

Mr Aitken also points to a pivotal moment in April this year when the People's Bank of China created a "Pledged Supplementary Lending" program to channel funds to the China Development Bank. The 1 trillion RMB [$180 billion] "liquidity injection" to recollateralise the Chinese financial system acted as a catalyst to propel Chinese equities.

These structures bear some similarities to the rescue facilities created by the US Federal Reserve, the difference is that Chinese authorities are acting ahead of any credit crunch, effectively "foaming the runway" for a soft landing.

The net result is that China's authorities aren't tightening financial conditions but loosening them in a targeted and precise way as Premier Li forges ahead with financial and administrative reforms aimed at transitioning to a consumption-led economy.

"The Chinese authorities are all in and there is tremendous put [option] under Chinese assets," says Mr Aitken.Awkward moment for Australia

That's all well and good for China, but the shifting forces within the world's largest economy spell turbulence for the benefactors of its steel-intensive investment-led growth that is set to slow.

Mr Aitken says it's a case of "China fine, Chinese suppliers not so fine". Australia is facing an awkward moment.

"The Reserve Bank of Australia has been right to have a balanced view and so far we have muddled though but it gets trickier from here. It gets trickier.

"The housing card has been played and what's next, I am not sure. I don't think they are either."

RBA governor Glenn Stevens has pinned his hope on the Australian dollar falling and until last week has been left frustrated. But a combination of rising expectations that the US Federal Reserve is edging closer to lifting interest rates coupled with a sharp fall in the price of Australia's major export – iron ore – has hit the currency hard.

Mr Aitken does expect some benefits from a falling dollar but says it's time to reconsider just how much the currency needs to fall to come to the economy's aid.

"Because ore and coal prices are wobbling the terms of trade are falling more rapidly than people would have expected. So the AUD should fall further than one would have thought a year ago to be able provide an air bag. A year ago the RBA might have thought 85¢ [against the US dollar], now the better range might be 80¢ or below."

What does that mean for Australian investors? Here Mr Aitken is in agreement with his brother Charlie, who recently told clients to look abroad for much-needed diversification.

"Now is a wonderfully opportune moment for Australian funds to think about their exposure to offshore assets and if the AUD has conclusively topped out then doesn't it make sense to increase exposure to offshore assets?"

He is bothered that local investors, lured by tax incentives, are too concentrated in the dividend-paying banks and Telstra.

"It's a rational decision but it's an all-in bet on Australian beta [highly sensitivity to the local market and economy] and I'm not sure at this moment this is wise decision."

However, betting against the Aussie banks might be a trade worth revisiting.

"Trying to short the banks has been a fool's errand but now the general drift in unemployment is higher, the Murray inquiry is going to require the banks to hold more capital and if you think the latest leg-up in housing is running out of steam, you start to think the Aussie banks look a bit rich."More market turbulence ahead

Local investors might have to act soon. Aitken is more convinced that market turbulence lies ahead and sees a sharp spike in currency volatility from its low base as a sign that more money is playing the "carry trade" [borrowing in a cheap currency and investing in a higher yielding one in the hope that markets remain calm], than previously thought.

"The world is a lot shorter US dollar and volatility than is properly understood and it seems we are on the front edge of another liquidity event," he said.

He also doubts that the European Central Bank's new phase of quantitative easing will fill a liquidity void when the Fed vacates. The US dollar is the world's reserve currency issued by a nation with a current account deficit while the Euro currency bloc runs a current account surplus.

"The US has been on a five-year non-stop rights issue of USD and it's the global reserve currency. It's all well to say ECB starts QE and prints euros, but the impact on global liquidity will be different because it runs a surplus."

And it would be a mistake to assume that central banks will stand in the way of a market correction as they have done in the past. They're now ready and willing to accept more asset price volatility in financial markets.

"If you look at what [US Fed governor Janet] Yellen, [Bank of England governor Mark] Carney and others have been saying they have been warning about taking too much risk, and warning of volatility going up. The idea that Yellen will come rushing in at the first sign of a wobble is not correct."

The Fed could very well be on track to finally lift interest rates around the time Ms Yellen initially hinted. Her comments at a press conference in March that that would be "about six months" after the end of quantitative easing were seen as a blunder – but that forecast – which would mean March next year – is a distinct possibility.

And we could see clearer evidence of the shift in messaging from the Federal Reserve as early as this week, Mr Aitken says.

This time they are not bluffing.

"We have passed the point of peak US dollar liquidity. You need to be conservative and mindful of exposure to credit and have to be prepared for a 10 per cent fall in equities, maybe more.

"For years there has been no reason to hedge against risk because the hedge has been the Fed. That's changing. It's time to hedge."

$180 **billion** amount of liquidity injected into the **Chinese** financial system by its 'Pledged Supplementary Lending' program

RE china : China | austr : Australia | usa : United States | apacz : Asia Pacific | asiaz : Asia | ausnz : Australia/Oceania | bric : BRIC Countries | chinaz : Greater China | devgcoz : Emerging Market Countries | dvpcoz : Developing Economies | easiaz : Eastern Asia | namz : North America

PUB Fairfax Media Management Pty Limited

AN Document AFNR000020140915ea9g0002l