China Macro Monday

The Week Ahead (August 7-11) and the Week Behind (July 31 - August 4)

The focus this week will be on new credit and TSF data, but this is only half of the story. The other half relates to the fiscal and quasi-fiscal credit data for July, much of which (local government bonds and policy bank bonds) is NOT included in the TSF series.

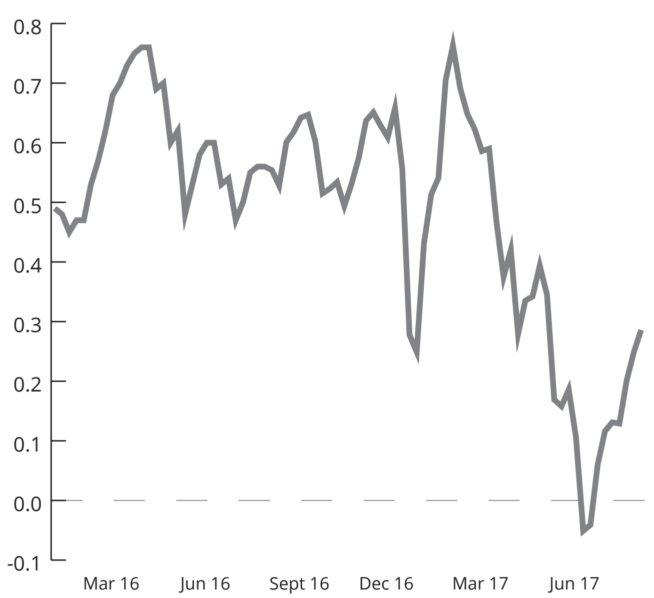
- First, we note that it was another strong week for industrial production activity, with our index of operating rates ticking higher. As described below, local government bond issuance jumped in July, which is supportive of fixed asset investment and infrastructure construction, and this may have boosted producer confidence. However, as detailed in **China H2 Cyclical Outlook – Narrowing Margin for Error** (Aug. 4), upstream restocking and inventories in just about everything but low-end steel may have overshot the cycle and expected softening final demand. Restocking in rebar, wire rod and other low-end steel segments may keep operating rates in the industry up, but this could be an exception in Q3. Weekly transportation indicators may already be showing that seasonal restocking in energy and upstream industrial segments has peaked.

- The pullback to the SHCOMP at the end of last week was led by a sharp loss of momentum among financial shares, particularly smaller joint-stock and city-level banks. We expect this divergence in share performance between the largest SOE banks and others to continue as the regulatory crackdown plods on.

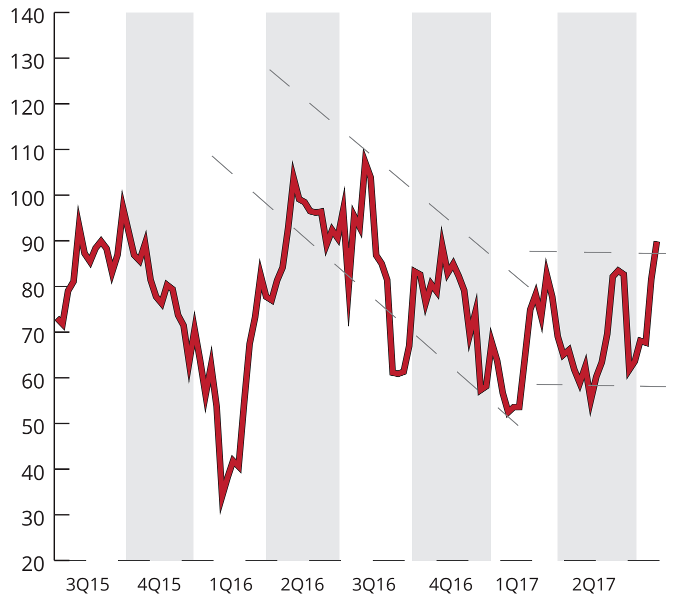
- For new RMB loans, we will be looking for a figure around RMB 750 billion (slightly above the domestic consensus of RMB 706 billion), with potential upside risk coming from the extent of conversions of off-balance sheet credits to on-balance sheet loans. On a seasonal basis July is generally a slack month for new loans. For TSF, we will be looking for a figure of around RMB 1.4 trillion, with renewed support from corporate bond issuance and continued lending to developers via trust loans.

- **As detailed below, however, the real credit story for July – and potentially H2 – is the resurgence to fiscal issuance, particularly from local governments. Local government fiscal (non-swap) issuance in July was RMB 742 billion, and there are signs that local governments may get an extra quota of RMB 940 billion in special purpose bonds for H2 to counter the austerity effects of efforts to stop illegal local government guarantees for borrowing by local financing vehicles.** Add in the remaining target government fund expenditure budget of RMB 3.5 trillion, and there will be a healthy fiscal backdrop to growth and activity in H2 that will not be captured in the TSF data.

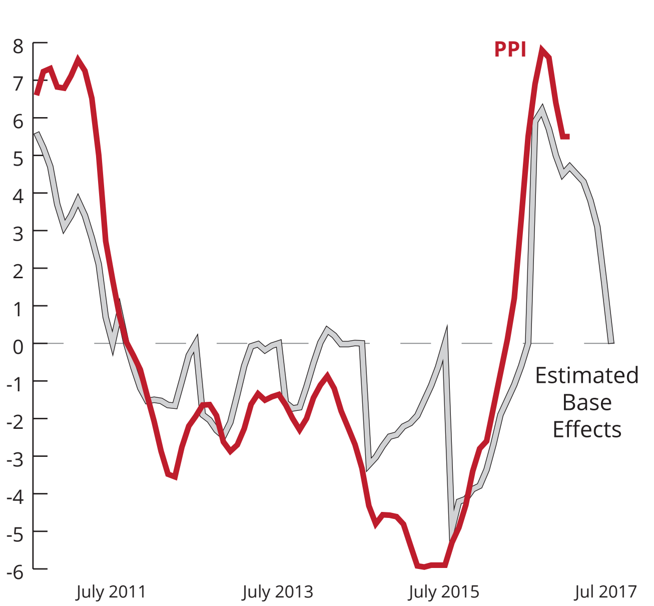
CGB 10YR-1YR Spreads Signalling a Shift in Money Market Alloactions and Rate Expectations
percentage points - as of 8/4



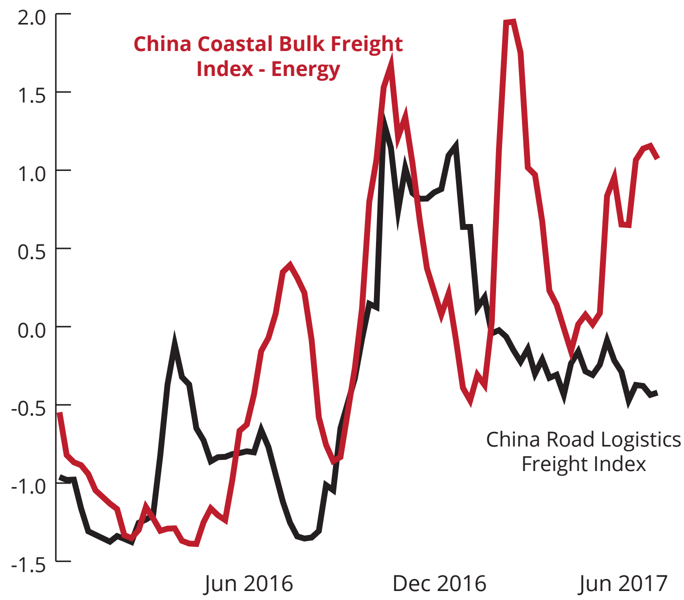
Weekly Industrial Operating Rates Index
(PRC Macro series / Wind data)



PPI and Expected Base Effects
percentage points - through December 2017



Highway and Energy Transport Indicators
standardized / weekly data / as of Aug. 4



It should, however, trickle into the M1/M2 data as the funds are spent.

• PBOC injected net RMB -40 billion into financial markets last week, following total injections of RMB 790 billion during the previous two weeks to facilitate elevated maturities and the issuance of a boatload of new fiscal bonds. We expect the PBOC to be active with liquidity injections in August: there is RMB 780 billion in OMO and MLF maturing next week, we well as 860 billion in CGBs maturing this month, RMB1.6 trillion in NCDs and several hundred billion in corporate bonds. PBOC needs to keep domestic interest rates under control, and faces continued pressure from maturities.

• China's yield curve continued to steepen last week (the 10Y-1Y spread), and this resulted from banks and money market funds piling into the short-end of the curve. We attribute this to overall flush interbank markets, which was manifest in a falling repo VWAP to repo fixing ratio, and a contained 7-day drepo spread.

• Both the PBOC and State Council want to contain corporate borrowing costs, and while various rates and spreads show that the price of funds may be trending down, the July credit data may show that the volume of available credit – particularly short-term working capital – for smaller firms may still be contracting.

• Interestingly, high-yield spreads have compressed far more than AAA spreads (here we look at 6-month bills and 5Y bonds) as investors continue to chase yield. **Our take remains, however, that corporate credit risks will return in H2. Domestic investors are being too complacent about the PBOC and CBRC and their tollerance for private corporate credit defaults.**

• For inflation, we are looking for a PPI number of 5.4%, just below the 5.5% consensus, and note that after July the base effects from 2016 start to drop out quickly. The recent surge to domestic commodity prices may slow the pace of producer price disinflation in H2, but it should still be evident in the data for August.

• For the RMB, although we expect the PBOC to respond to the surge to the dollar last week by guiding the USD/CNY fix higher (depreciation). The recent appreciation of the currency has been too rapid, the Bank will probably wait for confirmation that a return to dollar strength is more than just a blip. The Bank has been comfortable with the stability of CNY relative to the basket, and short-term adjustments may be limited to maintaining this stability.

Now a little bit of drilldown into the July bond data. First, the credit market data that will be included in the TSF new loans data:

• Corporate bond issuance in July (MTNs + enterprise + corporate bonds) for July rebounded to total issuance of RMB 350 billion, and net new issuance of RMB 252 billion. YTD at the end of July, however, total corporate bond issuance of RMB 1.24 trillion represents a YTD YoY drop of 55% compared to the same period of 2016, with the net figure of RMB 410 trillion representing an 80% drop compared to the same period of 2016. In other words, new total corporate issuance YTD at the end of July was RMB 1.55 trillion less (RMB 1.74 trillion less on a net basis) compared to a year earlier.

• New commercial paper (CP) issuance in July was RMB 231 billion, which translates to net new issuance of RMB -60 billion. YTD YoY at the end of July, total new CP issuance came in at RMB 1.34 trillion (35% less than the same period of 2016), with net CP issuance of RMB -470 billion YTD.

Although net new corporate bond issuance in July was obviously far stronger than in previous months, it is still weak on a cumulative YTD basis. The corporate paper market is small relative to overall credit markets (~RMB 1.6 trillion at the end of July), but the outstanding balance in this market at the end of July was RMB 900 billion less than a year ago, and this represents one of the channels where working capital is still being squeezed.

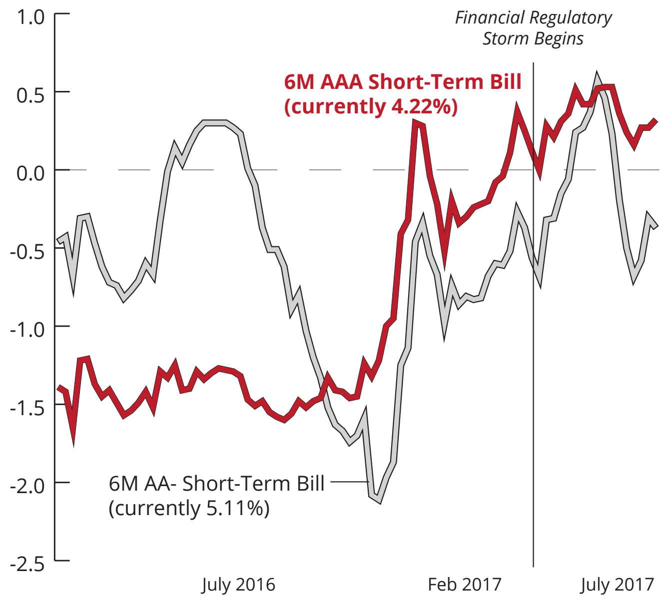
On the fiscal side of the equation July was a big month for government bond issuance, with levels adequate to have potentially shifted the yield curve.

• New sovereign CGB issuance in July came in at RMB 315 billion (net RMB 204 billion). At the end of July, total YTD CGB issuance of RMB 1.76 trillion (net RMB 684 billion) represented an RMB 67 billion increase compared to the same period of 2016. Strong new and net issuance in June and July thus marks an acceleration to issuance compared to weaker figures for earlier in the year.

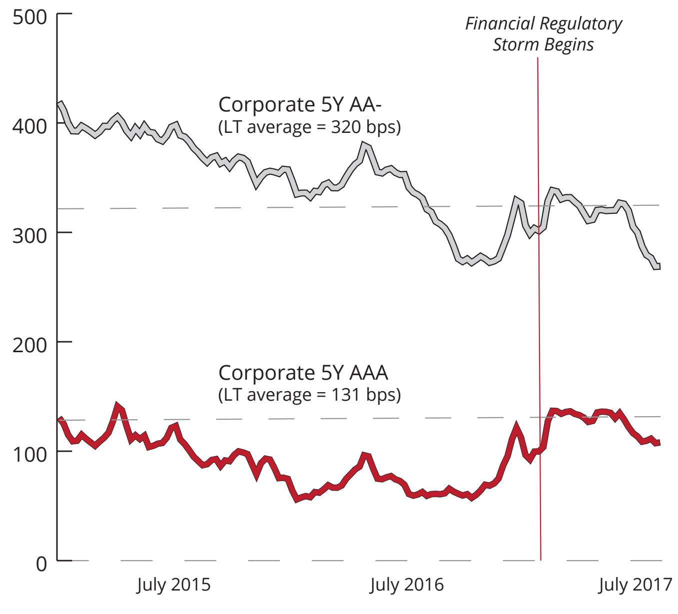
• **The bigger story, however, is local government bond issuance (fiscal bonds, not bond-swap bonds) of RMB 742 billion in July. This acceleration to LG issuance brings the YTD total (the new and net figures are the same) to RMB 1.29 trillion. Overall, this helps to close the gap compared to the same period of 2016, and at the end of July total LG issuance was just 14% less than a year earlier (previously this figure was -40%+).**

• Also note that local governments have been given new quota for special purpose bond issuance in 2017 of RMB 940 billion. This would be on top of the RMB 830 billion in budgeted ordinary debt, and the RMB 800 original allocation of special purpose debt. Realistically, local governments may have trouble issuing and spending this total new quota by the end of 2017. Additionally, a big piece of this additional quota is probably to compensate for significantly reduced issuance by local government financing vehicles as regulators target soft guarantees by local governments and attempt to make LG liabilities more transparent.

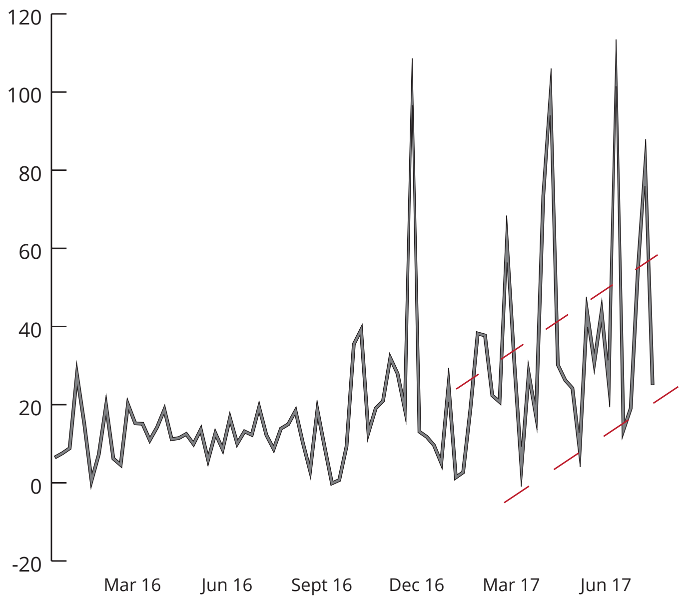
Short-Term Bill Rates
standardized data / sample = 2012-present



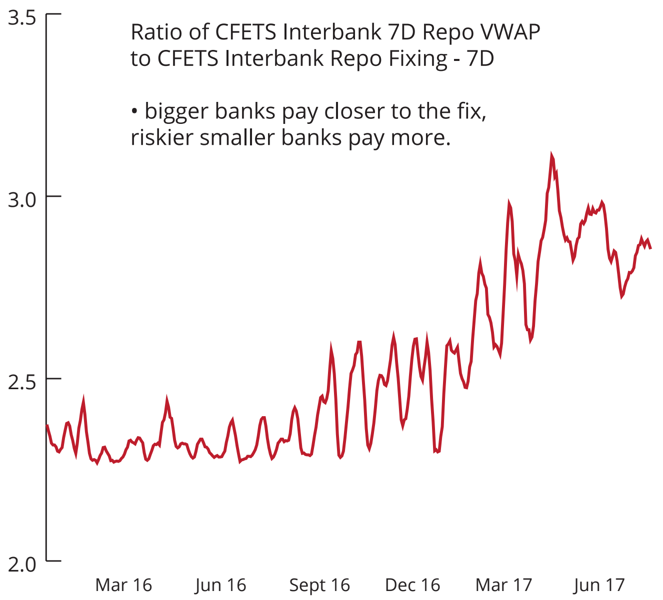
Relative Corporate Bond Spreads Over CGBs
basis points / sample = 2008-present



7D DREPO Spread
(GC Interbank Repo - Depository Inst. Repo)
basis points / weekly data as of 8/4



Weighted Average Interbank Repo Rates Show Stress for Smaller Banks (5D MA)



Nevertheless, this funding will be used to build stuff, and will NOT be included in TSF data (whereas LGFV bonds are under the corporate category).

• On the quasi-fiscal side of the equation, policy bank bond issuance in July came in at RMB 286 billion (net RMB -3.6 billion). YTD new issuance by policy banks at the end of July totaled RMB 1.93 trillion (net RMB 377 billion), which represents a 16% YTD YoY decrease for the total, and a whopping 64% YTD YoY decrease on a net basis. Note that policy bank bonds are not included in TSF, but their loans are.

• For urban development construction bonds (which overlap with corporate bonds, but we call quasi-fiscal because of the intended use of the funds), new issuance in July came in at RMB 208 billion (net RMB 102 billion). Although these totals represent an improvement over recent months, YTD at the end of July, total issuance was RMB 903 billion (RMB 650 billion less than the same period of 2016), and net YTD issuance was just RMB 112 billion (RMB 840 billion less than the same period of 2016). Note that these bonds are captured in the TSF bond category because they are corporate.

The policy bank and urban development construction bond data illustrate the quasi-fiscal local government austerity that has resulted from controls on local government guarantees and MOF inspections of actual levels of local government debt. One factor that has compensated for some of the slowed total quasi-fiscal issuance compared to 2016 levels is the increase to government fund expenditure. Recall that this account is tied to land sales and improvements, and the 20% growth target for 2017 would being the annual spend to RMB 5.5 trillion. At the end of June, RMB 2.05 trillion of this target had been spent (an RMB 390 billion increase over the YTD figure for 2016), and this implies that spending here, too, will pick up alongside stronger local government fiscal bond issuance in H2.

In total, the combination of the incremental annual government fund expenditure (RMB 850 billion) and new quota for local government special purpose bonds (up to RMB 940 billion) will compensate for a big chunk of the slowdown to bond issuance in 2017, and is growth and activity positive.

Clips You Might Have Missed

AMC IPO On Track (7/31): China Orient Asset Management Co said it is on course to sell a 15% stake by the end of this year to strategic investors in a pre-IPO funding round. Great Wall Asset Management Co is also seeking up to eight strategic investors ahead of a planned IPO. China Huarong Asset Management Co and China CindaAsset Management Co have already listed on the Hong Kong bourse.

DATA RELEASES

Official Reserve Assets, USD100m (8/7) PBOC: No market forecast, last period 31,504, year ago 32,999.

Gold Reserves, 10k Fine Troy Ounces (8/7) PBOC: No market forecast, last period 5,924, year ago 5,879.

Foreign Currency Reserves, CNY 100m (8/7) PBOC: No market forecast, last period 30,568, year ago 32,011.

Balance on Current Account: (Preliminary)USD 100m (8/8) PBOC: No market forecast, last period 190, year ago 594.

Trade Balance, USD 100m (8/8): China Customs Market forecast 469.6, last period 427.5 year ago 483.5.

PPI (8/9) NBS: Market forecast 5.5, last period 5.5, year ago -1.7.

CPI (8/9) NBS: Market forecast 1.5, last period 1.5, year ago 1.8.

M2 (8/10) PBOC: Market forecast 9.6, last period 9.4, year ago 10.2

Aggregate Financing to the Real Economy. RMB 100m (8/10) PBOC: No market forecast, last period 17,800, year ago 4,879.

Bankruptcy Case Increases Shows Zombie Firms Under Pressure (8/2): Data released last week from China's judicial system showed that through H1 2017 courts had accepted 4,700 bankruptcy cases, an increase of 65% from H1 2016. Last year's figures were themselves up 54% YoY on 2015. The number of cases actually settled by courts was equally impressive, the judicial service resolved 1,923 bankruptcy cases from January to July this year, up nearly 30% YoY. The courts settled 3,602 cases in 2016, up 60.6% YoY.

Beijing Introduces Government-Citizen Owned Housing (8/4): In a new measure to stabilize the housing market, Beijing is planning to introduce homes with joint property rights shared between the government and buyers. According to a document published by local authorities to solicit public opinions, individual buyers will be able to buy a share of a house but still have the full "right of use." Chen Zhi, secretary general of Beijing real estate association, said the new homes were part of the city's long-term housing controls, making the system fairer by allowing more people to buy their own homes. The policy has several restrictions. Buyers and their families cannot already own homes in their name. Single people making purchases must be at least 30 years old. And a family can only apply for one home. Five years after purchase, owners can sell their shares based on the market price, but the government or its assigned management agencies have first-refusal to buy-back.

Provincial SEI Investment Announced (7/31): Beijing is set to boost investment in emerging sectors ranging from artificial intelligence to biopharmaceuticals as it seeks fresh growth impetus in the new industrial revolution. A number of local authorities, including Ningxia, Guangxi and Shandong, have rolled out support policies and detailed investment plans over the past week. A month earlier, the NDRC inked an agreement with the China Development Bank, securing no less than 1.5 trillion yuan of loans from the policy bank to the sectors by the end of 2020. The government expects the combined output of emerging sectors to account for 15 percent of GDP by 2020. Each of the five new pillar industries, information technology, bio-industry, green and low-carbon industry, high-end manufacturing, and digital and creative industry, will see output of 10 trillion yuan by 2020.

LED Development Plan, M&A Coming (7/31): In a development plan jointly released by 13 government agencies, China unveiled a target of achieving breakthroughs in key technologies in the LED industry to expand market value to RMB 1 trillion by 2020. The plan states that China should have at least one LED company with sales volume of more than 10 billion yuan, and one or two world-renowned brands. The government will encourage more M&A in the industry to push concentrated and differentiated development in the sector.

Coal Power Capped (7/31): By late 2020, China will suspend the commissioning of coal-fired power plants that could together produce 150 gigawatts of power

China also aims to stabilize coal-power production capacity at 1,100 gigawatts by the end of the 13th Five-Year Plan in 2020. To address an electricity supply glut, China's central government has expanded its capacity cut drive beyond the steel-producing and coal-mining industries to include coal-burning power plants. The total installed capacity of China's coal-fired power plants at the end of 2016 was 943 gigawatts. However, the average number of hours that each kilowatt of capacity was used last year was only 4,165 hours, far lower than the 5,500 hours of use operators need to break even. At the end of April, an additional 350 million kilowatts in coal-power production capacity in the form of planned power plants was waiting to be added to China's energy network.

Debt Management Specialist To Head CCB (7/31): China Construction Bank nominated Tian Guoli as its new chairman. Tian, current head of the BOC, was named party secretary of CCB by the Communist Party's organization department. With his appointment as CCB chief, Tian returns to the bank after almost 20 years. Tian left CCB in 1999 to help establish China Cinda Asset Management Co., one of China's four state-owned bad-asset managers set up to take over distressed loans from big state banks. Tian's experience at Cinda may have been a reason for his promotion to the CCB chief. His appointment is another anecdotal sign that Beijing is serious about keeping the pressure on financial sector clean up.

Xi Holds Onto Barrel Of The Gun (8/1): Chairman Mao famously said "power grows out of the barrel of a gun". President Xi, evidently adheres to this belief, last Tuesday the President reaffirmed the Party's complete control of the PLA. Xi stated that, "to build a strong military, [we] must unswervingly adhere to the Party's absolute leadership over the armed forces, and make sure that the people's army always follow the Party." We noted in last week's Macro Monday that the previous weekend's PLA parade contained a number of aspects demonstrating Xi's strength and control of the army going into Beidaihe. The trend if anything strengthened this week, a strong signal that Xi will continue to tighten the screws on his political rivals leading into Beidaihe and in advance of the Party Congress.

New Bond Pilot For Local Governments (8/2): China will attempt to widen financing channels for local governments through a pilot revenue bond program. Last Wednesday, the MOF said provincial areas would be encouraged to issue bonds to finance public projects that generate stable income. The new product, equivalent to US revenue bonds, is another step toward standardizing local authority fund-raising and defusing the risk of accumulating debt. The central government's plan is to strictly separate each project, so that borrowing is clearly tied to revenue generation from a specific development. Cash flow generated from a project must be used to pay the interest and principal on the associated bonds. The MOF said the bonds will satisfy capital needs in key areas and attract private capital into public services. Bond issues should not exceed annual quotas approved by the central government.

SOE Overseas M&A Framework (8/2): An MOF produced guideline that took effect last week will standardize the financial management of SOEs throughout the overseas M&A process, and tackle key issues including poor project feasibility and lack of risk management. Specifically, the guideline clarified the financial management responsibilities of these types of investments, asking SOEs to assign a specific person from top management to head each respective project. The guideline's also requires SOEs to specify rules on feasibility and financial due diligence, making sure projects are financially viable before decisions are made. The guideline applies to both central and local SOEs. Financial SOEs will follow separate rules to be released at a later date.

Interbank Assets Plummet In Beijing (8/4): Commercial banks in the capital are shrinking interbank and off-balance sheet business activities as financial regulators step up efforts to reduce financial leverage. By the end of June, interbank assets in the capital city declined to almost 30% from the beginning of the year to RMB 1.5 trillion. According to data from the Beijing branch of the CBRC, interbank liabilities, decreased by almost 14% to RMB 3.2 trillion yuan. As a result, total assets of Beijing's banking sector dropped 1.8% between January and June to 21.2 trillion yuan as of June 30. Off-balance sheet wealth management business also declined over the first six months. By the end of June, the outstanding value of WMPs held by Beijing banks dropped 2.2% from the beginning of the year to 3.16 trillion yuan. Total funds raised by bank WMPs declined 5.5% to 6.77 trillion yuan.