Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

# Credit Where Credit Is Due

**ACTIVE FUNDAMENTAL EQUITY** | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | APRIL 2019


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After a few months of equity market enthusiasm driven by expectations of still decent global gross domestic product (GDP) growth, perennially low interest rates and, at the time of writing, potential resolution of trade tensions, we thought it worthwhile to provide an update on one of the major global tail risks we see – Chinese corporate debt.


Within the private sector in China, total credit rose from 115% of GDP to 207% of GDP between the fourth quarter of 2008 and the first quarter of 2017, according to the Federal Reserve Bank of St. Louis.[1] As the International Monetary Fund wrote in its working paper in January 2018, “International experience suggests that such rapid growth is not sustainable and is typically associated with a financial crisis and/or sharp growth slowdown,”[2] a view we share.

The Chinese government seems aware of these risks and began to slow credit growth starting in the first quarter of 2017. The debt-to-GDP ratio has subsequently declined moderately. In particular, the component of credit supply commonly called the shadow banking system declined from an annual supply of ~5-10% of GDP to effectively zero or negative by the middle of 2018.[3] Given the dependence of the Chinese economy on debt supply, this led to a slowdown in GDP expansion. However, in the last few months it appears as though the Chinese government has reversed course to shore up flagging GDP growth.

[1] Source: https://fred.stlouisfed.org/series/QCNPAM770A

[2] Source: https://www.imf.org/~/media/Files/Publications/WP/2018/wp1802.ashx

[3] There are various definitions and measurements of the shadow banking system. We use the “Total Social Financing” numbers provided by the People’s Bank of China as well as the Autonomous calculations for shadow banking.

While shadow banking remains subdued, the official banking system has stepped in to offer support by, amongst other things, cutting reserve requirements. This lending effort is directed at privately owned small- and medium-sized enterprises (SME), a sector previously dependent upon the shadow banking system.

This return to credit growth brings back concerns about a major financial crisis in China as non-performing loans have also been building up. In particular, the fact that banks who had previously not been lending to SMEs are now pushing hard into this higher risk sector is not very reassuring.

We do not have any ability to predict how far the Chinese government is going to push credit growth as a means of maintaining high GDP growth nor whether there will be a return to rapid debt-to-GDP expansion. We nevertheless notice that there are developments that indicate the government is aiming to make the financial system more robust. On one level, supervision has substantially tightened. In 2017 and 2018, the China Banking Regulator Commission (CBRC) issued fines at a run-rate of approximately 1.5 billion renminbi (RMB) – a huge step up from the approximately 100 million RMB run rate issued up until 2016. That tougher approach has resulted in banks gradually unwinding some of the more egregious accounting schemes. For instance, banks used to regularly classify loans as investments by putting a rather flimsy wrapper around the issuance, a practice initially meant as regulatory arbitrage to circumvent loan-to-deposit limits and capital requirements. More recently, these structures were used to reduce the amount of reported non-performing loans, a practice the CBRC is now clamping down on.[4] Equally, regulation that allowed loans over 90 days overdue to remain as performing assets is being abolished. These as well as other measures should improve the quality of bank balance sheets in China, in particular amongst the smaller, more vulnerable banks. How fast and how successful this will be depends also on the recovery of the distressed debt market and capacity expansion amongst asset management companies (the Chinese variant of the "bad banks").

Hence, we see some positive trends to reduce the tail risk of a financial crisis in China. That being said, the levels of debt are still extraordinarily high, and the pressure to achieve strong GDP growth going forward may still trump the need to achieve medium-term deleveraging. In part, this will also be impacted by the U.S.-China trade negotiations, where a potential failure to agree on a new relationship would trigger more stimulus that supports GDP in the short term but pushes up risks in the long term.

"In the case of a new financial crisis, we believe high-quality health care and consumer staples companies would be more resilient"

Our portfolio has an overweight to emerging markets on a revenue basis. The companies we invest in generate an estimated 31% of their revenues in emerging markets versus 22% for the market as a whole. Revenues from China directly account for around 6% (6.0-6.7%) of our global portfolios.[5] This exposure is concentrated in consumer staples and health care. We believe these sectors have less exposure to either risk. In case of a slowdown of GDP growth in China, these sectors tend to see far less earnings erosion than the overall market as they enjoy recurring revenues and pricing power. In the case of a new financial crisis, we believe these sectors would be more resilient given the lower leverage. We would suggest that the portfolio offers a good way to gain exposure to the long-term growth prospects of emerging markets in general and China in particular while remaining focused on capital preservation.

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[4] Source: UBS, April 2019.

[5] Source: Morgan Stanley Investment Management, April 30, 2019.

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**Gross domestic product (GDP)** is a broad measurement of a nation's overall economic activity. GDP is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

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