China Macro Monday

The Week Ahead (Apr. 24-18) and the Week Behind (Apr. 17-21)

PRC Macro

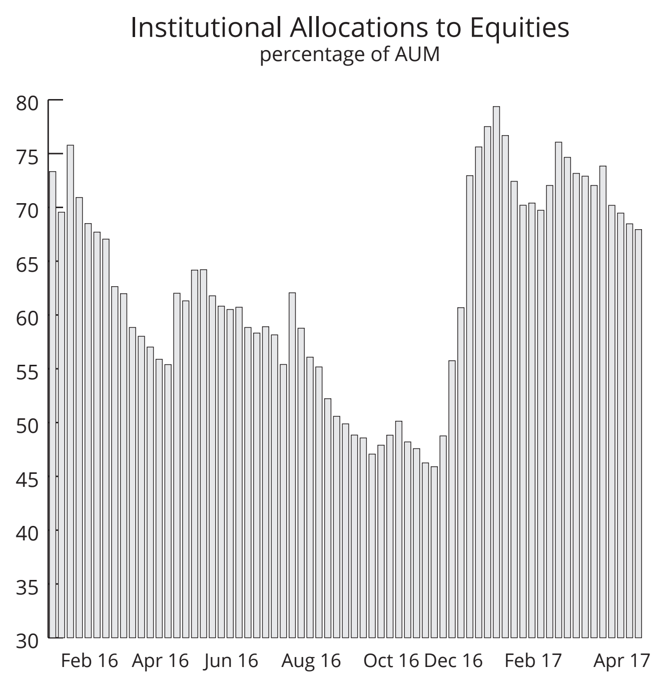
This weekend all eyes are on French politics, but an equally interesting drama is unfolding in China. Elite political tensions have spilled over into the streets, metaphorically of course, with social media the new battleground. This is all a function of the political cycle leading up to the Party Congress in October, which will decide the apex leadership for the next five years. The most recent developments are a product of the recently launched anti-corruption probe in the financial sector, which is clearly intended to pressure President Xi's political rivals by squeezing their economic support bases. This follows an earlier effort to crush the Youth League faction and the announcement by Wang Qishan and CCDI last year that the broader anti-corruption effort would target the business interests of the family members of elite political families. Two evolving cases involve threats by fugitive businessman Guo Wengui to disclose the dirty secrets of a group of elite political families to the media. This dynamic has recurred numerous times earlier on in the current political cycle, where one powerful faction essentially takes political hostages, with the associates using sensitive information on their captors as an insurance policy or bargaining chip.

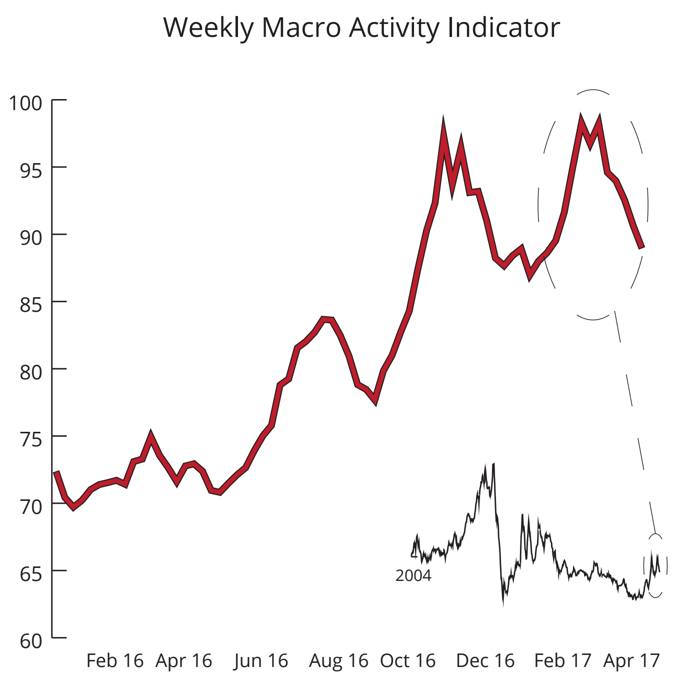
Other related cases involve the Hainan Airlines Group, which has been on an overseas buying spree recently, at the same time that other princeling entities, like Anbang, have seen their deals nixed behind the scenes. Social media exploded this weekend about discussion regarding the political linkages supporting HNA, which include a close relationship to the wife of a very senior CCDI individual. This all translates into political tail risks, which are further magnified by Guo Shuqing's effort to clean up the financial sector. In this context it is even more difficult than normal to segregate well-intended regulatory actions from bare-knuckle politics (see: **Guo Shuqing's Squeeze on Regulatory Arbitrage**, April 12).

Macro and Markets

- As detailed in recent research releases (see: **A Cyclical Turn on the Horizon for China**, April 19) we think that the economy in China is at or near to an inflection point. From a structural perspective this is evident in readings from our proprietary business cycle index and output gap analysis. Shorter-term, as indicated below, our weekly indicator for measuring macro activity indicates a retreat starting in early April.

- As seen below, this is in part a natural product of regular leads and lags between monetary policy and activity. Our measure of excess liquidity has rolled over, which coincides with a more concerted regulatory effort to deleverage the financial sector and segments





of the corporate economy (SOEs). This implies a slowdown to real sector activity, which should quickly feedback into major indices.

• Onshore equity markets have broadly lost momentum in the past 10-days, led by the financial sector (no surprise given the regulatory push) and followed by cyclical sectors. More broadly, markets responded relatively slowly to the uptick to real sector activity in 2016, perhaps in part to smoothed government data. However, our weekly and monthly indicators make clear that the cyclical response last year was stronger than reported, as could be the downside in the coming months.

• The confluence of regulatory action, cyclical factors and short-term readings of macro activity imply the potential for a downward turn for China equities.

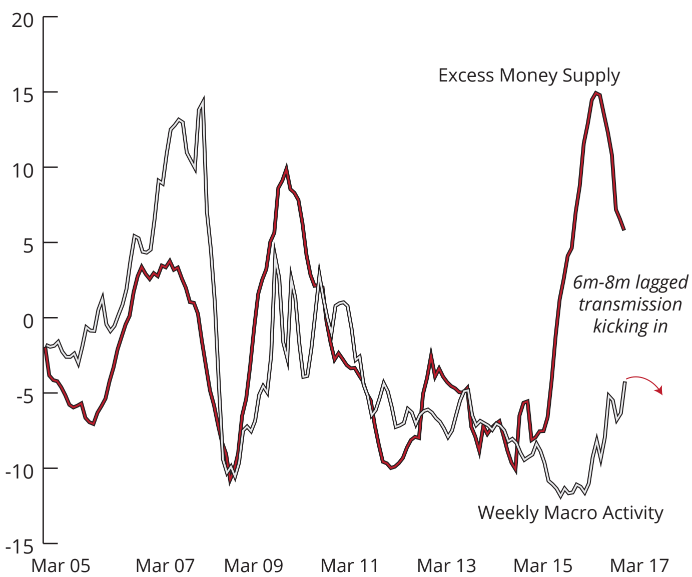
• However, despite numerous "flash crash" events for individual shares cause by the liquidation of blocks of holdings in response to regulatory actions, broad based measures of market volatility remain low. As we have written previously, ever since the market "circuit breaker" fiasco, Beijing has shown a penchant for maintaining stability for major indices. In the current environment the stability bias favors large-cap shares, with more volatility allowed for medium and small-caps, which are often targets for leverage speculation (which is in regulatory cross hairs).

• We note, however, that there are pockets of resentment towards the way CSRC has handled what many believe is CSRC chairman Liu Shiyu's bias towards 'value investing', or basically SOE shares. The main reason has to do with the recent announcement about the Xiongan New Zone, after which related shares (mostly SOEs) surged. After these shares rallied for two weeks, "national team" investors sold, shortly after which CSRC suspended trading for shares in 14 companies. Following the suspension share prices for these companies plummeted, which resulted in large margin calls for retail investors. Looking ahead, broader retail withdrawals from equity markets in response to this regulatory disposition will be something to watch out for.

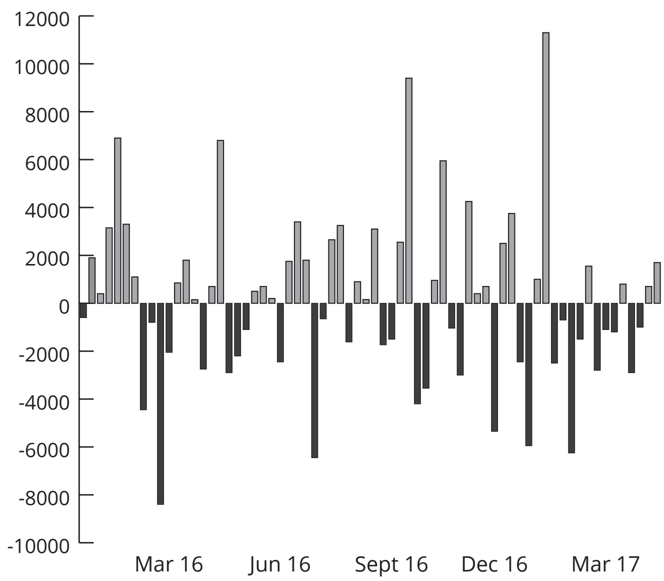
• Even before this happened, an additional indicator of potential market softness ahead comes in the form of reduced inflows to mutual funds, evident in slowing fund share sale data, which is a key source of market liquidity. Elsewhere, retail deposits in the securities clearing system have come back from January lows, but are not moving in a manner indicative of inflows. Margin credit and turnover to free float market cap remains stuck at post-crash low levels.

• We estimate there is RMB 11 trillion in bond market exposure behind bank WMPs, some of which may be subject to regulatory driven redemptions. This should, however, disproportionately impact lower rated corporate bonds, with a flight to quality helping to keep sovereign and quasi-government yields down.

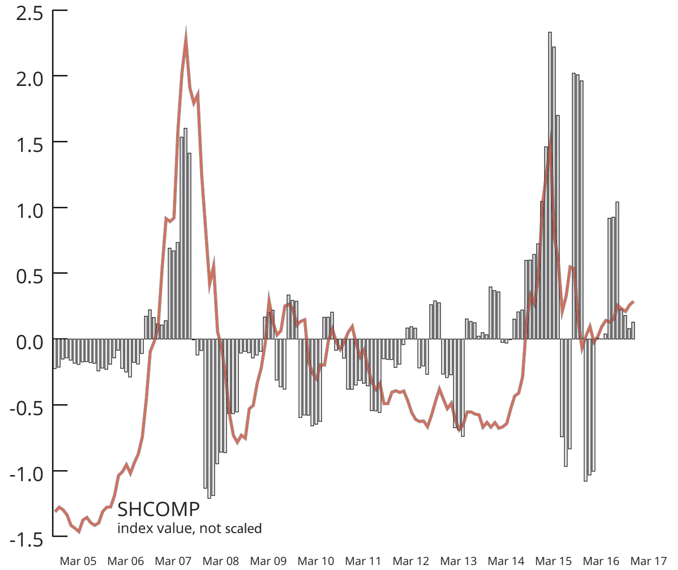
Excess Liquidity and Macro Activity
monthly series



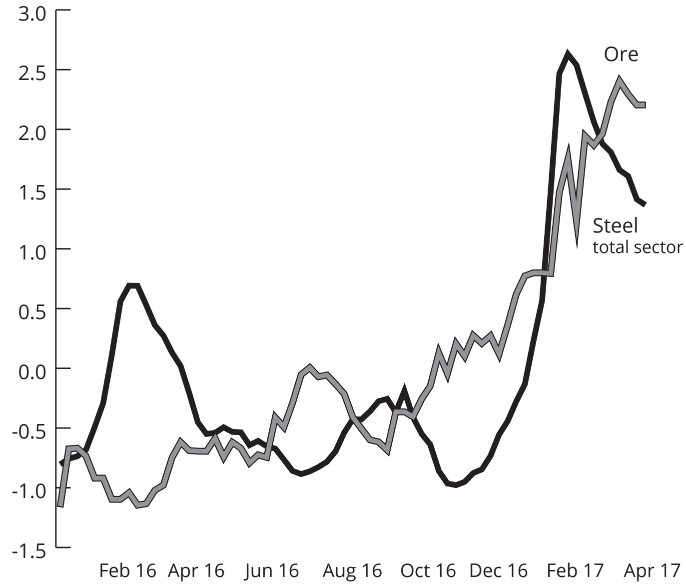
Weekly PBOC Net OMO Injections
RMB 100 million



China Monthly Mutual Fund Inflows
standardized values, 3MMA



Steel and Ore Inventories
standardized values



• Where it comes to monetary policy, we expect PBOC to remain cautious in the weeks ahead as the current regulatory cycle unfolds, and as MLF maturities remain above RMB 400 billion per month. As we wrote last week, senior PBOC speakers have already struck a more dovish tone where it comes to providing adequate liquidity for market stability just a few weeks into the current regulatory movement.

• Two important, positive data points for this week include: first, regulators have indicated that close to 13,000 "regional credit committees" have handled close to RMB 15 trillion in troubled loans by the end of 2016. We estimate that 60%-70% of this total involves bank loans, with the remaining balance with NBFs. **Although bank shares may be under pressure from Guo Shuqing's regulatory cleanup, we think this will be positive for large SOE bank shares, which are some point are due for a positive re-rating.** The impact of "regional credit committees" and the creation of dozens of "bad banks" at the local level has been under-appreciated by markets. This does not by any means signify that Beijing and the PBOC have conquered China's credit overhang and related "systemic risk". Rather, with this and the local government bond swap program they have extended maturities for around RMB 20-25 trillion in credit. This may be just be buying time, setting up an even larger wall of credit maturities for 2018.

• The second positive signal is that CBRC has hinted that the current regulatory storm could clear by the end of June. *Quick, dirty, and tough*. Individuals and institutions in China are adept at weathering such storms, and we think this signal will be received generally positively. This should be followed by the National Financial Conference. How well this round of "reform" changes the game with respect to excess leverage and systemic risk is TBD, but in the short-term we continue to believe that to some extent "this time is different" given the added political (albeit politicized) backing from the very top.

DATA RELEASES

Profit of Enterprises (4/27) NBS: No market forecast, last period 31.5, year ago 7.4.

Balance Services Trade (4/27) SAFE: No market forecast, last period -176, year ago -210.1.

FX Market Turnover (4/30) SAFE: No market forecast, last period 5,514.40, year ago 7,063.60.

Domestic Credit, RMB 100m (4/30) PBOC: Market forecast 1,650,629, last period 1,629,442, year ago 1,425,207.

Manufacturing PMI (4/30) NBS: No market forecast, last period 51.8, year ago 50.1.

Non-manufacturing PMI: Business Activity (4/30) NBS: No market forecast, last period 55.1, year ago 53.5.

Clips You Might Have Missed

Shares Unfrozen (4/23): Lock-up shares worth about RMB 46.39 billion will become eligible for trade this week. About 4.59 billion shares will become tradable from April 24 to April 28. Beijing Shougang is set to unlock 2.32 billion non-tradable shares, the largest volume to be released.

CIRC Red Alert (4/23): Yesterday, China's insurance regulator warned insurance companies against liquidity risks. A CIRC circular noted that firms must follow and analyze changes in the macro-economy, stock and bond markets. In addition, insurance companies must also conduct regular cash flow tests. The document specified that; "a prudent investment scheme must be established to strengthen asset and liability management and to avoid using return on investment as the only investment goal and performance indicator."

State Council Maintains Reform Push (4/18): Last week, the State Council vowed to continue cutting excessive capacity in steel, coal, coal power, and other industries, and reduce inventory in the real estate market. Cuts were called for on corporate leverage ratios, particularly SOEs. Meanwhile multiple measures will be created to help lower business costs, including taxes and administrative fees. According to the guideline, the government will cut more administrative permits and licenses for businesses and ease market access. Pricing reform will continue for electricity, gas, agricultural irrigation, railway transportation and aviation.

Two Million Home Housing Target (4/18): China will create 2 million units of public rental housing in 2017 to provide affordable housing for low-income people. MOHURD Vice Minister Lu Kehua said accelerating the construction and allocation of public rental housing is high on the agenda. Beijing sees public rental housing as a way of providing homes for families who have been priced out of the property market.

NPL Securitization Pilot (4/18): China has expanded a pilot program to allow more domestic banks to issue securities backed by non-performing assets. Commercial banks including China Minsheng Bank, China Everbright Bank, and China CITIC Bank were among the institutions recently selected for the program. China started a pilot program for non-performing asset securitization in 2016, allowing five state-owned banks and China Merchants Bank to repackage non-performing assets into securities. By the end of 2016, 14 securitization products had been issued with a total value of RMB 15.6 billion, covering RMB 46.1 billion of underlying non-performing assets.
Crude Oil Futures Launch In 2017 (4/18): China is planning to launch crude oil futures in Shanghai in 2017. Part of Beijing's plan to generate global pricing power over China's major import commodities. CSRC vice chairman Fang Xinghai said Chinese securities regulators are confident that the launch of crude oil futures will happen this year.

ODI Plummets (4/18): MOFCOM said Chinese ODI in nonfinancial sectors plunged 30.1% YoY in March. Chinese investors spent a total US$7.11 billion acquiring overseas assets in nonfinancial sectors last month. In Q1 non-financial ODI slumped 48.8% YoY to US$20.54 billion. China's ODI in nonfinancial sections has now fallen in four consecutive months.

China Launches Second Commodity Option (4/19): White sugar become only the second commodity to be cleared for options trading in China, and trading for the product from last Wednesday on Zhengzhou Commodity Exchange. The launch of white sugar options follows those for soybean meal, currently trading on Dalian Commodity Exchange.

Rural Income Growth (4/20): China's rural residents saw faster income growth than urban residents during Q1 2017. The increase largely came from migrant workers' income, injections of fixed asset investment, and soaring transfer payments to rural residents. Average disposable income for urban people in China was RMB 9986/month, while the rural average remained far behind, at RMB 3880/month.

CBRC Multiple Guarantor Crackdown (4/21): China's banking regulator has begun reining in corporate loans backed by multiple guarantors, in a bid to curb the spread of financial risk posed by chains of companies offering their own credit to support less creditworthy peers. Earlier this month the CBRC sent a notice to its local branches urging them to identify risks associated with cross-guarantees. Cross guarantees threaten to become a financial accelerator with Chinese characteristics.

Record High Migrant Numbers (4/20): The number of rural migrant workers totaled 172.53 million during Q1 2017, up 2.7% YoY and a record high. The NBS said monthly income of rural migrants averaged 3483 yuan was up 6.4% YoY. The combination of more rural people working off farms and higher wages pulled up the rural income average. Rural transfer payments are also booming. The average rural income from transfer payments was 746 yuan per person, up 11.7% YoY.

SAFE: Outflow Pressure Falls (4/20): Chinese banks' net foreign exchange sales contracted 67%YoY to RMB 281.5 billion in Q1. SAFE said capital outflow pressure has greatly eased, and the supply and demand for China's foreign exchange reserves have basically been balanced since the beginning of 2017. SAFE predicted that China's cross-border capital flow will continue to head toward a balance thanks to the high growth rate of China's economy and measures to attract foreign capital.

Mining Equity For Beijing (4/20): A new equity benefit system will be built to protect national mineral interests and share earnings between central and local governments. According to a plan issued by the State Council last week, fees for mining exploration and exploitation rights will be turned into mineral resource equity benefits for the government, the share proportion of which is split 4:6 between central and local governments. The occupation of mineral resources will also be charged, divided 2:8 between central and local governments.

Tax Cut Boost (4/20): China has unveiled plans to ease the tax burden on companies and consumers by more than RMB 380 billion. As of July 1, the government will streamline the VAT structure, reducing the number of brackets from four to three, and reduce the VAT on agricultural products and natural gas from 13% to 11%. Small companies with annual taxable earnings of 500,000 yuan or less will enjoy a discounted corporate income tax rate of 20%, compared with a standard rate of 25%, on half that amount for three years until the end of 2019. Tax breaks will also be granted to startups and SMEs in the technology sector.

Lou Calls For Defaults (4/21): Former Finance Minister Lou Jiwei said China should allow smaller local governments to default on debt to upper levels of government because it would signal that central government bailouts aren't assured. Lou's comments reiterate those by PM Li Keqiang and other central government officials such as current Finance Minister Xiao Jie that local government debt shouldn't be bailed out, or benefit from assumptions it will be.

MOF Publishes Local Government Finance Investigation (4/21): Last week marked the first time China's MOF revealed details on investigations and subsequent punishment of illegal local government lending. Domestic media reported that the MOF document highlighted that local government financing irregularities largely stemmed from official guarantees for local firms and projects. Amongst all financing practices investigated nonstandard financial products such as entrusted loans and lease agreements were the most common.

Xiongan GDP Estimates (4/21): Minsheng securities estimated last week that President Xi's Xiongan New Capital development could eventually have a population of between 9-12 million, with FAI of RMB 300-400 billion and a GDP of 1.4-1.9 trillion. In the short term, Xiongan will account for 0.04% of China's total FAI, and 0.03% of national GDP. Under a conservative estimate the report forecasts FAI inflows will reach 103.7 billion by 2020, accounting for 0.04% of national FAI. The brokerage's neutral and optimistic scenarios predict FAI of 136.7 billion and 173.3 billion, accounting for 0.06 and 0.09 percentage points respectively, by 2020.