

# Macro Matters.

## What can't go on forever, won't

For professional advisers and trustees only



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Emiel joined LGIM in August 2013 as Head of Asset Allocation with responsibility for asset allocation, strategy and macro research.

He has wide experience in managing a range of multi-asset strategies, including absolute return, diversified growth funds, LDI and fiduciary, balanced mandates and multi-manager mandates.

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Erik joined LGIM in 2014 as a global emerging market economist with the responsibility to analyse and identify investment opportunities. Erik joined LGIM from Autonomy Capital, a global macro hedge fund, where he held the title of Senior Economist. Prior to that, he worked four years as sell side economist for RBS, based in Hong Kong, and 10 years for the IMF, based in Washington. Erik graduated from the University of Freiburg and holds a PhD in Economics.

### What can't go on forever, won't

To paraphrase a Fed official, boosting growth through leverage is like wetting the bed. It feels good at first, but pretty soon it becomes a real mess<sup>1</sup>. This is how we look at China: Recent stimulus is boosting sentiment, but the rise in debt is creating serious problems down the road.

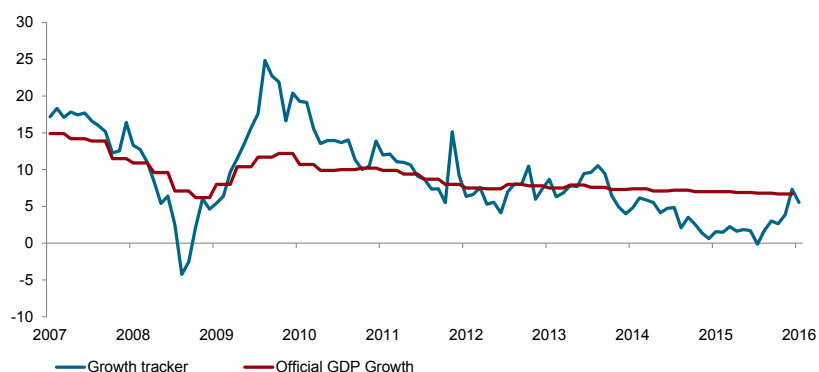
### The sugar high

Chinese activity has firmed on the back of fiscal and monetary stimulus and the easing of property rules. Nominal output jumped 7.1% yoy in Q1, from 6% in the previous quarter. High frequency indicators suggest that Q2 growth may rise further. LGIM's economists use a proprietary growth tracker which comprises 13 high-frequency indicators. According to this model, growth has returned to mid-2014 levels (**figure 1**).

Many people see the infamous Chinese ghost towns as the proof that the Chinese housing market is in a bubble. For sure, the market has bubble-like characteristics. For instance the home price to income ratio in Beijing is more than twice as high as the already expensive housing market of London. However, property has been at the centre of the recent rebound. Surging property sales have translated into rising housing starts, suggesting that the housing overhang is less pronounced than expected, and or more localised. There is a considerable lower strain on the tier 1 and 2 cities, with tier 2 cities up 20% in the year to April.

All of this is important as property accounts for 25% of Chinese output after taking into account upstream industries like cement, steel or excavator makers. In light of its strong performance we have updated our 2016 and 2017 growth forecasts by 0.3ppt to 6.6% and 6.7%, respectively.

**Figure 1: LGIM China growth tracker and official GDP**



Source: Macrobond

1. Wall Street Journal 4th of February 2013: "Currency War Has Started"

### The flipside

The current cyclical upswing comes at a high price in terms of debt build-up. For one thing, Chinese debt is already high and on an unsustainable path. For another thing, the trade-off between growth and debt is becoming more unfavourable. Chinese debt rose from 150% of GDP in 2008 to an estimated 290% of GDP in Q1 2016. Few countries currently have higher debt levels than China. Those that do are developed markets with theoretically stronger institutions, and yet several have nonetheless experienced a financial crisis (Ireland, Portugal, Greece).

It also seems that less and less debt is used for productive investment. Misallocation of capital has become a serious problem. How else can one explain credit growth of at least 16% yoy, while nominal GDP is growing at 7%? A rising share doesn't go into productive investment at all, as shown by a falling investment-to-credit ratio. Instead, debt is increasingly used for interest payment on existing debt. For example, the IMF finds that 14% of debt is owed by companies that generate insufficient earnings to cover debt interest payments (28% if you strip out subsidies).

The reason is, of course, falling investment opportunities after years of massive capital spending and lacklustre global growth. Without the underlying organic growth, doling out more credit is like pushing on a string. And, without organic growth the debt burden eventually becomes unbearable.

### Is all debt the same?

Economist Herb Stein once said: What can't go on forever, won't. In this light we ask ourselves the question are we on the brink of a financial crisis?

A crisis is triggered if the credit eventually becomes impossible to roll over. The good news is that Chinese debt is almost entirely domestically funded. This is because China has an exceptionally high savings rate and the relatively closed capital account ensures that these funds are invested domestically. As a result, foreigners won't be able to pull the plug on China's debt binge—as has happened in so many other emerging market (EM) crises.

Some 70% of debt is funded by Chinese banks which are state-owned. This ensures that bank capitalisation is not (yet) an issue. For example, the IMF and others estimate that non-performing loans amount to around 20% of GDP. With a recovery rate of 40%, the cost to the sovereign would amount to 12% of GDP. Given government debt of 50% of GDP, this is still manageable. Even with an unusually low recovery rate of zero, this would raise government debt to a still manageable 70% of GDP.

The banks, in turn, are almost entirely funded by deposits—again a function of captive domestic savings and a relatively underdeveloped capital market. Wholesale funding which has played a prominent role in many financial crises, including the 2008 global financial crisis (GFC), is negligible. In fact, China's loan-to-deposit ratio, below 70%, is the lowest among emerging markets. The ownership and funding structure of banks makes a bank run pretty unlikely.

Another 20% of debt is funded by shadow banks. Chinese banks have enough funding to move the shadow banks back on their balance sheet. US banks had a loan-to-deposit ratio of 260% at the outset of the 2008 GFC, compared to China's 70%. After re-incorporating shadow banks, the loan-to-deposit ratio would rise to 95%, still among the lowest among emerging markets.

Not only have Chinese banks a large deposit pool relative to loans, they also have very high required reserves (16.5% of deposit; common is 5%). This is because required reserve ratios (RRR) were used to sterilise the effect of large capital inflows on the money supply. This liquidity could be released through an RRR cut to 5-6% if panic sets in. Put differently, if state-owned banks took the loans of shadow banks onto their balance sheet they would not be in breach of a 6% RRR.

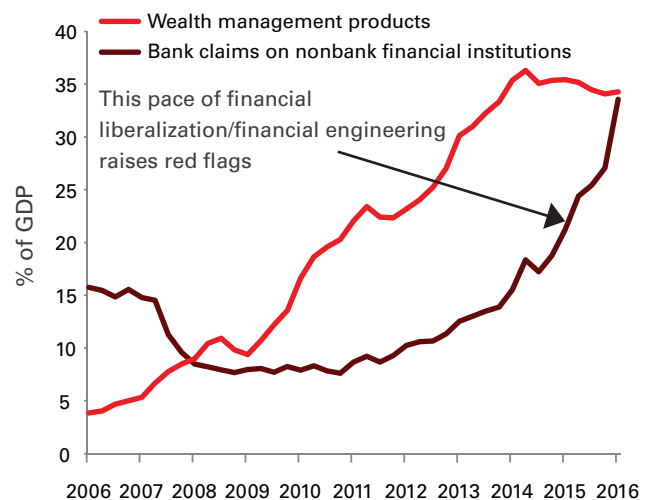
### Crisis within sight, but not imminent

We need to be realistic; a crisis is inherently difficult to predict. If predicting them was easy, the authorities would do something about them and there wouldn't be a crisis. Predicting exact timing or triggers is even more difficult.

We don't expect a financial crisis just yet, but on current trends China is likely to experience a crisis in the next few years. This risk is important and relevant enough to impact our investment strategy today. Moreover, it's fair to say that our fixed income colleagues believe these crisis risks are indeed more imminent.

The Chinese authorities could continue with 'extend and pretend' policies for another few years, resulting in a more than doubling of losses and required state support. Postponing loss recognition would come at a high cost as banks' support for unproductive enterprises will steadily erode free cashflow and require higher reliance on wholesale financing, thereby sowing the seeds of crisis.

Figure 2: The rise of the shadow banks



Source: Macrobond

In addition, financial liberalisation—particularly the rapid rise of shadow banks and the opening up of the capital account—is undermining the traditional funding model.

Falling interest rates could also induce more depositors to seek higher returns abroad, ie trigger a crisis due to uncontrollable capital flight. We got a taste of that in August and January when attempts to liberalise the FX regime triggered significant capital outflows. A dovish Fed, tighter capital controls, and some FX reserve drawdown stabilised the situation, but pressures are likely to remerge as the Fed resumes its hiking cycle.

What are the risks to our baseline: muddle through for now but increasing risks and a crisis in the coming years (but not this year)? There is the risk of policy mistakes. The authorities could strike the wrong balance between fighting moral hazard and guaranteeing savings. They may misjudge the risks of a financial panic or simply be late in assuring savers. In this case, the financial crisis may arrive earlier.

Conversely, the authorities may pull back from the edge and contain credit growth. This would prevent a financial crisis but result in many years of low growth. Given the strong and public commitment to a 6.5% growth target until 2020—reiterated by President Xi at this year's National People's Congress—we currently attach a low likelihood to this scenario.

### Tracking the risks

To be ahead of the crisis, we track crisis risk through a range of indicators. These include variables that

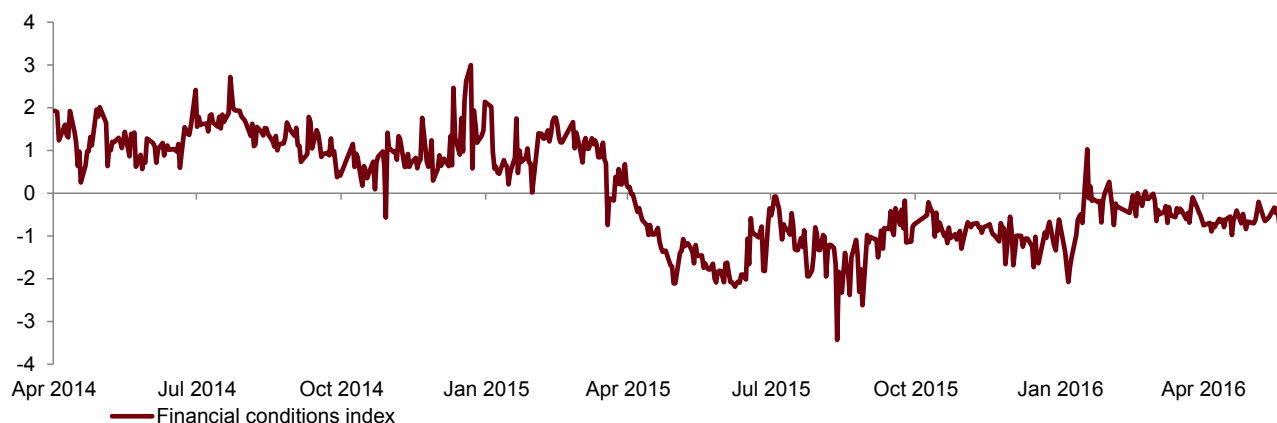
capture the funding risks discussed above, such as industrial profits, credit growth, loan-to-deposit ratio, and capital outflows and a proprietary LGIM financial conditions index (figure 3). Currently these indicators give a reading of increased longer term risks but few short-term pressure points.

### How do we use this insight in our investment strategy?

Regular readers are well familiar with our medium term framework that covers three levers: the economic cycle; valuations; and systematic risks. All else being equal, this makes us more cautious on risk assets and confirms the de-risking we have implemented in our portfolios in the last eight months.

Our equity weight is currently the lowest it has been in years. Moreover, we remain zero weight or short commodities even though there has been a rally in the last two months. We are underweight both EM equities and local currency bonds. We expect the dollar to strengthen, especially against EM currencies. We believe there is a significant risk the renminbi will weaken quite a lot in anticipation of a crisis, taking other EM currencies down in a competitive devaluation spiral. This will then increase global deflationary pressures and increase the chances that central bankers rush for the helicopters<sup>2</sup>.

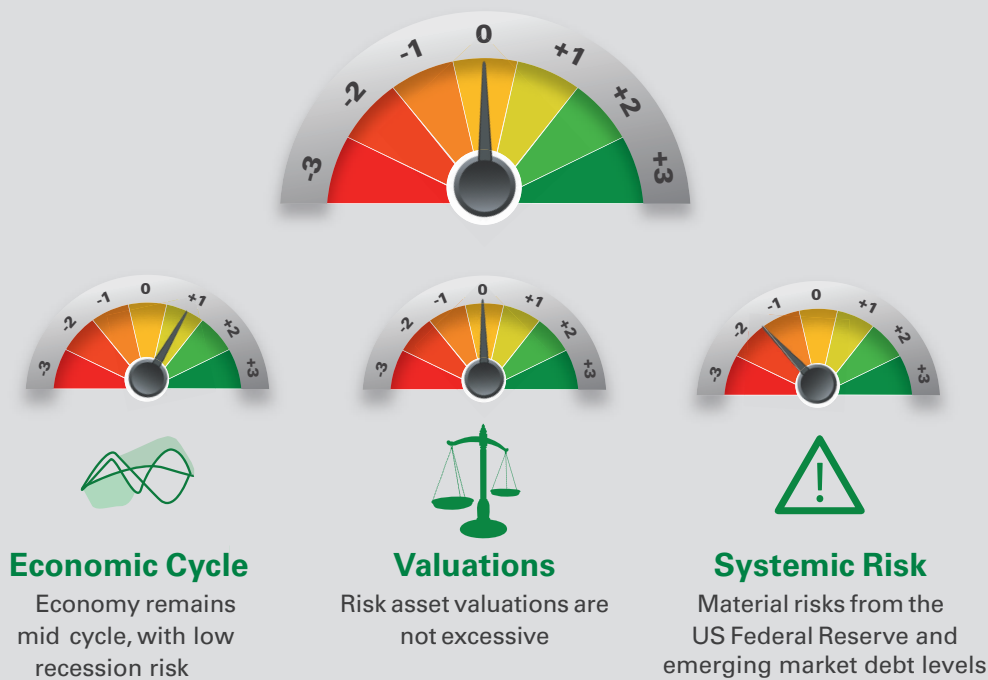
Figure 3. LGIM Chinese financial conditions indicator



Source: LGIM, Macrobonds

2. See Macro Matters April 2016: "On our way to the helicopters"

## Our medium-term framework



Source: LGIM

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