

China: Managing financial risks will be challenging in 2014

- ▶ Concerns over a potential trust default, interbank liquidity squeeze and slowing Chinese economic growth weighed on Chinese financial markets at the start of 2014
- ▶ The absence of defaults has become a major distortion in China's shadow banking system. The increased shadow banking credit risks will test the government's willingness and ability to eventually allow selective defaults to address the moral hazard problem and impose market discipline, while containing the contagion risk of credit crunch
- ▶ Interbank rates will likely drift higher with increased volatility in the interbank market this year, amid policy efforts to slow credit growth, interest rate liberalisation, and seasonal, policy and structural factors driving liquidity demand
- ▶ Managing financial risks - liquidity and credit risks - will be a major challenge for Chinese policymakers this year. We believe the government has the policy options and power to avert a credit crunch or systemic financial stress
- ▶ Ongoing concerns over financial risks, on the back of slower economic growth, could weigh on the financial markets, although the current low valuations may have priced in many macro risk factors. Stock and credit selection are important

Volatile start to 2014

Concerns over the risks of potential default of a troubled CNY3bn mining trust loan, interbank liquidity squeeze, and economic slowdown in China weighed on Chinese financial markets at the start of 2014, against the backdrop of volatile emerging market (EM) assets.

The MSCI China index and Hang Seng China Enterprises index fell 6.6% and 9.2%, respectively, in January, following a loss of 3.4% and 5.5% in December. Particularly some credit-dependent, investment-heavy cyclical sectors came under pressure. Concerns over the potential trust loan default and the repercussions for the trust industry and the shadow banking system in general, also weighed heavily on China sovereign credit default swap (CDS) and China credits. CDS widened more than 20bp to a high of 105 on 24 January (from around 80 at end-December 2013) before pulling back to around 100bp.

Money market rates spiked and remained volatile in H2 of December 2013 and through most of January 2014, raising market concern over a repeat of the June 2013 liquidity squeeze. To calm the market fear and ensure the stability of the money market, the People's Bank of China (PBoC) injected liquidity via its Standing Lending Facility (SLF) and reverse repo operations. The PBoC also started pilots of the SLF to allow qualified small-and-medium-sized banks to tap central bank in case of liquidity shortfalls.

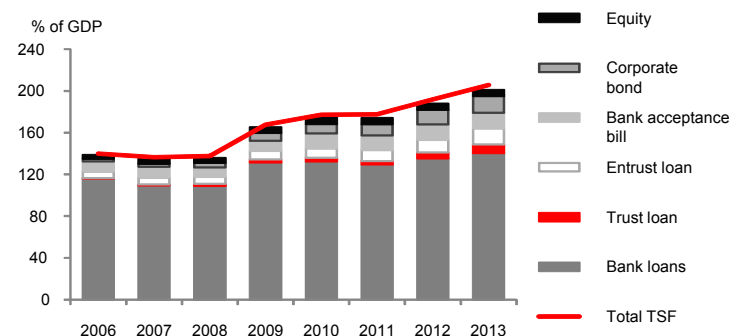
The downbeat manufacturing PMIs for January added further evidence to December 2013 activity data that China's economic growth has lost steam in Q4 2013 or into Q1 2014. Investment growth slowed amid tighter credit conditions, local government funding constraints, stricter environmental standards, as well as on-going government efforts to reduce excess capacity.

(Shadow banking) credit risks

Default of the CNY3bn troubled mining trust loan was eventually avoided - narrowly. The trust company reached a last-minute agreement with trust investors, with an independent investor agreeing to buy the underlying assets and all principal and most accrued interest to be repaid. While averting yet another default brings short-term relief to the market, it will only delay or even amplify the problem in the future, in our view. In fact, prior to this case, there were several reported cases of investment failure of trust products or wealth management products (WMPs), but eventually investors were all repaid under various arrangements. The underlying problems are corporate insolvency risks (which have been covered up by debt rollovers and ample credit supply) and insufficient risk control for shadow banking products.

The strong demand for trust products/WMPs has been driven by high net-worth individuals or depositors looking for alternative investment opportunities to low interest rate deposits and long under-performing local stocks, as well as by a perception that product issuers and distributors provide an implicit guarantee. The trust sector's AUM grew rapidly from CNY3trn at end-2010 to CNY10trn as of September 2013. The outstanding amount of WMPs issued by Chinese banks surged to CNY9.9trn (9.4% of bank deposits) as of September 2013, from just CNY1.7trn (2.7% of bank deposits) at end-2009. The absence of defaults has been a major distortion in China's shadow banking system.

Trust loans have expanded rapidly, despite still accounting for a small share of total social financing (TSF)



Source: CEIC, HSBC Global Asset Management

There are likely to be more headlines of potential shadow banking product defaults over time, amid slower economic growth, tighter liquidity conditions, higher interest rates, increased regulation, and a busy schedule of trust products maturing and refinancing for local government financial vehicles (LGFVs) and trusts this year.

Volatile and higher interbank rates

We think the increased volatility of the interbank market and spikes of money market rates since H2 2013 have been driven by factors beyond seasonal liquidity demand (e.g. timing of tax payments, end-year draw-down of fiscal deposits, banks competing for funds to meet regulatory requirements towards the end of the quarter, and pre-holiday cash demand, etc.) and FX flows. The explosive growth in WMPs and interbank assets in recent years amplifies seasonal funding needs by banks. Most WMPs banks sold tend to mature before quarter end. One main reason behind the rapid growth in interbank assets is that banks have informally securitised credits into interbank assets and/or securitised investments through repos. Some of these credits/investments are related to the shadow banking industry. Concerns about tightening of shadow banking credit and the impact on precautionary cash demand and uncertainty about policymakers' intention have also contributed to the volatility.

We expect interbank rates to drift upwards and on-going bouts of volatility in the interbank market this year, albeit not to the extent witnessed in the middle of 2013, amid policy efforts to rein in credit growth to a more sustainable pace and interest rate liberalisation. We do not think PBoC's policy actions to stabilise the interbank market constitutes as an active easing. We expect the PBoC to maintain its prudent monetary policy stance with a tightening bias in practice, provided that the current economic situation remains supportive of eventually normalising the excessively loose policy. That said, there will likely be some policy fine-tuning in response to changes in short-term liquidity and economic conditions to minimise risks. While more proactive PBoC liquidity management could help reduce the liquidity risk and the potential risk of substantial corporate defaults or small bank defaults, it does not remove these tail risks.

Deleveraging and policy challenges

Interest rates are moving higher, with policymakers pushing forward interest rate liberalisation to gradually end financial repression, as deleveraging gets underway. Deleveraging in a rising interest rate environment could exacerbate vulnerability in the heavily leveraged sectors and investment projects (e.g. LGFVs) that have cash flow problems and rely heavily on shadow banking financing. We think managing financial risks - liquidity and credit risks - will be a major challenge for Chinese policymakers this year.

With (shadow banking) default risks likely to rise this year, it will test the central government's willingness and ability to allow selective defaults to address the moral hazard/implicit guarantee problem, impose market discipline and improve risk control, while preventing any significant ripple effects from individual default cases into a systemic financial problem, which could result in heavy economic and social costs. We believe China's deleveraging will be a gradual adjustment and multi-year process, not a quick fix, so as to alleviate the impact on growth and system-wide liquidity. The government does not intend to make a system-wide credit crackdown, but instead aim to correct the problems of financial excesses and credit dislocation. We

expect the government to continue with reform, to expand the financial safety net (e.g. deposit insurance scheme, exit mechanism for failed financial institutions, etc.), to further tighten shadow banking regulation and supervision, and to make further moves towards deposit rate liberalisation.

Chinese policymakers have the ability to respond to systemic financial risks using fiscal, regulatory and monetary policy. China's controlled capital account also protects China from bouts of global risk aversion or the risk of foreign capital withdrawals which would make policy management more difficult. The government holds major stakes (and control) in many banks and the central government balance sheet remains sound with moderate borrowings in local currency and significant financial resources, e.g. owning the country's natural resources and holding large FX reserves, etc. The government has a set of policy options to avert a crisis, including debt nationalisation, securitisation, asset management companies (AMCs), and government-led restructuring. In addition to the SLF and open market operations, the PBoC can also inject liquidity via direct lending to specified banks, cuts to reserve requirement ratios, or even loosen the quantitative controls of bank credit expansion to avert credit crunch. We think the government should be able to contain the contagion risk from selective and managed cases of defaults within a manageable level.

Investment implications

An expected slower economic growth, tighter macro policy and financial conditions, occasional negative headlines on shadow banking credit risks and money market rate spikes, and possible frequent policy fine-tuning to changes in economic and liquidity conditions could unsettle the financial markets from time to time and cause higher volatility. The low valuation of the Chinese stock market probably has discounted many macro risk factors. However, a sustained market rebound looks unlikely until there is some conviction that financial risks have been brought under control and reform plans are clarified and implemented. Reform expectations if kept up with tangible progress, could raise, or normalise, valuations of Chinese stocks. However, reform-driven re-rating potential is likely to take time to be realised. We think 2014 will be another year for stock picking.

In the credit complex, the (expected) elevated onshore credit risks could spread to the offshore space. Despite the recent sharp widening of China sovereign CDS largely pricing in the perceived higher default risks, we think the room for spread compression looks limited in the near term. This year, there will be greater differentiation between stronger and weaker credits, especially against heavy supply pressure. Credit selection is key. The CNH bonds offer solid returns with relatively low volatility and the defensive nature makes them still attractive.

We see more two-way fluctuations in CNY this year, largely reflecting capital flows and the trend in USD, as policymakers aim to reduce intervention in the market and further widening of trading band is expected. Periods of depreciation are possible especially driven by concern over China risks. However, increased FX volatility will probably not significantly undermine CNY appreciation expectation. We remain constructive on the medium-to-long-term CNY outlook, driven by deepening financial and structural reform and the internationalization of CNY.

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