In Case You Missed It: CSOP's Weekly China Wrap Up

US Treasury Secretary Mnuchin says "no rush" on China currency manipulator label

US Treasury Secretary Steve Mnuchin declared that the United States was in "no rush" to label China a currency manipulator, and would instead wait until Treasury's annual April report to review international foreign exchange policy.

The announcement is the second bit of good news for China watchers in recent weeks. It formally negates Trump's promise to assign the label his first day his office and complements the US' decision to abide by the longstanding "One China" policy governing relations with Taiwan. Taken together, the items suggest that the wider administration is moderating its stance on China.

Despite the positive signs, some resistance remains from the Commander in Chief. President Trump off-handedly called China the "grand champions" of currency manipulation last week, a statement not well-received by the country's leadership. Foreign Ministry spokesman Geng Shuang condemned Trump's allegation, stating "there is no basis for the continued devaluation of the renminbi." Onlookers too were skeptical of the charge, pointing to China's recent depletion of FX reserves to steady the falling currency.[1] They also note the IMF's stance, which does not presently label China a currency manipulator.[2]

Regulators draft rules reminding investors of Wealth Management Product risk

China's financial regulators are drafting new rules to remind investors that Wealth Management Products (WMPs) are not guaranteed by the government. Regulators wish to proactively stem the growth of the popular off balance-sheet products, which total an estimated RMB 26 trillion (USD 4 trillion) as of December 2016.[3]

Offering a higher return than equivalent savings accounts (~8% vs. 1.5%), Wealth Management Products are beloved, though misunderstood, by Chinese investors. Although investors can purchase WMPs at their local banks, banks are not the issuers. Rather, the products are issued by trust firms, who use the sale proceeds to offer high-interest loans to high-risk corporations starved for funds—especially real estate developers. As the distributors of the products, banks and trusts help themselves to a generous share of the interest rate. Critically, though, they bear no investment risk themselves. Rather, WMPs investors bear losses when corporations fail to repay their loans. Investors, however, widely overlook this detail. Because investors purchase these retail junk bonds at banks, they assume the products are risk free; Chinese banks are state-owned and essentially cannot go bankrupt.

Investors received a rude awakening in 2014 when a WMP sold at ICBC failed to repay investors. The deal was eventually bailed out, with local government playing an important role in negotiations. Investors might not be so lucky in the future, however. As China's economic growth slows, more corporate borrowers are struggling to repay the expensive WMP debt, and the central government is hesitant to resolve defaults in the USD 4 trillion product segment.

Therefore, by convincing investors not to expect a bailout, the government is transferring risk back to individuals. Optimists welcome the move, asserting investors should naturally bear more risk for higher returns. Critics, however, argue that the banks should bear consequences for their morally hazardous behavior. After all, it is they who knowingly sell risky WMPs to less-educated retail investors.

The views expressed represent an assessment of market conditions at a specific point in time, are opinions only and should not be relied upon as investment advice regarding a particular investment or markets in general. Such information does not constitute a recommendation to buy or sell specific securities or investment vehicles.

Reformer promoted to top spot as President Xi reshuffles economic regulators

China reshuffled its top economic leadership last week, as President Xi promoted loyalists to key positions. The most noted change is Guo Shuqing, who will reportedly take the helm of China Banking Regulatory Commission (CBRC). Mr. Guo previously headed the state-owned China Construction Bank (CCB) from 2005 to 2011 and has proved himself a long-term strategic thinker—especially in the aftermath of the Global Financial Crisis.

In announcing China's controversial RMB 4 trillion stimulus policy in 2008, China's top leaders asked banks to lend more aggressively. While most state-owned banks followed the instructions, Mr. Guo implored his bank to maintain their internal guidelines, angering then-Prime Minster Wen. Although Mr. Guo's savvy bet left his bank with one of China's lowest non-performing loan ratios, Mr. Guo was not promoted the following year. Instead, ex-Bank of China boss Xiao Gang was rewarded for his loyalty, even though BoC has struggled with bad loans in the aftermath of his tenure.

In 2011, Mr. Guo was redeemed by China's current Prime Minister, who tapped him to lead the China Securities Regulatory Commission (CSRC). However, Mr. Guo's ascendance did not last long. His securities market reform proved unpopular, and he was demoted local government leadership less than two years later.

Now, however, Mr. Guo might find himself absolved yet again. His appointment as head of CBRC, if confirmed, could indicate that his reformist view is gaining popularity in the Communist Party. Onlookers expect him to lead ongoing efforts to consolidate the three regulatory agencies (CBRC, CSRC and CIRC) into a superpower financial regulator, possibly with him at the helm. [4]

US dethrones China as world's largest trading country

After maintaining the top spot for three years, China has been dethroned as world's largest trading country (in USD), ceding the title to the United States. Through its manufacturing prowess, China became the world's largest exporter in 2009, surpassing the US as the largest trading country in 2013. However, 2016 brought yet another role reversal, with the US besting China by USD 20.4 billion. China's total import and export tallies were USD 1.5 trillion and USD 3.6 trillion, respectively, in 2016.

Officials at the Ministry of Commerce (MoC) blamed currency volatility and cheap commodity prices for the usurpation. The MoC fingered currency conversion losses as the primary culprit, indicting depreciation of China's preferred settlement currencies-- EUR and RMB—for the comparatively poor performance. Other onlookers argue that the issue runs deeper. This camp attests that China is gradually losing its traditional advantage as the world's manufacturing base thanks to growing protectionist sentiment and lower labor costs in other regions.

Despite diverging explanations, most watchers agree on the upset's implication. They conclude that China's era of low-cost manufacturing has come to an end, and the country urgently needs to seek a more balanced, consumption-driven growth model.

Commercial airline passenger numbers grow 11.2% during Chinese New Year holiday

This year's Chinese New Year saw 11.2% growth in commercial passengers YoY, offering further evidence that China's economy is avoiding a hard landing.[5]

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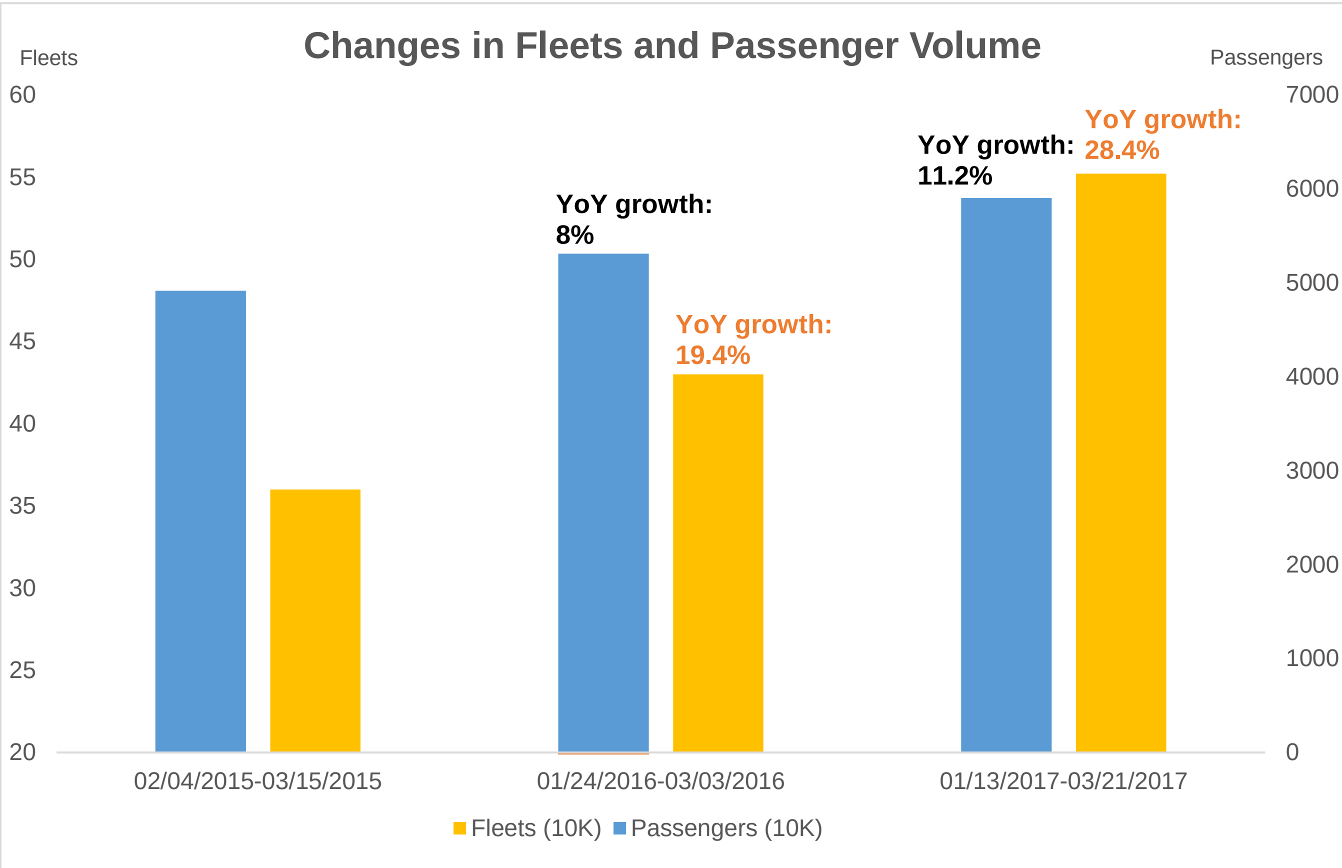
According to the Civil Aviation Administration of China (CAAC), China's airlines ferried 59 million passengers across 552,000 fleets during the 40-day holiday period, increasing from 53 million and 430,000, respectively, in 2016. The average occupancy rate reached 84.2% this year, implying that airlines were operating close to full capacity.

Further heartening investors, the 2017 YoY growth rates were higher than the 2016 rates (details in below chart). Such growth is especially impressive considering travelers' increasing preference for the lower fees and shorter delays found on high-speed trains-- especially for short-haul routes. Even in spite of train competition, transportation experts anticipate that air travel demand will continue growing robustly for the foreseeable future.



Source: Civil Aviation Administration of China
Note: All periods represent Chinese New Year holiday for respective years

Notes:

1. FX: Foreign Exchange
2. IMF: International Monetary Fund
3. RMB: Renminbi, the national currency of China
4. CIRC: China Insurance Regulatory Commission
5. YoY: Year on Year

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