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

China's M2 Growth hits record low in June, bringing good news despite increasing New Yuan Loans

China's Money Supply M2 growth hit a record low of 9.4% in June compared with one year ago, a rate below both consensus and May's 9.6% increase.[1] M1 and M0 YoY growth also slowed further in June.[2,3,4] Offsetting those slowdowns, New Yuan Loans and Aggregate Financing hit RMB 1540 billion and RMB 1780 billion respectively, exceeding both market expectation and May's figures. [5]

How should investors interpret the seemingly contradictory monetary data?

The record-low M2 growth data demonstrates the effectiveness of China's intensified financial supervisory tightening. Since last spring, authorities have targeted highly-leveraged firms in a risk mitigation campaign, resulting in soaring rates and a credit market sell-off.

Despite the slowing M2 growth, New Yuan Loans – an indicator of bank balance sheet lending – expanded in June. Although seemingly contradictory, this growth is attributable to the government's crackdown on shadow banking activities; less regulated off-balance sheet lending was replaced with bank loans. Moreover, as banks struggled to raise capital through the shadow banking, some chose to issue bonds, contributing to the Aggregate Financing figure.

The ultimate conclusion?

All told, China's credit structure is growing increasingly healthy as deleveraging continues and shadow banking shrinks faster than regulated credit grows.

S&P reiterates "negative" outlook ahead of China's Financial Work Conference

Ratings agency Standard & Poors (S&P) reiterated their "negative" outlook on China, expressing skepticism about efforts to contain the country's credit risk. Although their Aa- rating remains unchanged, S&P cited the seemingly insatiable demand for credit by state owned enterprises and local governments as the major cause for concern.[6] China's top regulators have acknowledged the issue and worked to craft a new regulatory framework during the weekend's Financial Work Conference.

Why is S&P so bearish?

S&P acknowledged that China was actively working to deleverage its financial system, evidenced by the PBOC's reluctance to inject additional liquidity into the system and investigations into highly visible—and highly-indebted-- firms like Anbang, Wanda and HNA.[7] However, the ratings agency expressed dismay that Chinese leadership seems hell-bent on prioritizing economic growth, lamenting that the PBOC didn't mimic the US Fed's recent rate increase. Hiking rates is necessary to defend China's currency and foreign reserves, but would increase the debt burden of local governments and SOEs—an outcome China is desperate to avoid.

Will the Financial Work Conference help China change direction?

Developing a framework to manage credit growth was the primary agenda item on last weekend's Financial Work Conference. Initially developed to encourage sustainable growth in the aftermath of the Asian Financial Crisis, the meeting brings together regulators every five years to contemplate China's rapidly-evolving financial system. At the 2012 meeting, then-Premier Wen focused on mitigating the risks of local government financing vehicles (LGFV). Preceding that, banking reform dominated the 2007 meeting.

In contemplating the issues that have arisen since 2012—shadow banking, growing leverage, and the 2015 equity market meltdown, to name just a few—onlookers anticipated that China's financial regulatory framework would be the main topic of concern in 2017. As the existing regulators—the CSRC, CBRC, CIRC—often fail to coordinate policies, investors partake in regulatory arbitrage, structuring products and business lines to secure governance under the most lenient rules.[8,9,10] This practice has directly resulted in the ballooning of risky off-balance sheet wealth management products. To promote enhanced coordination, conference organizers decided to concentrate power in a new commission housed under the Central Bank. However, some onlookers are fearful that the reforms will not go far enough given the existing entrenched interests and body's lack of real enforcement power.

Themes of Previous Financial Work Conferences

	Theme	Background before the meeting	Changes after the meeting
1997	Discharging non-performing loans (NPL)	NPL reached 24.75% at June 1996	RMB 270 billion injected into banks; 4 Asset Management Companies established; CSRC and CIRC established
2002	Listing banks	Banks were solely owned by state	BoC, CCB, ICBC and BoCom were listed on Shanghai Stock Exchange[11,12,13,14]
2007	Banking reforms	Banking governance lagged international peers	ABC dual-listed listed in A and H-Share markets in 2010[15]
2012	Mitigation of LGFV risk	Substantial LGFV risk after RMB 4 trillion stimulus package deployed in 2008	Tighter control on LGFV, debt swap with banks, other measures to reduce debt burden on local governments
2017	Reform of financial regulatory framework	Rising credit risk, regulatory arbitrage	Development of new sub-PBOC commission focused on financial stability

China's fiscal income figures show promise for 1H2017

China's fiscal income grew 8.9% YoY and budget expenditure increased 19.1% June, both exceeding May's figures. In 1H2017, fiscal income expanded 9.8% and budget expenditure grew 15.8% compared to the same period in 2016. The MoF attributed the rapid growth to China's stabilizing economy and improved business profitability.

Growth drivers

- Revenue from corporate income tax grew 15.6% YoY due to increasing company profits
- Revenue from VAT and consumption taxes on imported goods soared 34% on strong import growth[16]
- Property tax income saw a ~20% jump YoY in June; the five largest Chinese property developers saw contract sales leap 50.6% YoY in 1H2017.
- Automobile tax revenue also saw a 20% increase YoY, rebounding from a lukewarm spring
- Personal income tax growth added 18.6% YoY in June, attributable to increased income in large cities

How was it spent?

With the growing income, authorities allocated more resources to support education, social security, urbanization, and science-related R&D.[17] Tempering these productive outlays, interest payments jumped 31% YoY, a disturbing sign of China's lingering credit problems. Despite their significance, the outlays in fact represent an improvement. The MoF emphasized that total municipal government bond issuance was RMB 1.86 trillion in 1H2017, almost half of the size of that in 1H2016.[18]

Sector	Budget expenditure in billion RMB	Increase YoY in 1H2017
Education	1534.6	17.2%
Social security	1480.3	24.6%
Urbanization	1189.2	20.1%
Science R&D	290.5	22.7%
Interest Payments	307.5	31.0%

Source: China's Ministry of Finance, as of 7.14.2017

Citibank encourages investors to focus on emerging markets

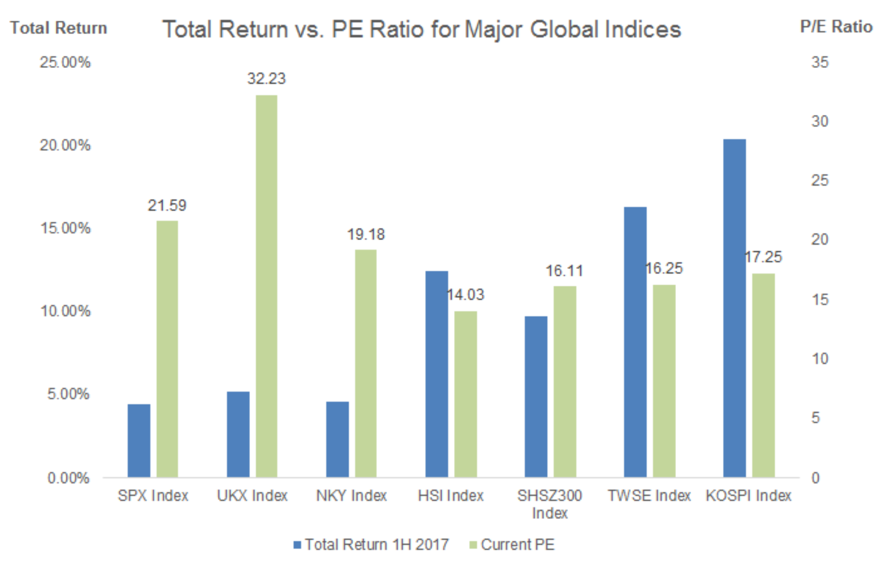
Citibank advised investors to focus on emerging markets in its newly-published 2H2017 investment outlook, citing as justification monetary policy challenges in developed countries and encouraging asset valuations in emerging markets. In discussing China specifically, the bank forecast that the A-Share weighing in MSCI's Emerging Markets (EM) Index would reach 20% in 2030 from the initial 0.73% in 2018.[19]

Rationale for the viewpoint

Emerging markets such as Hong Kong, Mainland China, Taiwan and Korea have all recorded double-digit returns in the first half of 2017, compared with high single digit returns from the US and Japan. Although USD 35 billion inflows entered emerging markets in 1H2017 to chase those returns, valuations remain attractive.[20] The current Price to Earning (PE) ratios of Hang Seng Index and CSI300 Index are 14x and 16x respectively, considerably lower than the 21x of the S&P 500 Index.[21]

10+ years for 20% inclusion?

Citibank's estimate about the 20-year A-Share EM Index inclusion process might prove overly conservative. Taiwan and Korea took only 3 years and 6 years respectively to secure full inclusion. Whereas skeptics assert that China's market cap is comparatively larger-- resulting in a longer period for inclusion-- optimistic onlookers expect the full weighing to arrive sooner. They cite Chinese authorities' capital market liberalization progress as justification that MSCI will move more quickly.



Source: Bloomberg, 7.14.2017. **Past performance is not indicative of future performance.**[22,23,24,25,26,27,28]

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.

Crackdown against insider trading manifests in unlikely places

China's Focus Report – a popular state-run news show-- discussed the crackdown on front-running and insider trading in China's mutual fund industry. Separately, the Ministry of Public Security (MoPS) announced a major corruption investigation involving China's mutual funds, insurance firms, and brokerage houses.

Why do these announcements matter?

Launched in 1994, Focus Report reports the prevailing issues commanding top brass attention. The well-respected program has interviewed three Chinese Prime Ministers. Onlookers were shocked that the program overviewed insider trading and other ill-gotten gains in the securities industry, as the issue has historically been kept hush-hush among regulators.

Indeed, it wasn't until recently that insider traders were sentenced to imprisonment. Prior to 2010, improprietous fund managers were given administrative slaps on the wrist rather than incur prosecution by MoPS. Regulatory deployment of big data technologies has also contributed to the heightened penalties. China's stock exchanges now monitor every individual stock and mutual fund account on a real-time basis and alert regulators of suspicious trading patterns.

The takeaway?

Taken together, the Focus Report and MoPS' announcement signify that Chinese authorities will ramp up anti-corruption efforts even more aggressively in the second half of this year, increasing the cost of crime in attempt to obviate future criminal activity.

Notes:

1. M2: defined as M1 plus savings deposits, small-denomination time deposits less than $100,000, and retail money market mutual fund shares.
2. M1: defined as the sum of currency held by the public and transaction deposits at depository institutions
3. M0: defined as liquid or cash assets held within a central bank and the amount of physical currency circulating in the economy.
4. YoY: Year-over-year
5. RMB: Renminbi, the national currency of China
6. S& P bond ratings categories: AAA: An obligation rated 'AAA' has the highest rating assigned by S&P Global Ratings. The obligor's capacity to meet its financial commitment on the obligation is extremely strong. AA: An obligation rated 'AA' differs from the highest-rated obligations only to a small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong. A: Obligations rated A are judged to be upper-medium grade and are subject to low credit risk. BBB: An obligation rated 'BBB' exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation. BB; B; CCC; CC; and C: Obligations rated 'BB', 'B', 'CCC', 'CC', and 'C' are regarded as having significant speculative characteristics. 'BB' indicates the least degree of speculation and 'C' the highest. While such obligations will likely have some quality and protective characteristics, these may be outweighed by large uncertainties or major exposures to adverse conditions. D: An obligation rated 'D' is in default or in breach of an imputed promise. For non-hybrid capital instruments, the 'D' rating category is used when payments on an obligation are not made on the date due, unless S&P Global Ratings believes that such payments will be made within five business days in the absence of a stated grace period or within the earlier of the stated grace period or 30 calendar days. The 'D' rating also will be used upon the filing of a bankruptcy petition or the taking of similar action and where default on an obligation is a virtual certainty, for example due to automatic stay provisions. An obligation's rating is lowered to 'D' if it is subject to a distressed exchange offer. NR: This indicates that no rating has been requested, or that there is insufficient information on which to base a rating, or that S&P Global Ratings does not rate a particular obligation as a matter of policy. http://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352
7. PBOC: People's Bank of China
8. CSRC: China Securities Regulatory Commission
9. CBRC: China Banking Regulatory Commission
10. CIRC: China Insurance Regulatory Commission
11. BoC: Bank of China
12. CCB: China Construction Bank
13. ICBC: Industrial and Commercial Bank of China
14. BoCom: Bank of Communications
15. ABC: Agricultural Bank of China
16. VAT: Value Added Tax
17. R&D: Research and Development

18. MoF: Ministry of Finance
19. USD: US Dollar, the national currency of the United States
20. PE Ratio: Price/Earnings ratio, current market price of the stock divided by earnings per share
21. MSCI EM Index: The MSCI Emerging Markets Index captures large and mid-cap representation across 23 Emerging Markets (EM) countries. **One cannot invest directly in an index.**
22. SPX: Index of 500 large capitalization U.S. equities. **One cannot invest directly in an index.**
23. UKX: Index of most highly capitalized companies traded on the London Stock Exchange. **One cannot invest directly in an index.**.
24. NKY: Index measuring the performance of the Toyko Stock Exchange. **One cannot invest directly in an index.**
25. HSI: Index measuring the performance of the Hong Kong Stock Exchange. **One cannot invest directly in an index.**
26. SHSZ300: Index designed to replicate performance of 300 stocks traded in the Shanghai and Shenzhen stock exchanges. **One cannot invest directly in an index.**
27. TWSE: Capitalization-weighted index of all listed common shares traded on the Taiwan Stock Exchange. **One cannot invest directly in an index.**
28. KOSPI: Index of all common stocks traded on the Korean stock exchange. **One cannot invest directly in an index.**