China Macro Monday

The Week Ahead (July 10-14) and the Week Behind (July 3-7)

PRC Macro

The focus in China this week may quickly shift back from liquidity risks for financial sector firms to credit risks for real sector borrowers. This could be amplified by market anticipation of the National Financial Conference (NFC), expected to open on July 14, and the near simultaneous PSC mid-year meeting on the economy. As is the case for equities, we see the potential for divergent performance of SOE versus private sector credit (large cap versus small cap), as part of a bias in the reform agenda that clearly favors the state sector. This week we are (again) flagging disinflation risks for China in H2, with another misleading reading for PPI expected this week. The first weak print for PPI may not show up until July, but nominal flows in the economy are not as strong as PPI implies.

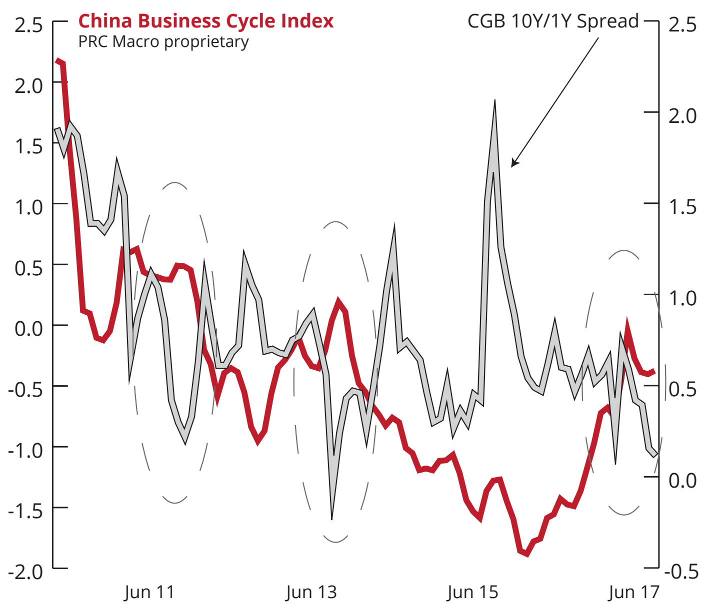
Yield curve steepness is inversely correlated with the phase of the business cycle in China. For example, just as did in June 2011 and June 2013, relative yield curve flatness in China appears to be bottoming out as the cycle is peaking. Related to this is the real interest rate cycle, and historically the PBOC has allowed real rates and yields to peak as the cycle bottoms. This is precisely where we are now: the yield curve is sending highly bearish signals and real rates are close to zero, just as the cycle is rolling over and disinflation is set to accelerate.

NFC Expectations

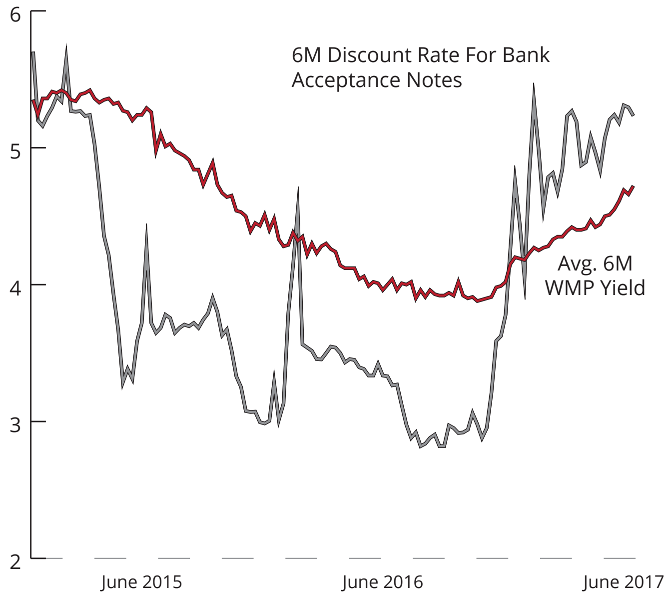
In earlier pieces we have detailed expectations for the NFC, and refer you to **NFC expectations and Debt Restructuring** (July 7) and **The NFC and Policy Bull Market Possibilities** (June 15). We will note, however, that just before the PSC mid-year meeting on the economy in 2016, Beijing published two policy documents which are arguably more relevant today than they were then: first was "Leading Opinions on the Promotion of Central SOE Structural Adjustment and Reorganization by the State Council"; second was "Opinions on Deepening Structural Reforms to Finance and Investment". As is typically the case, these documents did not include quantitative targets, but still read like signals that the pace of SOE financial "reorganization" and debt restructuring was going to increase, as would impulse-style fiscal stimulus. Back then we got the latter, but not the former. These documents were setting the stage for the potential opening of the National Financial Conference in November of last year, which was delayed due to personnel disagreements and a lack of consensus (see: **Politburo Mid-Year Meeting on the Economy**, July 2016 and/or **July 2016 "Opinions" in Financial Sector Reforms**, July 2016).

China 1YR Swap Spreads Signalling a Pessimistic View of Inflation Expectations
percentage points - as of 7/7

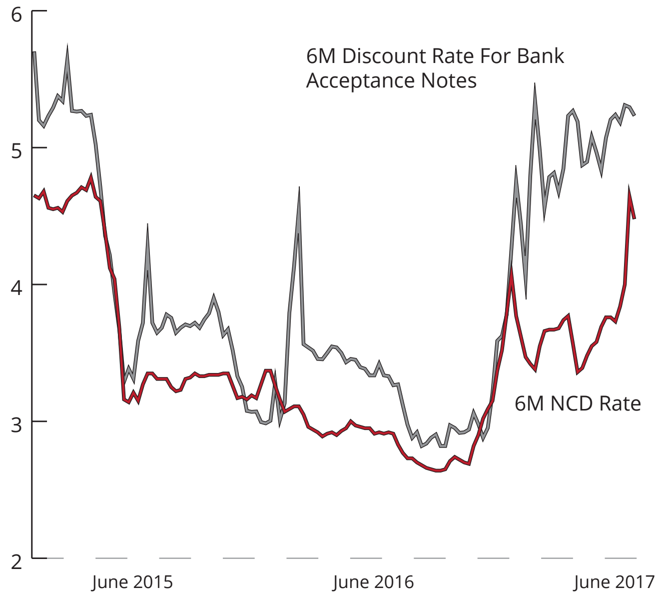
CGB Yield Curve A Predictor of Cyclical Peaks



Borrowing Costs for NBFs and Real Sector Remain High Despite Ample Liquidity
percentage points - as of 7/7



Spread Between Interbank Lending (NCDs) and Real Sector Borrowing Costs Remains Elevated
percentage points - as of 7/7



As a final preparatory step for the opening of the NFC we believe that Beijing has appointed a new chief insurance sector regulator. The likely new CIRC chief is Yang Xiaochao, formerly a vice-mayor of Beijing whose only previous financial sector experience was as the director the Beijing municipal financial affairs office from 2008-2013. Yang's career progression has been 100% dependent on patronage from Wang Qishan, and with him in place at CIRC, this would create the appearance of clear Wang Qishan faction in the financial sector. Recall that Wang is also a main political patron to Guo Shuqing at CBRC and Jiang Chaoliang, the likely successor to Zhou Xiaochuan at PBOC (see: **Rumors and Two Candidates for PBOC Governor**, June 6). It is beyond the scope of this note, but we think such a brazenly partisan appointment could spark a significant technocratic backlash. Additionally, in the context of escalating attacks on Wang Qishan by Guo Wengui and the reality that Wang Qishan has antagonized wide swaths of the bureaucracy with his own power consolidation as the head of the Party inspection apparatus, his expanding influence over the financial sector could increase pressure from the Party elite on Xi Jinping to rein Wang in.

A Shift from Liquidity Risks to Credit Risks

For now, financial market liquidity conditions in China appear to be flush, but there are looming drains on liquidity that could reverse this perception in the coming two-weeks. Perhaps even before this occurs, we will be looking for emerging signs of corporate credit risks as important segments of financing to the real sector continue to contract on year-on-year terms. Market sentiment should thus reflect a return to cyclical credit risks, and away from the recent obsession with interbank liquidity. Among other things, rapidly falling interbank rates reflect a liquidity preference on the part of both banks and non-bank financials (NBF). This has been apparent in an increase to the price and reduction to the volume of credit available to the real sector. This could exacerbate short-term funding stress, which is already rising on both a seasonal and cyclical basis. In recent weeks we have cited the RMB 1 trillion+ reduction to available discount bill financing since CBRC launched its regulatory storm, not to mention a RMB 1 trillion+ reduction to the volume of quasi-fiscal bond issuance compared to a year earlier at the end of June.

Liquidity Recap

In addition to seasonal factors (i.e. interbank liquidity always tends to be loose in the beginning of the first month of each quarter due to reset of monthly loan quotas for banks by regulators), there are a couple of key underlying factors that have made interbank liquidity unusually abundant in the last two weeks (starting from June 20) despite PBOC's net withdrawals via OMO.

Fiscal Fund Disbursement: The last month of each quarter is normally the time for MOF to refund tax revenues back to local governments, and local governments are supposed to spend the refunds. Recall that fiscal deposits are not included in monetary aggregates, so a reduction to government deposits results in an increase to base money. The flip side of this is that when corporates andl local governments remit taxes it (increasing fiscal deposits) it shows up as a withdrawal of liquidity from the system. Corporate tax submissions also occur regularly in the first month of each quarter (April, July and October), meaning more withdrawals of base money, whereas tax disbursements often takes place in the last months of each quarter (June, September and December), which is often associated with a windfall increase for interbank liquidity. It is believed that fiscal spending this June (the disbursement of tax refunds from MOF to local governments) was likely larger than previous years because MOF has been sending inspection teams to urge local governments to initiate their spending more quickly. For instance, MOF published a notice titled "Implementing More Effective Measures to Strengthen the Management of Local Government Deposits" on May 23. According to this add-on to the budget law, local governments are supposed to keep minimal deposits on hand during regular months (except the months for tax submissions to MOF). Ideally, local governments should disperse tax refunds as soon as possible once they are received from MOF. In fact, the monetary effects of increased fiscal disbursement is the only reason that PBOC has specified for its suspension of OMO during the last two weeks.

However, a glaring omission in the central bank's explanation is the fact that banks are withdrawing funds from corporate bill financing and WMPs as the existing stock of asset matures, and are dumping these funds back into the interbank market (and to some extent money market funds), resulting in an abundance of short-term liquidity. ***The reason we think that the fiscal effects cited above will be transitory is that by the end of July local governments and corporates alike will have to submit seasonal tax proceeds, and this could drain anywhere from RMB 650-750 billion from commercial banks.***

MPA Reviews and Market Expectations: The latest MPA reviews in June caused a large distortion to interbank liquidity conditions. This was the second quarterly MPA inspection where the PBOC required a hard cap on its measure of "broad credit growth", which is the M2 growth target +20%. Recall that "broad credit" includes loans, securities investment, interbank assets and lending to NBFs. In early June commercial banks were worried that NCDs would be included in this definition, and NCD rates spiked hard. However, around June 20 banks were informed that NCDs would be exempted from the cap for another quarter, and rates began to come down. It is still unclear, however, whether NCDs will be subject to MPA related caps in the future, so banks have been attempting to suck in as much funding possible via NCDs in the short-term. On the funding side, banks and NBFs have been happy to take advantage of elevated NCD yields, and the net effect is to draw liquidity into the interbank market, and away from segments of real sector lending.

As mentioned previously, It is also rumored that a large proportion of commercial banks have lent out around 70%-80% of their annual new loan quotas, and this could mean that new loan growth in Q3 remains soft, as banks wait for yearend demand from their prime borrowers. ***Something else to keep in mind is that maturing OMO + MLF in July should total RMB 918 billion. The breakdown is around RMB 358 billion in MLF and RMB 560 billion in OMO. Add in the withdrawal of corporate deposits in July for the submission of tax payments, and the amplitude of this first-month-of-quarter swing is large.***

This all translates into a crowding out effect for real sector borrowers as banks' shift away from off-balance lending to shadow banks that has ultimately flowed to corporate borrowers. Some of this real sector funding volume has been replaced by a flood of new funds into money market funds, who purchases short-term credit assets. However, on balance it is clear that as existing WMPs and off-balance sheet assets roll off, that the funds are being directed into safe, short-term parking places, and this has been one of the factors behind dramatically lower corporate and quasi-fiscal bond issuance YTD.

An interesting indicator to follow in terms of tracking the divergence of market stress for interbank funding and funding for NBFs (which translated into greater funding stress for real sector borrowers) is to compare NCD rates and rates on discounted bank acceptance notes. NCDs reflect a form of unsecured interbank funding, whereas rates on discounted bank acceptance notes are considered as secured bank lending to NBFs and real sector borrowers. The security is the margin deposit that corporate borrowers put up with the commercial bank underwriting the note. Theoretically, the discount rate on bank acceptance notes should be only slightly higher than NCD rates because it is a form of secured lending to NBFs. This has always been the case up until the beginning of this year. However, discount rates on bank acceptance notes have remained elevated even after NCD rates have come down. This implies that there has been a return of liquidity to interbank markets, which is expansionary for interbank lending, but contractionary for commercial banks' medium-term lending to NBFs. More importantly, it also implies that banks are pricing in greater credit risk for corporate borrowers despite abundant liquidity.

June Credit Data and a PPI Warning

Where it comes to expectations for credit data in June, we expect a repeat of the pattern seen last month. Abundant interbank liquidity should not disguise the fact that credit provisioning for real sector borrowers in shadow banking markets remains tight, exemplified by elevated bill financing rates.

This means relatively high growth to new bank loans against a further contraction of lending to shadow banks. New RMB loan issuance should be in the neighborhood of RMB 1.1-1.2 trillion, with TSF at just around RMB 1.2-1.3 trillion. June is traditionally a large month for bank lending. However, due to the ongoing regulatory crackdown on shadow banking and banks' lending to NBFs, commercial banks will likely continue to shift credit creation back to explicitly "on balance sheet" sources in the form of conventional bank loans. Where it comes to net new lending to the real sector, we think that around RMB 200 billion of the new RMB loan figure will reflect the reclassification of loans previously warehoused with shadow banks as on-balance sheet loans, and this amount should be netted out from the loan data. Overall, bank lending to real sector borrowers via NBFs as intermediaries should continue to contract, with very low volumes expected for entrusted loans, bill financing and bond issuance. The only potential bright spot that we expect to see where it comes to lending from shadow banks is new trust loans, which is the sole remaining permissible funding source for real estate developers. Equity financing should also remain positive, but at a slower pace compared with previous months due to CSRC's tightening of IPO approvals.

This supports out view that the aim of the current financial crackdown is about recentralizing (or re-nationalizing) credit creation. On the surface, the headline credit data may not look so bad in any given month. In reality, however we think the contraction to NBF lending will ultimately hurt large and small private borrowers that have been more reliant on the availability of shadow bank credit. The creates the potential for credit-related headline risks for large private firms – especially high-fliers with problematic political backing – such as LeTV, Wanda, Fosun, Anbang and others.

The M2 growth figure for June may appear to signal a modest rebound for June – say back above the 10% YoY level – but as discussed above, we think that it would be a mistake to take this as a signal of a recovery to bank lending. Instead, the modest rebound of M2 growth will likely be the result of faster disbursement of MOF's tax refunds to local governments and acceleration of spending by local governments. In turn, this may cause an unexpected increase to corporate deposits (especially from SOEs and LGFVs), but based on our reading of the overall situation this will not imply a recovery to the money multiplier and improved funding conditions for the real sector more broadly.

In contrast, M1 growth will likely decline again in June as housing sales growth remains weak under renewed policy restraints. In addition, the financial crackdown has significantly impaired the credit access for corporate to commercial banks through NBFs (off balance sheet credit channels), thereby hindering corporates' ability to raise short-term funding. It is important to note that interbank deposits and liquidity are not included in M1 and M2 statistics, and as a result, abundant interbank liquidity in recent weeks will not have a large impact on growth to monetary aggregates for June.

Slower M1 growth should naturally exacerbate disinflationary effects for PPI. As noted previously, we are expecting disinflationary pressures to accelerate in H2 (see: **Disinflation Expectations and the Yield Curve**, June 27). Even for June PPI, current disinflationary forces may still be understated.

The main reason has to do with base effects: recall that PPI remained subdued for most of the first half of 2016, before rising rapidly in Q4. Our estimates show that base effects will fall out of the monthly PPI readings at an accelerating past in July, with June representing the peak for 2016 base effects. Base year effects alone will account for 4.7% YoY growth for PPI in June, with new price factors alone accounting for just 0.7% YoY growth, which is equivalent to 0.3% deflation on a sequential basis. As a result, the headline PPI may come in at 5.4% YoY in June, largely the same as of last month. The point is that this result is misleading as a result of base effects, as the actual YoY comps for commodities and other major contributors to industrial producer prices are all strongly negative. ***This brings us back to more risks to the global reflationary consensus out of China: base effects will fall out of the data quickly in H2, and by November 2017 we estimate that base effects will contribute just 1.6% YoY to PPI growth; this implies that if sequential disinflationary momentum persists in H2, as it very likely will, then monthly readings for PPI in China will fall back towards 0 by year-end.***

DATA RELEASES

CPI (7/10) NBS: Market forecast 1.6, last period 1.5, year ago 1.9.

PPI (7/10): Market forecast 5.5, last period 5.5, year ago -2.6.

Aggregate Financing to the Real Economy, RMB 100m (7/12) PBOC: No market forecast, last period 10,600, year ago 16,300.

M1 (7/12) PBOC:No market forecast, last period 17, year ago 24.6.

New RMB Loans, RMB 100m (7/12) PBOC: Market forecast 12,385, last period 11,100, year ago 13,800.

M2 (7/12) PBOC: Market forecast 9.6, last period 9.6, year ago 11.8.

Trade Balance, USD100m (7/13) China Customs: Market forecast 423.7, last period 407.9, year ago 453.4.

Power Consumption: YTD % (7/16) NBS: No market forecast, last period 6.4, year ago 2.7.

Domestic Credit, RMB 100m (7/16) PBOC: No market forecast, last period 1,665,100 year ago 1,496,112.

Clips You Might Have Missed

Shares Unfrozen (7/9): Lock-up shares worth about RMB 26 billion will become eligible for trading on the Shanghai and Shenzhen stock exchanges this week. The amount is almost 70% less than the previous week.

Asset VAT Postponed Again (7/4): Beijing recently slashed the rate of a pending controversial VAT on asset management products and pushed back the launch date for the second time. MOF and the State Administration of Taxation (SAT) said that a 3% VAT on gains on assets under management will be levied on asset managers and trust companies as of Jan. 1 2018. The rate is down substantially from the 6% that authorities proposed earlier this year, which resulted in heavy resistance from the investment community.

Money Market Fund Inflows Soar (7/4) : As of the end of June, the size of money market funds reached RMB 5.11 trillion, compared to RMB 4.32 trillion at the end of 2016, a net increase of RMB 783.2 billion. Alibaba's YueBao is the largest, with AUM of RMB 1.43 trillion and accounting for 23% of the entire market. Rising inflows are putting pressure on bank deposits (see: Impacts of Contracting Bank Lending to NBFs, June 29)

Logistics Cost Cutting Boost (7/5): China is set to reduce logistics costs and improve logistics efficiency to spur the real economy, according to guidelines approved at a State Council meeting chaired by Premier Li Keqiang. Data from the NDRC showed that the cost of logistics in China took up about 14.9% of the GDP in 2016, down by 1.1 percentage points from the previous year. Beijing aims to establish an integrated nationwide cargo clearance system and to cut cargo clearance times by one-third by the end of this year.

A-Share Mergers Accelerate (7/6): Last month, the CSRC gave the green light to 24 listed companies to merge, acquire or restructure their businesses. It was the highest monthly total since the beginning of this year. Most of the approved plans were reverse mergers or so-called backdoor listings, in which unlisted assets are injected into another publicly listed shell company. The increased activity has been taken as a signal that the CSRC will allow more publicly traded firms to improve their quality through consolidation. Domestic markets are expecting the deal flow to continue over the short term.

For Overseas Media Acquisitions (7/6): China Media Capital (CMC), a private-equity investor has raised US$600 million for its second fund to expand its portfolio of entertainment and internet investments. CMC's previous headline-grabbing deal was in April, when it formed a joint venture, CAA China, with Creative Artists Agency. If CMC is permitted to continue overseas acquisitions, despite high profile public reprimands for other private Chinese firms earlier this year, it will demonstrate Beijing's commitment to foreign investment in strategic areas, particular soft power assets in which CMC specializes.

China Robot Market Continues To Grow (7/6): China remained the largest market for industrial robots in 2016, with sales rising by 26.6 % YoY to 88,992, according to a report released by the China Robot Industry Alliance. China's robot density, measured by the number of robots per 10,000 manufacturing workers, was 49 in 2015, compared with the world average of 69. A factor that sometimes gets overlooked in discussions of China's industrial upgrading "Made In China 2025" strategy is its impact on employment. One industrial robot replaces between 3-5 workers. Assuming all 61.5% of advanced robots sold last year were installed then 164,190 - 273,650 workers would have been made redundant (see: **Labor Outlook for Automating Industrial China**, October 2016)

Li Focus On Stability (7/7): At a meeting held ahead of quarterly economic data releases, the PM said that after the economy stabilized in the first half, "we should not only have firm confidence, but also be well prepared for dealing with all kinds of difficulties." Adding that, the country will continue to stabilize macroeconomic policies, market expectations and the financial market, by sticking to its proactive fiscal policy and prudent monetary policy, taking forward-looking and effective macroeconomic regulation measures, and properly defusing risks. The stability emphasis is a slight departure from the usual rhetoric for PM Li, who generally does not name specific areas for stabilization in his pre-quarterly data meetings. Previously there was only a singular "stable macro policy orientation", as opposed to the three mentioned last week.

China Backs Natural Gas (7/7): China has narrowed its target for how much of the country's total energy consumption will be made up by natural gas. China is aiming for natural gas to account for around 10% of the country's total energy consumption by 2020, according to a directive jointly published by 13 governmental agencies. The figure is at the high end of a target of between 8.3% and 10% for natural gas set by the NDRC in December. In 2015, natural gas made up 5.9% of China's total energy. The document reiterated a goal to boost natural gas use around 15% by 2030.

New Power SOE Merger Rumors (7/9): China's state energy giant State Power Investment Corporation (SPIC) has indicated a potential merger with China Huaneng Group, another power SOE According to Wang Binghua, chairman of SPIC, his company and China Huaneng are "both thinking about forming a union," but all related processes are still ongoing. SPIC and China Huaneng are among the big nine SOE power companies in China. Wang said that the highpoint of mergers and restructuring in the power sector is yet to come.