CHINA AND THE CRISIS NARRATIVE

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For a little more than a decade, China has been at or near the center of investors' hopes and fears. The mix of its spectacular growth, scale, unorthodox policy and limited transparency has made it easy to believe a variety of well-told, fear-inducing narratives. Yet, while the crisis narratives persist in the mainstream, investors have found it counterproductive to position for anything more than just a modest negative adjustment in the Chinese economy and related assets. We do not think it is time for this to change and expect more of the same: high and steady, but then gradually slowing, growth rates.

This past summer, two well publicized narratives aligned with momentary price action to cause many EM investors to ask, "Is this the big one?" Our short answer at the time was, "No, China is different." Yes, the growing debt stock is large. Yes, the off-balance sheet leverage from so-called wealth management products is large. However, China remains a planned economy with massive savings where domestic asset prices more accurately reflect government policy mandates than economic fundamentals.

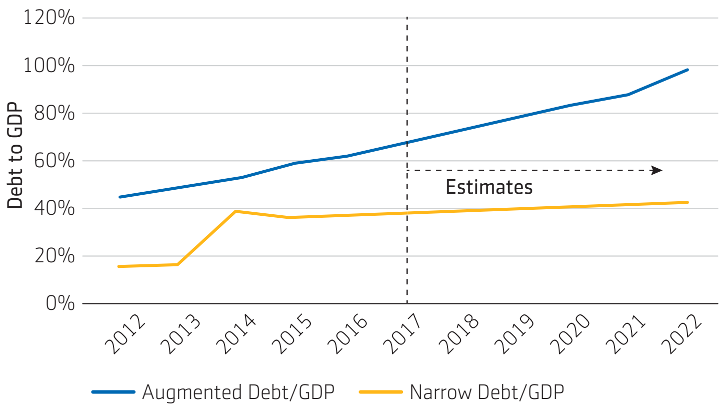
China has gone through three notable phases of economic growth, all of which were planned:

- **Phase 1: Mercantilist export-based,** with the notable side effects of extreme reserve accumulation and current account surpluses, and an economy with a relatively miniscule growth contribution from domestic consumption and no internal leverage.
- **Phase 2: Domestic investment-based,** driven by large fixed capital/real estate projects with notable side effects of increased public sector leverage, inefficient allocation of capital and zombie companies.
- **Phase 3: Domestic consumption and services-based,** driven in part by a stronger currency. This involved a large rebalancing of the economy internally and externally with new sources and demand to financially intermediate the massive private savings to the new private consumers.

The end result of these transitions is a services-led economy with high growth, low inflation, enormous savings, large public-affiliated debt, and lightly regulated financial products. This is certainly not an optimal situation as the economy is susceptible to an accident in the over-levered, lightly regulated segment. However, our view is that China has the means to absorb these issues without substantial damage to its target.

Central government debt-to-GDP is roughly 20%, which is a minor amount when the savings rate is 45% of annual GDP. Including both official and un-official local liabilities, debt-to-GDP is roughly 60% (Exhibit 1). While these are larger amounts, China can hold higher debt loads than its peers because of its structurally higher savings rate.

Exhibit 1: China debt-to-GDP (%)



Source: International Monetary Fund data and estimate
Data from IMF 2017 Article IV Report published August 8, 2017.

Augmented fiscal data expand the perimeter of government to include local government financing vehicles and other off-budget activity. Official government debt (narrow definition). Estimates of debt levels before 2015 include central government debt and explicit local government debt. The large increase in general government debt in 2014 reflects the authorities' recognition of the off-budget local government debt borrowed previously. The estimation of debt levels after 2015 assumes zero off-budget borrowing from 2015 to 2021.

The more shocking debt figures are from quasi-sovereign and government-related private enterprises, which amount to 150% debt-to-GDP. Both are assumed to be agents of the central government and, as such, losses would fall to the central government's balance sheet.

Recent International Monetary Fund estimates forecast nonperforming loans (NPL) of 7%. However, if we are more aggressive and assume NPLs of 20% and a 50% recovery rate, the central government can absorb those losses via a debt swap that will increase central government debt-to-GDP to between 70-80%. From a policy perspective, the swap is straightforward until losses require either a fiscal adjustment or a change in FX (monetary) policy, which we suspect they wish to avoid because of the knock-on effect to planned growth.

The weak link in the Chinese economy appears to be an outgrowth of the third phase of development—namely the proliferation of wealth management products (WMP). WMPs are essentially bank workarounds to regulations that were developed during China's domestic investment-based phase as a means to control loan and credit growth.

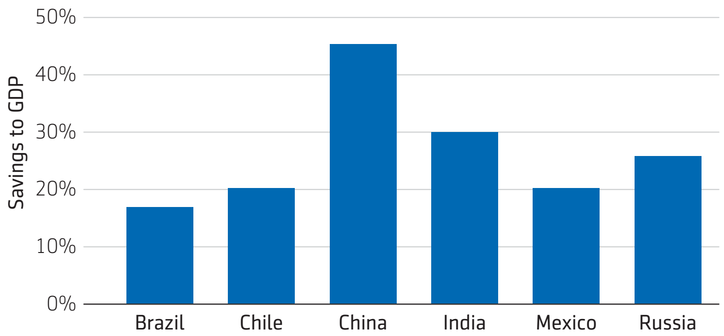
WMP interest rates are not regulated, are reported off-balance sheet, and society has assumed an institutional guarantee. As such, they are attractive to borrower and lender but not to the government. WMP losses that are not back-stopped by local or central government balance sheets could cause wide-spread credibility issues for the product, and potentially a run on one or all providers. Ultimately, we expect the central planners will be forced to offer enough guarantees to maintain confidence in the system while they target new regulations to quickly reduce or eliminate WMP growth.

Presently, China has a formal loan-to-deposit (LTD) ratio of about 75%. However, including WMP and other informal sector wholesale funding, the ratio is closer to 100%, which is about 15 percentage points higher than when the formal cap was eliminated during the tail end of the second phase of development in 2015. Relative to peers, China's LTD is higher than average. Should the ratio climb much higher, it could expose the country to a violent credit contraction. It is not the absolute level of loans-to-deposits that concerns us, however, but the pace of buildup during the last few years.

This brings us back to the stories of China's imminent demise. This past summer, the WMP market faced increased regulatory scrutiny. In response, China's renminbi-denominated corporate and government bond yields rose rapidly. More acutely, stock prices fell for financial institutions heavily involved in WMP products.

China continues to save an enormous amount of GDP each year and the financial system as a whole is lending to the rest of the world (Exhibit 2). These are simple but important indicators that there is plenty of capacity to absorb losses and maintain its currency policy. The reaction to WMP this summer also suggests we are firmly in the domestic consumption and services-based phase of economic growth, and policymakers may have less tolerance for credit expansion to maintain growth.

Exhibit 2: Gross national savings as a percent of GDP (2017 estimates)



Source: International Monetary Fund data
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It is important to reiterate the planned nature of the Chinese economy and the extent to which this caused, in our analysis, regulators and policy leaders to take an inconsistent path through the three transitions as they attempt to maintain high, stable growth while minimizing imbalances. We view these as largely incompatible goals that require investors to taper their growth expectations.

Further, while China appears firmly on the path toward market-based capitalism, they remain far from it. The risk of expected investor loss is not fully reflected in market prices, as it would be under capitalism. Until then, we expect the government to absorb volatility as needed. Improved regulations, higher consumption, lower savings, and lower growth are all good, important developments for China, as well as the global economy.

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