MACROLENS
Markets in High Resolution

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China: Where the Credit Risk Goes

- Credit events accumulate, but **the process remains "linear"**
- Liquidity control + regulatory forbearance = solvency control
- The systemic constraint is capital flight, but access to FX is heavily curtailed
- Remain steadfastly short Chinese growth prospects

One might think a headline like "China's No. 2 Auditor Is Accused of Faking Data; Clients' IPOs Are Halted" would cause a bit of a ripple in credit markets. I mean, after all **they audited almost one-third of all listed companies in China** and apparently have a penchant for fraud:

> *(Yicai Global) July 29 -- China's securities regulator has suspended 43 initial public offerings and refinancing cases being handled by the country's second-largest accounting firm, including IPOs on the country's new Nasdaq-style trading venue, as the company is probed for allegedly falsifying information.*
>
> *Ruihua Certified Public Accountants, which audits almost a third of all listed companies in China, is implicated in a scandal involving chemical maker Kangde Xin Composite Material. The struggling firm is accused of inflating profits by CNY11.9 billion from January 2015 to last December. As the CPA responsible for the company's auditing all those years, Ruihua is also under scrutiny, the China Securities Regulatory Commission said in a statement on its website on July 26.*

While it's not yet clear that Ruihua's fraudulent behavior was systemic, no one will be surprised if it was. Nonetheless, markets yawn.

Why, despite an historically rapid accumulation of debt, white elephants abounding, widespread fraud, and growing string of defaults, do Chinese credit markets not dislocate in a panic? Here's a list – by no means complete - of "first ever" or "watershed" credit events:

First SoE default in two decades:

NYT: Chinese State-Owned Company, in a first, Defaults on Its Domestic Bonds (4/21/15)

> *For decades, regardless of weaknesses or inefficiencies, an overriding certainty of state-backed capitalism in China has been that the government looks after its own. That may be changing. The development could signal a watershed moment for China's state-owned businesses, which tend to enjoy easy access to cheap sources of debt funding — often with little apparent regard for the health of their finances.*

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First Offshore SoE default:

WSJ: In Rare Default, Chinese State-Owned Firm Misses Bond Payment (2/26/19)

> *Chinese aluminum maker Qinghai Provincial Investment Group Co. failed to pay interest due on a $300 million bond, a rare missed payment by a state-owned firm at a time local government finances in China are turning increasingly strained.*

First LGFV default (sort of):

Global Times: LGFV Makes Overdue Payment After Rare Bond Default (8/16/18)

> *A State-owned asset management firm in Northwest China's **Xinjiang** Uyghur Autonomous Region has made payments on its bonds after missing the deadline earlier, in what was a very rare bond default by a Chinese local government financing vehicle (LGFV).*
>
> *"Traders are losing trust in LGFV bonds," said a trader at a local asset management firm.*

First publicly reported Trust default:

FT: Public Default at Chinese Trust Company Highlights Cracks in the Market (6/25/19)

> *"It's impossible to not have defaults as they make a break with guaranteed payments," said Xie Yunliang, chief macro-analyst at Minsheng Securities, referring to the conventional expectation among investors that all products would eventually be backstopped by the government.*

They were even able to cauterize the implosion of the peer-to-peer lending industry:

NYT: As Chinese Investors Panic Over Dubious Products, Authorities Quash Protests (8/9/18)

> *"High returns mean high risks," Guo Shuqing, the chairman of China's Banking Insurance Regulatory Commission, said in June in public remarks at a conference. Any product that offers an 8 percent return, Mr. Guo said, is "very dangerous." Investors in products with returns of 10 percent or more, he went on, should "be prepared to lose all the principal."*
>
> *Almost immediately, the concerns prompted a run on the industry, as investors demanded their money back. A wave of defaults followed, with each collapse setting off the next, like a set of dominoes.*

And of course, most recently, the first Bank default in two decades:

Reuters: China's Baoshang Bank Takeover Raises Contagion Fears (5/27/19)

> *The seizing of Baoshang fanned concerns about indebted small banks across the country, pushing up yields on some negotiable certificates of deposit (NCD) issued by regional banks…*

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> *"We recommend paying close attention to the impact on liquidity that could be triggered by this event," analysts at China Merchant Securities said in a note, referring to the Baoshang takeover.*

Baoshang is instructive. It did raise contagion fears., but they were quickly addressed as PBoC quickly guaranteed the next bank that came under scrutiny, which was subsequently shoved into the warm embrace of ICBC:

WSJ: Struggling Chinese Bank Gets a Lifeline from State-Backed Investors (6/29/19)

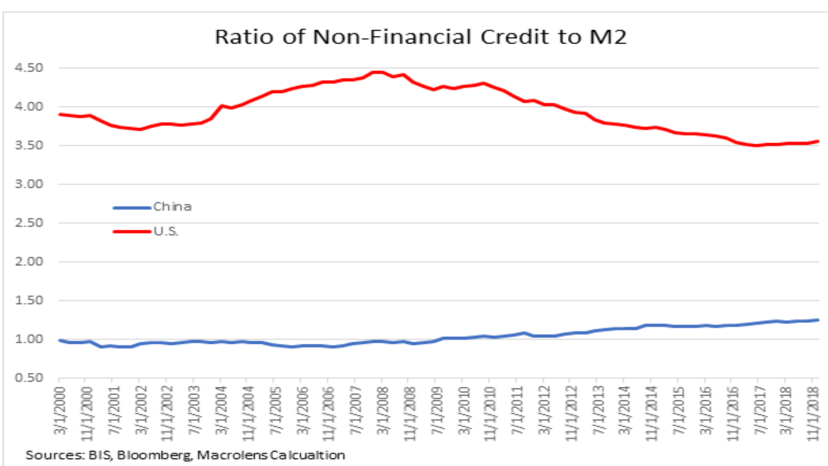
> *Three of China's state-backed financial institutions are to take stakes in a struggling commercial bank, indicating a different approach by regulators toward the country's small troubled lenders.*
>
> *The Industrial and Commercial Bank of China, the country's largest bank by assets, said one of its units would pay up to 3 billion yuan for a 10.82% stake in Bank of Jinzhou Co…*
>
> *ICBC said its investment was aimed at supporting the regulators' goal of channeling more funding to the private sector.*

Monday's deliciously indelicate Bloomberg headline – Why China Has Chickened Out on Another Bank Seizure - illustrates how **regulators' fleeting experiments with credit risk lead to quick retreats that end up reinforcing the moral hazard**:

> *The PBOC tried to do the right thing with the Baoshang takeover. But now, fearful of market jitters, the central bank is chickening out. Instead, China has resorted to the old trick of a national team rescue, which does little to break the implicit guarantee of state support. At this rate, investors in China's $13 trillion bond market have little hope of pricing in the appropriate risks.*

Liquidity control + regulatory forbearance = solvency control

Fundamentally, China is still a **bank-centric credit market**:



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With near-total control over the predominant intermediaries, Chinese authorities not only control M2 but can also largely dictate the "velocity" at which M2 multiplies into broader credit (which in China is only a marginal contributor to credit creation anyway).

In the U.S. by contrast, the Fed controls base money and private banks control M2 – which accounts for less than 30% of total credit extended. The bulk of credit is created by a "money multiplicative" process by myriad private sector actors. Those private actors are driven by perceptions of risk and reward and subject to fear and greed. This is the credit creation vector that is prone to panic – collateral standards tighten, rehypothecation chains contract, bonds fail to roll, mortgage standards tighten, interbank credit is pulled, etc etc.

The part of our credit creation process that is prone to panic doesn't really exist in China. So long as Chinese authorities control systemic liquidity and apply the requisite degree of regulatory forbearance **there is no limit to the amount of bad loans the system can be sustain**.

Control of Systemic Liquidity Becomes the Key

Chinese policymakers can't lose control of credit so long as they maintain the requisite liquidity in the system. Can they lose control of liquidity creation?

M2 is banking system-determined. The only way that market participants can "destroy" M2 would be through bank runs which transform M2 into currency. Of course, when everyone knows that the central bank will simply step in with fresh ink-money loans to keep the banks funded, there is little point in accumulating cash in coffee cans in the back yard.

"Capital flight" also does not "destroy" RMB M2. The money doesn't actually leave! The sale of an RMB deposit for a USD deposit does not change the balance of RMB deposits. But it does put pressure on the RMB exchange rate.

Hence, **the RMB exchange rate is the primary panic vector in Chinese credit markets and the only real constraint on the bad loan rollover process**. That's why the Chinese government's restrictions on FX market trading have become increasingly heavy-handed, devolving towards a regime of "FX quotas" designed to force balance in trading flows (as detailed in The Renminbi Regime, 6/25/19).

With FX flows balanced by regulatory edict, that balance is no longer a useful indicator:

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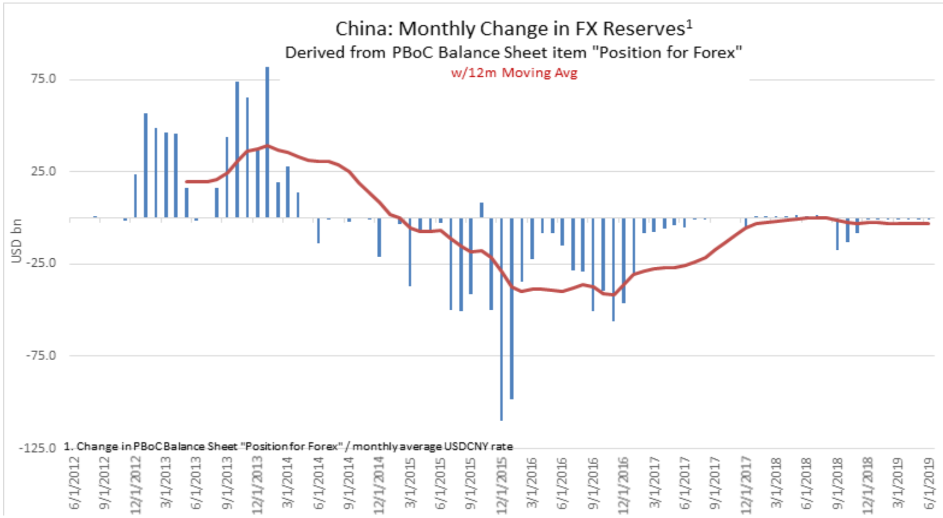

With FX markets operating on the basis of "whatever comes in will be allowed out again," the **gross inflow – total reported USD sales to Chinese banks – becomes the critical metric**. Chinese investors may not be able to get out, but those who have a trade-related means of doing so can avoid coming back.

Last time gross inflows rolled over in 2015-2016, PBoC supplemented market inflows with $1-$1.5T in FX liquidity out of FX reserves. That option is now off the table.

Recall also that SAFE has very little ability to ensure that a tightening supply of FX goes where its most needed – i.e. to companies genuinely involved in international trade. After all, if the capital controls actually worked as designed they wouldn't need to resort to blunt quotas to balance FX flows, and we wouldn't see this wide divergence between China's trade surplus and the USD-repatriation it actually generates:

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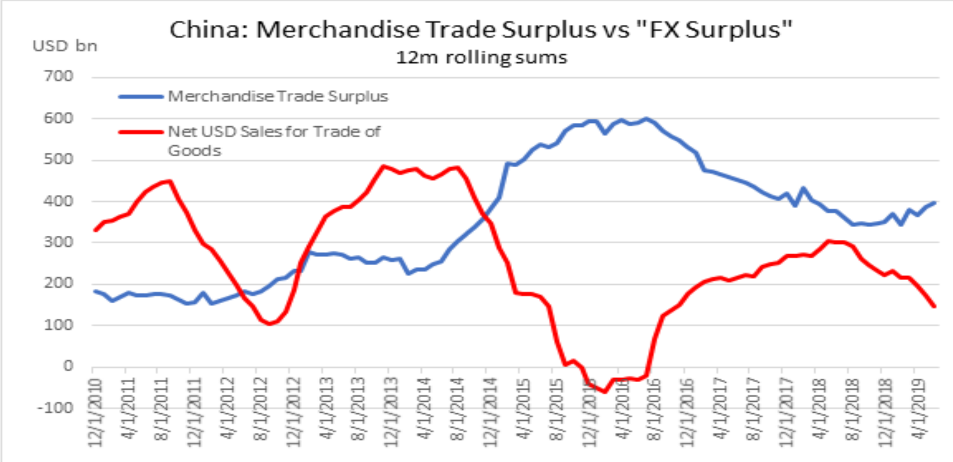

Source: China customs, Safe, Macrolens calculations

As FX liquidity dries up China's ability to import will be impaired. The "processing trade" (import components / export goods) will suffer, and China's outbound tourism will become curtailed. Along this path, **China begins to decouple itself**.

The financial ramifications are unclear. Does a more overt closing of the "exit window" elicit a panic in some other vector of Chinese finance? Given that the Politburo just made abundantly clear that they won't sanction another round of real estate speculation, where do the pressures emerge? Panic buying of gold? Bitcoin. Diamonds? Hording of commodities? Mules (literal and figurative) crossing the border with bag-loads of 100 RMB notes?

We're witnessing an unprecedented array of market distortions designed to bottle up the growing pressures of a $40t financial system riddled with bad debt. These measures cannot eliminate the pressures, but can obscure them. To do so indefinitely will require China to progressively wall itself off financially from the outside world.

That's the path we're on until China decides to relieve the pressure through a ritual sacrifice of the RMB.

Until then, **remain unwaveringly short of Chinese growth prospects**.

I continue to run long S&P vs FXI.