JCAP

China Primary Insight

March 30, 2015

J Weekly

Contemplating the Book of Changes

Why Near-Term Financial Crisis Looms

- Given the additional asset correlation generated by extensive financial and monetary operations over the last two years, financial crisis, as distinct from economic crisis, now appears inevitable.
- The stock market now seems the likeliest place to find a catalyst.

Anne Stevenson-Yang

Ancient Chinese wisdom held that change is a constant; things must reach a peak and descend, then reach a nadir and resurge. Sharp reversals of fortune have been an enduring part of Chinese culture, literature, and political theory since the earliest writings.

No government, including China's last dynasty and the subsequent Republican regime, has had the foresight and resources to avoid financial crises and post 1949, China endured two horrendous economic crises, in the Great Leap Forward and the Great Proletariat Cultural Revolution.

Many indulge in the fantasy that, because predictions of a financial crisis in post-reform China have been wrong, this proves that one will never occur. Instead, past avoidance heightens the risk for the future. The leadership has been adept at postponing a day of reckoning only by engaging in more and more of the kinds of interventions that have made reform-driven growth so strong and the building imbalances so toxic.

The 'Lost Decade' That Almost Was

Other scenarios were possible. After the post-2008 flood of money, China's economy in 2012 began a quiet deflationary bust that looked like it might be the beginning of a "lost decade" that would at least avoid financial if not economic crisis. But after some dithering, the new Xi government determined that such sharp slowing was politically unacceptable and began a program of massive re-stimulation, relying on steep leveraging domestically and easy inflows of undirected capital. It happened that the monetary expansion out of the United States reinvigorated Chinese financial growth by creating an enticing arbitrage trade in money. Inbound capital controls became increasingly leaky for domestic interests with the right connectivity, but not so much as to erode the lending rates within China's walls. Now that buoyant ride is ending, and there's a fare to be collected

> Monetary expansion out of the United States reinvigorated Chinese financial growth by creating an enticing arbitrage trade in money.

The steps the leaders have taken and are now ramping up even more will actually make the coming financial crisis worse. That is because bailouts have maintained bloated asset values, and leveraged up step by step, from one bloated asset class to another, pulling taut the ties that bind assets, such that now, when one goes it will cause a chain reaction.

Last year's break in the property market, which came most visibly with reports in February that Hangzhou developers were offering 30% off, generated a slow deflation rather than a panic, thanks to governments' ability to hide true pricing and transaction levels. Higher transparency and liquidity make the stock market more dangerous as the promoted asset class. The market has soared thanks to leverage created by the capital fleeing property for more liquid investments, but the A shares are marked to market daily, and interventions are more or less visible. That quality makes it seem likely that a sharp market decline will be the trigger for crisis.

Crisis by Fission

The development model of the reform era has concentrated considerable wealth at the center, considerable but finite. That has enabled a quiet but growing series of rescue operations from the impacts of normal market forces in an economy floating on a bloated money supply and perilously rocked by debt.

Like everything in China, the scale is breathtaking. Each time bailout funding goes into a bankrupt trust, property developer, bond, or bank, the infusion supports the collective social delusion that acres of empty and decaying properties are really worth something, that they represent a prosperous future in a bustling new metropolis, even as the default signals money to migrate to a new asset class, evidence that people with assets no longer believe it.

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The successively abandoned assets produce no return in the real economy, but their notional value underpins more and more credit in the financial system. Thus, the refusal to accept defaults has bloated collateral value and enabled massive correlation of assets, leaving fundamentally dead assets with nominally high values standing like a forest of dry trees, kindling for a future conflagration. This ratchets up the risk across asset classes and means that a financial crisis will not be a regional or a quiet event, nor will it be limited to one asset class, because the value of real estate, stocks, wealth management products, and bonds each depends on another asset's notional value. For households, unacknowledged paper losses and demanding debt problems will be spread visibly on the table.

There is nothing surprising about this: the Chinese economy is sucking investment capital far faster than it is producing value. What investors inside and outside of China fail to appreciate is that monthly addition of capital knits more tightly the latticework of related assets.

Bloated

In China, the asset underpinning all other values is ultimately real property. Tellingly, among the economic statistics hardest to locate in China's abundant databases is that for the average price of housing. Local land bureaus, which register purchase transactions and so have the best source of data, consider underlying price data too sensitive to release. Secrecy gives them maximum leverage on one hand to avoid predatory regulation by the central authorities and on the other to create the impression among the public of a rising market amid the reality of high volatility and plunging realizable values. Meanwhile, developers routinely over-report their prices: they want the public to believe that strong demand is driving prices higher, because no one wants to buy in a falling market.

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An Evergrande villa complex about 50 km from Urumqi, totally unoccupied but valued, according to Fang.com, at 13,000 RMB/sq m or USD 194 per square foot. | Photo by J Capital, June 2014

Sources for average prices tend to be academic studies, which yield an average annual growth in housing prices of around 19% for over a decade. The state monopoly in land sales, the obscure process of reckoning values, and the scope of incentives to inflate steeply the value of everything in the system all make suspect the realizable value of everything the banks lend against. Both residential and commercial real estate assets produce zero or very low returns; the path to repaying debt is at best completely unclear. Even those who dream of a bustling metropolis emerging from the dismal, crumbling towers of China's ghost cities do not have an answer to the debt question.

From a macro point of view, gross capital formation in China, according to the World Bank, has regularly amounted to roughly half of GDP versus about 19% in the United States, a country that can hardly be accused of under valuing its assets. Gross Capital Formation measures the value of new fixed assets acquired minus those disposed of. In 2013, the World Bank recorded USD 4.37 trn in GCF for China versus USD 3.24 trn in the United States, even as the United States produced USD 7.53 trn more in GDP. The growth of nominal wealth per capita in China has also vastly exceeded the growth of income or any measure of productivity In other words, both China's GDP growth rate and current GDP are dependent on declarations of asset values that have never been tested in markets and are obscure in their calculus. How much real wealth resides within the sea of bloated assets?

Levering

On top of basic asset overstatement, borrowing is built on incentives to gear up assets and amplify them into new levels of credit. The recent troubles at Kaisa Group, which appears close to collapse, show how robustly property is used and re-used to collateralize loans: news reports say that some Kaisa properties have been collateralized 24 times over.

Other types of collateral can underpin borrowing as well, commodities being the most common, especially coal reserves, steel, and copper. The first public trust default, of the Liansheng Group assets funded by Jilin Trust, was of a financial product supported by coal mine assets that had shrunk in value with the fall in the price of coal. Liansheng had apparently been idled for some time. But instead of defaulting and selling off its assets for partial recovery, Liansheng had its debt paid by a consortium of banks under the direction of the Chinese government, leaving the bankrupt coal assets at the original nominal value.

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Virtually any physical commodity can be turned into leverage. Before the anti-corruption campaign crushed the price of Moutai and other white spirits, for example, Guizhou Province was filled with cooperative "liquor banks" where distributors would pool unsold inventory and collateralize it for bank loans. Garlic at one point became a highly sought-after form of collateral, as prices for garlic were spiraling, and distributors hoarded in dedicated warehouses. Small loan companies in mining regions, where the wealth created by easy credit made luxury autos a commonplace for a time, specialize in lending against luxury cars; the owner transfers title for the period of the loan but retains the right to drive. Company accounts receivable are another popular form of collateral as well as being a saleable asset.

For all these unconventional forms of collateral, Chinese banks seldom mark the value of collateral to market; rules generally require them to do that only when collateral is sold off for cash, so it can sit on the books at an inflated value as long as the collateral has not been successfully auctioned. The only attractive sale option is to a purpose-built asset manager or equity investor willing to take them at par, against all commercial logic. For the bank that solves all problems.

Never a Mark

Because collateral tends to be illiquid, Chinese banks work mightily to avoid acknowledging any reduction in its value. The recent negotiations with Venezuela over that country's roughly USD 52 bln in debt to China provides an example: with the falling price of oil, Venezuela has been patently unable to make payments on the outstanding balance of USD 20 bln. In December, Venezuela reportedly offered China an island in lieu of the debt (China denies that this occurred). In January, China made a USD 20 bln loan commitment to Venezuela, just as Bloomberg estimated that Venezuela had a 90% chance of default this year. That new loan would seem to help the bank avoid recognizing an impairment. The Mainland practice of evergreening loans to maintain optics of very low default rates has now migrated into China's external financial activities.

Local governments also use new money to sustain the value of the old. Last year, for example, local governments around China used new loans from the China Development Bank to purchase properties in the governments' own "new city" zones in order to prop up prices. Recently, when we have inquired about surging sales statistics in a few smaller cities around China, we have found that local governments seem to be aggregating capital from the public to drive into unsold local properties, and that keeps the prices from collapsing for the moment. To address this accretive local government borrowing, the Finance Ministry will now permit issuance of municipal bonds, reducing the interest and stretching out the repayment term. It is hard to imagine anything but more expansionary borrowing at the local level as an outcome.

The Risk from Visible Prices

The mark-to-market risk creeps in when there is a public, usually international, market in the collateralized commodity. In 2014, copper hypothecation became a scandal as soon as the RMB began to depreciate, because the international price and margins could not be hidden. Qingdao metal traders had hocked the same copper inventories many times over and tried to export them before the copper losses became one of China's biggest financial scandals to date, involving both domestic and foreign lenders.

In 2009, China built up massive inventories of steel that were used to collateralize loans: service companies could not obtain credit unless they had collateral, so they would pay steel traders for the right to "borrow" inventories to collateralize for debt. But there is an active market for steel, unlike unmined coal reserves or land, so falling prices induced traders to dump their inventories. The resulting losses at banks prompted the government to restrict lending against steel collateral. Unlike residential property, for steel and copper, the global markets had a com-

100056	富国低碳环保股票型证券投资基金	2.216	29.44%	77.56%	86.06%	90.38%	236720954
000697	汇添富移动互联股票型证券投资...	2.131	29.78%	73.68%	102.57%	83.55%	60741226
000574	宝盈新价值灵活配置混合型证券...	1.585	20.93%	72.45%	83.40%	67.81%	37760605
470009	汇添富民营活力股票型证券投资...	2.786	23.00%	69.05%	71.45%	76.89%	37802183
470028	汇添富社会责任股票型证券投资...	2.128	31.20%	69.02%	84.08%	76.01%	29314513
519979	长信内需成长股票型证券投资基金	1.588	30.92%	66.46%	50.09%	73.36%	36068971
000404	易方达新兴成长灵活配置混合型...	2.113	26.98%	64.82%	71.65%	74.34%	0
257070	国联安优选行业股票型证券投资...	2.046	25.06%	63.16%	75.62%	75.17%	6428701
000083	汇添富消费行业股票型证券投资...	2.345	22.52%	62.17%	64.33%	68.46%	20422082
519690	交银施罗德稳健配置混合型证券...	1.860	24.81%	61.38%	81.01%	60.76%	4057411
720001	财通价值动量混合型证券投资基金	2.146	27.74%	60.51%	82.17%	56.07%	19390617
000124	华宝兴业服务优选股票型证券投...	1.850	24.08%	59.35%	72.09%	58.25%	2143400

宝盈新价值灵活配置混合型证券投资基金

Screenshot from Taobao offering a menu of funds and showing expected returns

mutable price, so the declining asset value could not be hidden.

As each of these channels becomes problematic, it is abandoned and the cash washes into a new channel. A classic example is the rise and fall of the P2P industry, a set of some 3,000 websites that raise money from the public for all sorts of loan securities. Virtually unknown in 2012, by the end of last year, these sites had moved around a half trillion in loans. Now, the domestic ratings agency [Dagong has estimated] that 45% of the sites will be bankrupt before the end of this year.

That is fine, because the sites are already nearly forgotten, and money is now flowing into the various types of funds to invest in A shares.

Ziggurat

Obtaining a bank loan against collateral is only the first stage in creating multiple layers of leverage. The loan can be deposited against a Bank Acceptance Note issued at 200% of the loan value, which then can be cashed, deposited, and leveraged again. It may be pooled with other loans into an "umbrella trust" dedicated to margin trading on the A share market. Leverage can be magnified with multiple layers of trusts and wealth management products.

Once the cash value of the collateral has been amplified three or four times, financiers create derivatives from the asset pools, and the derivative products can be bought, sold for cash, and evaluated on sites like Taobao.

Sometimes, wealth management companies provide ways for the public to spread their risk by investing in pools of these derivative assets. As before the U.S. financial crisis, investors have no idea what they are actually buying.

Round Tripping Offshore

One popular way of leveraging lending against collateral is to move the money obtained onshore at low, even subsidized borrowing rates, to an offshore "subsidiary." The offshore affiliate can take out a hard-currency loan against Chinese collateral, arbitraging the low offshore interest rates against much higher Chinese returns in the Mainland short-term capital marketplace. The offshore company can also keep a piece of its new capital safely in hard currency and invest the remainder on the mainland. The recent cut in the statutory bank reserve ratio provides an example of this. The December cut moved about RMB 500 bln from the vaults of the PBOC to the commercial banks, and suddenly, in January, it became very easy for fund and wealth managers to raise money. At the same time, both Foreign Direct Investment and Overseas Direct Investment surged out of proportion to observable reality. It seems that some of that half trillion in new credit was spirited out of the country via ODI, put into the accounts of newly registered offshore companies, then re-injected via FDI accounts into equities-based securities.

One of the mechanisms facilitating this sort of transfer is the new "Qualified Domestic Investment Enterprise" program approved in Shenzhen's Qianhai District in early 2015. A trial plan was approved in 2013, and in Q2 2014, Shenzhen approved a USD 1 bln quota for cross border trade by the QDIE companies. All sorts of companies have been setting up cross-border funds. Great Wall Securities, for example, recently established a USD 700 mln cross-border investment fund under the program. All of this attracts widespread approval from foreign analysts, who call it a mark of "reform." It is really one more way to create incentives for the privileged class to speculate in domestic securities, ensuring this class that they can realize high rates of return while enjoying the security of offshore bank accounts.

The popularity of these strategies seems to be eroding the Chinese reserves faster than reported. For the last three years, the PBOC has accumulated more foreign exchange reserves than foreign exchange on the balance sheet. This should be impossible, because balance sheet forex should include reserve forex. That suggests that the reserves are being over-reported, and there is in fact no way to corroborate the officially published numbers.

Building the Asset Chain: The Stock Market

Given the irretrievable decline of the property markets, a critical key goal of China's financial authorities is to create investment returns somewhere else so that investors will not try to sell their property; after all, so much of the property sold in recent years is ultimately valueless. Meanwhile, the government needs a funding channel for companies that will be of minimum cost to the banks: the best is equity funding. To the extent that the public can be coaxed to provide equity capital to companies, the demand for credit is held in check. Thus the new A share market and its meteoric 2014 rise has been engineered and will continue, if authorities have anything to do with it, through 2015 and beyond, at least until the Shanghai exchange reaches the peak values of the 2007 bull market. The new Third Board is designed to allow more companies through the IPO gate by lowering standards for accounting and profitability. So far, the strategy is working.

But publicly traded stocks differ from land collateral in that they are quoted and tradable every day at a public price. Intervention has limited effectiveness, since it consumes cash and ultimately, pricing cannot be hidden. Those qualities make the current promotion of the stock market a very high-stakes gamble.

The Imperative of Endless Growth

All this leverage is designed to act as a sort of coiled spring catapulting the borrower into a growth arc that will enable him to raise much more money, with an IPO imagined as the ultimate goal and a sort of escape velocity. On this logic, companies are taken private at inflated values. As long as a high value can be established for the shares, they can be collateralized to raise debt and used to make acquisitions that bulk up the company's assets prior to an IPO. In other words, raising money enables the company to raise more. In many cases, companies may believe they will make good on the capital raised, but equity capital in the end does not have to be returned, so nirvana consists of replacing debt with equity at a high valuation. The goal of SOEs is to raise debt, more than ever justified by historical profit; in 2013, the China Industry Steel Association let slip a report estimating that 85 steel mills were carrying RMB 3 trn in accumulated debt. For the State, which owns equity in the companies, debt is more or less free money. For private companies, the goal is to raise more equity capital on public markets than they ever make through operations. In fact, the business of Chinese companies in all sorts of sectors is simply raising more and more capital. The increasingly intricate dance among State and non-State companies with mergers, acquisitions, mutual investment, mutual borrowing, privatizing, and IPO'ing chunks up revenue and market value needed to maintain these ever-lofting market valuations.

Triggers

Through each credit cycle, the degree of interdependency of credit instruments increases, with all poised upon the fulcrum of underlying land or commodity assets whose market value can no longer support the weight of the financing. One by one, the cards holding up the whole house are falling away. One WMP default could mean the collapse of loans from a dozen banks, a margin call on securities, which would cause a sudden drop in share prices, which could bring about a sell-off on the stock market, defaults by the umbrella trusts, and lots of individuals who lose their money and cannot ignore that fact. Apart from such a wildcard event, the more likely stone to shake loose will be the stock market, because even furious intervention by governments will not stanch a decline if investors panic.

The China Dream

Aptly named, the China Dream is just that because it is far from reality. I recently met with a popular local author and political personality who advises the government, although the degree of his influence is unclear. He advocated driving interest rates to zero and property values to 200,000 RMB/sq m (USD 3,000 per square foot) so that Chinese people would be "the wealthiest in the world" and using the wealth to buy influence in surrounding countries.

That Swiftian modest proposal differs from the current situation only in degree, where asset values have reached a point where the average Chinese has wealth equal to the average American, in a per capital economy one-eighth the size, with households consuming less than one-twelfth what US households spend at current exchange rates. In fact, it represents the *reductio ad absurdam* of the Party's view of the China Dream outcome, in which bloated nominal asset values are savored in every household, and the glory of the nation requires that the people are forever satisfied to sit on assets said to be of great value while actually consuming next to nothing. Like the relentlessly promoted Maoist hero Lei Feng, people now should be satisfied knowing that they are helping the country and being virtuously frugal at the same time that they are really really wealthy.

The sustainability of the Party, it is said as a matter of natural law, depends on its delivering financial value to the masses, the kind of steeply increasing value that the last 15 years have seen. While the new administration is facing the economic slowdown by promoting the image of great virtue among the Party leaders, the pillars of power are still maintained by economic growth. Ultimately, the Dream ends when and if the masses awaken to realize that only a harsher reality lies ahead. That is why scholars, comics, firebrands, Politburo members, and the man on the street now draw a straight line between the troubles in the economy and the closing of this chapter of Chinese Communist Party rule.

Data Matters

FDI

Anne Stevenson-Yang

January and February evidenced new liquidity flowing into the stock and fixed-income markets in China following a cut in the bank reserve ratio that freed more than RMB 500 bln.

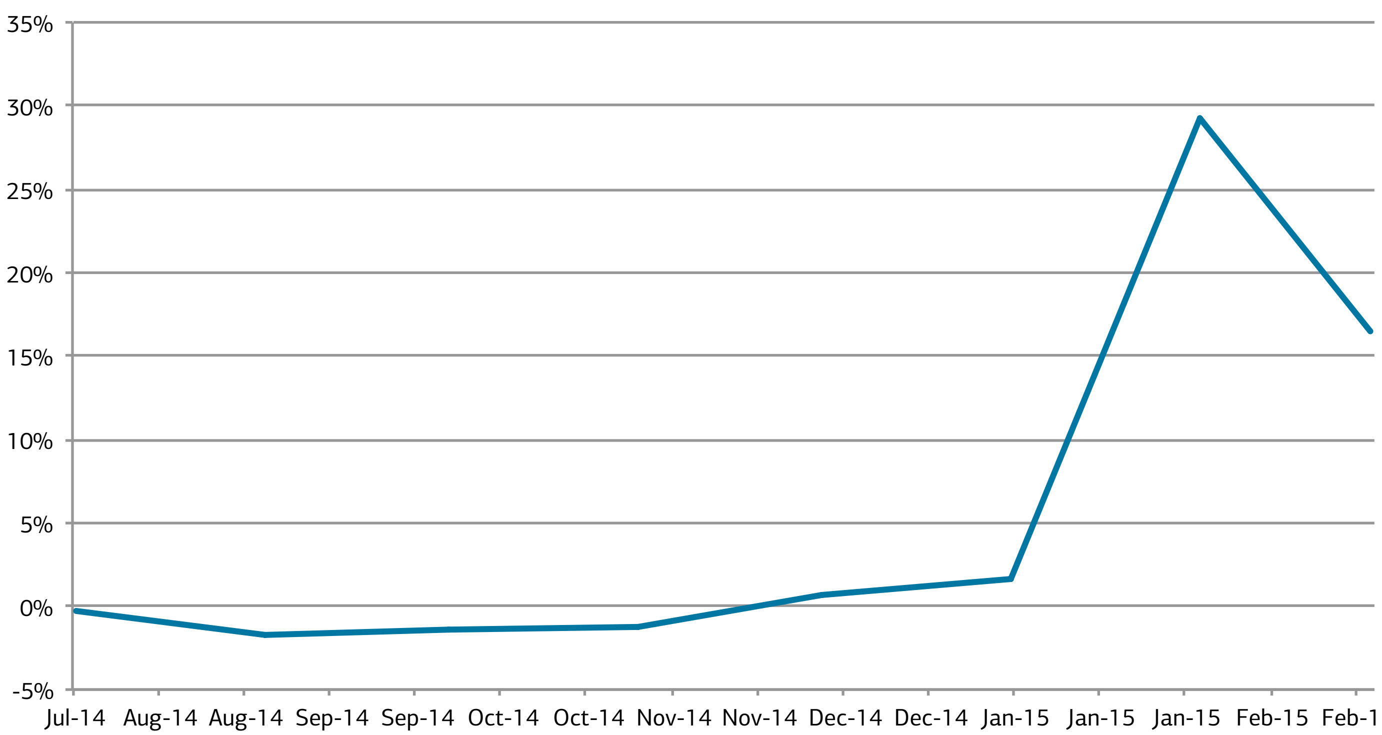
Wealth managers and brokers in Shanghai and Shenzhen said that they are finding it extremely easy to raise money for new investment funds. It appears that some of that money is being shipped offshore then brought back as Foreign Direct Investment; that way, Chinese with access to credit can secure their money overseas but realize the higher rates of return on offer in China.

China's FDI surged in the first two months of the year to USD 22.5 bln, up from USD 19.3 bln in the first two months of 2014, after having seen negative growth through the second half of 2014. At the same time, China's Overseas Direct Investment rose by 51% in the first two months, to RMB 106.76 bln (USD 17.81 bln). Those increases may represent round-tripping.

Numbers given for specific investment partners support a round-tripping hypothesis. FDI sources with robust reporting procedures showed decline.

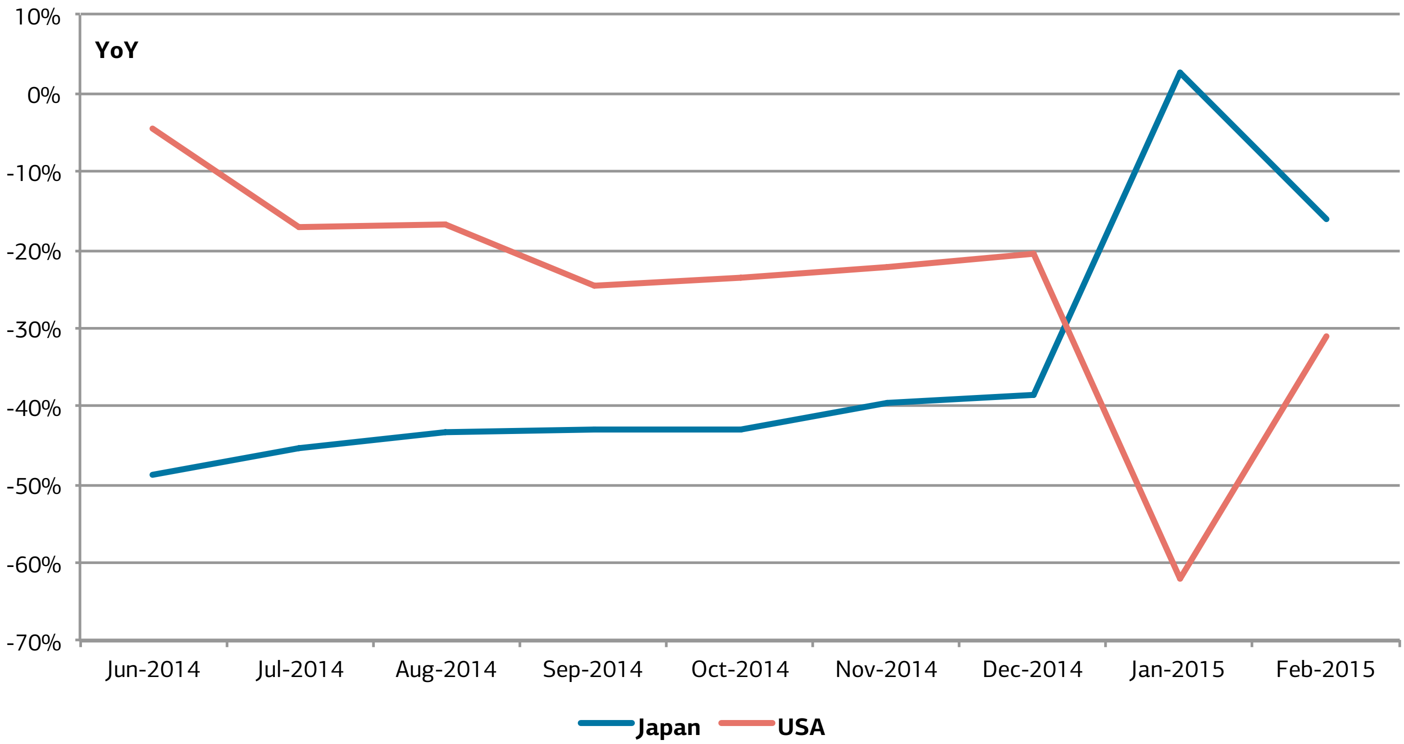
Hong Kong and South Korea showed sharp increases. Hong Kong is the biggest center for gray money flows in and out of China, and trade and investment flows with South Korea have also shown irregular patterns.

Growth of Utilized Foreign Direct Investment July 2014-February 2015

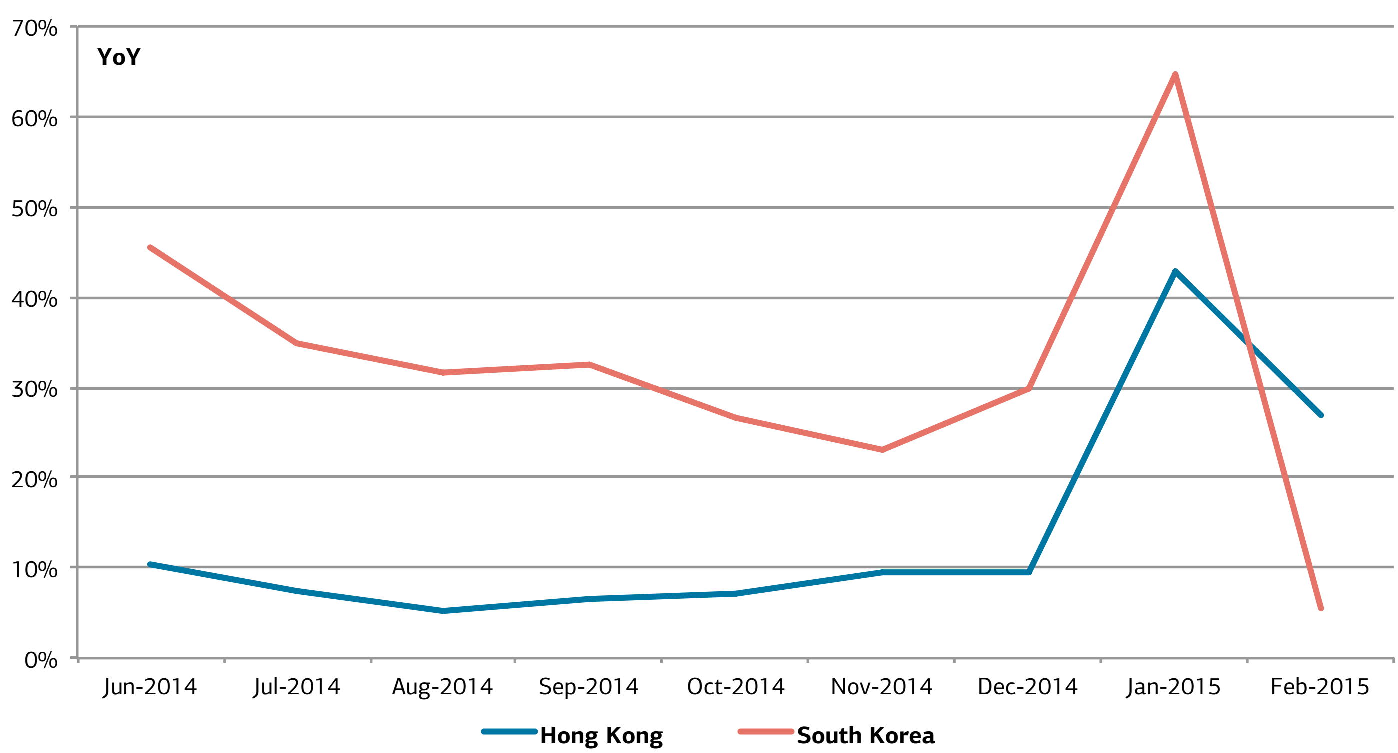


Source: Ministry of Commerce

Declining Trend of FDI from Japan and the U.S.



Increasing Trend of FDI from Hong Kong and South Korea



UPCOMING J CAP EVENTS

Anti-Corruption, Asian Longs, and Food Supply

Calls

Political Risk & Corruption

Research Director **Anne Stevenson-Yang** will give a brief presentation on findings from her recent visits to state-owned enterprises and think tanks in China and will take questions at the end of the presentation. Topics will include:

- What are the true goals of the anti-corruption movement?
- Risks and opportunities: Is there a "reform" agenda? And how much backlash is the campaign incurring?
- Cutting the fat of SOEs.
- Lowering growth expectations.

- **Tuesday, March 31 at 10 am EDT .**

April Trips

Longs in Developed Asia

Australia, New Zealand, Singapore. We will visit consumer staples, agriculture, dairy and fishery companies to look at the increased importance of exports to developing Asia. We will then look to emerging sectors that are getting a new boost from new Asian customers, such as education, tourism, biotech, and software. In Singapore, we will meet with REITs that focus on developed Asia. Click here for the trip schedule.

- **Led by Susannah Kroeber, April 7-10.**

United States Macro Briefing

Two days of discussions with macro economists and academics in New York and Washington on U.S. monetary policy and how it will affect world economies.

- **April 15-17, in conjunction with J Capital partner Global Frontiers.**

Finishings: Elevators, Ceramics and Copper

Xiamen, Hangzhou, Xian, Hefei. We expect property construction completions to decline this year and sales of elevators, sanitary ceramics and copper to follow. We will visit Xiamen, Fujian will then visit Xian, Shaanxi an important West China market for elevator and ceramics sales before we visit Hefei, Anhui a key copper processing area. For elevators and ceramics we will meet with property developers, distributors, agents and producers of equipment to understand what is happening with orders and sales in the peak construction period. For copper we will speak with traders and processors of copper to get an understanding of the end demand for copper this year. Click here for the trip schedule.

- **Led by Tim Murray, April 20-24.**

Property

Shenzen, Hangzhou, Shanghai, Beijing. We will visit Kaisa, Renhe Commercial (another distressed bond), properties in Shenzhen, Hangzhou, Shanghai, and Beijing. an important property market and a ceramics production base.

- **Led by Anne-Stevenson-Yang, April 26-29.**

The A-Share Mkt

Shanghai, Shenzhen, Beijing. Together with Kevin Yeoh, formerly co-manager of the best-performing fund trading A shares, visit the Shanghai and Shenzhen exchanges, major brokerages, funds providing financing, and some of the companies on the A share index.

- **Led by Kevin Yeoh, April 27-29.**

May Trips

Food in China

Qingdao, Tianjin, Henan, Hebi, Beijing. We will look at the performance and supply chain for fast food brands in China like Burger King, Dicos, KFC, Starbucks. We check the distribution and performance of convenience food companies like Want Want, Tingyi, and Heinz.

- **Led by Anne Stevenson-Yang, May 7-10.**

Please email Brian Emanuelson (brian@ jcapitalresearch.com) or Roberta Sanminiatelli (roberta@jcapitalresearch.com) if you'd like to see a preliminary agenda for any of the listed trips, or share with us any trip bespoke ideas you might be thinking about.

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