China Macro Monday

The Week Ahead (May 1-5) and the Week Behind (Apr. 24-28)

Last week we noted that elite political tensions have spilled over into the streets, metaphorically of course, with social media the new battleground. This week things went mainstream in the form of a feature by Caixin about the Anbang Group. To us, this is a continuation of President Xi's earlier decision to target the business dealings of family members of elite political families about 8-months ago, an effort that escalated with the start of Guo Shuqing's campaign to go after corruption and regulatory arbitrage in the financial sector. Anbang is thought to represent a mainstay of the commercial interests of the Deng family, and while partially true, it is also a great example of a princeling corporate group whose stakeholders cannot be neatly categorized according to factional/political affiliation. In other words, going after Anbang is a throwdown against princelings in general, and we see this as a very risky move by Xi and Wang Qishan.

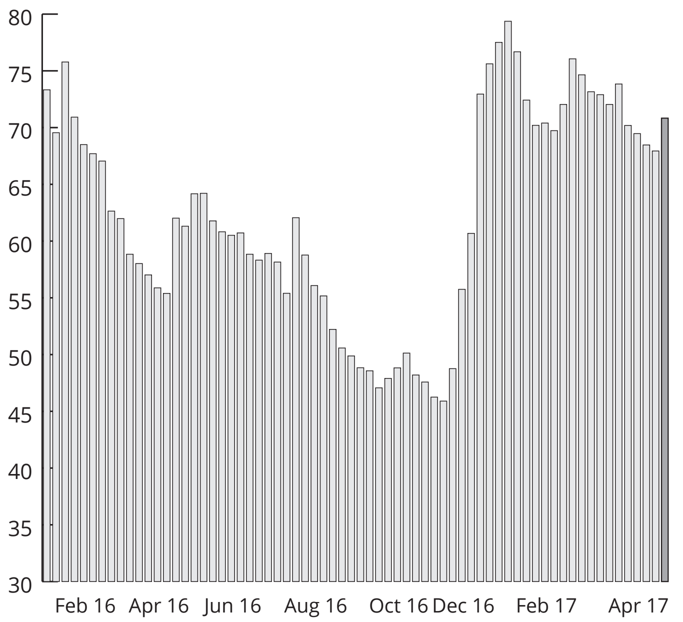
Wu Xiaohui, the head of the Anbang Group, is reported to have flaunted regulatory guidelines across many jurisdictions with impunity for years. He and those behind him are not going to go quietly. Anbang announced that it formally suing Caixin over the contents and implications of the article, and will probably encourage those who have been slinging mud at Wang Qishan (because of his wife's apparent support for the HNA Group) to continue to do so. The main reason is that Hu Shuli and Caixin are generally assumed to derive political backing from Wang Qishan.

Clear outcomes from this case are hard to predict, but suffice it to say that these atmospherics are not good for domestic investor sentiment in either the real economy or markets. This is especially important at this point in the macro/business cycle in China, and a number of our recent pieces have cited the potential for a cyclical inflection point based on the confluence of the leads and lags in the monetary and excess liquidity cycle, inventory destocking and of course the political cycle. Elite political tensions have gotten messy, and could become messier still.

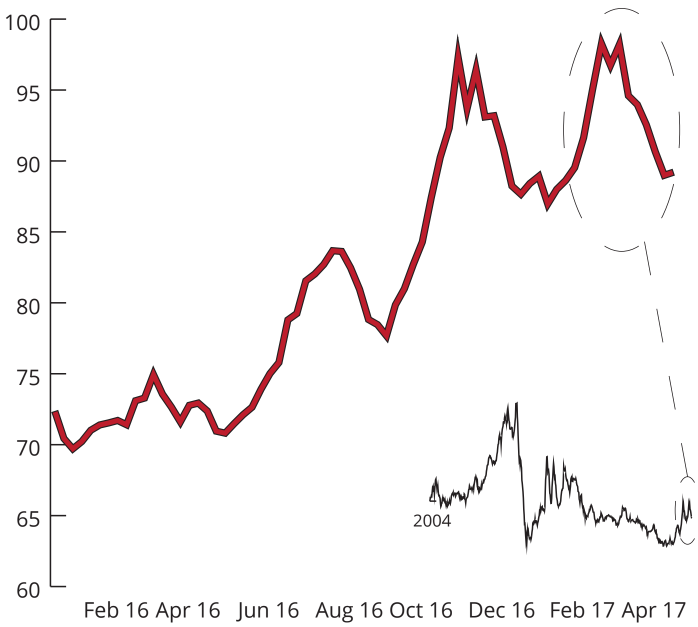
Macro and Markets

- Institutional allocations to equities picked up last week, rising by close to 4 percentage points to keep the SHCOMP buoyant. However, this appears to have disproportionately helped large-cap SOE shares, with related indexes outperforming mid-cap and small-cap indexes by a wide margin. We expect this divergence to continue as the CBRC's regulatory crackdown on NBFs drains funds from sub-segments of major markets where speculation and share price manipulation have been more common.

Institutional Allocations to Equities
percentage of AUM / weekly - as of 4/28



Weekly Macro Activity Indicator
as of 4/28



• This helped to offset slow mutual share issuance and purchasing data for the last couple of weeks, which reflects tepid retail investor interest. The balance of retail funds in the securities clearing system fell by an estimated RMB 200 billion in April, which is not a huge number, but indicative of weak overall market liquidity.

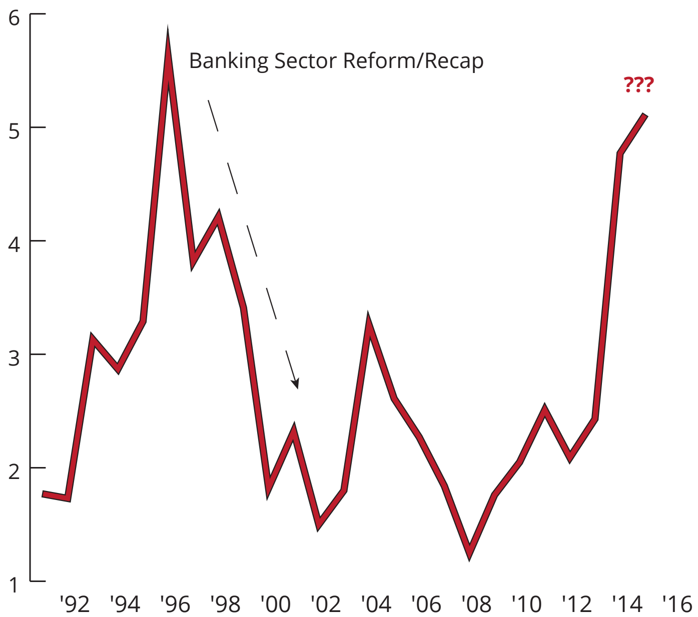
• Bond market data for April indicates that the effort to shift financial leverage back onto bank balance sheets and away from NBFs in favor of real sector lending should be supportive of conventional credit aggregates, including M2 and TSF. For example, net new corporate bond issuance came in at RMB 502 billion for April (against a total of RMB 636 billion), with net new CP issuance rising to RMB 317 billion (against a total of RMB 597 billion). Net NCD issuance tumbled in April, falling to RMB 510 billion (against total issuance of RMB 1.627 trillion, and redemptions of RMB 1.177 trillion).

• In the background to all of this, PBOC was relatively restrained with OMO injections into the financial system last week. We will have to compare this against April bank balance sheet data when it becomes available, however, because we continue to expect the central bank to do more behind the scenes than it does with headline policy tools. Borrowing rates continue to rise, and the NCD data, for example, indicates that funding conditions for city-level and joint-stock banks - as well as NBFs - have tightened considerably.

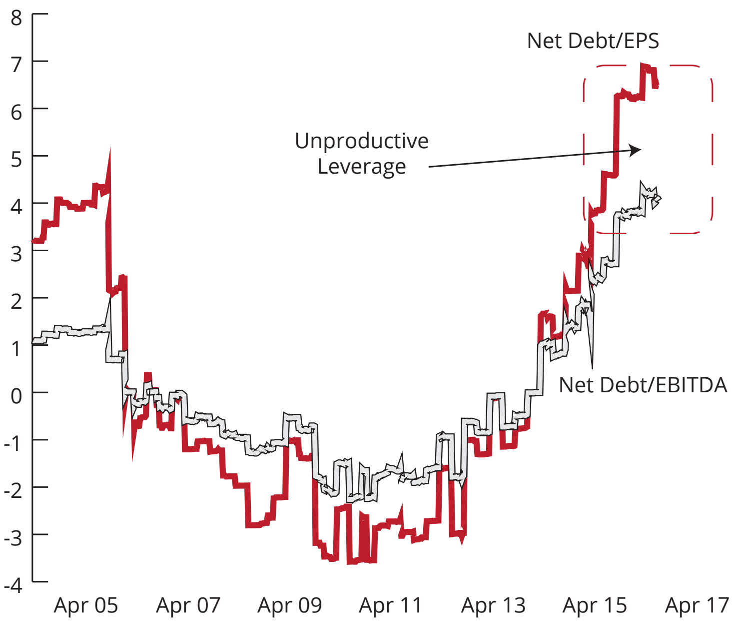
• Slightly longer-term we expect the National Financial Conference (NFC) to convene in Q3. Even if it doesn't, the senior leadership will continue to lay the groundwork for a restructured regulatory and market universe. What we think has been under-appreciated by markets so far is that the policy logic of "supply side reform" in the financial sector is probably far more similar to that for the real sector than has been discussed so far. In other words, excess leverage is essentially the product of "excess capacity" in the financial system, and deleveraging should ultimately reduce the number of firms and increase sector concentration ratios. To some extent, China looks "over-banked", and this leads to excessive competition, speculation and regulatory arbitrage as institutions chase shrinking returns. For the real sector this ends up being deflationary.

• An eventual banking sector consolidation would also be convenient for recapitalizing the system. As we have seen so far in the attempted consolidation of upstream industrial sectors so far, a lot of bad assets and debt can be swept under the proverbial rug by merging bloated balance sheets with targeted financial support. Other pieces of the puzzle for the NFC and an eventual restructuring of the banking system (if not a move more towards big universal banks) include the creation of dozens of regional "bad banks" and industry development/consolidation funds. Once fully capitalized and operational, these entities - along with the RMB 17 trillion LG bond swap - could help defer a lot of marginal/bed debt through 2025.

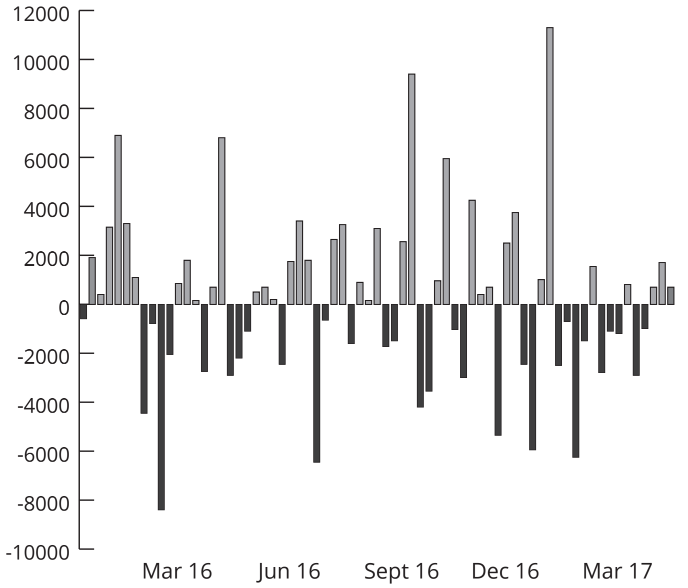
China Incremental Capital Output Ratio
annual / expenditure side GDP data



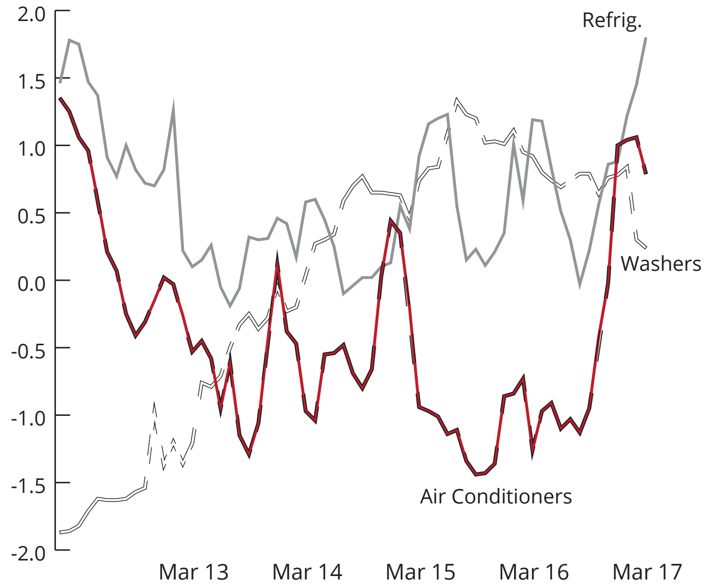
SHCOMP Debt and Earnings Divergence
weekly data



Weekly PBOC Net OMO Injections
RMB 100 million



Reported White Goods Inventory Levels
standardized data / units / China IOL



• As noted in the charts above, the persistent increase to China's incremental capital output ratio (ICOR) has been mirrored recently in the divergence between measured net debt to earnings per share, and net debt to EBITDA. These measures echo what occured in the late 1990s and early naughts in China.

• A closer look at strong recent industrial profit growth data shows that more than half of YTD profit growth has come from the mining and steel/metals sectors, both of which have been the primary beneficiaries of the reflationary cycle (and to some extent price intervention by the NDRC). The recovery to profits elsewhere has been more modest. Additionally, inventory levels in a number of major industrial segments - below steel and float glass - remain high relative to already low utilization rates. More broadly we take this to mean that a big inventory build occurred in 2016 on a smaller increase to capacity utilization than has previously been the case. Looking at available inventory data for downstream final goods segments, seasonal inventory levels for autos and white goods look pretty high, just as correlated activity, such as turnover in major urban property markets, slows. More broadly, factoring in the leads and lags from the business and monetary cycles, strong reported profit growth could decelerate more quickly than typical moving average models may indicate.

• As we wrote last week, we took the PSC's reference to "stable growth" last week was a put on marginally lower growth (a floor or 6.5%). However, if the confluence of cyclical macro, regulatory and monetary factors become a drag on growth during the remaining months of Q2, as we expect they will, Beijing may be back to providing direct growth support via conventional quasi-fiscal spending sooner than many currently expect.

DATA RELEASES

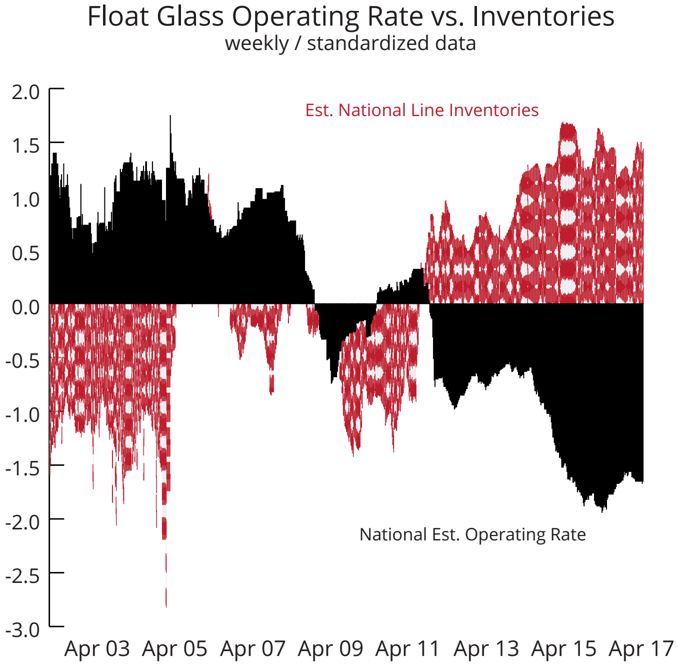
Caixin Manufacturing PMI (5/2) Caixin: No market forecast, last period 51.2, year ago 49.4.

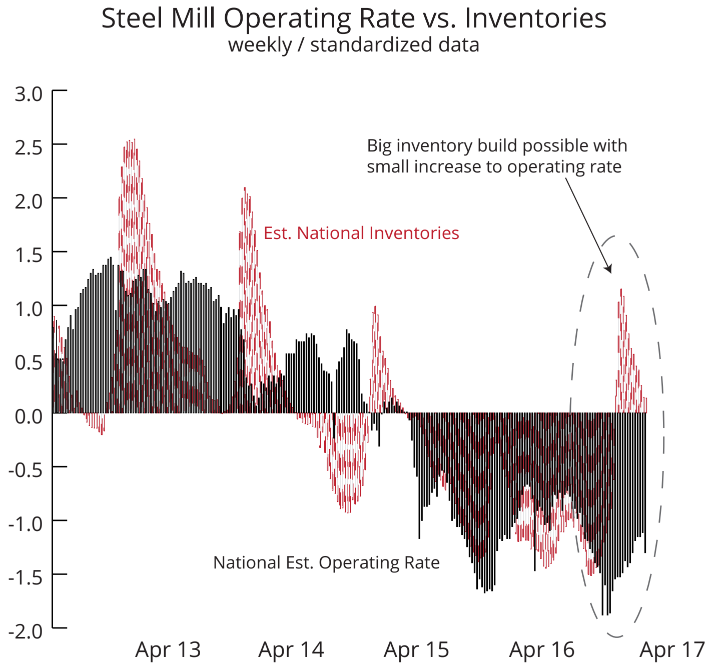
Caixin China Services PMI: Business Activity Index (5/4) Caixin: No market forecast, last period 52.2, year ago 51.8.

Official Reserve Assets, US$100m (5/7) PBOC: No market forecast, last period 31,027, year ago 33,161.

Gold Reserves, 10K ft ounces (5/7) PBOC: No market forecast, last period 5,924, year ago 5,814.

Foreign Currency Reserves, CNY 100m (5/7) PBOC: No market forecast, last period 30,091, year ago 32,197.





Clips You Might Have Missed

Yi Gang Positive On NPLs And Investment (4/24): China's NPLs have stabilized and pressure from capital flight has eased off, according to Yi Gang, deputy governor of the PBOC. Yi made the remarks at the a forum in New York. While acknowledging that China's financial market still faces different types of risks, he said that "the overall risk is under control." He pledged to improve shadow banking regulation and transparency and monitor NPLs, capital outflow and divergent movement of property prices in cities in order to prevent systematic risks (see: **Guo's Financial Sector Cleanup and Capital Flows,** 4/27).

Steel Makers Disqualified (4/24): China has removed 29 firms from its list of "qualified steel makers", the first time it has taken such action, and threatened another 40 with removal if they did not reform. MIIT started compiling its list of "qualified steel makers" in 2009 in an attempt to regulate quality and curb overproduction. After topping out at 304 company names in 2015, the list now stands at 275. The delisted companies don't immediately have to close, and punishment for continued noncompliance is unclear, with the warning simply saying that producers must meet standards for environment, safety, quality, energy consumption and technology. The companies can apply to be relisted in 12 months. Some are subsidiaries of big-name industry players such as Baosteel and HBIS Group Co. The 40 companies who were not delisted but were warned include subsidiaries of steel giants Shougang Group, Benxi Steel Group Corp. Ltd. and Dongbei Special Steel Group.

Food Prices Lead CPI (4/24): The average price of food in 50 Chinese cities continued to drop between April 11 and April 20. Prices of pork, chicken and egg declined from the last sampled period of April 1 to April 10. NBS data showed beans led the fall in vegetable prices dropping 6.8%, while cucumber and tomato prices dipped by 3.9% and 3.1%. Continued falling food prices will put pressure on China's next CPI reading due 5/10. China's consumer inflation grew 0.9% YoY in March.

Job Creation Strong (4/25): China's quarterly job report delivered a positive message with 3.34 million new jobs created in Q1, with the unemployment rate falling to 3.97%. The number of new jobs was 160,000 higher than that in the same period last year, and the unemployment rate was down 0.07 percentage points YoY and 0.05 percentage points lower QoQ. From January to March, job vacancies rose 7.8% YoY while applicants increased 2.1%. Labor is a lagging indicator, but for now the labor market is relatively good.

4G Users Approach 900 Million (4/25): China had a total of 836 million 4G network users as of the end of March, up from 770 million three months ago. China has the world's largest 4G network and is aiming to add 2 million 4G base stations, mainly for townships and villages, by 2018.

Steel Output Up Exports Down (4/24): China's crude steel output grew 4.6% YoY to 201.1 million tonnes in Q1 2017. In the first three months, China's steel exports declined 25% YoY to 20.73 million tonnes. Steel exports to the US plunged 51.76% YoY in 2016 to 1.17 million tonnes, accounting for 1.08% of China's total steel exports. In Q1, sales revenues of China's steel companies rose by more than 40% YoY to hit a total of RMB 839.3 billion. China plans to reduce steel output by100 million to 150 million tonnes by 2020.

Chalco Profits Rise Ali Cap Imminent? (4/26): Net profits of Chalco increased sharply in Q1. The company made just RMB 920 million in net profit. There are rumors that a number of recent high profile project closures received direct approval from either Liu He (Xi's aid) or PM Li, and that some form of production cuts will soon be imposed. There are currently two rumored versions for the form of restrictions, with a regulatory document expected any time. NDRC will propose to a capacity cap. One version of the cap may keep capacity at the current level 40 million metric tons (only including already approved production and already completed construction with no more new construction) and tear down all illegal capacity and production (roughly 110 million metric tons), which are estimated around 26% of the existing legal capacity of 40 million metric tons. Another version is to cut capacity by 20% from the existing 40 million metric ton level.

Coal Supply Boost (4/27): China will increase the supply of coal and lower prices of the fuel to help power plants that are grappling with slumping profits despite growing demand for electricity. The NDRC said the government will "increase the effective supply of coal". The commission will send inspectors to supervise the signing of coal-supply contracts and monitor whether they are being honored. Last month, seven coal-fired power companies in Ningxia called on the provincial-level government to intervene in contract talks and force their dominant supplier, Shenhua Ningxia Coal Industry Group, to lower its prices, but the company refused. China's power producers have seen their profits plummet as a surge in coal prices.

Gold Sales Rise On Hedging (4/27): China's actual gold consumption rose 14.73% to 304.14 tonnes in Q1 due to steady gold ornament sales and strong sales of gold bars. Thanks to strong demand around Chinese New Year, gold ornament sales rose 1.4% to 170.93 tonnes and gold bar sales surged 60.18% to 101.19 tonnes.

Beijing Eyes Biomedics (4/28): China plans to build 10 to 20 professional biotechnology and medicine zones each with a total output value of RMB 10 billion by 2020. The Ministry of Science and Technology said Friday, that five to ten biological manufacturing zones will also be established each with10 billion yuan of output value by that time.

Financial Stability and National Security (4/28): Last Wednesday the PSC held its Q1 meeting on the economy, which was followed an even more important ideological "study session" led by President Xi on Thursday emphasizing the direct link between systemic financial stability and national security. Longer-term, Xi's general disposition towards the financial sector could have lasting consequences for the role of the Party in what has been a technocratic realm and for the future evolution of the financial sector in the economy more generally (see: **PSC "Studies" Financial Stability as National Security** 4/28).

Beijing Housing Regulations Tightening (4/29): Domestic media reports indicate the capital's real estate market could be in for fresh lending regulations beginning today. Rumors point to new restrictions that would apply to loans for second home buyers seeking to purchase both new and second hand homes.

Non Manufacturing PMI Slowing (4/30): China's non-manufacturing sector continued to expand in April, though at a slower pace compared with a month ago. The non-manufacturing PMI came in at 54 in April, down from 55.1 in March. The service sector slowed its growth pace in April. Notably, the index for new orders in the service sector fell below the boom-bust line of 50 to 49.7, indicating sluggish market demand.

Manufacturing PMI Expansion (4/30): China's manufacturing sector continued to expand in April, though at a slower pace. China's manufacturing PMI came in at 51.2 in April, lower than the 51.8 recorded in March. NBS attributed slower expansion to sluggish growth in both market demand and supply. NBS added that the lower-than-expected expansion was also a result of contraction in high energy-consuming industries, lower price at factory gate, and slower expansion in both imports and exports.