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A solvency crisis or a liquidity squeeze?

Louis-Vincent Gave

A solvency crisis or a liquidity squeeze?

- Whenever global markets fall in unison by more than -10%, we are forced to confront a simple question: are we confronting a liquidity squeeze or a solvency crisis? This question is pertinent for two reasons:

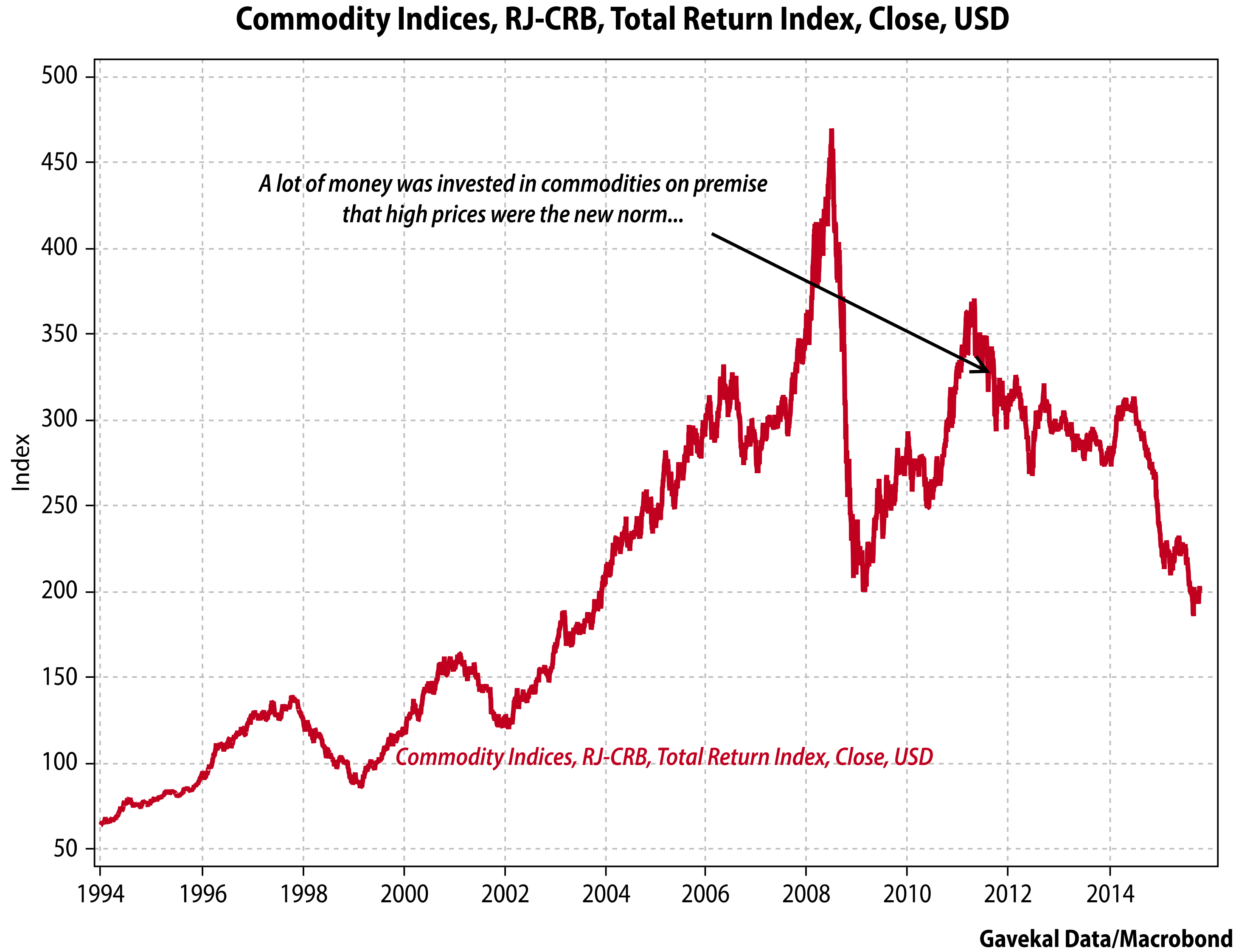
1. Global debt has increased by 40% of global GDP since 2007
2. Over the past couple of decades, investors have bounced around from 'solvency crisis' to 'solvency crisis' every three to five years.

- It is our belief that, once again, we are confronting a solvency crisis. But it is a fairly localized crisis; one that is decimating the commodity producing sector. It is also an ironic crisis indeed, six or seven years ago, when confronting ZIRP and QE, investors could find one of two reasons to be bearish:

1. The first was that ZIRP would allow zombies to stick around, hereby weakening growth and returns on invested capital (the Japanese scenario)
2. The second, more widely held view, was that the activism of Western central banks would trigger hyper-inflation. As such, many argued that portfolios needed to allocate into energy, precious metals, and agricultural land in order to 'hedge' the coming inflation risk.

- But instead, what we witnessed was massive mal-investment into commodities and we have now entered the capital destruction phase of the cycle.

Commodities attracted hundreds of billions on false premises



Between 2005 and 2014, money poured into commodity products on the false premises that:

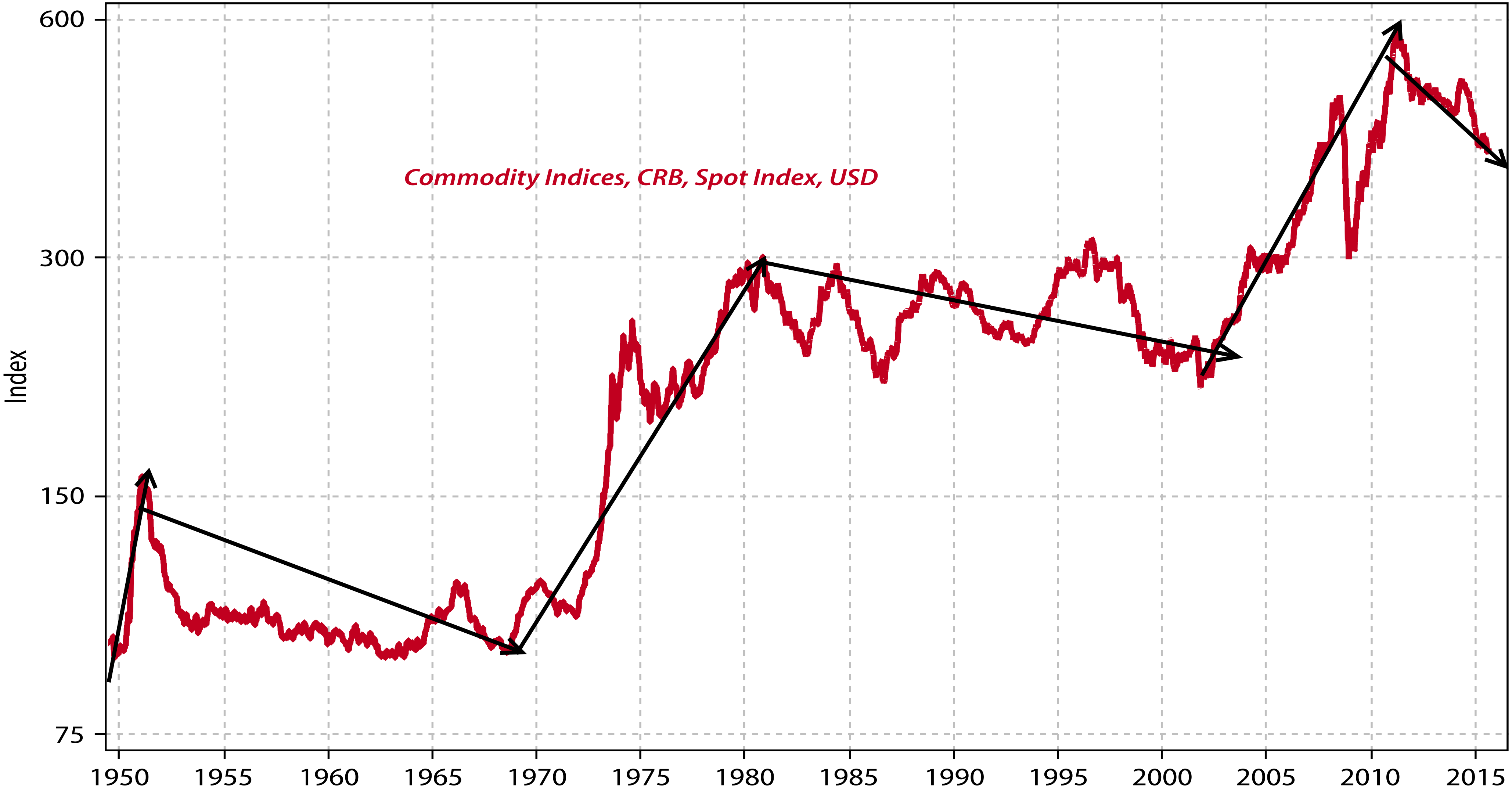
1. The world was set to run out of most commodities (i.e.: Malthusian theories).
2. Commodities would prove a good hedge against the inflation triggered by ZIRP.

Instead, the money that has poured into commodities has triggered a boom-bust cycle of enormous scale. And we are now in the bust phase.

These bust phases usually do not end without bankruptcies/ industry consolidation.

Instead, what we have is a typical cycle

After a decade of rising prices, two decades of downward range-trading?



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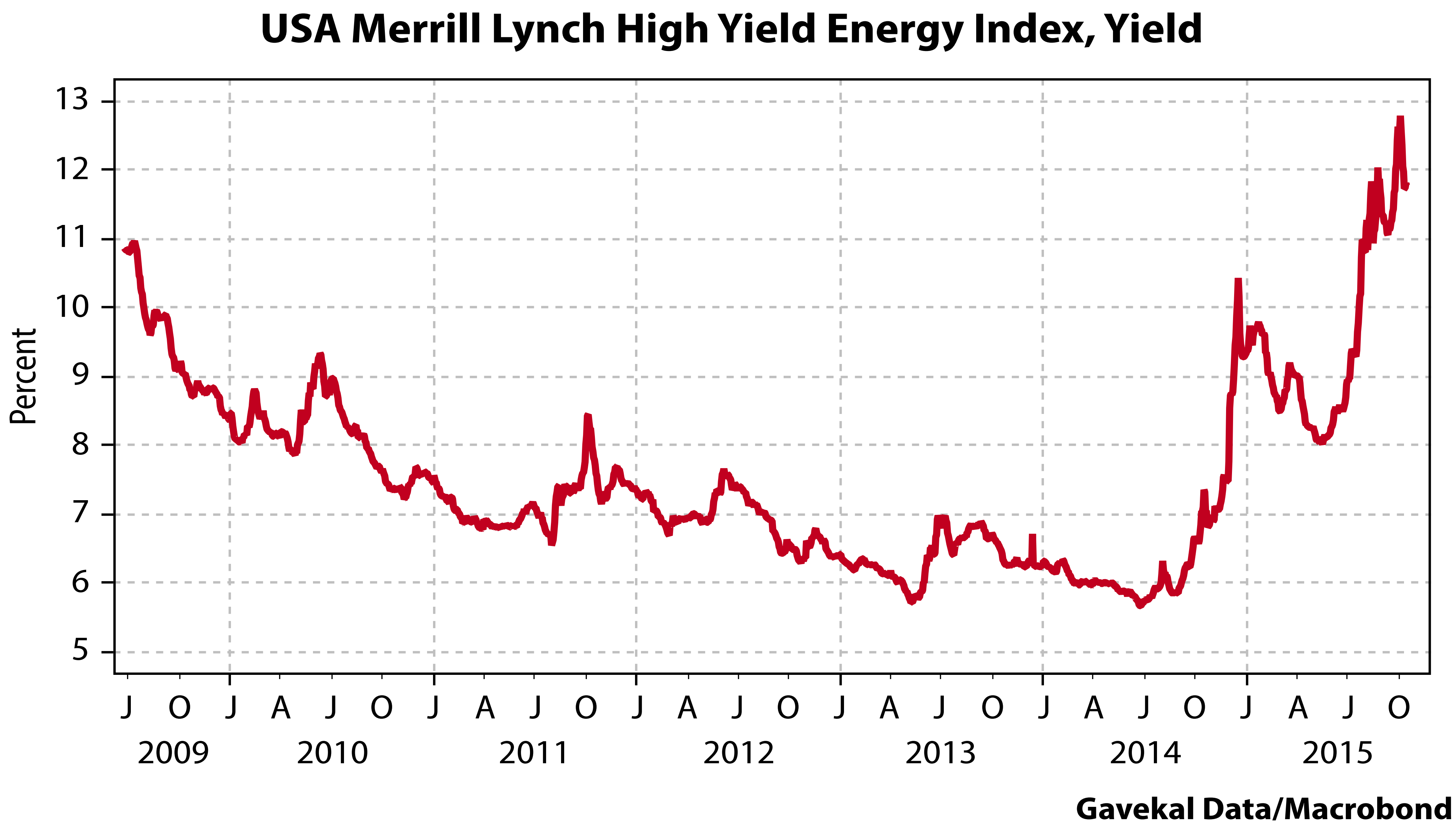
The pain is now spreading from the equity owner to the debt holder



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How the commodity bust will unfold

Countries dealing with bust through devaluation with little inflation risk

Norway

Indonesia

Singapore

Australia

New Zealand

Colombia

Canada

Export deflation to the rest of the world

Countries dealing with bust through devaluation & risking inflation

Russia

Brazil

South Africa

Argentina

Kazakhstan

Trigger asset impairments & volatility (bonds, equities)

Countries dealing with bust through activity and asset deflation

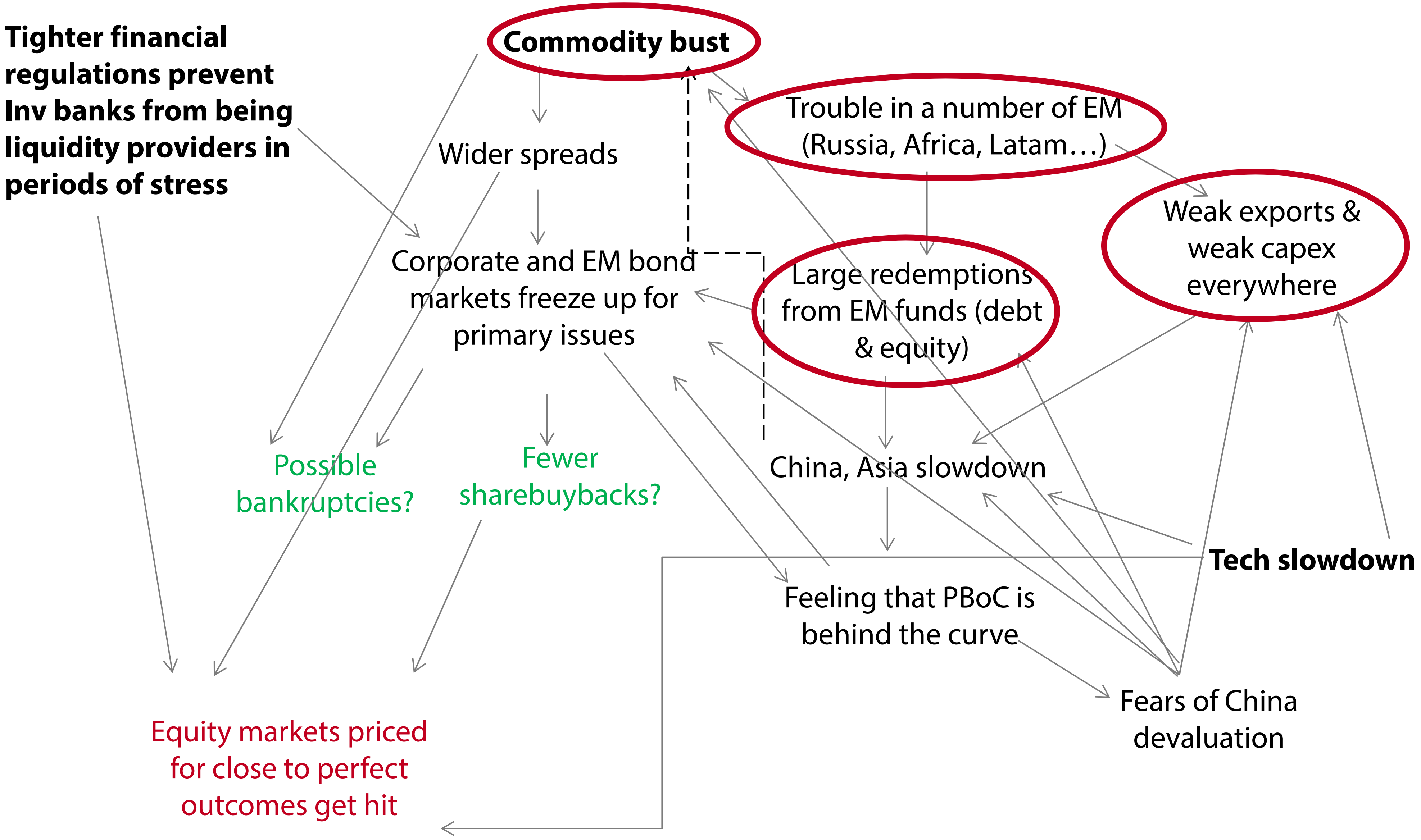
Saudi Arabia

UAE

Finland

Little impact on other countries as these countries are 'too small'… question is whether pegs will hold? And how much local asset prices will fall (i.e.: HK in 1997)

The unfolding commodity bust has had ripple effects



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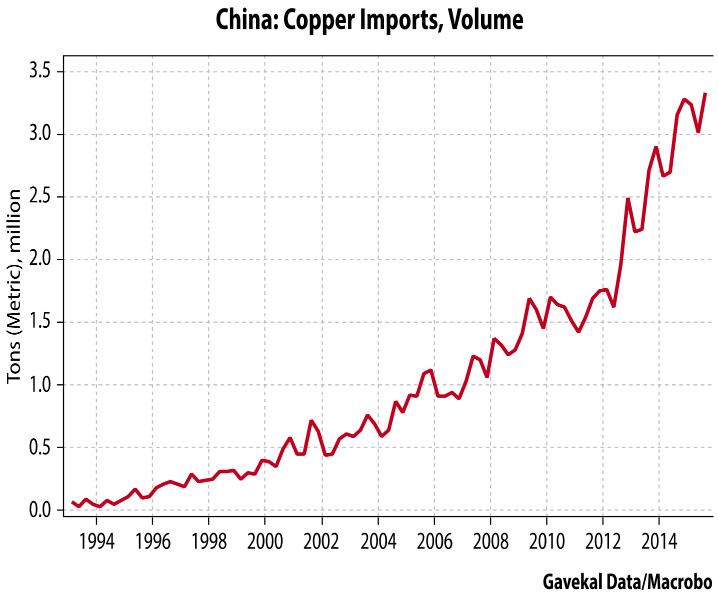
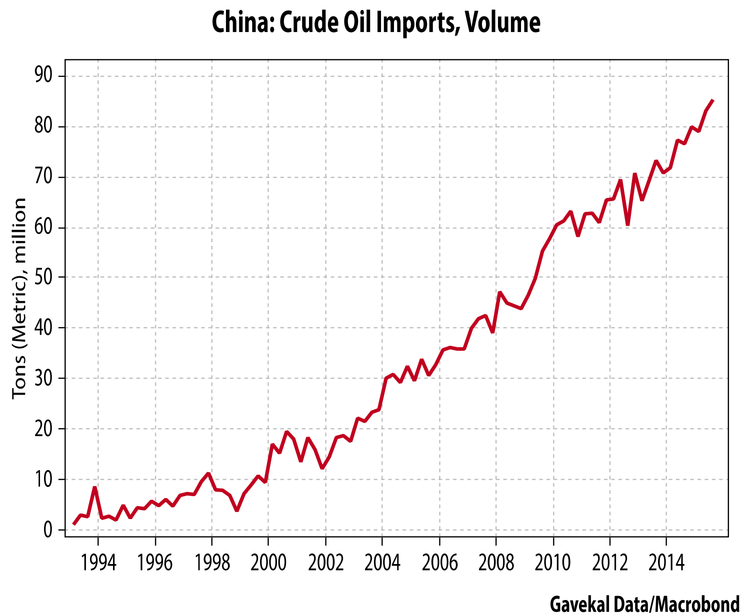
2- The biggest ripple effect: the China panic

The commodity bust and the China slowdown

- For most investors, China is a 'black box' . The data can't be trusted. The leadership can't be trusted. The companies can't be trusted… This (well-justified?) paranoia has led most investors to look outside of China for signs on how the country is doing. And in the past decade, most have grown to equate commodities with China.
- With commodities collapsing, this Commodities = China = Commodities allowed the market to whip itself into a frenzy of China bearishness this summer. Of course, the Shanghai equity market crash and the botched currency policy change did not help (more on that later).
- And undeniably, China is slowing. But the question at heart is whether the economy is confronting a deflationary bust? Or a slowdown? Importantly, one can not place the blame for the collapse in commodity prices on China alone:





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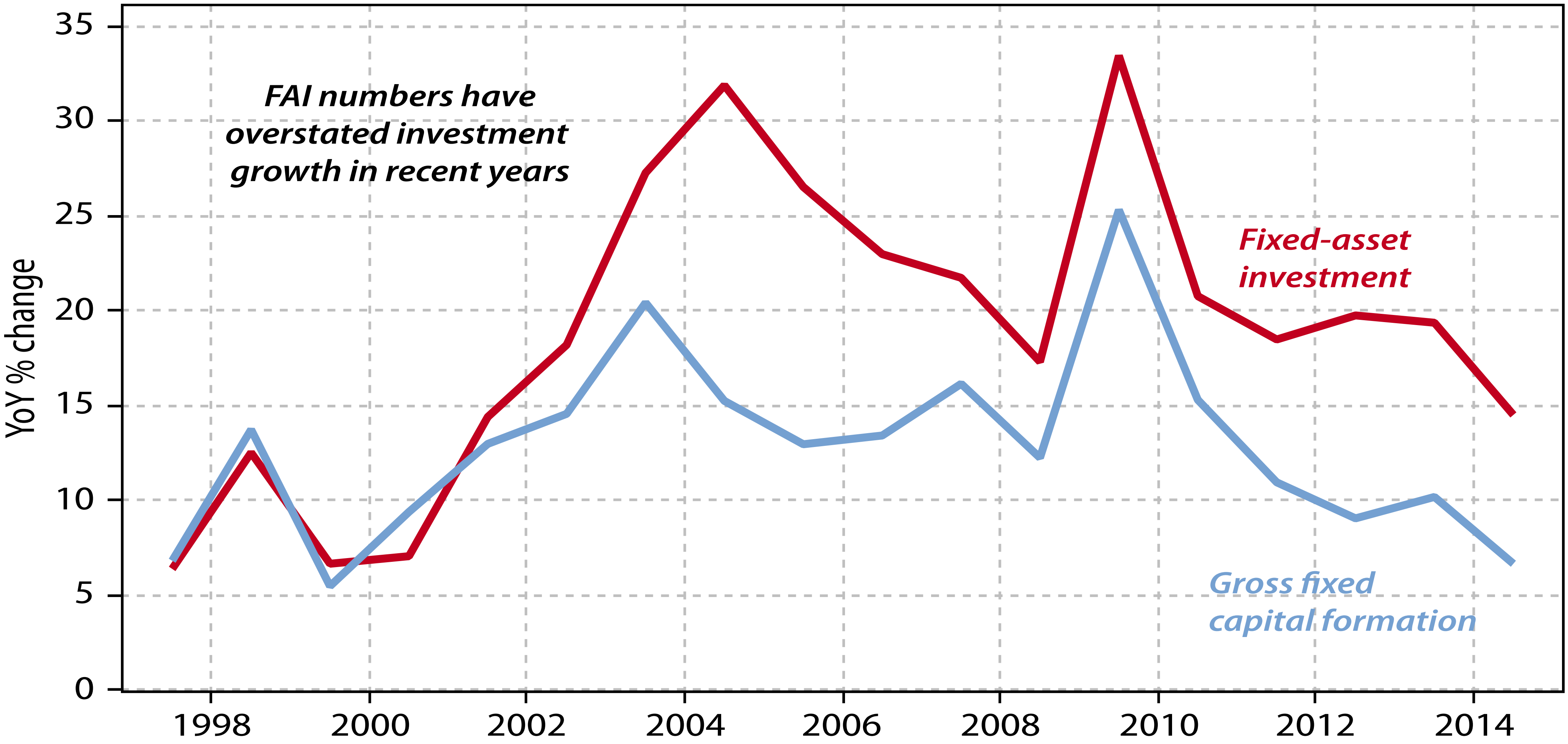
This is not to belittle the slowdown in Chinese growth

China's investment growth has plummeted since 2009

Annual real growth rates (both deflated by fixed-asset investment price index)



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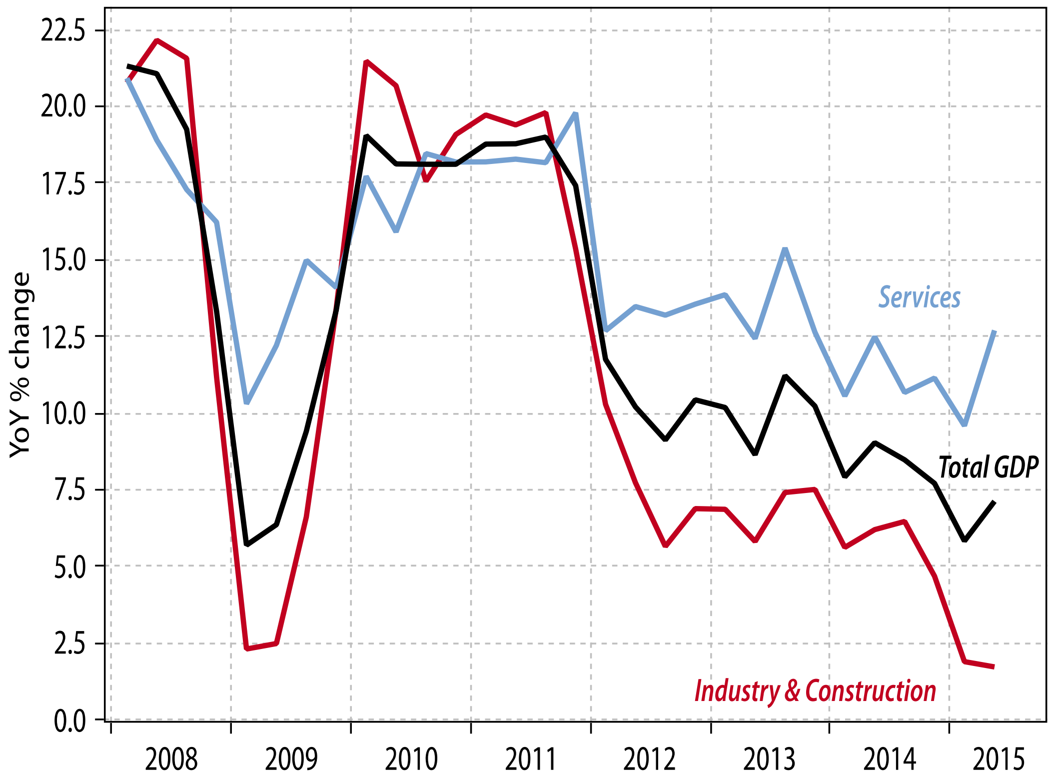
Undeniably China is slowing down… but is that such a surprise?

China's economic performance is diverging sharply

Nominal change in value-added by sector



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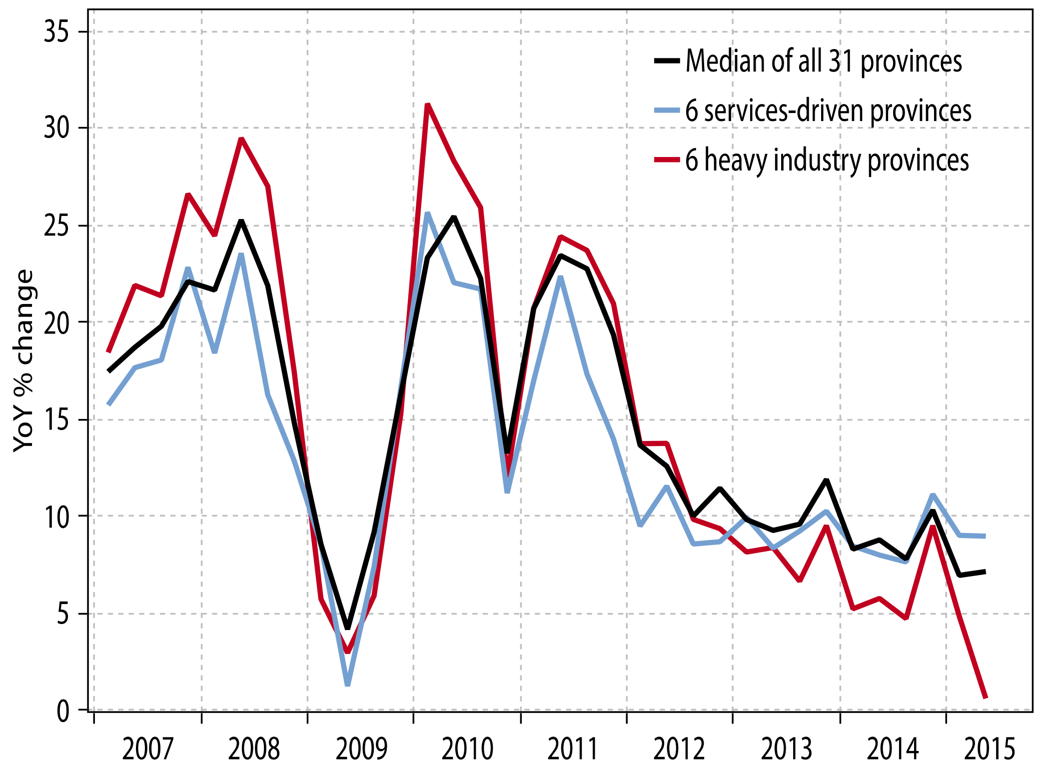
Services outperforming the resource-dependent provinces

Nominal quarterly GDP growth, by groups of provinces



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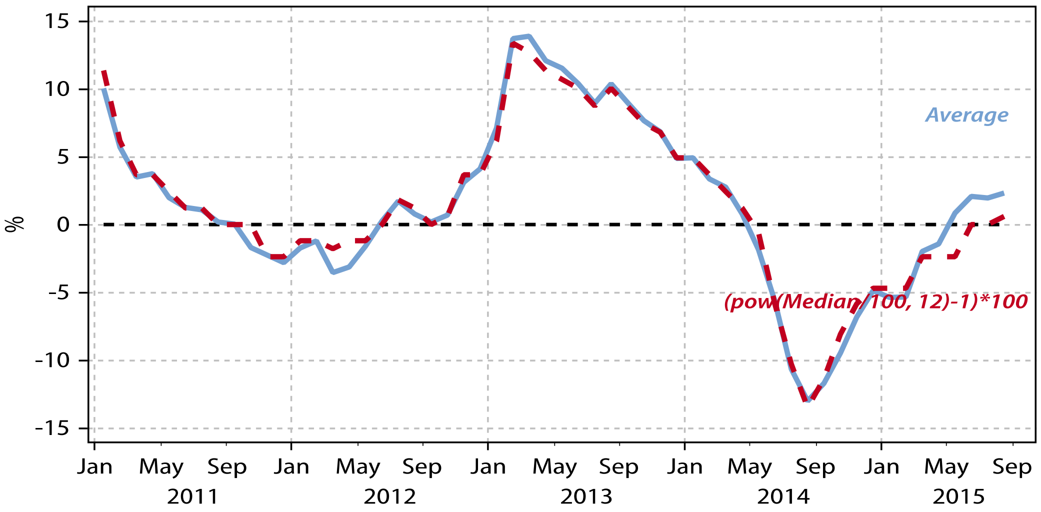
The question is whether China is slowing? Or falling apart?

Housing prices in China are recovering

Average MoM change of new housing prices in 70 big cities, annualized



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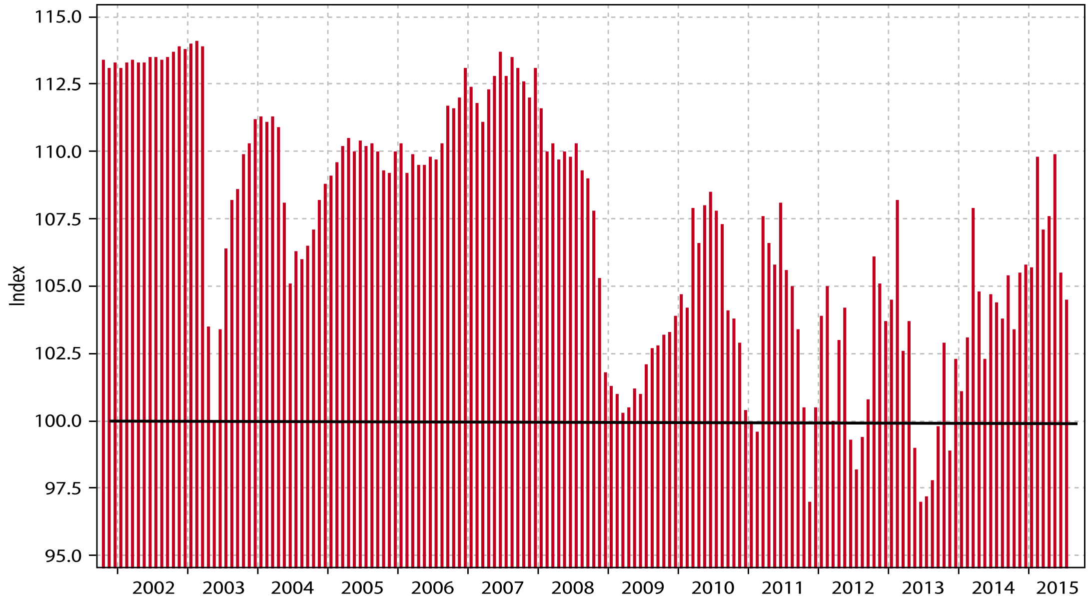
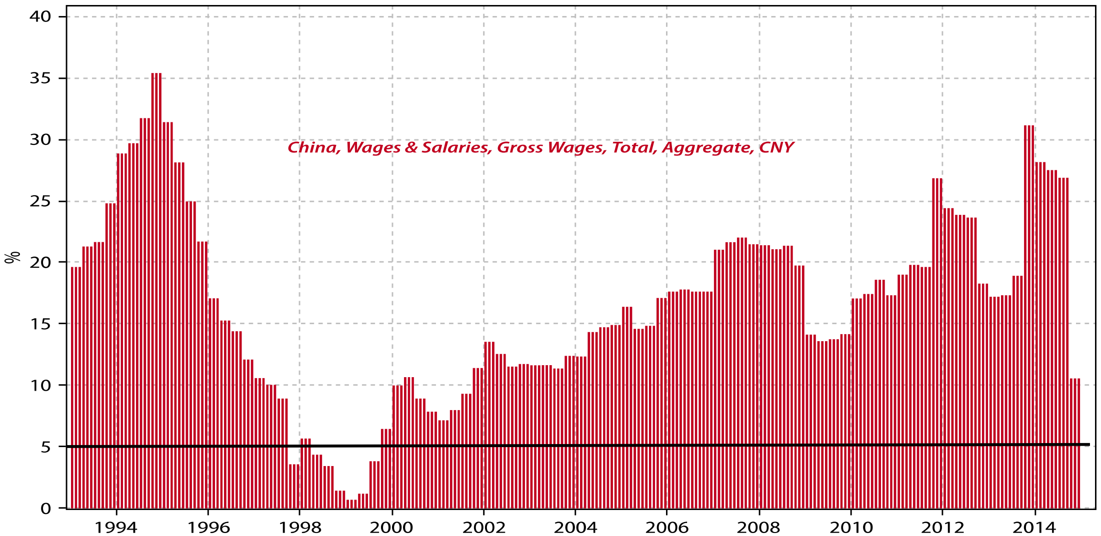
China Consumer Confidence



China, Wages & Salaries, Gross Wages, Total, Aggregate, CNY



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China, Consumer Price Index, State, All Areas, Total, Index

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So why did the market freak out?

Mike Tyson once said *"everyone has got a plan until I hit them on the nose"*. As we write, most China watchers have sore noses as recent months delivered:

- **Fear #1**: China is devaluing its way to growth.
- **Fear #2:** China is hard-landing and China's economic collapse threatens growth not only across EM, but also across the developed world.
- **Fear #3:** Policy-makers are losing control of the situation.
- **Fear #4:** We thought China's policy-makers were following a non-election encumbered roadmap. But now we realize that they are useless and making it up as they go along…

Some of these fears are of course legitimate. But they are most likely overblown. Here is how we see the situation:

3- Policy disappointments from China

A devaluation would do little to help China's slowing sectors

- China is experiencing a nasty slowdown in big and important parts of the economy. Much of this slowdown is structural and **not easily reversed by monetary or fiscal policy**.
- Just as importantly, the parts that are slowing (infrastructure spending and construction) are NOT likely to be boosted by a currency devaluation. China could place the RMB at 10/USD, and still China would not be needing more steel, cement, coal etc…
- The growing parts of the economy, mostly the service sector, are doing well but aren't big enough or growing fast enough to fully offset the slowdown.
- What is needed are structural reforms to:
  - ➢ **Remove barriers to growth in the expanding sectors**
  - ➢ **Use market mechanisms to facilitate reallocation of resources toward the expanding sectors**
- Following the Third Plenum, this is what investors expected – and this is where some of the disappointments lie today:

The to-do list from the Third Plenum was long – too long

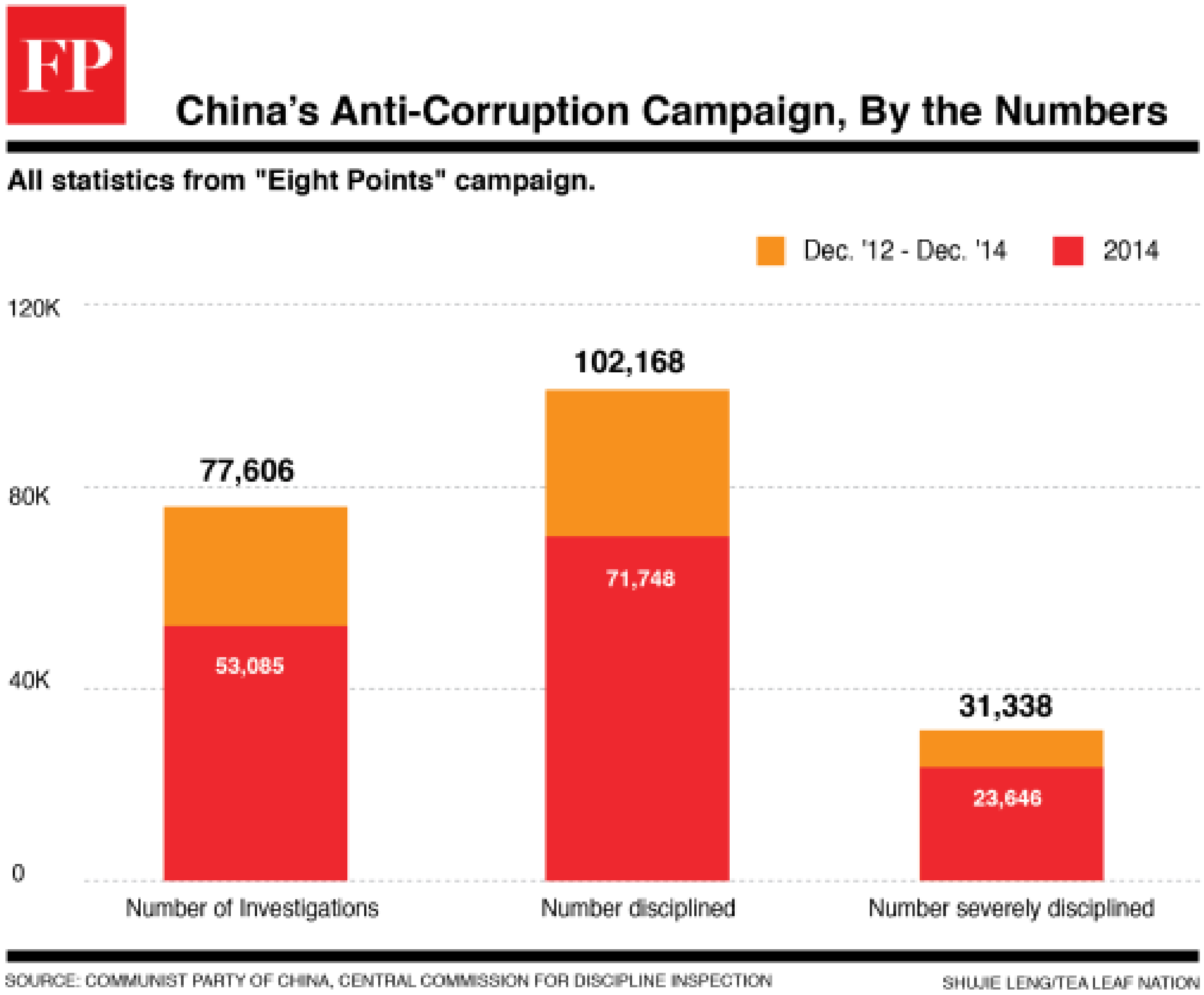
1. Improving the property rights protection system.
2. Vigorously developing a mixed economy.
3. Promoting a modern corporate system for SOEs.
4. Supporting the healthy development of the non-public sector.
5. Enacting market rules that are fair, open and transparent.
6. Improving the mechanism whereby prices are mainly determined by the market.
7. Forming a unified construction land market for both urban and rural areas.
8. Improving the financial market.
9. Deepening reform of the management system for science and technology.
10. Improving the macro control system.
11. Fully and correctly performing government functions.
12. Streamlining the government structure.
13. Improving the budget management system.
14. Improving the taxation system.
15. Establishing a system whereby authority of office matches responsibility of expenditure.
16. Accelerating the building of a new type of agricultural operation system.
17. Endowing farmers with more property rights.
18. Promoting equal exchanges of factors of production and balanced allocation of public resources between urban and rural areas.
19. Improving the institutions and mechanisms for promoting the sound development of urbanization.
20. Relaxing control over investment access.
21. Speeding up the construction of free trade zones.
22. Further opening up inland and border areas.
23. Bringing the people's congress system in line with the times.
24. Promoting wide, multi-tiered and institutionalized consultative democracy.
25. Giving full play to democracy at the community level.
26. Protecting the authority of the Constitution and laws.
27. Deepening reform of the administrative law-enforcement system.
28. Ensuring the independent exercise of the judicial and procuratorial power in accordance with the law.
29. Improving the mechanism for the use of judicial power.
30. Improving the judicial system to protect human rights.
31. Forming a scientific and effective mechanism to check and coordinate power.
32. Be more innovative in creating mechanisms and institutions to combat corruption.
33. Having systemic rules to improve work style.
34. Improving the cultural management system.
35. Establishing and improving a modern cultural market system.
36. Building a modern public cultural services system.
37. Improving cultural openness.
38. Deepening the comprehensive reforms in the area of education.
39. Improving systems and mechanisms that boost employment and business startups.
40. Forming a reasonable and orderly distribution pattern of income.
41. Instituting a fairer and more sustainable social security system.
42. Deepening reform in medicine and health care.
43. Improving methods of social governance.
44. Kindling the vigor of social organizations.
45. Innovating systems that can effectively prevent and solve social conflicts.
46. Improving the public security system.
47. Improving the system of natural resource property rights and the system of natural resource utilization control.
48. Delimiting the red line for ecological protection.
49. Implementing sound compensation systems for use of resources and for damage to the ecological environment.
50. Reforming the ecological protection management system.
51. Deepening the adjustment and reform of the military administrative setup and staffing.
52. Promoting adjustment and reform of military policies and systems.
53. Deepening the integration between the military and civilian sectors.
54. Ensure that the decisions of the Party Central Committee are carried out effectively.

The Third Plenum is NOT the actual reform strategy

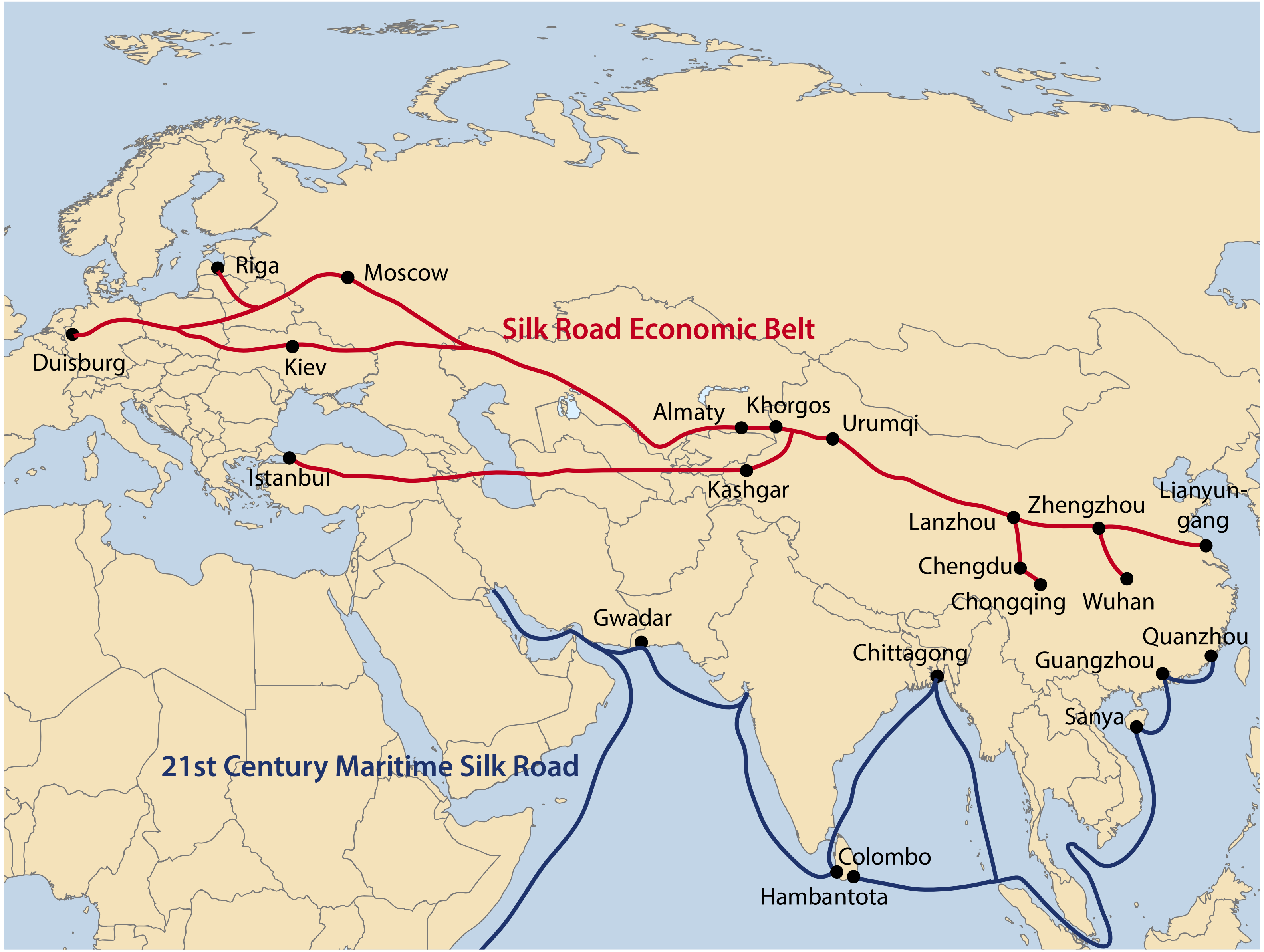
1) Internal contradictions
2) No ranking of priorities
3) Many important recent initiatives are not discussed

→ **Look at what Xi Jinping & Co. are actually doing**

First big priority: anti-corruption and tighter political control



Second big priority: reset foreign policy and boost global profile



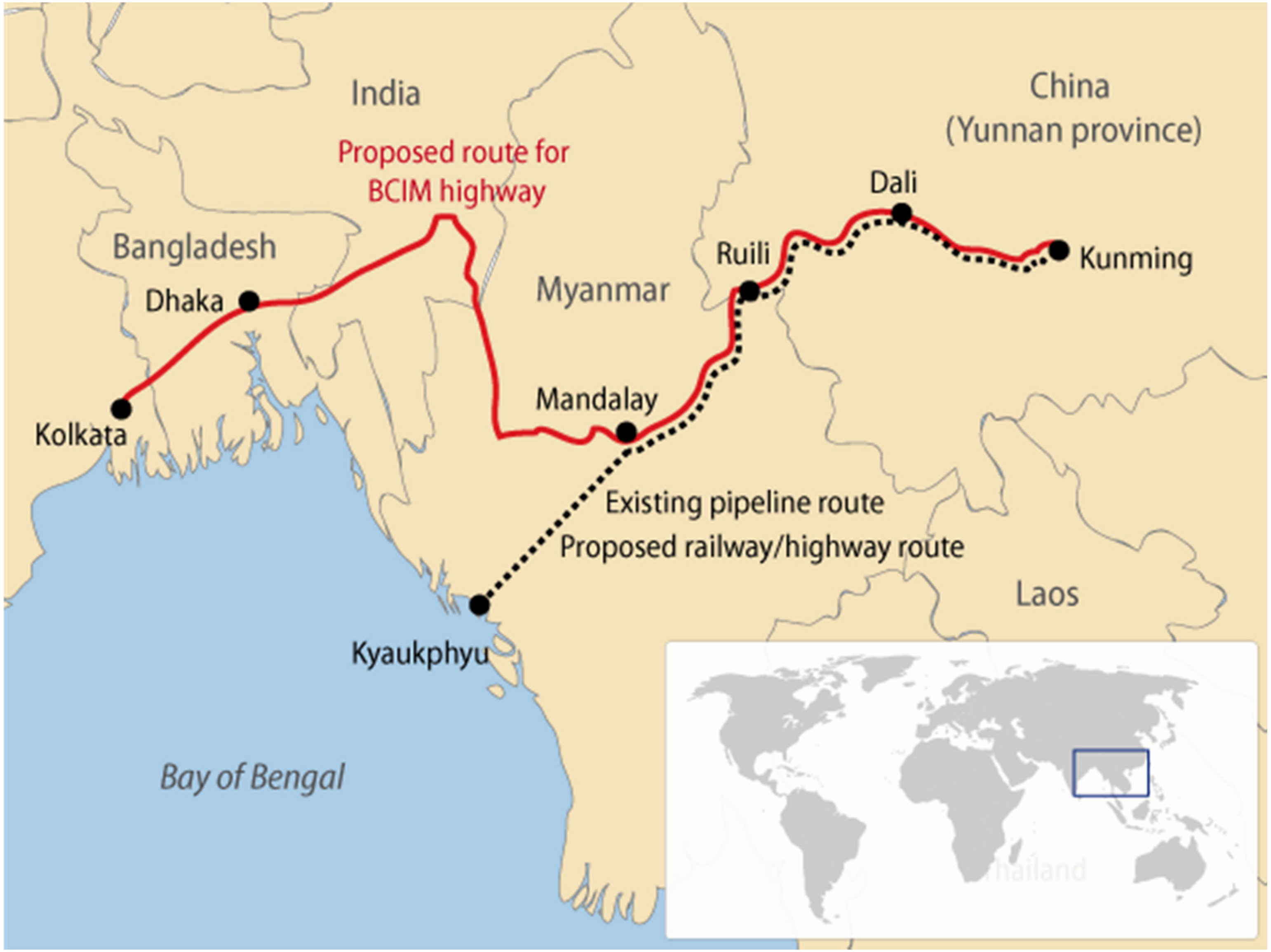
China is expanding south...

The southwestern province of Yunnan is a "bridgehead" for strengthening China's clout in the Mekong Basin. Its companies are building roads, dams and power grids, and investing in mines, real estate and agriculture.

A new US$4bn highway runs from Kunming, Yunnan's capital, to Bangkok.

China is also set to build a US$7.2bn high-speed railway through Laos, financed by China Exim Bank using untapped minerals as collateral.

… and south-west



The Bangladesh-China-India-Myanmar (BCIM) Economic Corridor will consist of a highway and other infrastructure connecting Kunming and Kolkata. Twin oil and gas pipelines already run from Kyaukphyu to Kunming.

Beijing's ultimate aim is to secure a western seaboard in the Bay of Bengal, enabling it to extend its sphere of influence into the Indian Ocean.

Myanmar canceled a planned railway, but both it and India have given the go-ahead to the BCIM plan.

Economic reform or national revival?

Q: Why has economic reform lagged expectations?

A: Because economic reform is not Xi Jinping's top priority.

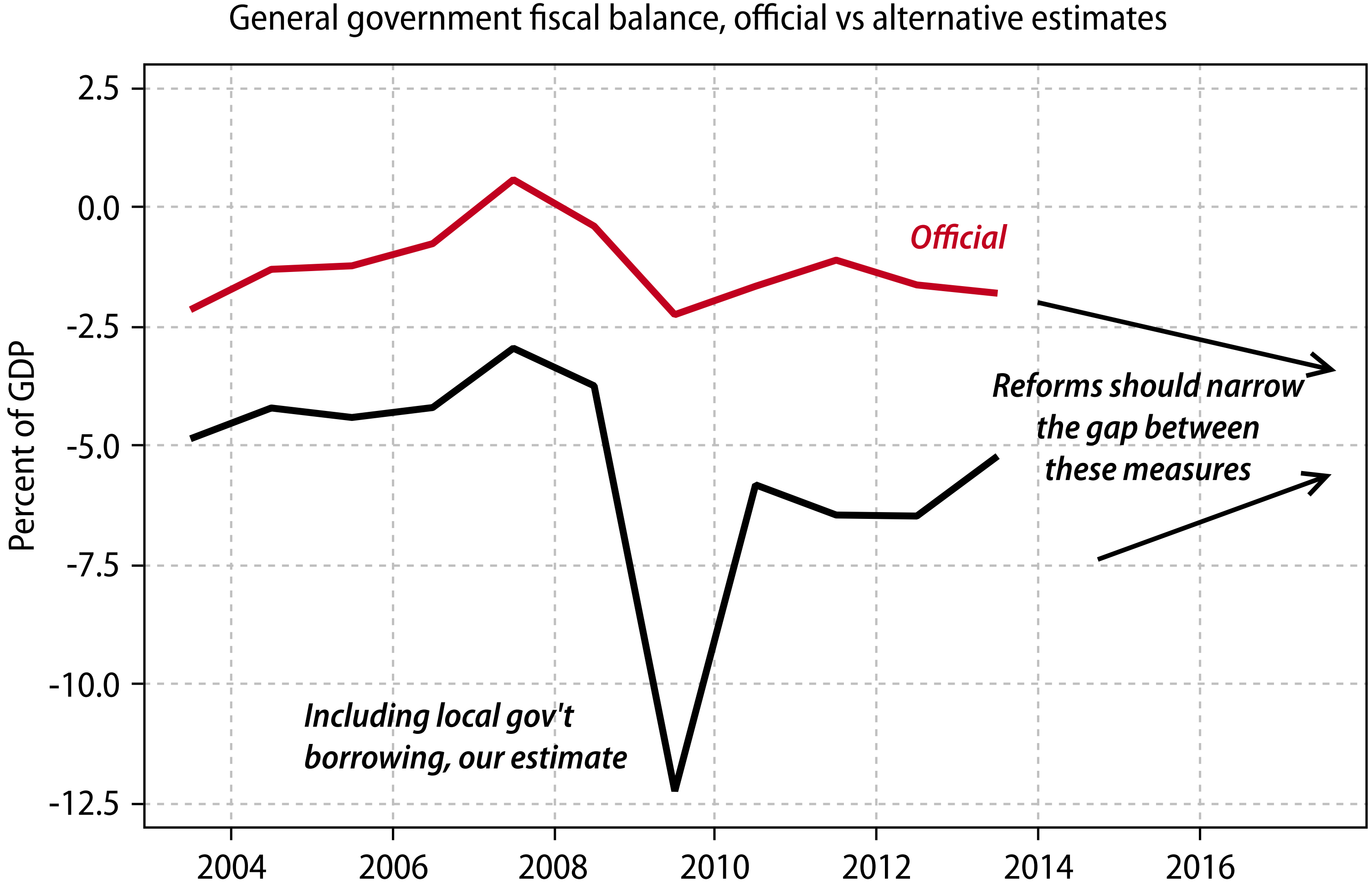
The great project of national revival and tying up all of China's neighbors into China's economic orbit is.

But some reform is still happening…

And a large RMB devaluation would go against the political goal of national revival

This does not mean a lack of reform: Lou Jiwei's is making progress

Fiscal reforms are beginning to bring order to off-budget debts



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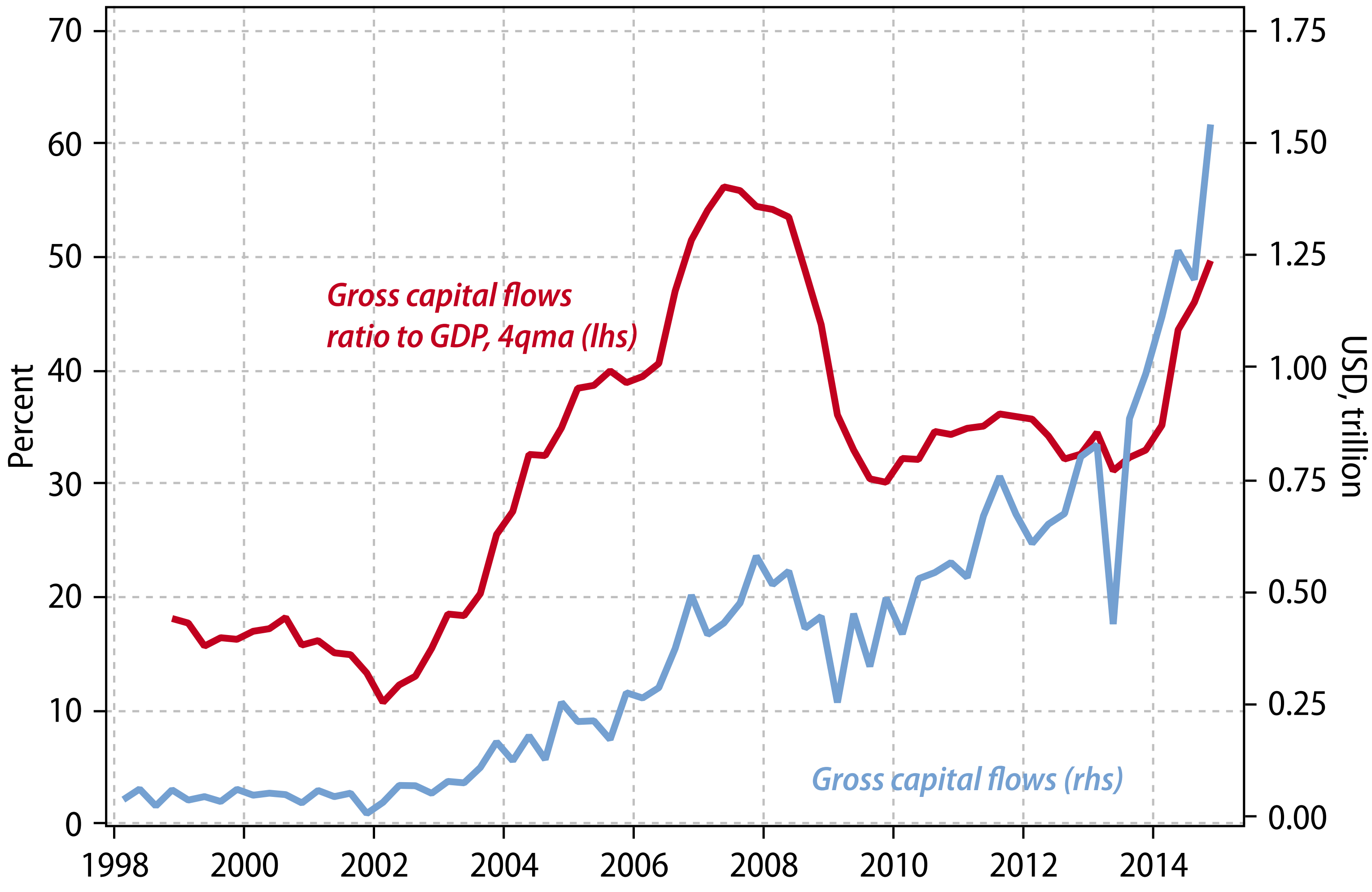
And Zhou Xiaochuan's financial liberalization agenda has progressed

Cross-border capital flows are now picking up after a post-crisis lull



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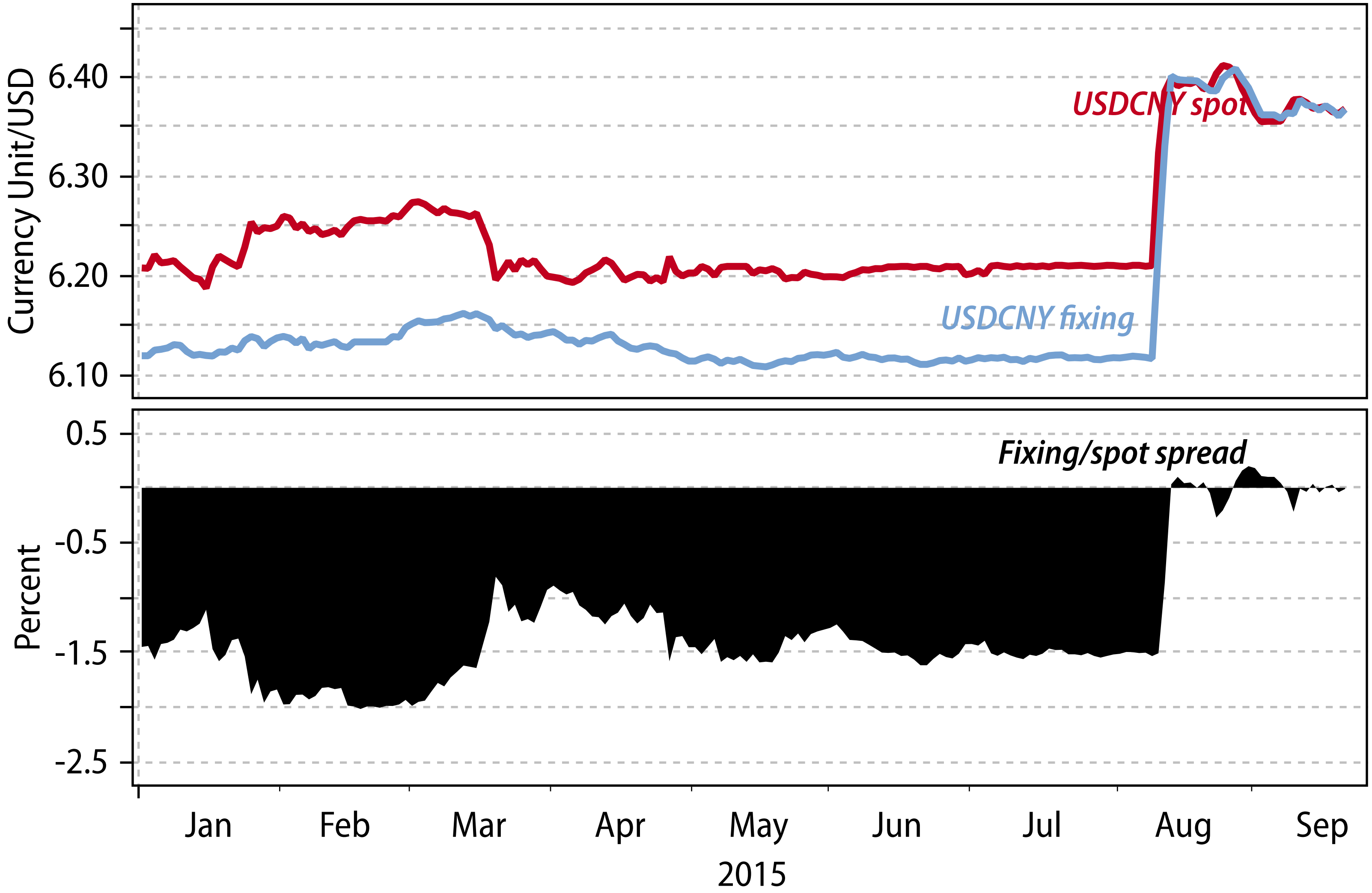
3- What just happened to China's FX policy?

On August 11th, China delivered a big surprise on the RMB

The central bank yielded to market forces



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Why did China change its FX policy?

China changes its FX policy

Scenario 1: China's policy-makers attempting to devalue their way to growth; becoming 'currency warriors!

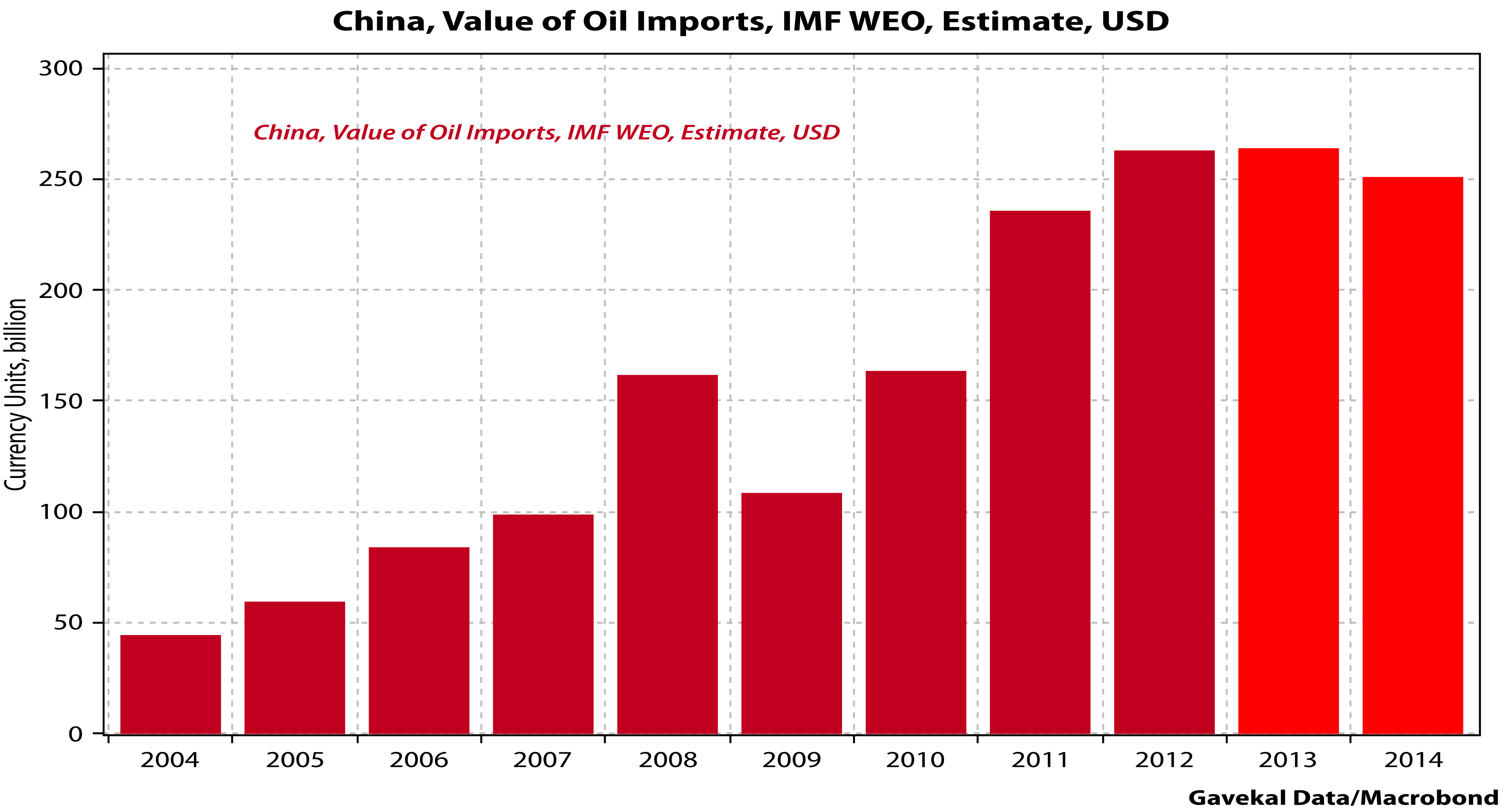
Our take: If that is the case, why did PBoC intervene for US$130bn (at least) in past six weeks to prevent RMB from falling?

Scenario 2: China completely mistimed and mis-communicated on a necessary adjustment to its FX policy.

Our take: much more likely… but it does raise the concern that, in recent months, China's policy-makers have failed to cover themselves with glory, on all fronts!

The idea that China needs to devalue to be competitive is nonsense

As high as China's trade surplus is, it will get at least US$100bn bigger



Why the IMF is likely to vote for SDR inclusion in November

1. **Better in the tent pissing out, then out of the tent pissing in:** The creation of the AIIB showed that China is not against creating its own set of multilateral institutions. With that in mind, better include China in the existing ones then see China create a rival set of institutions.
2. **IMF vote is in the next 5 weeks, but the US does not seem to be lobbying anyone to block China**. This either means that the US is inept diplomatically, or that the US has made its peace with China joining the SDR? In fact, what seems more likely is that a deal was done between Presidents Xi and Obama during the recent Washington summit.
3. **Blocking China would seriously undermine reformers like Zhou within the leadership** – is this really what the West would want?
4. **The IMF asked for a one year delay in implementation of the November vote…** Why ask for a delay in implementing the vote unless the odds that China joins are quite high?

Implications of financial liberalization & SDR inclusion

- Financial liberalization and renminbi internationalization mean:
  - **A "strong renminbi" policy.** Strategically, it is more important for the renminbi to be seen as a reliable store of value than to be used as a subsidy for exporters. This rules out competitive devaluation.
  - **Renminbi will be pushed abroad through loans and ODI.** To increase the currency's international use, China will not rely on running a trade deficit, as the US has done since the early 1970s. Instead, it will rely on renminbi loans and infrastructure investments along the New Silk Road.
  - **Yields will continue to fall as the renminbi is re-rated as a reserve asset.** Bond yields are sure to fall, and foreign investors will gain greater access.
  - **Equity prices will keep rising.** Substitution of equity for debt finance will help get leverage under control. Falling rates will boost stock prices, as will foreign flows prompted by China's inclusion in global indices.
  - **Falling rates/higher equity prices reduces risk of a real estate crash.** This in turn should ease concerns over the banking system's health.

The crocodile mouth is slowly closing?

Five Year Corporate Yield in the US & China (ML Indices)

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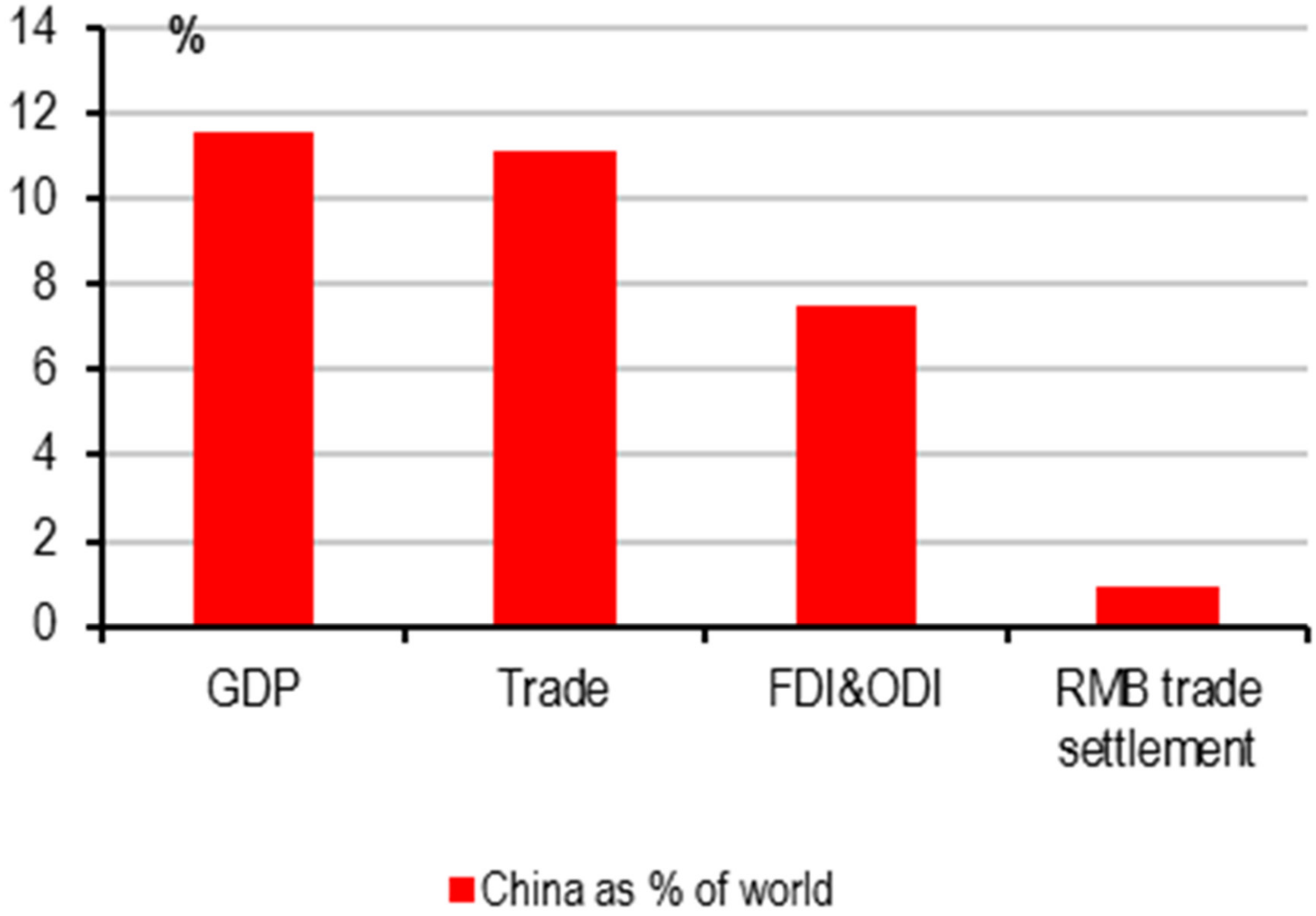
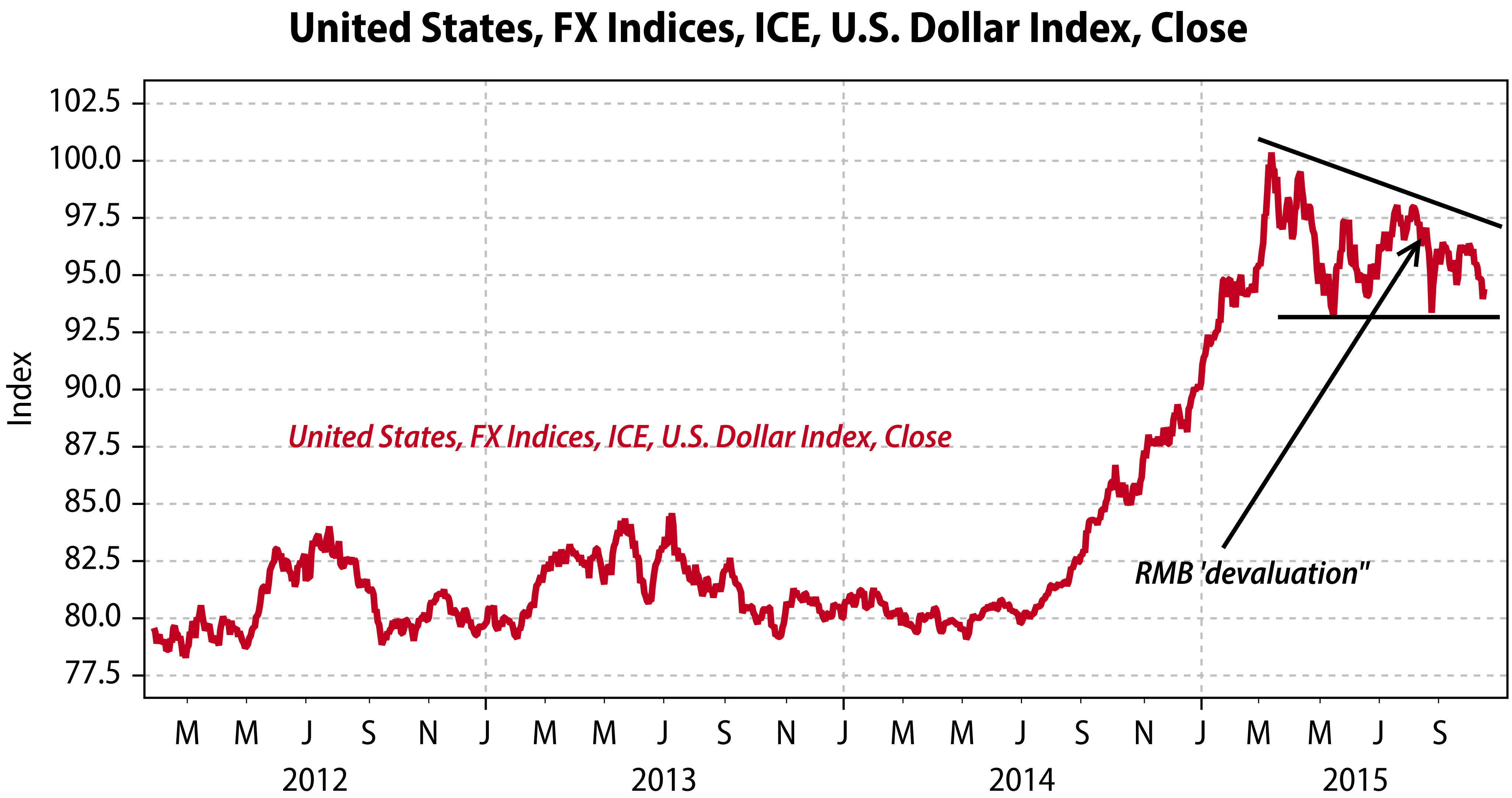
The smart bet would be that RMB use continues to expand



Source: World Bank, UNCTAD, SWIFT, 2012 data

Is change in RMB policy fundamentally US$ bullish?



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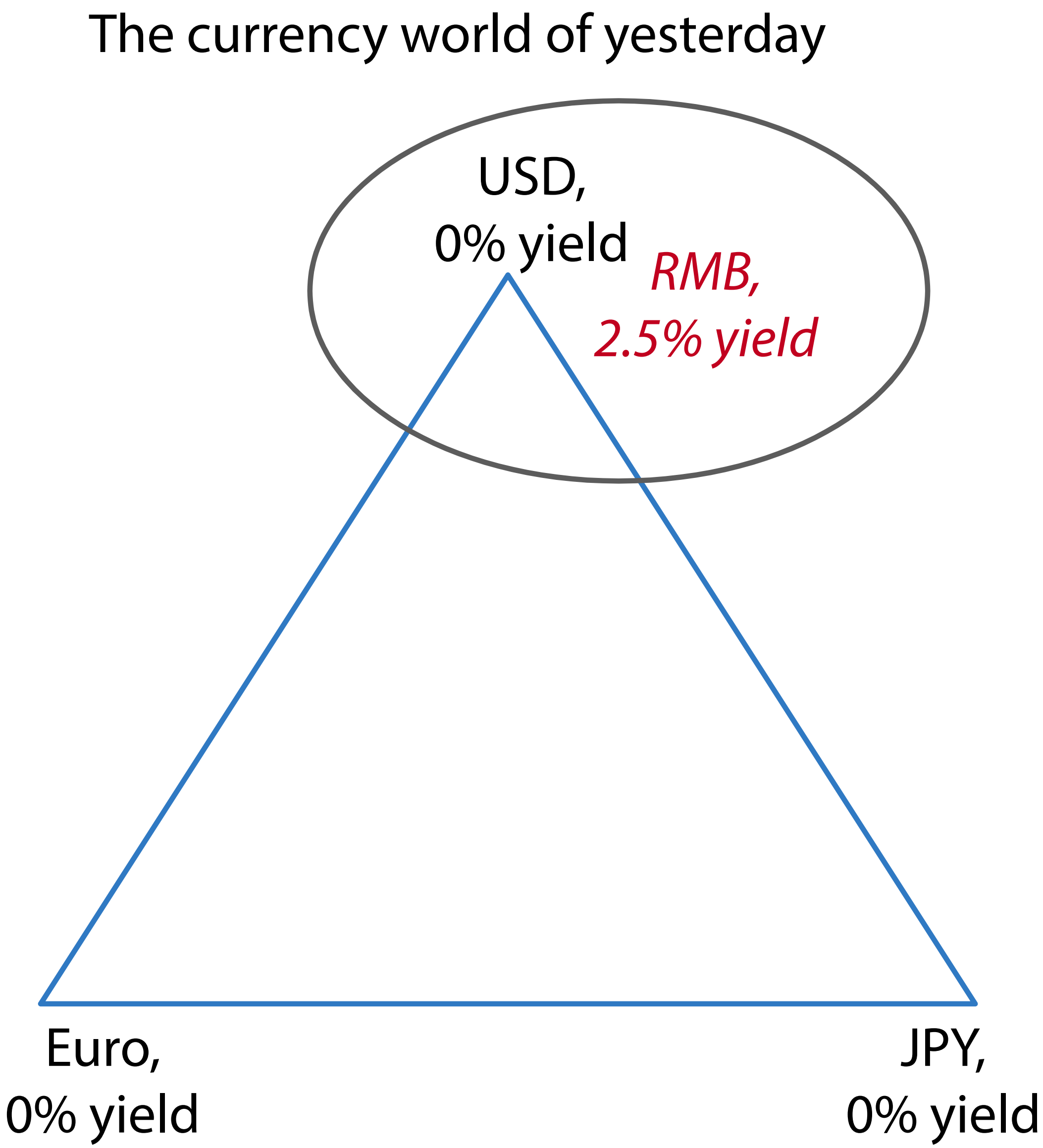
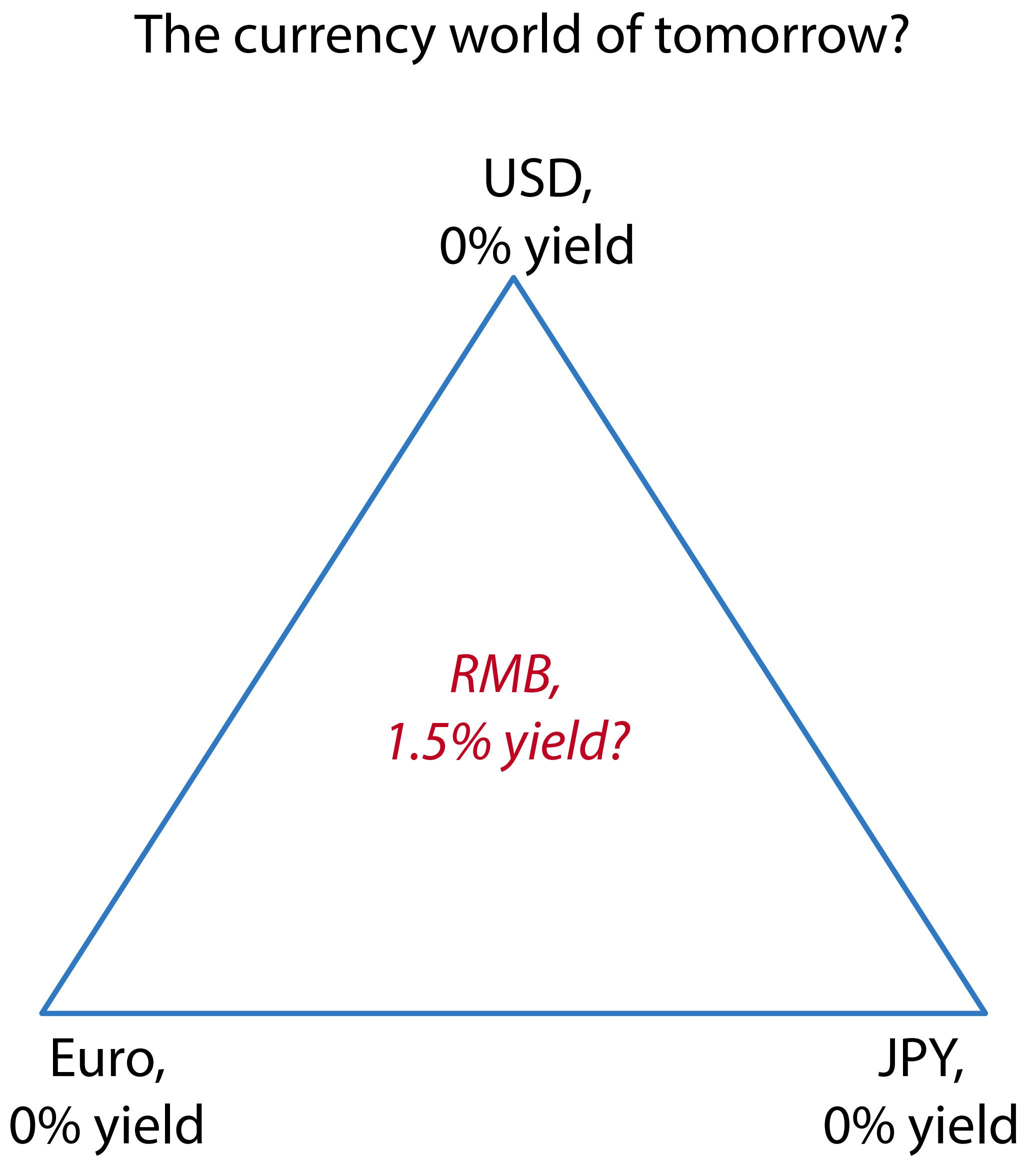
The fact that the RMB is no longer following US$ should be bearish US$!





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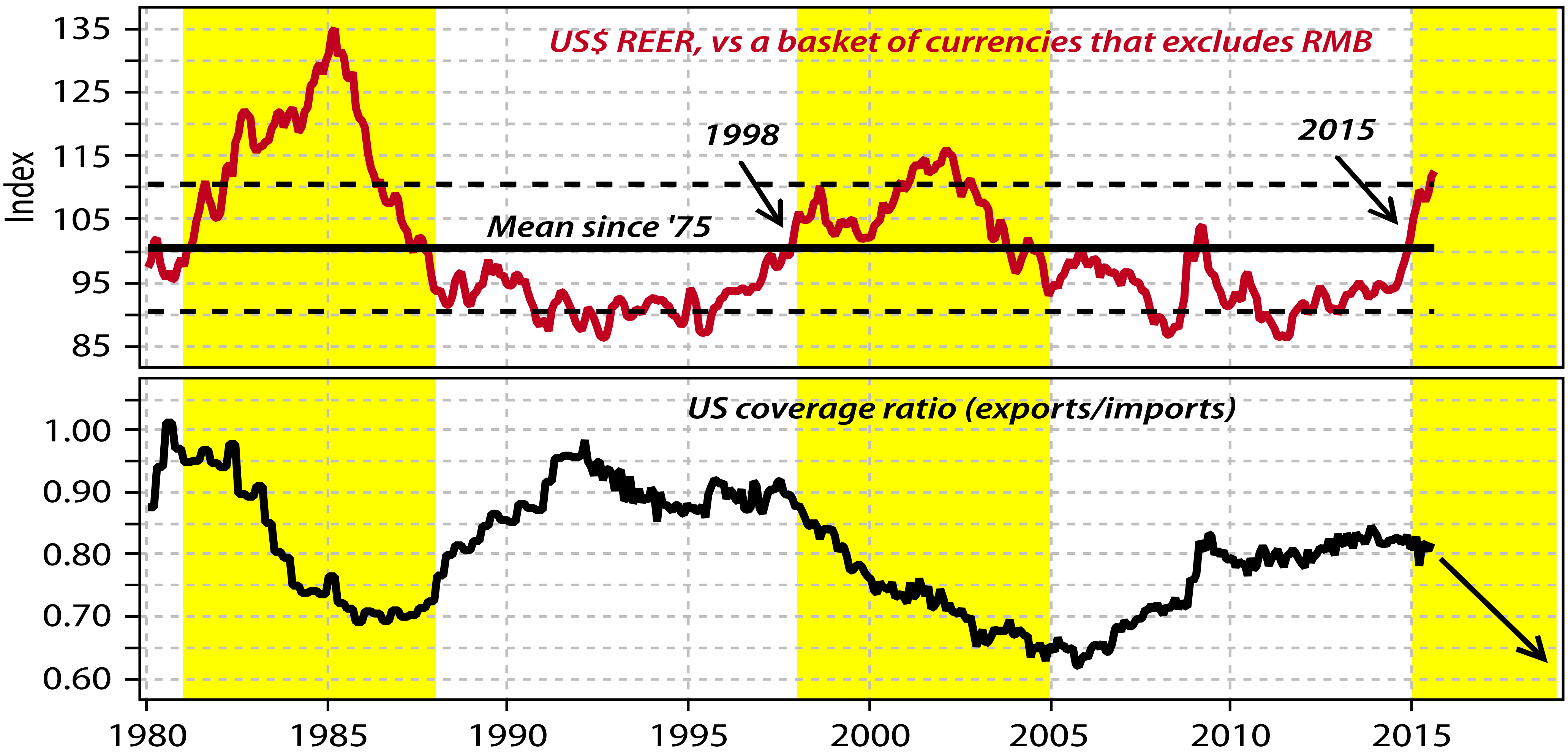
As should the continued widening of the US trade deficit

Expect a fall in US exports, and a rise in imports

BIS real effective exchange rates, CPI based; rebased around mean since 1975



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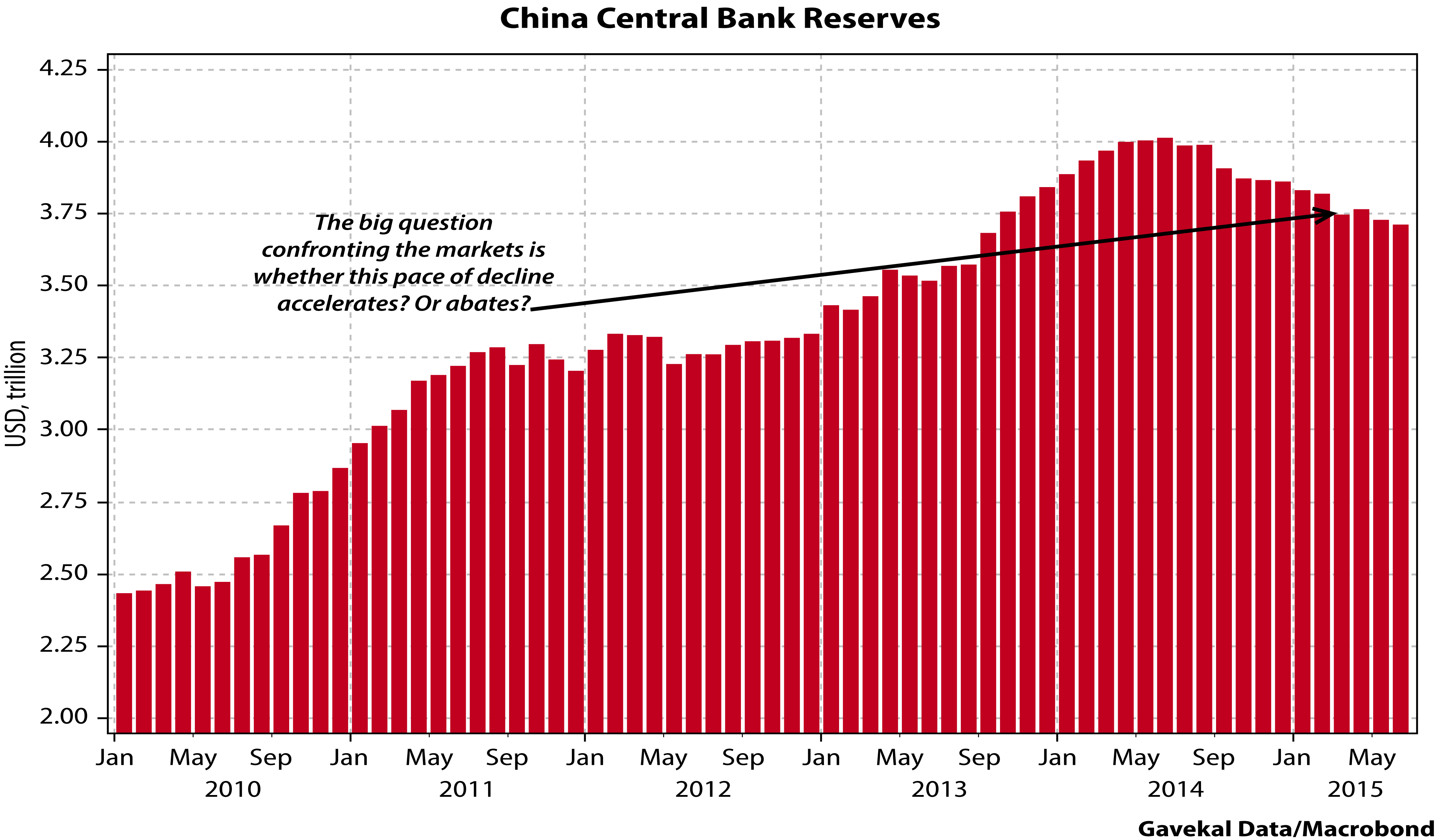
4- Where to from here?

Key take-aways from a few turbulent months

1. **China is not looking to devalue its currency:** a large devaluation would go against China's economic and geopolitical goals.
2. **This explains why the PBoC has intervened to the tune of hundreds of billions of US$ to prevent the RMB from falling**. If China really was a currency warrior, the devaluation would, by now, have happened. Instead, China has 'cashed out' the foreigners lining up to fire-sale the RMB.
3. **Thus, the 'bearish RMB' argument now has to rely on the fear that not only foreigners, but also Chinese people, will move to push capital out of China.** This may happen, but the overall odds still seem low, if only because domestic investors still have a positive carry.
4. **This fear of capital flight may help explain why the PBoC is so far behind the curve in slashing interest rates?** The fear being that, if domestic investors no longer have positive carry to stay in RMB, they will flood China's very large pool of domestic savings to US$.

Stabilizing Chinese reserves is an encouraging sign



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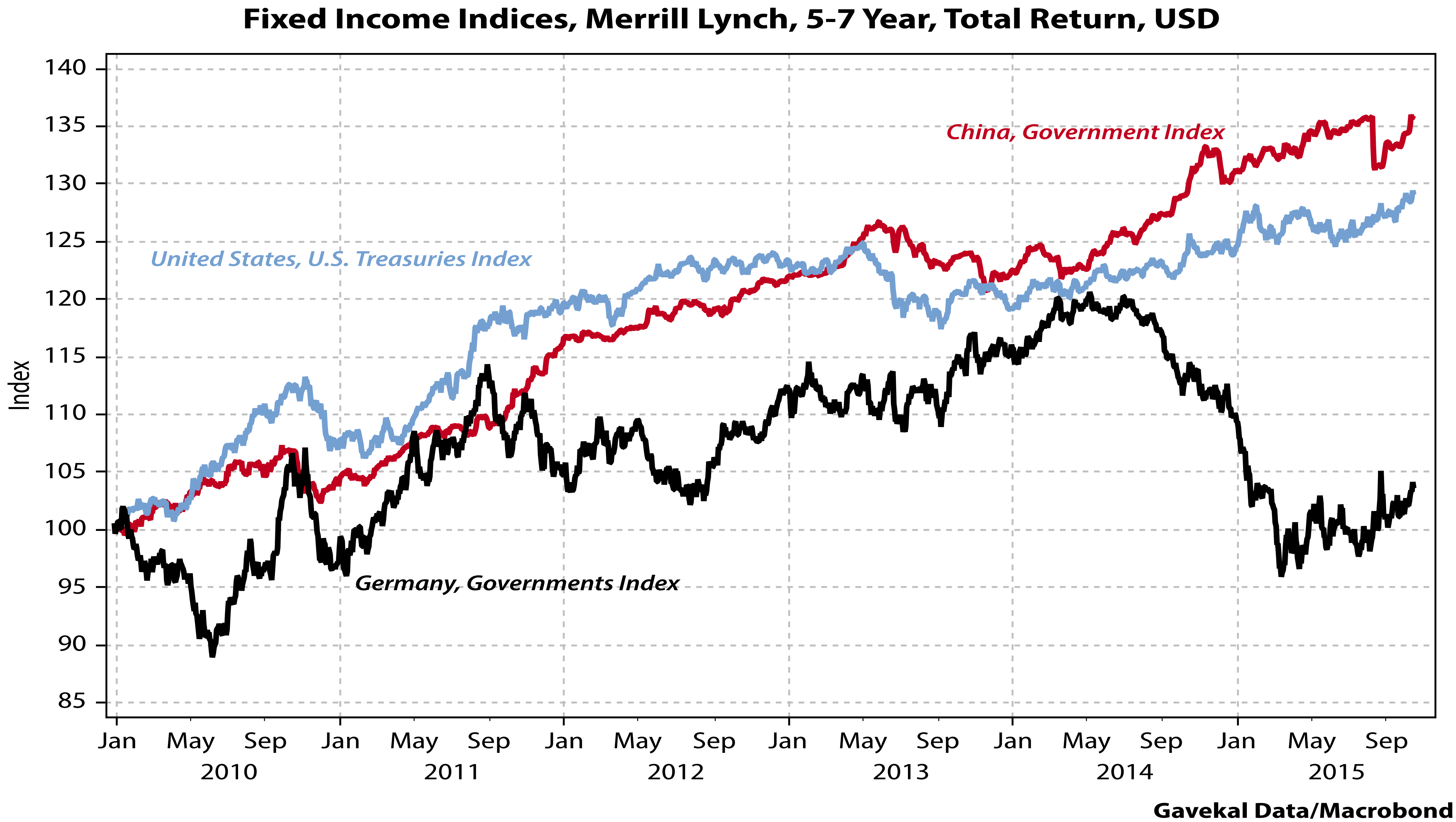
Already the dim sum bond market is 'mending' itself and making new highs



Offshore RMB seems to be settling down

Put it all together: the unleashing of the pain trade

US + Chinese consumers keeps on consuming

US trade balance deteriorates

Foreign central bank reserves rise again

EM currencies start to stabilize

China devaluation fears abate & RMB rises on short covering

PBoC slashes interest rates without fall in RMB

Dim sum and EM bond yields come down

EM equities outperform in USD and LC terms

Cyclicals everywhere outperform

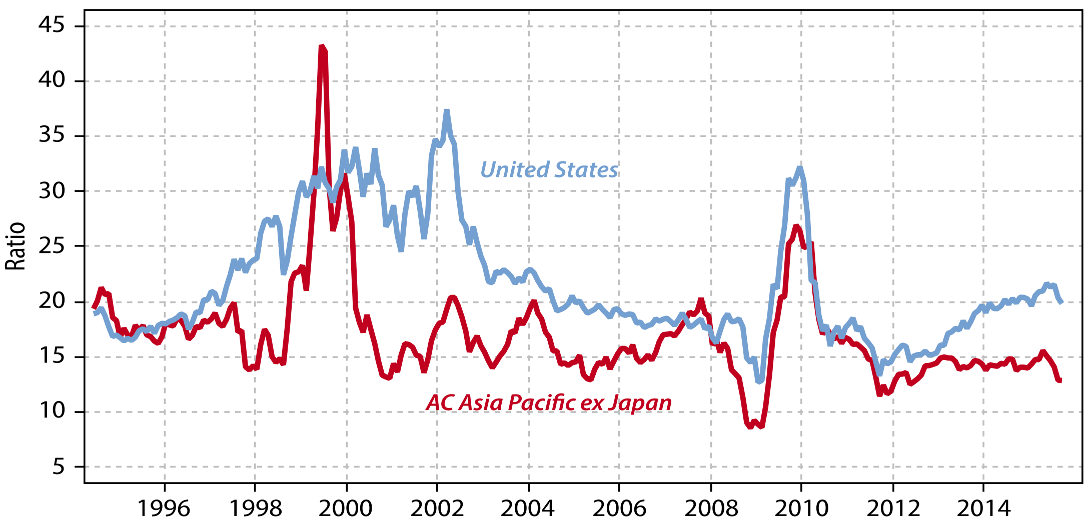
5- Why Asia is the right way to play the 'pain trade'

A positive and pro-active policy-mix

- **In Asia,** policy makers (Xi JinPing, Modi, Abe…) are clearly trying to SHAPE events.
- Contrast that with **the Western World** where, at best, policy makers are simply REACTING to events (i.e.: immigration crisis, Euro crisis, Shia-Sunni civil war…).
- **But is the SHAPING going the right way**? One might argue that the pro-activeness of Asian policy makers sets their countries towards conflicts. This is possible, (i.e.: China doesn't have much of a diplomatic corps, Japan remains paranoid etc…).
- Nonetheless, all the major policy announcements of recent quarters (TPP, OBOR, Silk Road, AIIB, RMB internationalization…) encourage grater infrastructure spending, greater trade, greater economic integration and thus **greater Ricardian growth down the line**.
- These announcements also weaken dependence of Western world hereby making Asia a more attractive diversification for portfolios.
- As an aside, it could also be argued that the **Japan vs China rivalry is a boon to the rest of Asia,** in that it permits the whole of Asia to industrialize/modernize on the cheap and on credit!

Valuations: crocodile mouths everywhere?

PE Ratios for Asia ex Japan MSCI & USA MSCI MSCI



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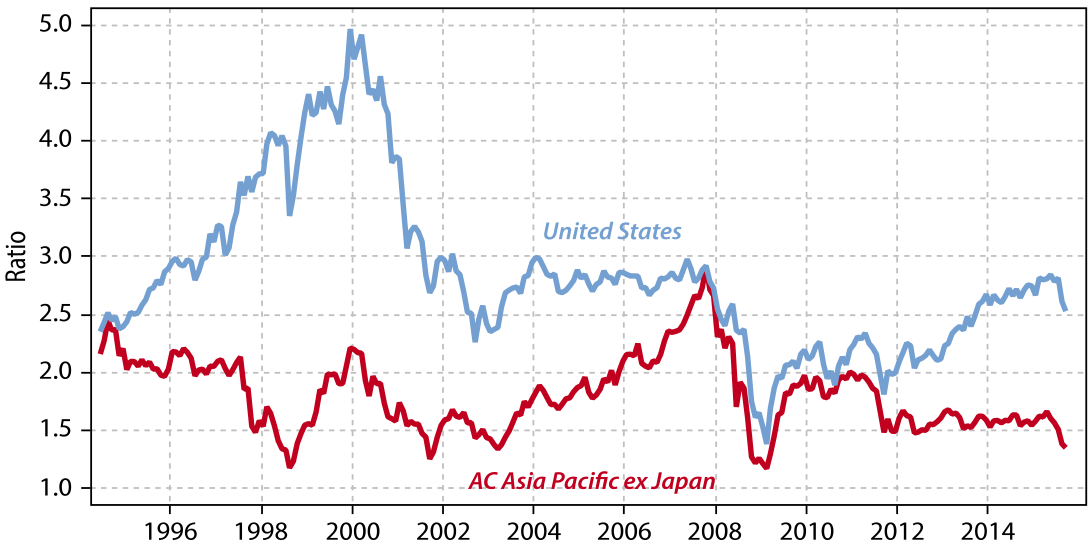
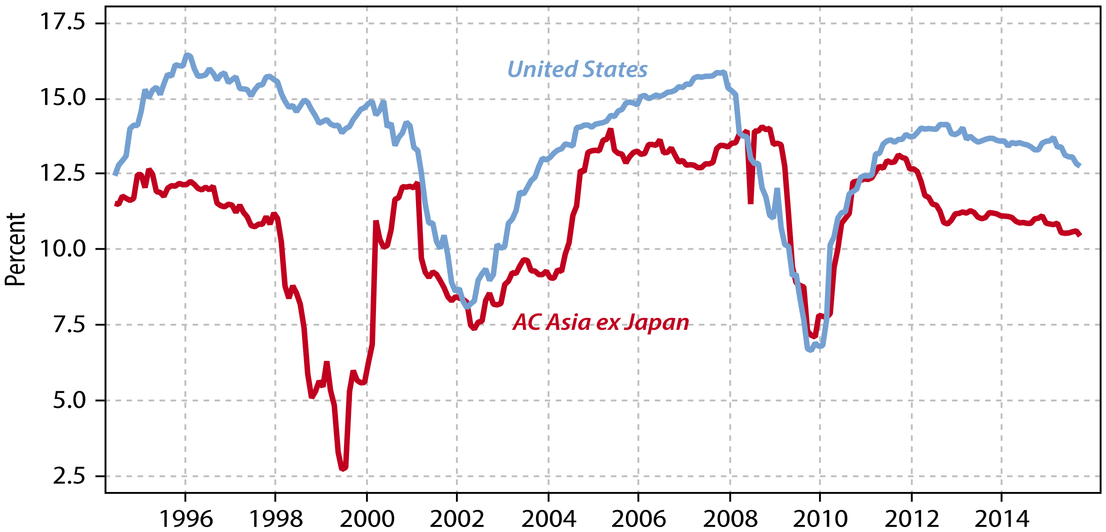
Price to Book: Asia ex Japan & USA MSCI



ROE for Asia ex Japan and USA MSCI



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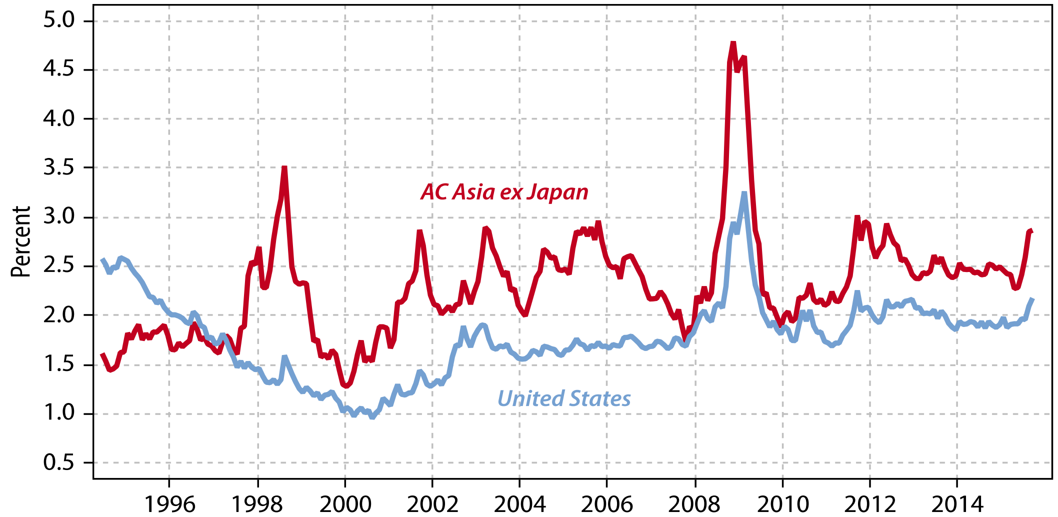
Dividend Yield Asia ex Japan and USA MSCI



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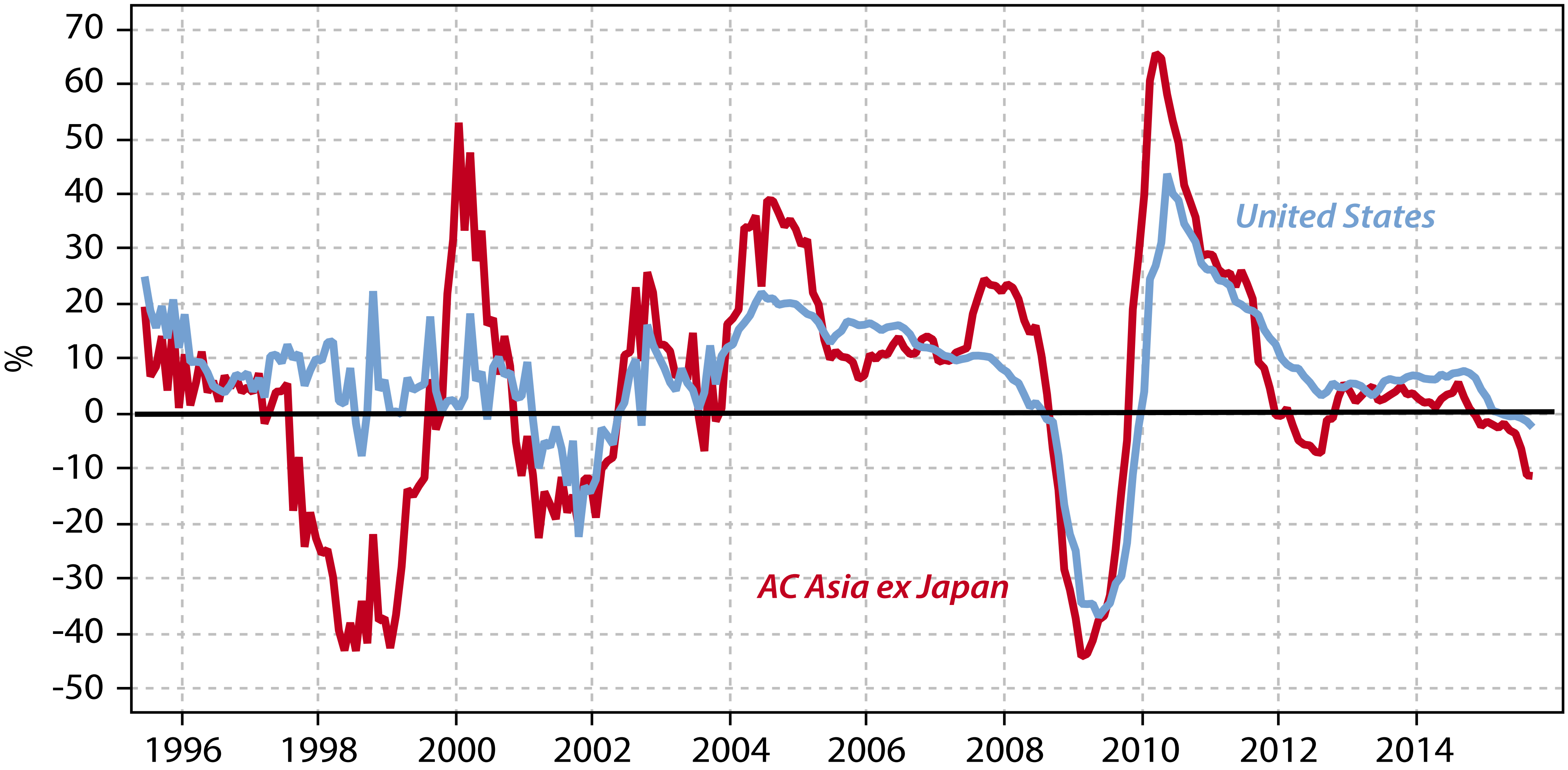
One obvious concern is EPS growth

MSCI 12 Months Forward EPS Growth



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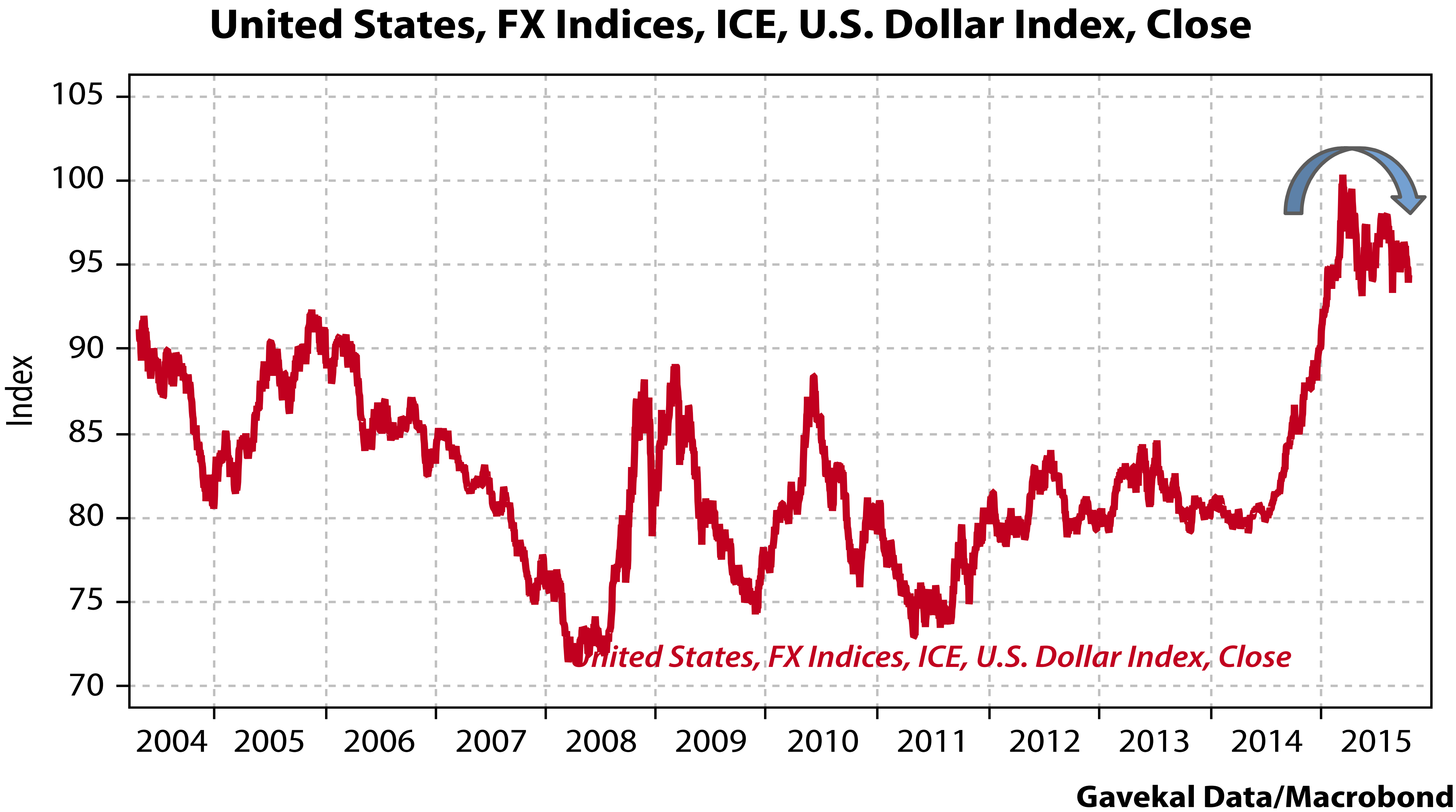
Momentum: the roll-over in the USD should help



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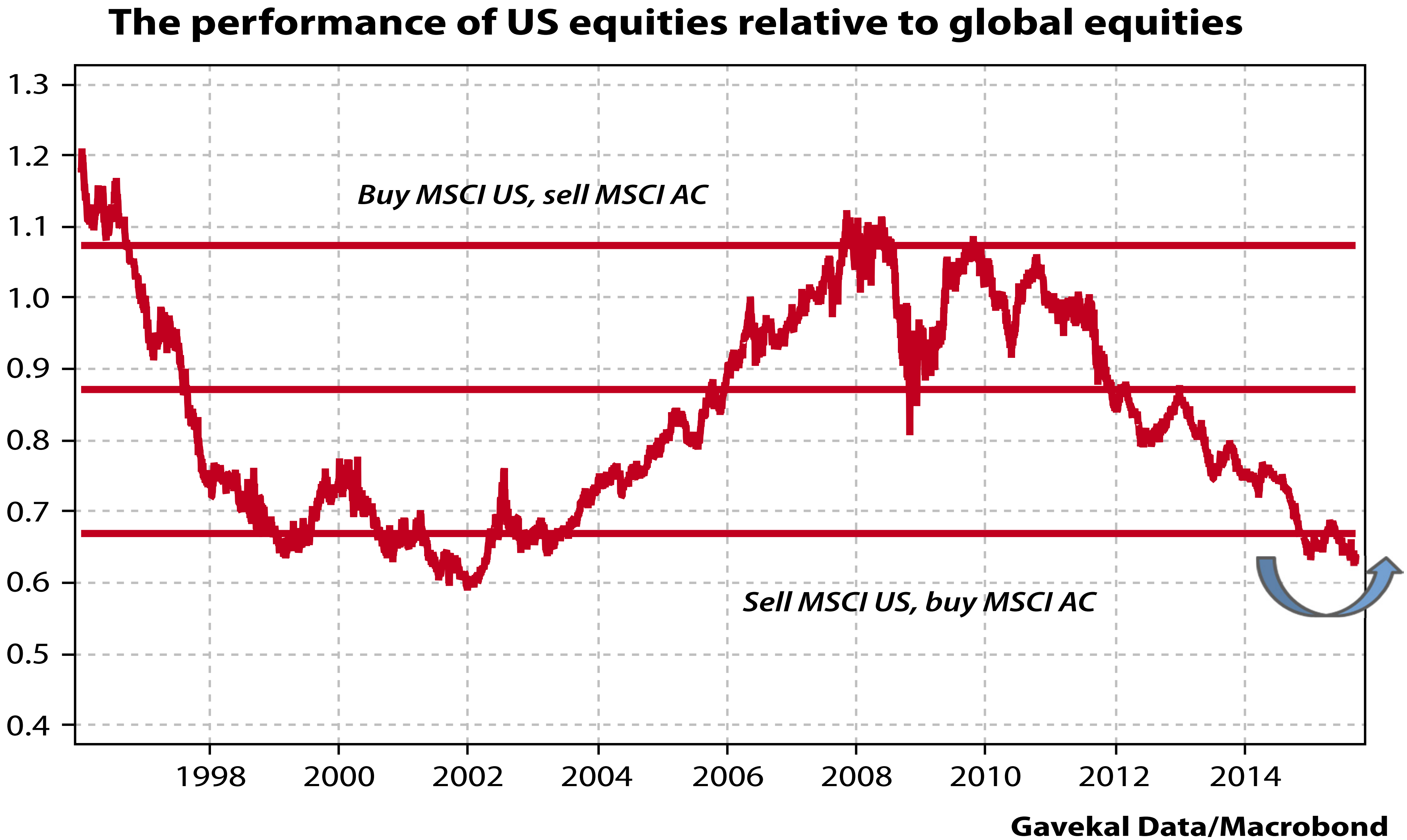
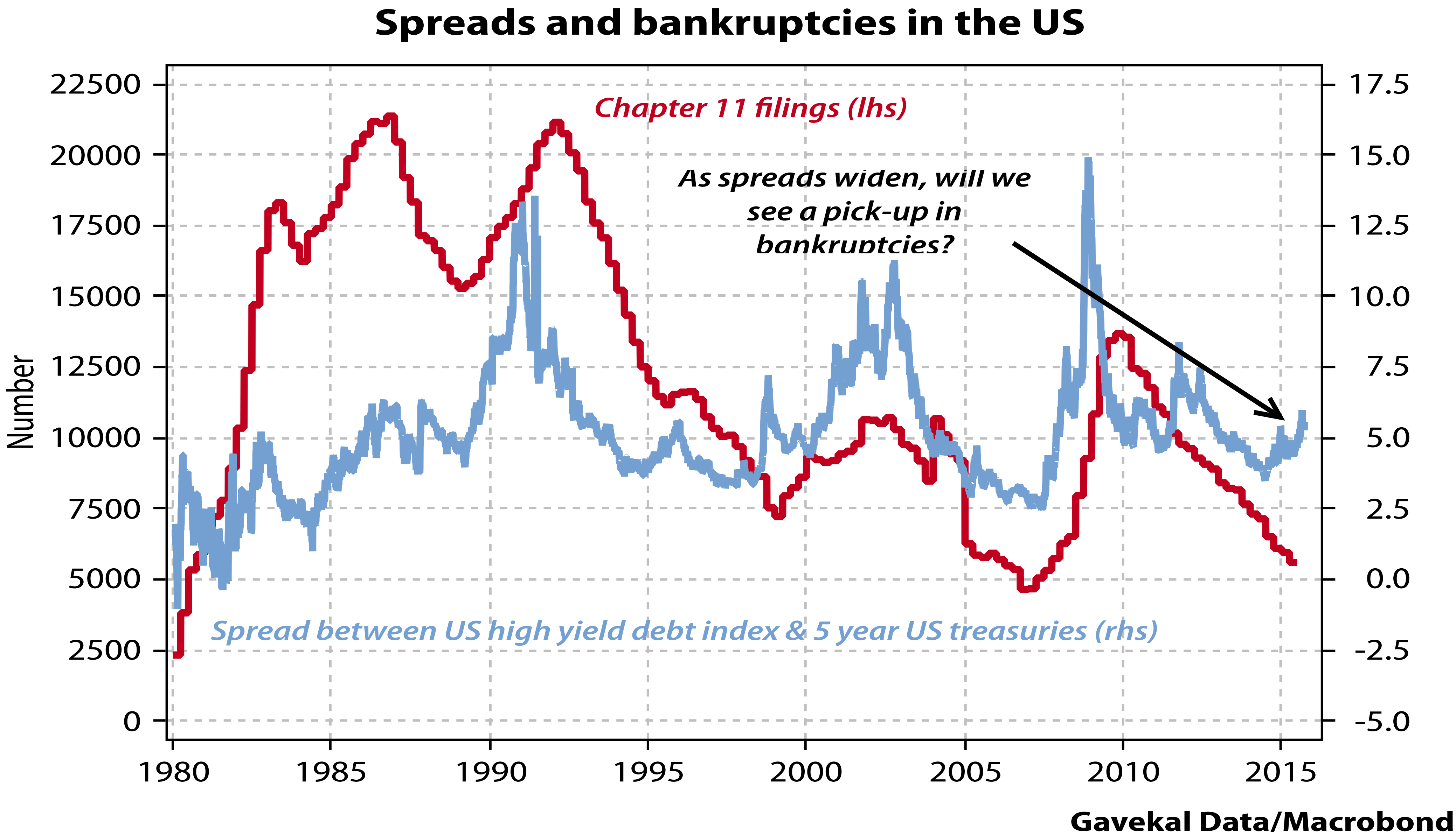
The outperformance of the US feels 'long in the tooth'



After all, as spreads widen, the ability to manipulate earnings disappears



Upcoming catalysts for Asian markets

- **The November SDR decision on the RMB** should finish calming underlying fears on the RMB. It could also trigger some 'short-covering' and, if we see mild upward pressure on the RMB, this will open a window for the PBoC to cut rates.

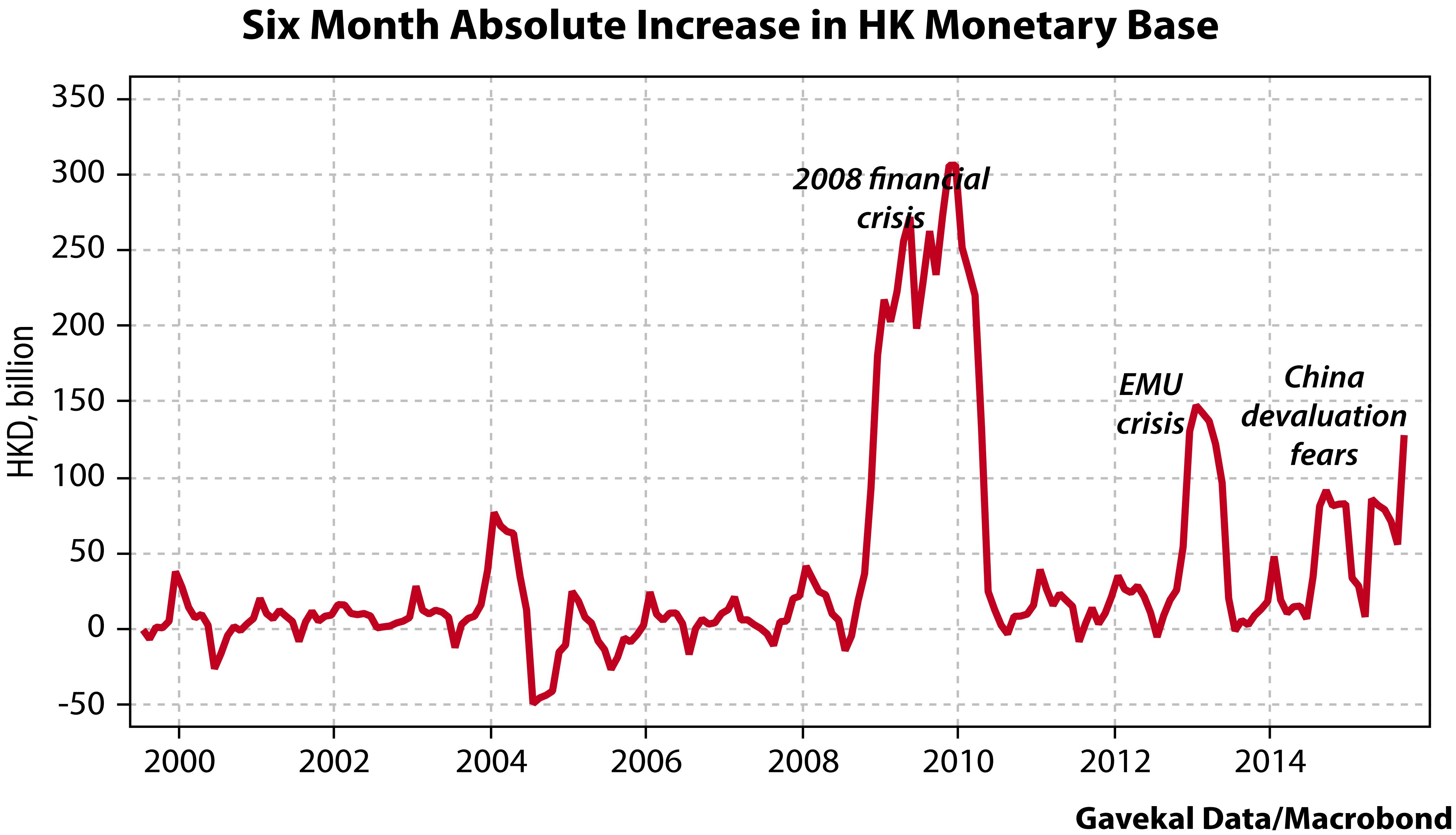
- Another important event in November is the **MSCI decision to include USA listed Chinese equities** (mostly tech names) into the MSCI China, Asia and EM. This re-weighting will occur in two waves: November, and May.

- The coming months should see **the benefits of the collapse in commodity prices** filter through most Asian economies, not least of which in the trade data.

- Combine that with **abating pressure on the US$** and, all of a sudden, Asia's terms of trades and balance of payments look a lot healthier than one might have feared a few months ago.

- As markets settle down, what will happen to all the cash that rushed for the sidelines in the summer sell-off?

After massive repatriation, where will the cash now go?



Simple trends emerging in the near term

- **North Asia & Europe suffered through a liquidity squeeze** – NOT a solvency crisis. The pullback should be seen as an opportunity to deploy capital there. This is all the more so since North Asia & Europe are the key long-term beneficiaries of the commodity bust and valuations (whether currencies or asset prices) across Asia and Europe are typically very attractive.
- **China is not going bust**. And with H-shares trading at 6.7x PE and 0.7x sales, the valuations are back to the levels of the 2008 crisis or below. A very attractive buying opportunity.
- **Europe is no longer the epi-center of the deflationary bust.** This means that shorting the Euro is no longer an appropriate hedge for portfolios. It also means that Europe's export champions are no longer the place to hide.
- **The commodity bust entails a serious solvency crisis for a number of companies**. Meanwhile, while most commodity producing countries should be sheltered in the near term by the years of accumulated gains, the pain will be long-lasting and will have to be absorbed through devaluations and/or write-offs.
- **The US market is a primary concern**: it now has negative momentum, it remains overvalued, and recent volatility (especially in ETFs) may keep retail flows away. Recent strong GDP data should boost Fed's willingness to raise rates, hereby boosting US$ and, hopefully, US current account deficit (a wider US current account deficit would help Europe and Asia tremendously).

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