

Global Multi Asset *Viewpoint*

Asian Crisis Redux, Part II

Consensus opinion is well aware of the debt problem in China. It was the topic of a detailed survey published by *The Economist* in early May (titled “The Coming Debt Bust”), and also of several presentations at CLSA’s recent China Forum in Chengdu, which was attended by Sergei Parmenov, portfolio manager on the Global Multi-Asset Team. Although the existence of this issue has been recognized, we believe its implications have not been fully understood. There is widespread belief that the Chinese government is in control and can keep stimulus going at will to achieve its growth goals. Consensus opinion also takes a benign view of credit and draws a parallel with Japan, which experienced slowing growth as a function of its highly leveraged economy in the early 1990s, but managed to avoid a financial crisis. We note that this market perception is actually incorrect, as there was a banking crisis in Japan from 1997-2002 in which the government purchased assets from banks, merged some of them, and forced aggressive recognition of loan losses. Ultimately, the total fiscal cost of this banking crisis came to 14% of GDP.¹ In contrast to the consensus opinion, our assessment is that the risks of an eventual financial accident in China have risen markedly, for several reasons which we discuss below.

AUTHORS



CYRIL MOULLÉ-BERTEAUX

Portfolio Manager
Head of Global
Multi-Asset Team
Managing Director

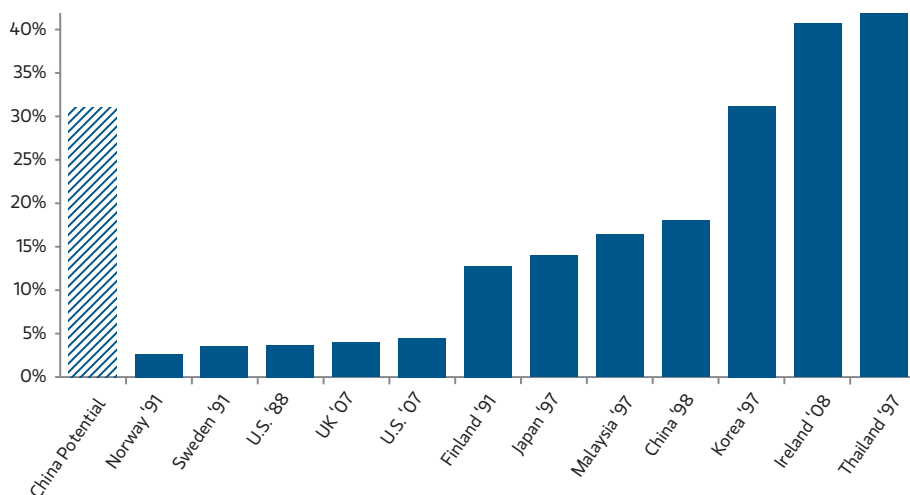


SERGEI PARMENOV

Portfolio Manager
Global Multi-Asset Team
Managing Director

Display 1: China’s Rising NPLs Suggest Costly Bailout

Fiscal Costs of Banking Crisis Bailouts, as a % of Pre-crisis GDP



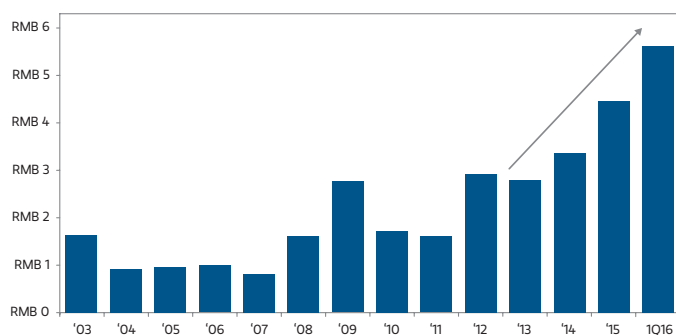
Source: MSIM Global Multi-Asset Team Analysis; IMF; Bank for International Settlements. Data as of May 2016. Estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

¹ MSIM Global Multi-Asset Team analysis; Asian Development Bank.

First, credit quality deterioration continues to be pronounced, and the problem is widespread across industries. The median number of days outstanding for accounts receivable at publicly traded companies reached 84 in 2015, compared to an average of 55 days from 2005-11.² Our recent meetings with financial institutions in Sichuan confirm that credit quality is deteriorating and that the problem is larger than official data suggests, as maturity extensions are widely used to keep reported nonperforming loans (NPLs) down. Even based on official figures, NPLs are rising. Estimates for current NPLs range from a benign 2% based on officially reported statistics, to more pessimistic (and in our opinion, more realistic) estimates such as the IMF's at 14% and CLSA's at 15-19% of loans, or 35% of GDP.³ This unofficial range is already much higher than the NPL peaks for most recent developed market banking crises implying significant potential cleanup costs. The median fiscal cost of a bailout has been approximately 60% of total NPLs for major banking crises since the 1990s, though this ratio reached 90% in China's 1998 crisis. Applying just the median fiscal cost ratio to estimates for China's total private credit NPLs (including unofficial shadow banking assets) suggests that the eventual cost of a bailout could be 30% of GDP, one of the highest costs of any banking crisis in history (*Display 1*).

Display 2: Diminishing Credit Impulse Suggests Severe Structural Problems

RMB of Credit Growth Required to Generate RMB 1 of China GDP Growth



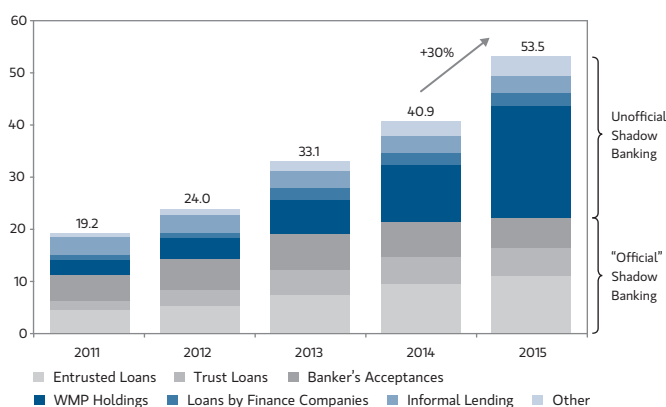
Source: MSIM Global Multi-Asset Team Analysis; People's Bank of China (PBoC); National Bureau of Statistics of China. RMB of credit growth required to generate RMB 1 of GDP growth defined as [Annual New Credit as a Percent of GDP / Nominal GDP Growth]. Data as of May 2016.

Second, we believe that massive levels of stimulus, which have been required to prevent a hard landing thus far, will not last. Diminishing returns on additional credit creation mean that even more credit needs to be continuously added to maintain the status quo: in 2003-08, it took an average of RMB 1 of additional credit to generate RMB 1 of GDP growth; this ratio increased to 2:1 in 2009-10, the first massive stimulus, and reached 4:1 in 2015. Taking Q1 2016 data into account, the ratio of new credit to subsequent GDP growth is now nearly 6:1 (this compares

to the U.S. going from less than 1:1 in 1990s to 3:1 during the housing bubble) (*Display 2*).⁴ We believe the authorities are beginning to realize that maintaining a positive credit impulse only exacerbates eventual problems, as evidenced by comments in official press outlets and speeches that they are unwilling to maintain credit issuance at the high pace seen in Q1. April credit data corroborates this, with mortgage lending and corporate bond issuance slowing significantly from the recent trend. Corporate bond issuance slowed to RMB 200 billion in April (down from an average monthly pace of about RMB 400 billion) following a recent uptick in bond defaults and a 30 basis point widening in AAA credit spreads.⁵ Similarly, after the authorities directed their attention to slowing the frenzied pace of housing activity, new mortgage lending slowed to RMB 160 billion in April (on a seasonally adjusted basis) and is now in line with the average pace over the past year, after spiking to nearly RMB 200 billion in March.⁶

Display 3: Total Shadow Banking Growth Explosive

China Shadow Banking Assets (RMB in trillions)



Source: MSIM Global Multi-Asset Team Analysis; Moody's. Data as of May 2016.

Third, the government has substantially less control over the credit system than it used to. The so-called "shadow banking system" is larger, comprising an estimated RMB 53 trillion in assets and 80% of GDP vs. only 40% four years ago (even on official data, shadow banking has grown to 23 trillion in assets, or 30% of GDP) (*Display 3*).⁷ While no one really knows the degree of leverage within the shadow banking system, moving it back onto bank balance sheets would likely increase the loan-to-deposit ratio for the banking system as a whole significantly above the official figures of 65-70%, and closer to 100%.⁸ These assets present heightened risks in the event of a financial meltdown, as their originators lack access to the lender of last resort (thus limiting the government's ability to bail out market participants quickly). In addition, 40% of total shadow

⁴ MSIM Global Multi-Asset Team analysis; PBoC; National Bureau of Statistics of China; FRED Economic Research.

⁵ MSIM Global Multi-Asset Team analysis; PBoC; Bloomberg.

⁶ MSIM Global Multi-Asset Team analysis; National Bureau of Statistics of China; Bloomberg.

⁷ MSIM Global Multi-Asset Team analysis; Moody's; PBoC.

⁸ MSIM Global Multi-Asset Team analysis; Autonomous Research.

² MSIM Global Multi-Asset Team analysis; Morgan Stanley Research.

³ MSIM Global Multi-Asset Team analysis; PBoC; IMF; CLSA.

banking assets are now funded by wealth management products (WMPs), which banks offer to retail investors as a means of earning a higher interest rate than the bank deposit rate, which is capped. WMP holdings are often vaguely disclosed, and their short-term maturities (which tend to imply lower risk to investors) are precariously mismatched with their holdings: of the RMB 25 trillion in WMP financing, roughly 75% needs to be rolled over every six months, and roughly 90% matures within 12 months, despite generally funding much longer-term assets with credit and market risk, or sometimes both.⁹ The Ponzi-like nature of this arrangement is exemplified by the fact that there have been no meaningful WMP or trust defaults despite clear deterioration in credit quality of the underlying assets overall. In case of default, investors in WMPs are usually made whole by their sponsoring banks due to the likely ramifications of letting the system falter. When asking questions about the absence of WMP and trust defaults to trust managers in our recent meetings in China, we were astounded by the disparity between the official, politically correct responses and what appeared to be the truth, and also by how widespread and well known this gap appeared to be by local participants.

Display 4: China Property Sales Rolling Over

Property Sales Volumes (3 month moving avg., in millions of sq. meters)



Source: MSIM Global Multi-Asset Team Analysis; SouFun. Data as of May 2016. Estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

In conclusion, while macro data in China stabilized during the first quarter, we believe that, as risks within the financial system continue to mount, a resumption of the slowdown could occur earlier and more sharply than the market expects, particularly if Chinese authorities step back from aggressive easing. Growth data remains only marginally better after a large dose of stimulus, and several leading indicators are already beginning to roll over, including retail and property sales (*Display 4*). We continue to believe that China's massive investment bubble will inevitably collapse, along with the record amounts of debt that made it possible.

About the Authors

CYRIL MOULLÉ-BERTEAUX

Managing Director

Cyril is head of the Global Multi-Asset Team at MSIM. He re-joined the firm in 2011 and has 25 years of financial industry experience. Before returning to Morgan Stanley, Cyril was a founding partner and portfolio manager at Traxis Partners, a multi-strategy hedge fund firm. At Traxis Partners, Cyril managed absolute-return portfolios and was responsible for running the firm's quantitative and fundamental research effort. Prior to co-founding Traxis Partners, in 2003, he was a managing director at MSIM, initially running Asset Allocation Research and ultimately heading the Global Asset Allocation Team. Previously, Cyril worked in corporate finance and derivatives in Emerging Markets at Bankers Trust from 1991 to 1995. He received a B.A. in economics from Harvard University.

SERGEI PARMENOV

Managing Director

Sergei is a portfolio manager on the Global Multi-Asset team at MSIM. He re-joined Morgan Stanley in 2011 and has 20 years of investment experience. Before returning to Morgan Stanley, Sergei was a founder and manager of Lyncean Capital Management, a macro hedge fund. Between 2003 and 2008, Sergei was an analyst and a portfolio manager at Traxis Partners, a multi-strategy hedge fund firm. From 2002 to 2003, Sergei was an analyst at a European mid-cap equities hedge fund at J. Rothschild Capital Management in London. Prior to this, he was a vice president in the private equity department of Deutsche Bank, and from 1999 to 2001, Sergei was an associate and subsequently vice president at Whitney & Co, focusing on European private equity investments. Sergei started his career at Morgan Stanley Investment Management in 1996. He received a B.A. in economics from Columbia University.

⁹ MSIM Global Multi-Asset Team analysis; Autonomous Research; China Banking Association.

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