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

China's Manufacturing PMI grows at the slowest pace since September 2016

China's Manufacturing Purchasing Managers' Index (PMI) dropped to 50.3 in April, falling short of the forecasted 51.0 and 51.2 figure reported in March. Although technically signaling growth-- a reading over 50.0 represents expansion-- April's PMI grew at the slowest pace since September 2016.

Why did the PMI fall?

Onlookers are citing two factors as responsible for the underwhelming PMI: a slowdown in manufacturing activity and a pickup in regulatory tightening. Not only were production growth and new total orders dampened, commodities like iron ore and steel saw prices plunge, leading to a decided cooling in producer price inflation. Moreover, although China's economy grew at an astonishing 6.9% in the first quarter, infrastructure and property development were the primary drivers. As the central bank and financial regulators continue their coordinated, system-wide deleveraging campaign, growth is expected to soften as rising borrowing costs deter investment in capital-intensive projects.

Implications:

All in all, the April figure suggests that China's growth remains strong, but is beginning to moderate after the first quarter's unanticipated expansion. Economists predict that the first quarter's 6.9% result will offer a sufficient tailwind to achieve 2017's target 6.5%, even if growth slows for the remainder of the year. Regulators' biggest challenge remains creating conditions that facilitate agreeable indicators (such as PMI just over 50). Only after striking that balance will they be able to focus energy on systemic deleveraging, and will not be tempted to employ short-term stimulus at the expense of long-term fiscal health.

Regulators ring alarm bells about risky asset pools, bond market on notice

China's brokerage sector sold off in response to regulatory warnings about the unsustainability of asset pools. Formal codification of the warnings is likely to deal a blow to China's brokerage businesses and potentially trigger a bond market correction.

What is the brokerage asset pool business?

Asset management units at brokerage houses accept funds of varying maturities from institutional investors and high net worth individuals and pool the capital into one investment vehicle. For example, a broker could combine investor A's assets with 6-month maturities with investor B's assets with 12-month maturities and invest the comingled funds into the fixed income market or other leveraged strategies. The historical success of this strategy allowed brokers to offer annual after-fee returns between 5% - 5.5%. The pools unable to achieve such returns will liquidate.

Why the regulatory intervention?

Brokers' asset businesses managed RMB 2.19 trillion as of December 2016, compared to the RMB 17.58 trillion under management in the wider industry, according to CICC.[1,2] Pool business contributes a significant proportion of brokerage assets under management; individual pools can hold up to RMB 0.1 trillion. Although up to half of pool assets can be invested in real estate, other assets are invested in even more illiquid classes, leading to fears of liquidity mismatch risk.

Regulators are worried that these highly-leveraged asset pools are vulnerable in a volatile and rising rate environment. If one pool is forced to liquidate, the sell-off of underlying assets can trigger other pools to bear losses. Some onlookers criticize that the regulations are too severe and could cause a bond market repeat of the 2015 A-Share meltdown.

China's HNA becomes Deutsche Bank's largest shareholder

China's Hainan Airline Group (HNA) increased their stake in Deutsche Bank (DB) to 9.92%, surpassing Blackrock to become the German bank's largest shareholder.

Why DB needs HNA

DB was founded in 1870 and grew to prominence with its world-leading foreign exchange business. After becoming Europe's largest bank by assets in 2011, Deutsche's star has fallen in recent years due to non-interest expenses and several multi-billion dollar fines. Although CEO John Cryan been actively offloading assets, securing a deep-pocketed investor to refresh capital seems to be the only option to stave off bankruptcy.

Why HNA needs DB

Founded in 1989, HNA began as a regional airline and logistics business in China and swiftly expanded, gobbling up competitor airlines and logistics outfits as well as hotel chains, cruise lines, golf courses, asset managers, and financial services firms. As a result of this acquisition spree, HNA has become China's largest outbound overseas investor, according to Dealogic.

HNA's Deutsche maneuverings began in February with a 3.04% stake that has gradually increased. Some onlookers argue that the purchase is financially strategic: DB's rock-bottom valuation could offer decent return for HNA, comparable to Goldman Sachs and Citibank after the 2008 global financial crisis. Other analysts believe the acquisition has broader goals: to help develop China's banking sector. DB's model of a global wholesale bank can serve as an example to younger Chinese peers that remain overly reliant on China's traditional, domestic-oriented banking business.

Making sense of recent headlines: how East Asian alliances are shifting in response to the ongoing North Korea tension

North Korea/China:

The headline: "North Korean media issues rare criticism of China over nuclear warnings"

The implication: Despite the stated "long history and tradition of friendship" between China and North Korea, the latter's official news agency warned that there would be "grave consequences" if China's state media continued demanding dismantling of North Korea's nuclear program. In response to pressure from the United States, China has recently begun adopting a harder line with North Korea, reversing the neighbors' historical, if uneasy, cooperation. China has been North Korea's closest ally since the Korean War, so the loss of that critical friendship has the potential to engulf the region in even greater uncertainty.

Japan/the Region:

The headline: "Japanese leader sets 2020 deadline for changing pacifist constitution"

The implication: Japan's Prime Minister Abe declared his intention to rewrite the Peace Clause of Japan's constitution by 2020. Written after Japan's defeat in World War II, the clause promises that Japan will not use force to settle international despites. Because Constitutional amendment requires a 2/3 majority of both houses of Parliament and majority support in a national referendum, some onlookers fear that Abe will abandon his "Abenomics" project to focus on Constitutional reform, a shift that could negatively impact the country's flagging economy. China and South Korea are also hesitant about Japan's quest to remilitarize. Memories of a 20th century imperialistic Japan continue to loom large in their collective memories.

Russia/the United States:

The headline: "Trump and Putin vow to take on Syria, North Korea together"

The implication: Trump and Putin convened their third phone call since Trump assumed office, a conversation the White House described as "very good." During the conversation, the two nations allegedly agreed to work toward resolution of issues in Syria and North Korea. Such an announcement represents defrosting of a relationship that cratered amidst accusations of election hacking and Russia's continued backing of Syria's Assad regime. The alliance could signify that North Korea has lost support of yet another neighbor, adding additional leverage to force a retreat on its nuclear program.

The Philippines/China:

The headline: "Philippine President Hedges on White House Visit as China Friendship Grows"

The implication: US President Trump invited controversial Philippine President Rodrigo Duerte for a White House visit last week. Duerte demurred, however, indicating he might be "too busy" to accept. Despite the historic United States/ Philippine relationship, the newly chilly relationship is good news for China, which has attempted to woo Duerte in recent months. Although the China/Philippine relationship has been shaken by disagreement over South China Sea issues, signs indicate that President Duerte is warming to China. Not only did China pledge $24 billion in aid to the Philippines in late 2016, but also docked three warships in Davao during a goodwill visit last week.

Asian Infrastructure Investment Bank (AIIB) approves first loan to India

The China-led Asian Infrastructure Investment Bank (AIIB) approved its first loan to India, a USD 160 million package to support a power transmission and distribution system in the country's southeast.[3]

India's thirst for foreign investment

The project is part of India's Power for All initiative, a program which aims to provide "efficient, reliable, and affordable" electricity to customers across selected Indian states. As India is notorious for the country's lack of reliable infrastructure, Prime Minister Modi has vowed to follow China's example and secure massive infrastructure upgrades through foreign fixed asset investment. Despite historically ambivalent relations between the behemoth Asian neighbors, India has shown great enthusiasm for the China-lead AIIB initiative. Of AIIB's 70 member nations, India is the second largest contributor. In turn, five out of the ten proposed projects on the AIIB website are based in India.

Notes:

1. RMB: Renminbi, the national currency of China
2. CICC: China International Capital Corporation
3. USD: United States Dollar, the national currency of the United States