Slowing Chinese Economy Increases Potential for Headline Risk in Some Money Market Funds

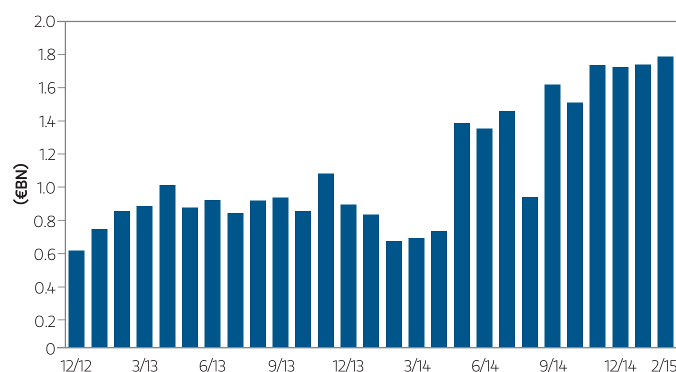
Overview

While some money market fund (MMF) managers continue to hold short-term debt of large Chinese institutions, Morgan Stanley Investment Management continues its steadfast approach of not utilizing Chinese credits in our MMF portfolios. In three prior articles in this series, we discussed the reasons why investing in Chinese debt is not consistent with conservative MMF management. We believe that the added compensation for holding these securities does not outweigh the increasing potential for negative headline risk.

Over the past two years, some MMF managers have been enticed by the high yields offered for securities of Chinese institutions – yields that are rarely found elsewhere in the investable money market universe. Particularly of note, the Chinese debt holdings in Euro MMFs have been increasing in the midst of an extremely challenging interest rate environment with money market fund yields approaching zero.

Chinese Debt Holdings in Euro MMFs

12/31/2012 – 2/28/2015



Source: Crane Data. Chinese Debt Holdings in Euro MMFs for Deutsche Bank, Goldman Sachs, Invesco and J.P. Morgan.

The Chinese Economy is Slowing

Although still outpacing most developed market countries, China's growth is steadily slowing. GDP growth in 2014 was 7.4%,[1] the slowest rate since 1990 and below the Government's target growth level, something that has not happened since the 1998 Asian financial crisis. Furthermore, Chinese economic data notoriously lacks transparency. As summed up by McKinsey & Company, "…be careful with national-level statistics from China in 2015. In times of slower growth, they are historically less reliable."[2]

While suspicions about the true health of the Chinese economy have been well documented, the issue may be coming to a head. Cornerstone Macro predicts that by 4Q15, growth will drop to 5% year-over-year, although they "think actual activity is closer to 3% year-over-year."[3] The Global Emerging Markets Equity Team at Morgan Stanley Investment Management recently commented on China's troubles.

> *The next year may also bring crippling pressure on the illusion of Beijing's economic invincibility. For some years now, most economists have tended to forecast that China will grow at a pace very close to whatever number Beijing sets as its official growth target—now 7 percent. The result has been a consistent failure to anticipate the full extent of the slowdown in China, which will be all but impossible to reverse, given the extent of the debts China has accumulated trying to keep growth alive. In fact, China's economy may already be growing at a pace of 6 percent or less, correcting for the suspected exaggerations in the officially published numbers. At some point soon, these doubts may overwhelm the belief that China's leaders can deliver on any growth rate they choose.*[4]

[1] Source: Bloomberg.

[2] McKinsey & Company, "What could happen in China in 2015?" December 2014.

[3] Cornerstone Macro, "Chinese Real Economic Activity May Already be as Slow as 3% Y/Y," January 23, 2015.

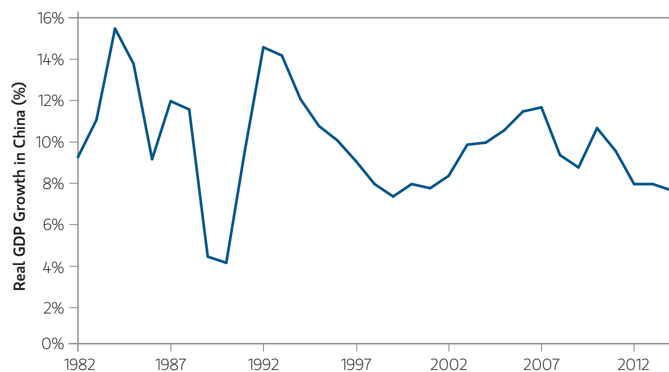
[4] Morgan Stanley Global Emerging Markets Equity team, "2015: The Final Exhaustion of an Era," *Tales from the Emerging World*, January 13, 2015.

Other economic indicators are also faltering. Inflation is at a five year low and consumer confidence has been steadily slipping. Consistent deterioration in economic data adds to the existing problems plaguing China. In our previous article on the topic, "Does Chinese Debt Have a Place in Money Market Funds?", we expressed concern over the increasing levels of leverage in the economy. With GDP slowing and more debt needed to sustain what growth remains, the problem is getting worse. While China's debt-to-GDP ratio of 282% is not the highest among major economies, the overall debt load in the country has quadrupled since 2007.[5] In a recent research report, Goldman Sachs highlighted China's escalating debt.

> *More concerning than the level of debt is its rate of increase in recent years. The bulk of academic and policy research on credit booms suggests that it is the rate of increase, rather than the absolute level, of debt which has the strongest association with future financial stress and growth costs. China's is one of the largest credit buildups as a share of GDP seen anywhere in the world over the past 50 years, and the largest ever on a nominal dollar-equivalent basis.*[6]

Real GDP Growth in China

As of 12/31/2014



Source: Bloomberg and the World Bank

Rate Cuts Needed to Stimulate the Economy

In late February 2015, the People's Bank of China (PBOC) cut interest rates for the second time in less than four months in an aggressive measure to stimulate growth. According to the central bank, the two main reasons for the easing were the increasing deflationary risk and the slowing property market.

This move represented a marked change in strategy from policies previously advocated by PBOC Governor Zhou Xiaochuan and Premier Li Keqiang. Zhou and Li had been steadfast in their preference for targeted reform over monetary policy to stimulate the economy; they viewed rate cuts as something that would add to the country's debt burden. In a speech in December 2013, Zhou noted, "We seek to maintain stable economic growth and support employment creation through market-oriented reforms rather than relying on expansionary fiscal or monetary policies."[7] Premier Li reiterated this thought in a speech in February 2014. "We were determined not to expand our fiscal deficit, and we resolved to neither loosen nor tighten our monetary policy. Even when we encountered short-term fluctuations in the money market, our response was calm and collected."[8]

Despite the potential economic benefits of a rate cut, there are drawbacks, especially for heavily indebted countries like China. While lower borrowing costs can help to stimulate growth, they can also aggravate existing debt problems. A rate cut may simply make it easier for the most debt-burdened entities, such as property developers and local governments, to borrow more rather than make the needed improvements.

Reform has not worked to reduce the reliance on leverage to fuel economic growth. China's hand has been forced to reluctantly use monetary policy in an attempt to reverse the slowing economy.

Given the mounting economic strains, the lack of transparency and the rising debt burden, we can be even more confident in our decision not to invest our clients' money in Chinese debt.

We continuously monitor the various developments and significant events affecting the financial markets and we modify our positions as conditions warrant. We are available to discuss your individual needs and concerns. If you have further questions or require additional assistance, please contact your Morgan Stanley Investment Management Relationship Manager.

For further reading, please visit www.morganstanley.com/liquidity to view the three previous articles in this series.

[5] McKinsey & Company. "Debt and (not much) Deleveraging." February 2015.

[6] Goldman Sachs Economics Research. "Untangling China's Credit Conundrum." January 26, 2015.

[7] People's Bank of China. "Speech of Mr. Zhou Xiaochuan at the third Sino-French Financial Forum." December 2, 2013.

[8] Li Keqiang. "On Deepening Economic Reform." February 18, 2014.

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