Comments on China

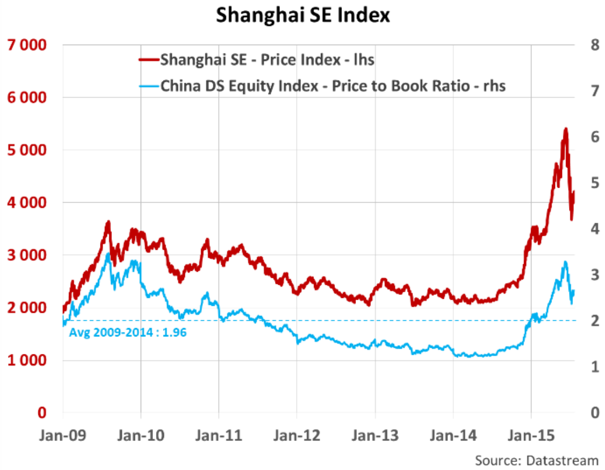
July 2015

The sequence of excessive euphoria and crash on China's equity markets is a clear illustration of the country's cyclical and financial challenges. Transmission to a macro risk or crisis has however a very low probability, but the corporate and banking sector will be affected, and the CNY is likely to register a mild depreciation.

TAC ECONOMICS has insisted for a very long time now on the structural slowdown in China's economic growth, a natural and almost mechanic result of changing demographics, a reduction in capital accumulation and investment growth, and the rapid catch-up of the previous decades.

In such a structural trend, cyclical management is more complex, especially in the case of China where the economy is characterized by excessive financial leverage (remember that China has the highest domestic leverage in our Banking System Balance among all countries monitored, at par only with Taiwan!).

In such circumstance, the policy of progressive financial liberalization is almost sure to create large fluctuation in asset prices.

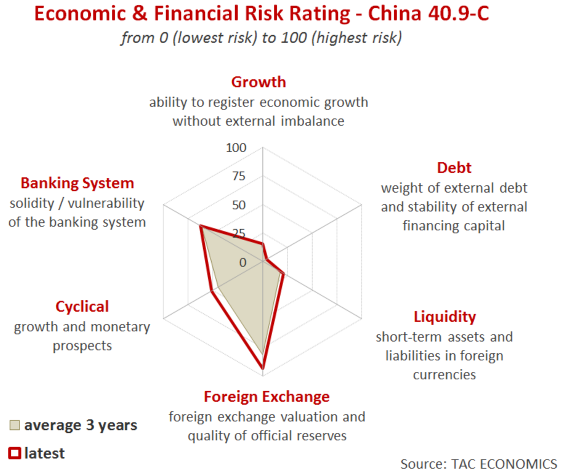


Source: Datastream

Indeed, the possibility for margin trading on China's stock markets triggered an "obvious" bubble: the 112% increase in the Shanghai SE index between November 2014 and the peak on June 8th, 2015 could not be justified on any fundamental basis, neither from the macro side (economic slowdown, corporate difficulties, excess capacities) nor from the valuation side, as evidenced by the parallel jump in Price-to-Book ratios. A brutal correction was therefore unavoidable.

Our quantitative tools measuring China's overall macro risk have been signaling a visible deterioration over the past few quarters. The current update moves the average Economic & Financial Risk rating above 40 into the C-category.

This results mainly from the simultaneous deterioration in the Cyclical and Foreign Exchange Balance, in a background of excessive *domestic credit leverage* in the Banking System Balance.



Source: TAC ECONOMICS

The collapse in equity markets is still leaving a decent positive performance for the year-to-date (+14% year-to-date on July 20th), and the combination of the risks reminded above and a still high valuation metrics suggest that further downside pressures are likely, notwithstanding the supportive measures decided by Chinese authorities over the past weeks, including the simultaneous cut in interest rates and reserve requirements (June 27), and direct technical / institutional support to the equity markets (e.g. liquidity support to brokers, restriction on share selling by large shareholders, encouragement of share buy-back by SOEs…).

This financial volatility is making China's cyclical management even more complex. We still consider that the resilience and control ability remain large enough to cope with such complexity, as suggested by the exceptional quality of the Growth, Debt and Liquidity Balances; it reinforces however our view that the most likely cyclical policy support will be a modest currency depreciation; the magnitude of the depreciation will be a compromise taking into account the large overvaluation registered today (above 20% according to our *exchange rate competitiveness* index), the implications of Beijing's strategy of internationalizing the CNY (putting a definite cap on a "maximum tolerable" depreciation), the overall tensions in emerging markets' currencies, and the results of other supportive policies engineered so far. Our analysis suggests that such a compromise would be around 10% depreciation against the USD over a relatively short period of time, between now and the end of 2016.