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The good and the bad

Verbier

One way of looking at events in China over the past week is that the mainland authorities have put a 'put' under the stock market. This is because the China Securities Regulatory Commission (CSRC) rules to tighten margin financing issued on Friday, as well as to prohibit OTC margin financing and umbrella trusts, were followed Saturday afternoon by a CSRC press release stating that the measures were not meant to kill the market and then by a 100bp reserve requirement cut on Sunday afternoon. The result is that the A and H share markets did not suffer the panic sell off on Monday that looked likely on Friday night when global stock markets sold off in response to the margin tightening news from China.

Still in *GREED & fear*'s view it is an exaggeration to say that the Chinese authorities' actions amount to a Greenspan or Bernanke style 'put' under the stock market, as some have suggested. Rather the authorities are trying to prevent the inflation of what would be an ultimately destabilising A share bubble, while maintaining a constructive stock market since there is no doubt that there are a lot of companies, including the banks, that need to raise capital. Since the banks are not allowed to raise equity at below book value that suggests H share bank stocks need to trade at 1.2x book to take into account the discount required for an equity issue. At the moment the big banks' H shares are trading at 1.0-1.1x book.

Still if it is in the interests of the authorities for the market to trade higher, it is also only common sense to regulate margin financing and related leveraged equity products. Indeed this is the second wave of prudential controls announced in this latest A share bull market. The first was introduced last December after margin financing outstanding rose to Rmb900bn. Since then the margin financing balance has risen to Rmb1.73tn, up 70% year-to-date and five times since the start of 2014 (see Figure 1). As for OTC margin financing and umbrella trusts, a lot of banks have provided credit to such umbrella trust products to buy A shares on leverage since 4Q14. China Reality Research (CRR) analyst Lei Chen estimates that between Rmb600bn to Rmb1tn has been invested in such umbrella trust products.

Figure 1
China total margin financing outstanding

Source: WIND

If the desire to cool down the stock market without killing it is understandable, amounting to a careful balancing act, the cut in the reserve requirement ratio was not driven by the stock market. Rather it was the consequence of the just released evidence that there were capital outflows out of China last quarter for the third consecutive quarter. Thus, foreign exchange

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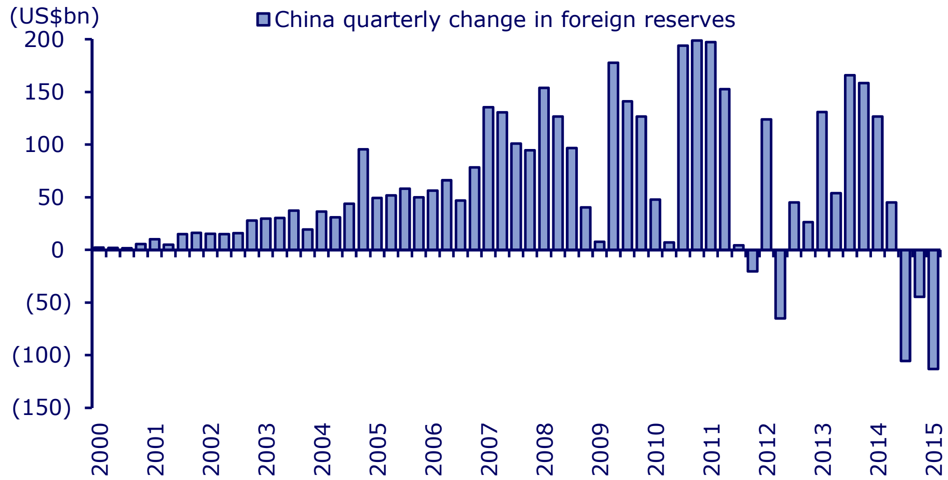
reserves declined by US$113bn in 1Q15 to US$3.73tn at the end of March, following a US$45bn drop in 4Q14 and a US$106bn decline in 3Q14 (see Figure 2). Interestingly, this data was released on 14 April, five days before the reserve requirement cut.

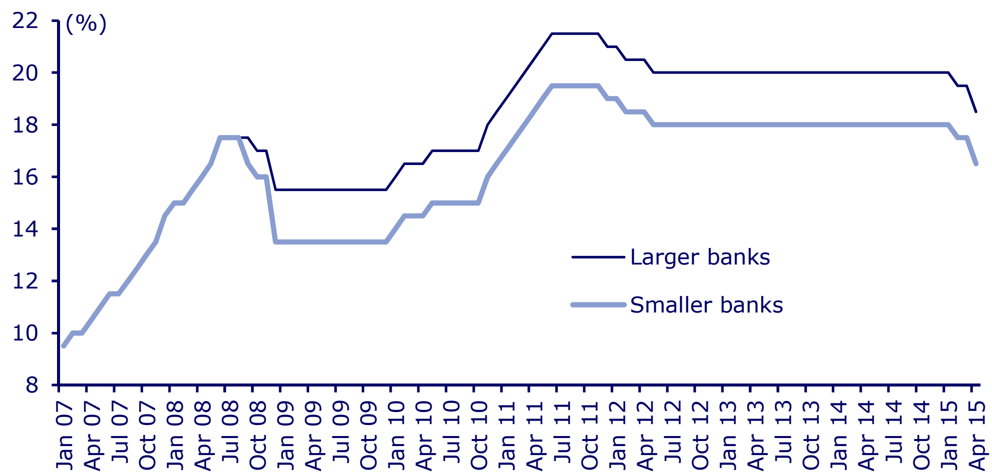
Figure 2
China quarterly change in foreign reserves



Source: CLSA, CEIC Data, PBOC

So, in this sense, the cut in the reserve requirement ratio was less an easing than an offsetting of the liquidity contraction that is the consequence of capital outflow. And if the capital outflow continues in coming quarters it seems almost inevitable that there will be further reserve requirement cuts. After all the reason the RRR reached the peak of 21.5% for the large banks in 2011 was precisely to offset the impact of hot money capital inflows. The RRR is now 18.5% for large banks (see Figure 3).

Figure 3
China reserve requirement ratio (RRR)



Source: CEIC Data, PBOC

Meanwhile, the latest credit data has provided further evidence of the need to ease monetary policy. Deposit growth has continued to slow as has M2 growth. Renminbi deposit growth and M2 growth slowed from 10.9%YoY and 12.5%YoY in February to 10.1%YoY and 11.6%YoY respectively in March (see Figure 4). This is also why cuts in interest rates so far have been asymmetric since the authorities want to encourage deposit growth. Meanwhile, on the lending side, bank lending is accounting for a growing proportion of total credit extended, otherwise known as 'social financing', as pressure has increased to bring off-balance sheet lending back on balance sheet. Thus, new renminbi bank lending accounted for 78.4% of social financing volume in 1Q15, up from 53.5% in 1Q14 and 59.6% for the whole of 2014. Still in aggregate

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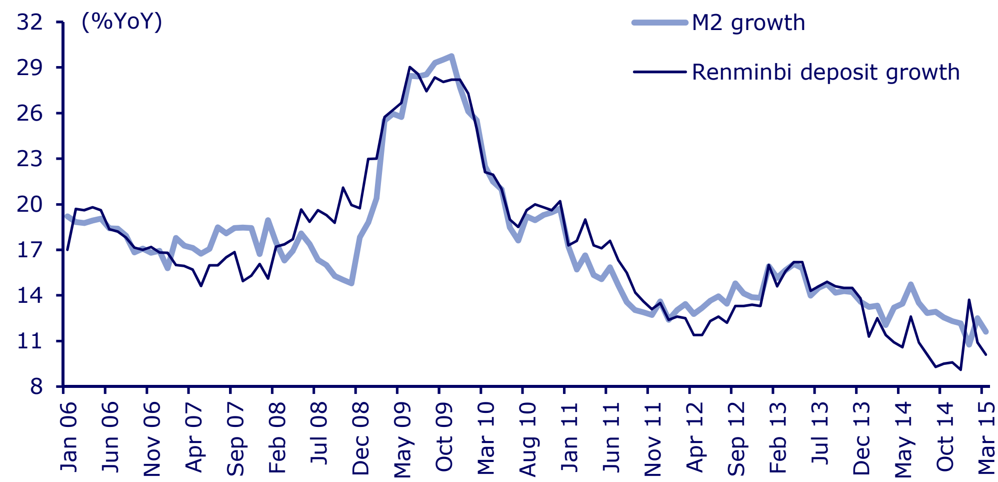
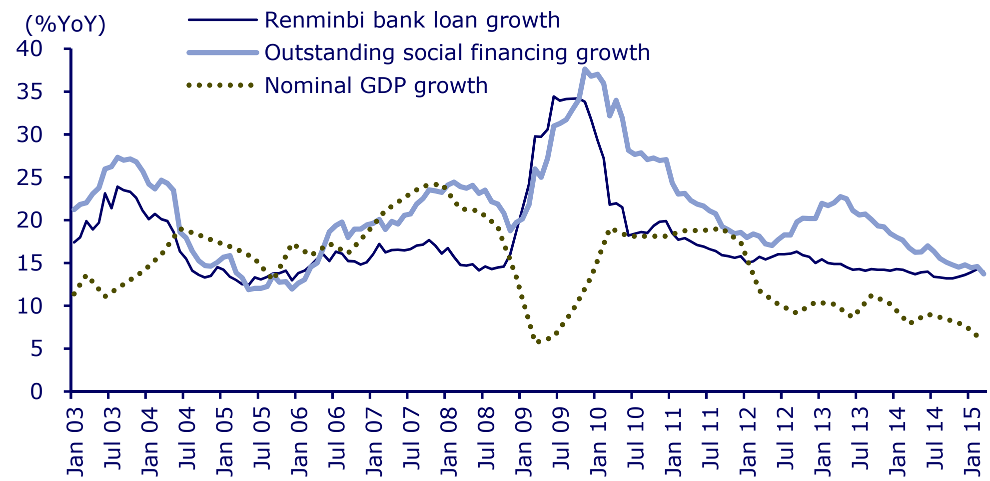
social financing is now growing at the slowest rate in nine years. But it is still running well above nominal GDP growth since nominal GDP growth itself continues to slow. Indeed last quarter nominal GDP growth was actually below real GDP growth. Thus, total social financing outstanding growth slowed from 14.6%YoY in February to 13.7%YoY in March, while renminbi bank loan growth slowed from 14.3%YoY to 14%YoY (see Figure 5). This is the first time since 2009 that total social financing has risen at a slower pace than renminbi bank lending. As for economic growth, China nominal GDP growth slowed from 7.7%YoY in 4Q14 to 5.8%YoY in 1Q15, while real GDP growth decelerated from 7.3%YoY to 7.0%YoY over the same period.

Figure 4
China M2 growth and renminbi deposit growth



Source: CLSA, CEIC Data, PBOC

Figure 5
China credit growth and nominal GDP growth



Source: CLSA, CEIC Data, PBOC

All this is evidence that the Chinese economy continues to slow, and most particularly the investment side of China. Still the trillion dollar question remains whether this will feed negatively into the seemingly still healthy consumption and service sector side of China with resulting negative consequences for employment. For now *GREED & fear* will continue to give this 'good' side of China the benefit of the doubt supported as it is by still strong real income growth. Thus, real urban and rural disposable income per capita rose by 7%YoY and 8.9%YoY respectively in 1Q15 (see Figure 6).

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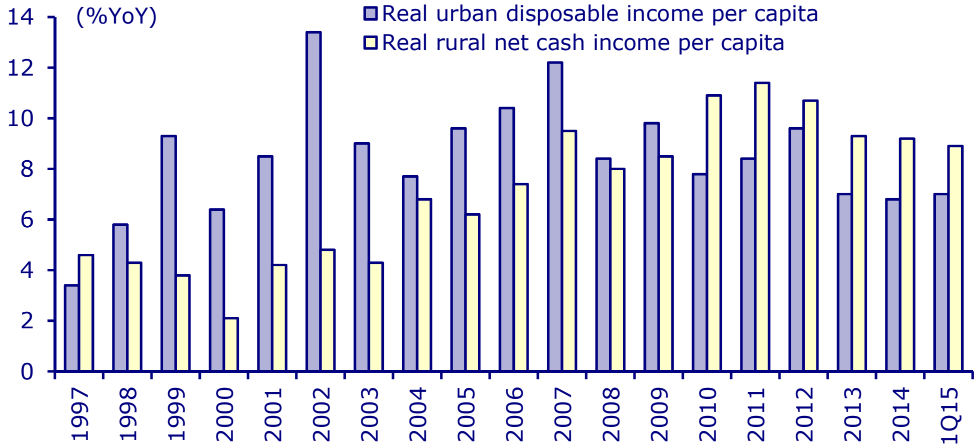
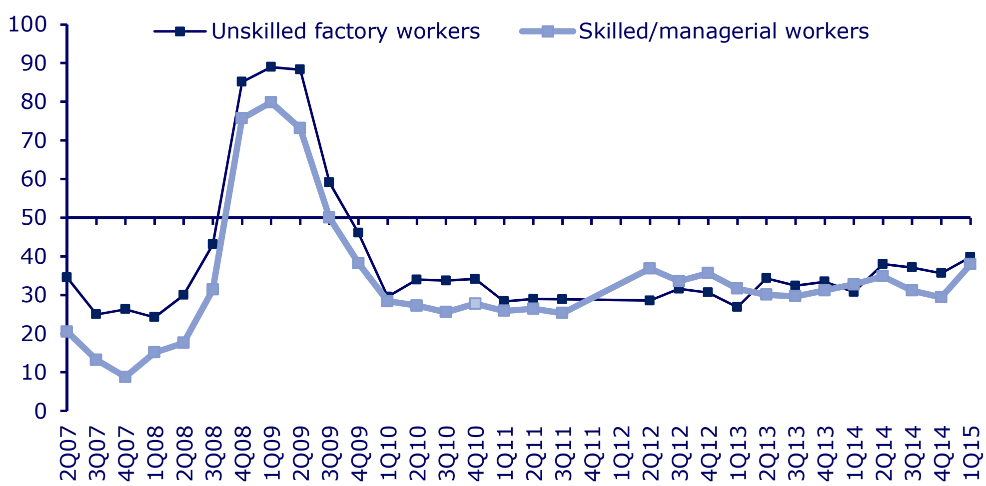
Figure 6
China real urban and rural disposable income per capita growth



Source: CLSA, CEIC Data, National Bureau of Statistics

Still the situation has to be watched closely given the clearly negative trend in the 'bad' side of the economy reflected in intensifying PPI deflation. The latest CRR SME quarterly report provides some warning signals in the sense that the CRR unemployment index ticked up last quarter (see CRR report *SME Quarterly: Worsening*, 19 April 2015). Still the index remains far below crisis levels. Thus, the CRR SME unemployment index for unskilled factory workers and skilled/managerial workers rose from 35.6 and 29.4 respectively in 4Q14 to 39.8 and 38 in 1Q15, the highest levels since 4Q09 (see Figure 7). But this is still way below the peak of 89 and 79.8 reached in 1Q09. Meanwhile, financing costs are falling for the SMEs with CRR's bank lending index having bottoming out in 1Q14 and rising sharply last quarter. Thus, the CRR SME bank lending index, a diffusion index measuring SMEs' access to bank loans, bottomed at 22.1 in 1Q14 and was up from 32.7 in 4Q14 to 45.8 in 1Q15, the highest level since 4Q09 (see Figure 8).

Figure 7
CRR SME Unemployment Index



Source: China Reality Research (CRR)

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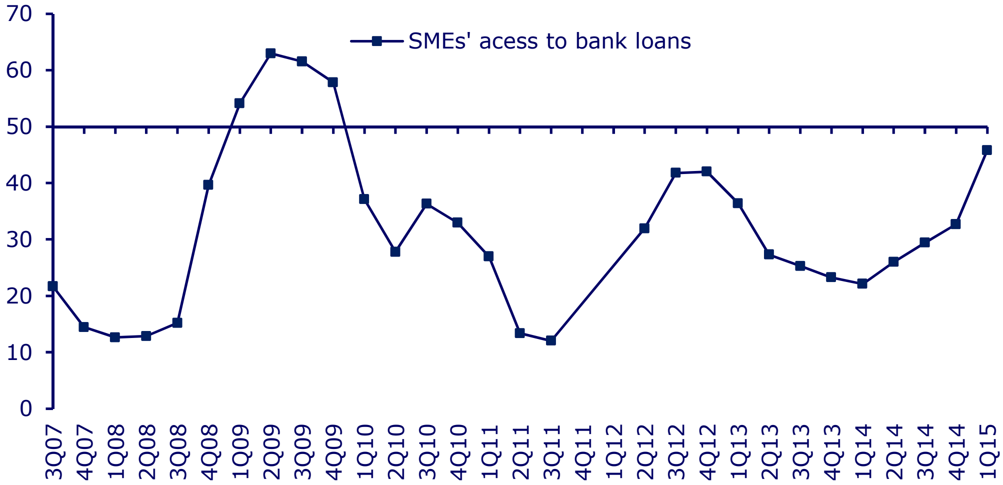
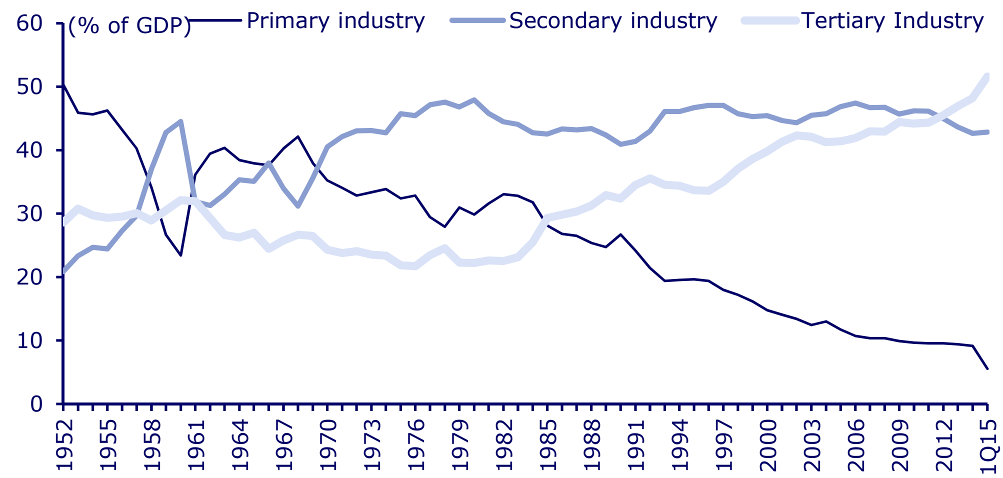
Figure 8
CRR SME Bank Lending Index



Source: China Reality Research (CRR)

Another positive is that the residential property market in the biggest cities is already showing some positive reaction to the more aggressive than expected property easing measures announced last month. Thus, residential transactions in tier-1 cities rose by 59.9%YoY last week, according to the China Real Estate Index System (CREIS). Remember that on 30 March the PBOC reduced the second-home downpayment requirement from at least 60% to just 40%. The downpayment for first-time buyers using pension fund was also lowered from 30% to a minimum of 20% (see CLSA research *China Property – Aggressive support*, 31 March 2015 by regional head of property research Nicole Wong).

Figure 9
Share of China nominal GDP



Source: CLSA, CEIC Data, National Bureau of Statistics

What does all the above mean for the China story and for investors in China stocks? In *GREED & fear*'s view investors should continue to give the benefit of the doubt to Beijing policy makers in terms of their ability to manage the transition from investment to consumption driven growth. Indeed last quarter's GDP data provided further evidence of this transition. Thus, the share of nominal GDP in the tertiary sector, including services, wholesale and retail trade, financials and real estate, rose from 48.2% in 2014 and 49.8% in 1Q14 to a record 51.6% in 1Q15 (see Figure 9). By contrast, the secondary sector's share, including manufacturing and construction, declined from 44.5% in 1Q14 to 42.9% in 1Q15.

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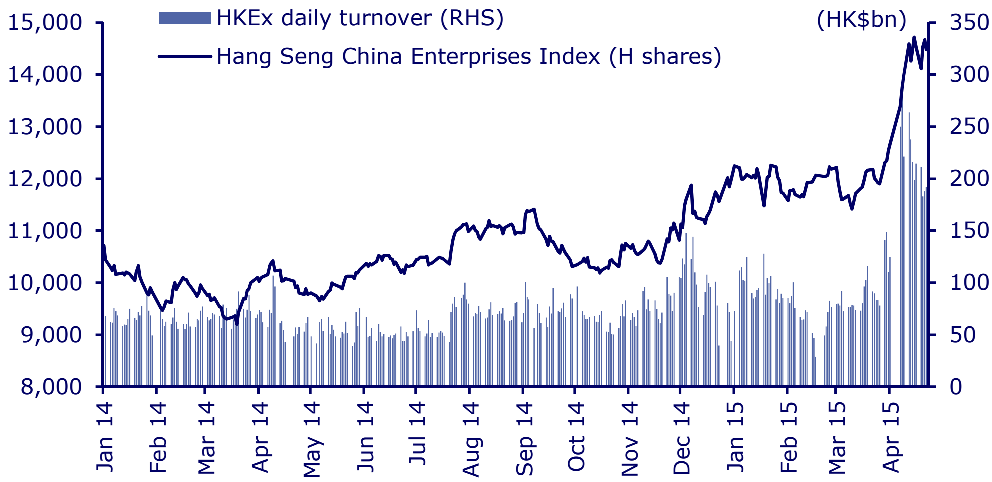
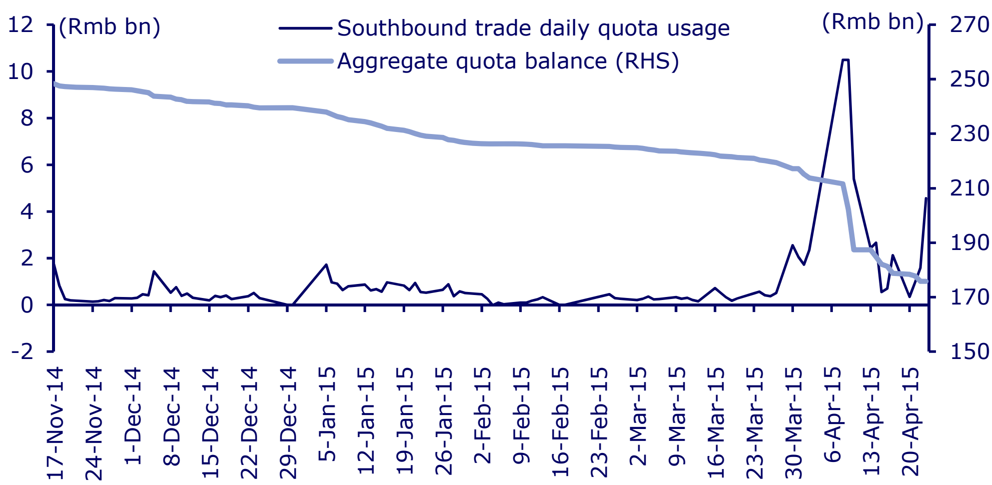
As for the stock market, *GREED & fear*'s Overweight in MSCI China has now become only a marginal Overweight (see Figure 24) as a result of the 16.2% rally in H shares in seven trading days between 8-16 April, a period which has seen average daily turnover in Hong Kong running at HK$240bn (see Figure 10). While this rally was undoubtedly sparked by the relaxation of rules concerning mainland institutional investors' ability to invest in H shares, there is no doubt that there has been a huge amount of catch-up buying by benchmark orientated investors who found themselves too underweight China. This can be seen in the fact that the daily southbound quota of Rmb10.5bn has only been filled in two of the past 11 trading days (see Figure 11).

Figure 10
Hang Seng H share index and Hong Kong Stock Exchange daily turnover



Source: CEIC Data, HKEx

Figure 11
Shanghai-Hong Kong Stock Connect Southbound trade daily quota usage and aggregate balance



Source: CLSA, Bloomberg

The most likely outcome now for H shares is an extended consolidation followed by another upward move before the China equity story is swamped by a wall of paper. But for now the best reason to own H shares is the continuing significant discount to A shares and the fact that H share quoted bank stocks have still not reached that 1.2 times book level, combined with the fact that many benchmark investors are probably still underweight MSCI China. Thus, A shares are still trading at a 30% premium to their H share counterparts (see Figure 12).

GREED & fear will for now maintain the current country asset allocation to China. Meanwhile, the big underweight is maintained in Australia which remains the economy most geared to the 'bad' side of China.

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Figure 12
Hang Seng China A/H Premium Index

Source: Bloomberg

It remains remarkable to *GREED & fear* how little comment has been provoked by the "Alice in Wonderland" world financial markets have now entered in terms of negative interest rates. The BIS estimated at the end of February US$2.4tn of global long-term sovereign debt was trading at negative yields (see *BIS Quarterly Review*, March 2015). Of that total more than US$1.9tn had been issued by euro area sovereigns, which is no surprise since it was Derivative Draghi's stated willingness in January to buy negative yielding bonds which precipitated the move into negative yields as bond traders have looked to front run the ECB.

The race to zero and beyond has only gathered momentum since with even the IMF's SDR, the chosen vehicle for Beijing to transition the renminbi to reserve currency status, only yielding 5bp at the three-month maturity (see Figure 13). As Claudio Borio, head of the BIS Monetary and Economic Department, stated at a media briefing to introduce the latest BIS quarterly review report in March, "If this unprecedented journey continues, technical, economic, legal and even political boundaries may well be tested".

Figure 13
IMF SDR interest rate

Source: IMF

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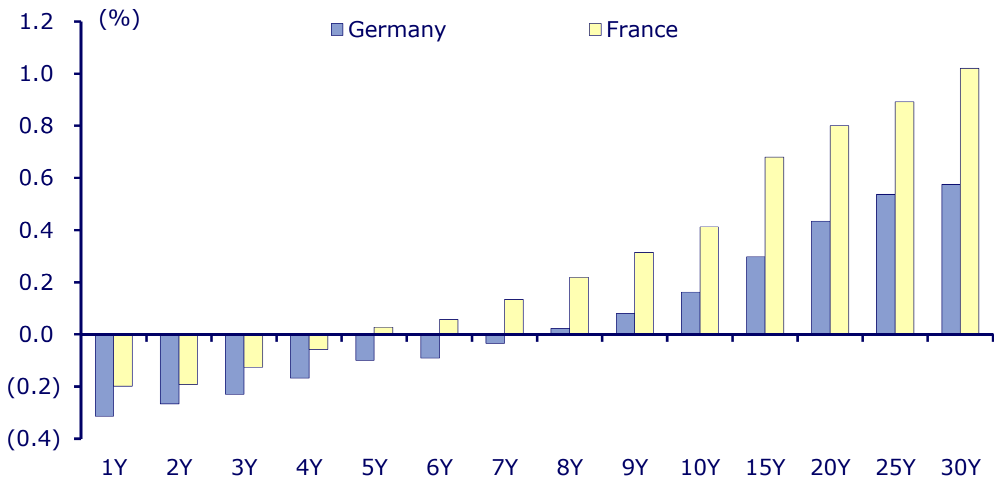
Figure 14
Germany and France government bond yield curves

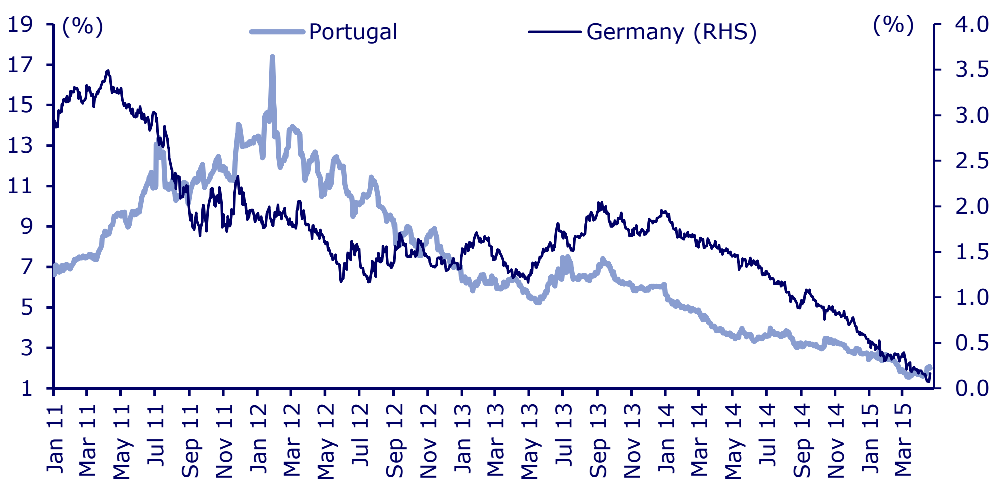


Source: Bloomberg, CLSA

If this is indeed the point, most market participants are simply focused on front running ECB buying since most bond yields have not yet reached the minus 0.2% level at which the ECB has stated it would stop buying. For example, the five-year German bund yield and French bond yield are still at -0.10% and 0.03% respectively (see Figure 14). Remember the ECB has stated that "purchases of nominal marketable debt instruments at a negative yield to maturity are permissible as long as the yield is above the deposit facility rate" which currently stands at minus 0.2%.

And Derivative Draghi certainly did nothing at his press conference last week to give any sign that the collapse in yields was overdone. Indeed, he did the exact opposite. Thus, Draghi said, "so far we have not seen evidence of any bubble (in the bond markets) … To ask about scarcity in the bond market is really premature". This is why the 10-year German bund only yields 16bp and why the Portuguese equivalent only yields 2.0% (see Figure 15), even though Portugal had aggregate debt of 359% of GDP at the end of 3Q14 (see Figure 16).

Figure 15
Germany and Portugal 10-year government bond yields



Source: Bloomberg

Still there are real practical issues raised by the race to zero and beyond which *GREED & fear* and doubtless many others are only just starting to get their heads around. One of the most interesting studies *GREED & fear* has seen so far was a report published by Swiss Re late last month titled "*Financial repression: The unintended consequences*". It is no surprise that the report, which is a studiously polite critique of unconventional monetary policies and resulting

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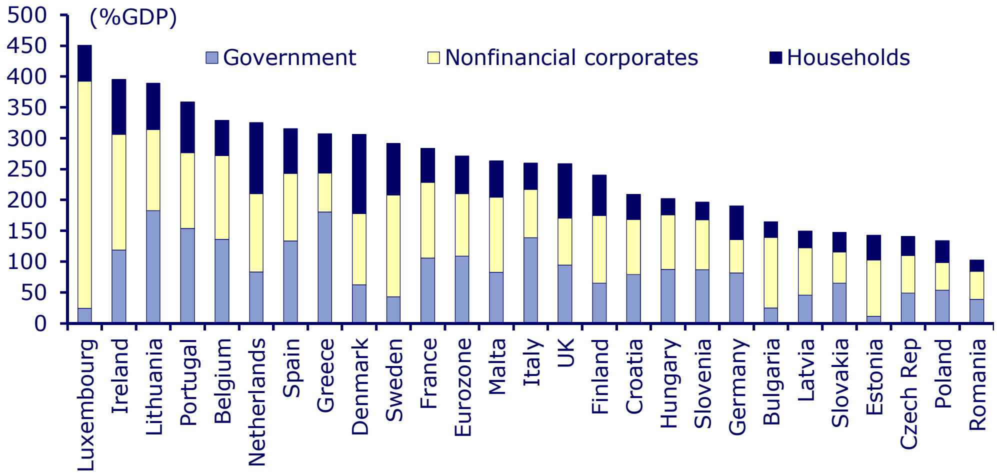
negative rates, is written by an insurance company. This is because insurance companies and pension funds will be the institutions most negatively impacted if negative bond yields persist. As the report notes, life insurers have struggled in recent years to meet their guaranteed rates even though the guaranteed life insurance credit rate has declined. It is now about a positive 2.5%. The Swiss Re report argues that had government bonds been trading closer to their "fair value", this would have translated into between US$20-40bn additional income for *both* American and European insurers given insurance companies' typical 50-60% allocation to fixed income assets in a portfolio.

Figure 16

European countries' total debt as % of GDP (End 3Q14)



Source: Eurostat

The report also notes that a one percentage point additional "running yield" would translate into an additional US$40-50bn per annum annual income for pension funds. Pension funds tend to have a smaller allocation to fixed income than insurance companies but the asset base is larger, in terms of the amount they manage. The pending problem of the Swiss pension system, courtesy of negative rates, was a subject of an article in the pinko paper's fund management supplement on Monday (see *Financial Times* article "*Swiss pensions 'bankrupt in 10 years'*", 20 April 2015 by Madison Marriage). This quoted one pension fund consultant as saying that some pension funds have considered extreme options such as depositing bank notes in bunkers or safes!

The Swiss Re report also estimates how much interest income has been foregone by American households if it is assumed that the Fed had simply followed the Taylor rule in terms of setting the level of short-term interest rates. It puts this at US$470bn since the global financial crisis net of lower financing costs. This, however, is a small number compared with the US$9tn increase in American households' stock market wealth since 2008 (see Figure 17). Still Swiss Re is sceptical of the alleged benign "wealth effect" of QE for the same reason long argued by *GREED & fear,* namely that only the very wealthy tend to be heavily geared into the stock market. The result, as the report notes, is "aggravated economic inequality". Thus, the report estimates, by assuming that US savers have on average profited from a 100% appreciation of their equity portfolios during the 2009-2013 period, that the wealthiest 1% of US households have an average gain of US$3.7m from the equity rally since 2009 equivalent to 50% of their total financial wealth. While the bottom 90% of households only registered a gain of US$7,300 or 12% of financial wealth (see Figure 18).

Meanwhile, as for the regular person with a bit of capital invested for retirement, the ultra-low interest rates mean more needs to be saved not less. This may help explain why the American savings rate has risen so far this year despite the lower oil price. The US personal savings rate

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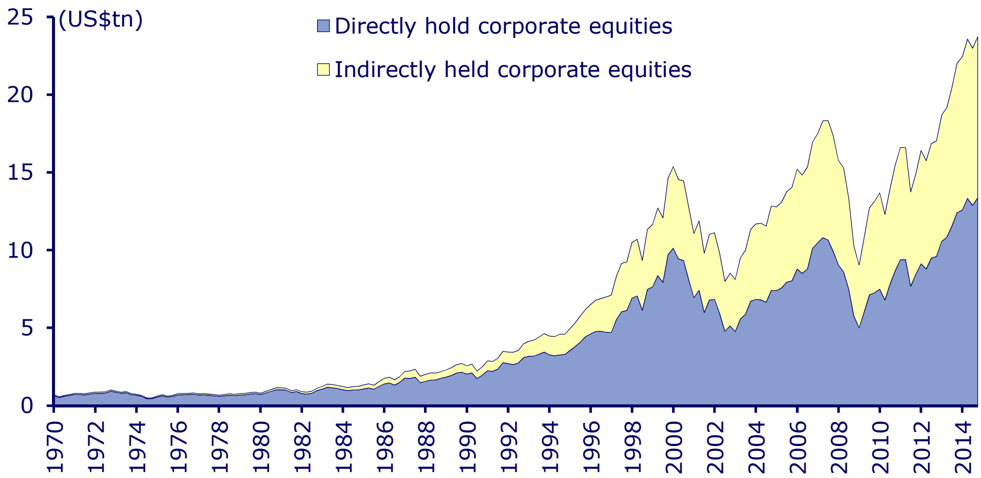
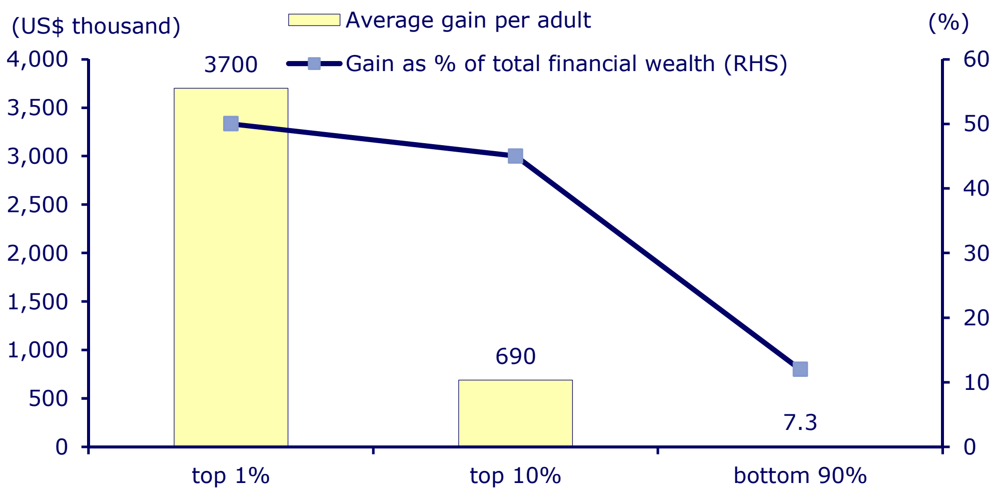
has increased from a recent low of 4.4% of disposable income in November 2014 to 5.8% in February (see Figure 19).

Figure 17
US household assets in corporate equities



Source: Federal Reserve

Figure 18
Average gains from the 2009-2013 equity rally in US household portfolio (per adult)



Note: Assuming US savers have profited from a 100% appreciation; ignoring legacy holdings. Source: Swiss Re

Figure 19
US personal savings as % of disposable income

Source: US Bureau of Economic Analysis

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The Swiss Re report is an interesting development since it marks a prominent establishment institution starting to break ranks with the policymaking consensus of the Davos crowd. But it also contains an interesting proposal for a tradable global infrastructure asset class. Swiss Re notes correctly that such an asset class would unlock the long-term investor asset base, which it estimates at around US$75tn globally, while also serving as a "disciplining instrument" for governments when considering policy or regulatory changes on infrastructure projects (e.g. in the emerging market space arbitrarily cutting power tariffs or road tolls).

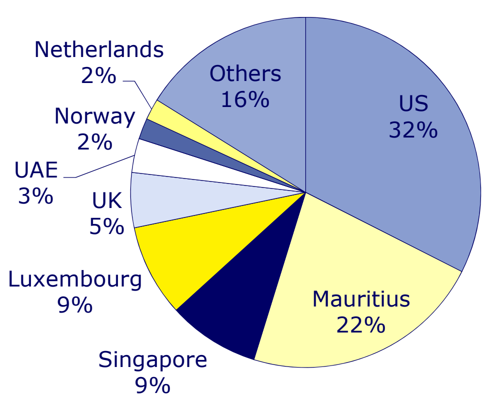
To *GREED & fear*, this raises a very pertinent issue. Long-term investors with long-term asset-liability issues, such as insurance companies, are the perfect entities to be investing in infrastructure while large parts of the world clearly need infrastructure. *GREED & fear* has been amazed that not more has been done during the Obama administration to kick start infrastructure given the anaemic economic growth in the US and the mostly subpar at best condition of American physical infrastructure. While Asia's infrastructure needs have received a lot of attention of late with China's highly effective marketing of the Silk Road Fund and the Asian Infrastructure Investment Bank, not to mention "One Belt One Road"! (see CLSA research report *ChinaOpps – A brilliant plan*, 1 April 2015 by head of China-HK strategy Francis Cheung).

Swiss Re puts the global economy's infrastructure needs at US$50-70tn through to 2030. While *GREED & fear* heard a presentation on Asian infrastructure spending last week that estimated Asia spending on new infrastructure at around US$700bn per year for the next five years with China and Silk Road countries accounting for about US$300bn of them, India US$200bn and Asean about US$150bn.

Governments and multilateral finance organisations are expected to provide over 75% of the funding. But the degree to which the private sector can participate will hinge, most particularly in the "emerging" world, on the degree of regulatory certainty. Swiss Re is surely correct that a transparent and tradable asset class would result in a huge improvement from the current status quo. The insurance company's proposal envisages, among other things, the creation of pools with projects from similar industries, thereby providing diversification, and also standardised reporting and debt documentation terms.

Back in Asia, *GREED & fear* is still a believer in the Indian story. But there has been some unhelpful noise of late in terms of retrospective tax claims levied on foreign institutional investors as regards notices to pay Minimum Alternate Tax (MAT). This is a tax which is applicable on short and long-term capital gains and interest income, and the potential tax liability could go back as far as FY09.

Figure 20
FII / FPI in Indian equities by country of domicile as of Feb-15



Note: Based on foreign portfolio investors' asset under custody (AUC). Source: CLSA, CDSL

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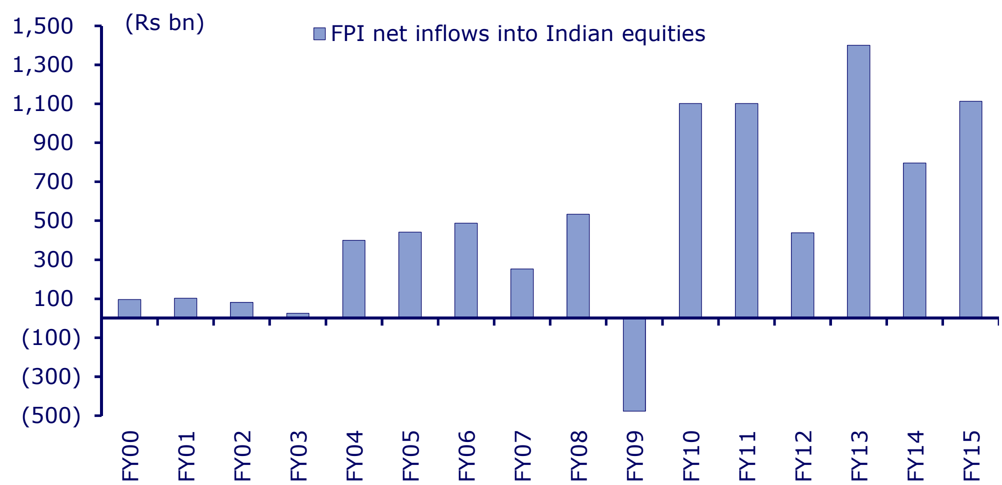
This issue is discussed in more detail in a research note published this week by CLSA's Indian strategist Mahesh Nandurkar (*India strategy – Tax menace*, 19 April 2015). While it is certainly an unhelpful development, and a reminder of Vodafone's problem with the issue of retrospective taxes in India, the tax claims have so far been confined to funds which are not domiciled in the so-called "treaty countries" such as Mauritius, Singapore and Netherlands. About one-third of Indian specialist funds are domiciled in these "treaty countries" (see Figure 20). It is also the case that the market impact of these tax claims has been limited because it is assumed, probably correctly, that the issue will be resolved in a legal process that could take years. That is if Indian Prime Minister Narendra Modi does not try to address the issue in a more proactive manner. His Finance Minister, Arun Jaitley, has for now unhelpfully stressed the need to observe the legal due process. Meanwhile, the good news is that the 2015 budget, the first under Modi, made it clear that FIIs do not have to pay MAT on capital gains from April 2015 onwards.

It would certainly seem to make little sense to do anything to deter foreign investor interest with foreign investor buying up 40%YoY in the fiscal year which has just ended. Thus, foreign investment in Indian equities rose from Rs797bn in FY14 to Rs1.11tn in FY15 ended 31 March (see Figure 21). While FII ownership was also at an all-time high of 20.7% at the end of 2014 (see Figure 22). This also comes at a time when the current earnings season in India has been relatively disappointing reflecting the fact that there remains a lack of evidence of a cyclical pickup in earnings growth. CLSA's Indian office expects a 6%YoY decline in earnings in the March 2015 quarter for the CLSA India universe of 111 companies under coverage, the worst seen in nine quarters. Earnings growth for pure domestic plays are something better at 4%YoY growth but it is still the worst in five quarters (see Figure 23 and CLSA research *India strategy – 4Q to bring earning cuts*, 8 April 2015).

Figure 21
Trend in annual net FPI inflows into Indian equities



Source: CLSA, CDSL

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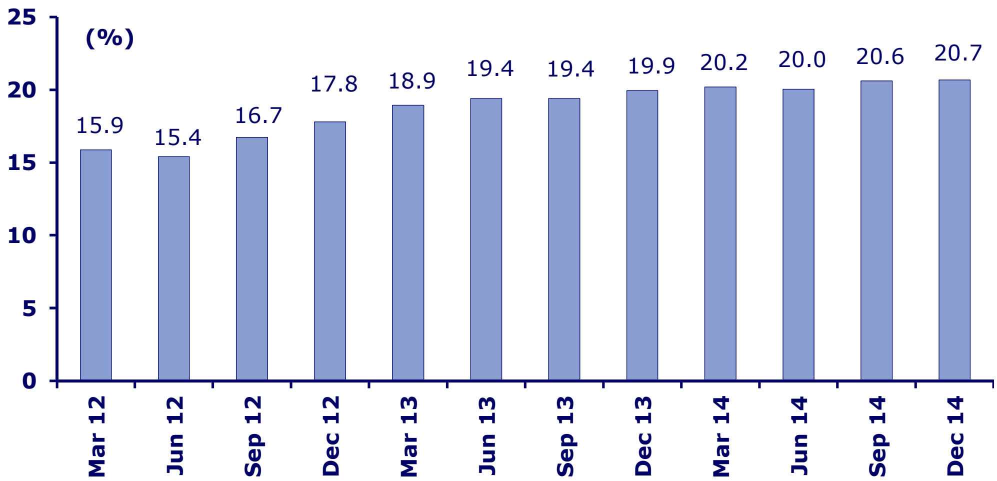
Figure 22

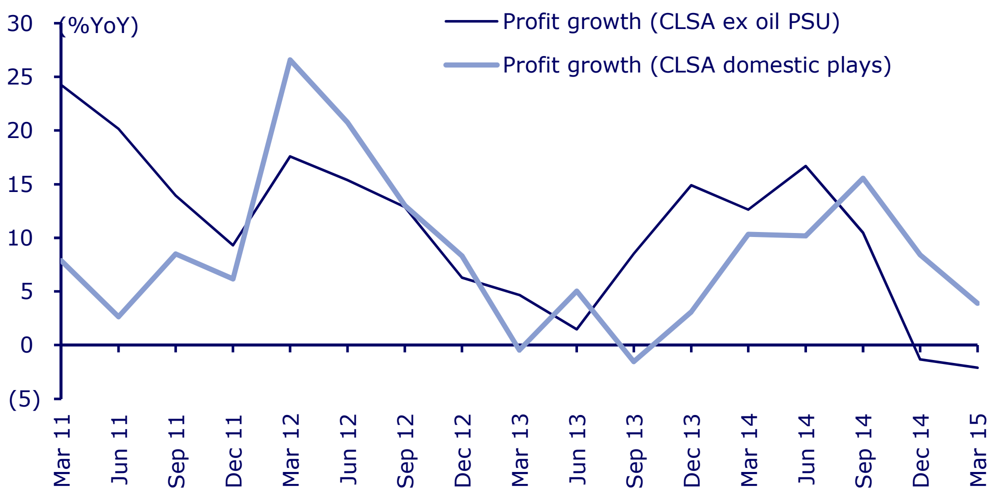
FII ownership in Indian equities, excluding ADRs and GDRs



Source: CLSA, Bloomberg, ACE Equity

Figure 23

CLSA India universe quarterly earnings growth



Note: Forecast for March 2015 quarter. Source: CLSA

Figure 24

CLSA Asia Pacific ex-Japan asset allocation and current benchmark weightings

	MSCI AC Asia Pacific ex-Japan weightings 31-Mar-15	CLSA recommended weightings 31-Mar-15	Mismatch from current benchmark	*Current benchmark weightings (22-Apr-15)*
Australia	22.4%	9.0%	-13.4%	*21.3%*
China	21.3%	24.0%	2.7%	*23.6%*
Hong Kong	9.6%	4.0%	-5.6%	*9.8%*
India	6.9%	19.0%	12.1%	*6.4%*
Indonesia	2.5%	4.0%	1.5%	*2.4%*
Korea	13.8%	14.0%	0.2%	*13.9%*
Malaysia	3.3%	1.0%	-2.3%	*3.2%*
New Zealand	0.4%	0.0%	-0.4%	*0.4%*
Philippines	1.3%	7.0%	5.7%	*1.2%*
Singapore	4.5%	2.0%	-2.5%	*4.4%*
Taiwan	11.8%	11.0%	-0.8%	*11.3%*
Thailand	2.2%	3.0%	0.8%	*2.2%*
Vietnam	--	2.0%	2.0%	*--*
Total	100.0%	100.0%	--	*100.0%*

Source: CLSA, MSCI

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