MACROLENS

UNDERSTANDING CHINA

How Ponzi Dynamics Doom the RMB

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Overview

- China's growth model is broken and can not be fixed
- Credit growth can not be slowed - home price declines will cause social unrest
- China's trade flows are too large to allow for sustained "capital control" in a stress scenario
- China has studied Japan: credit bubbles and strong-currency commitments do not mix
- There will be no trade deal - the U.S. objective is China's gradual disengagement
- The failed deleveraging campaign and mishandling of trade put systemic confidence at risk
- A break in confidence will require aggressive liquidity provision by PBoC
- The RMB will have to be let go

China's Economic Model is Broken

Capital Allocation Efficiency Problems…

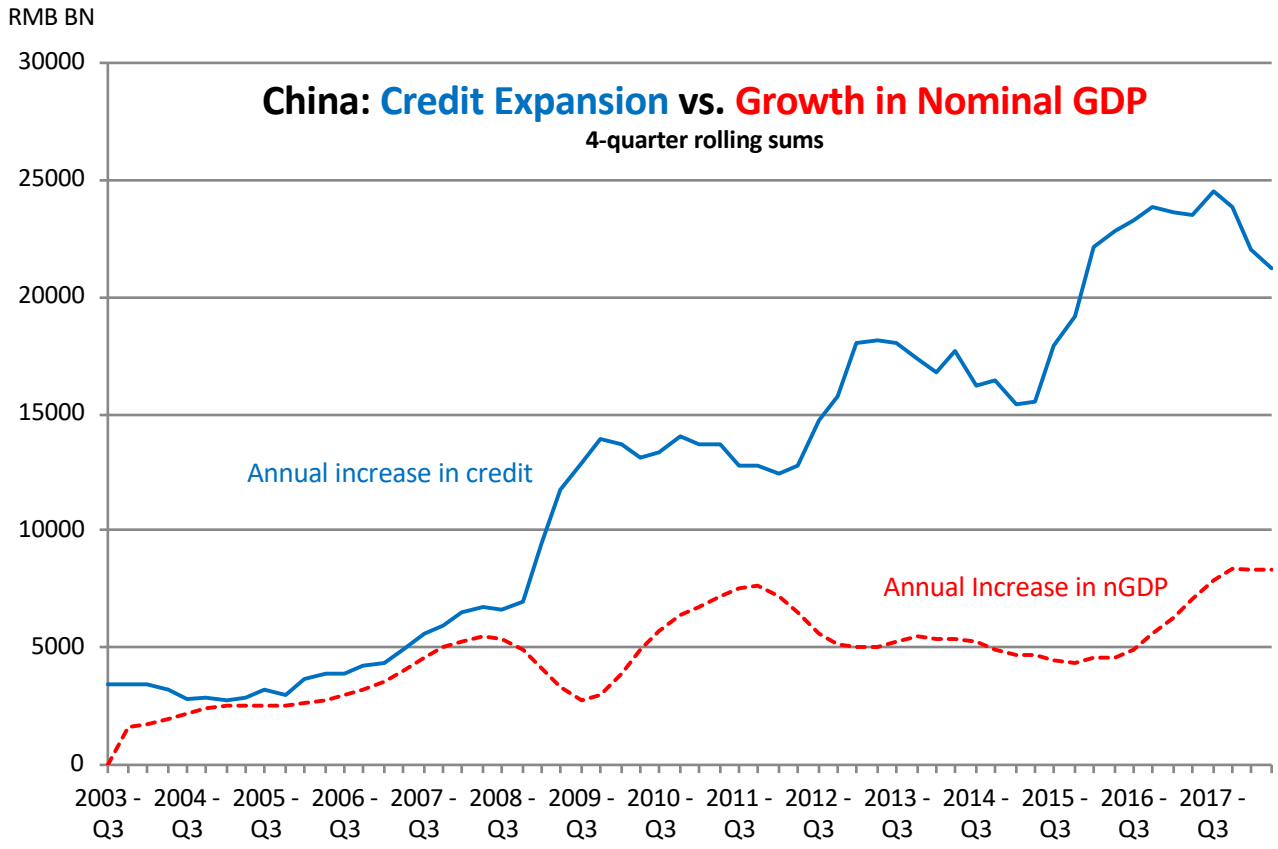
- Forced Investment
- Central Planning
- Moral Hazard
- Capital Controls
- Easy Credit Conditions

…Have Proven Impossible to Address

- Addiction to growth targets
- Integral to Communism
- Would Lead to Immediate credit crisis
- Would Lead to Immediate devaluation
- Bubbles Will burst

- The recently-abandoned "deleveraging" campaign marks the ***third failed attempt to "fix" these problems*** since the GFC

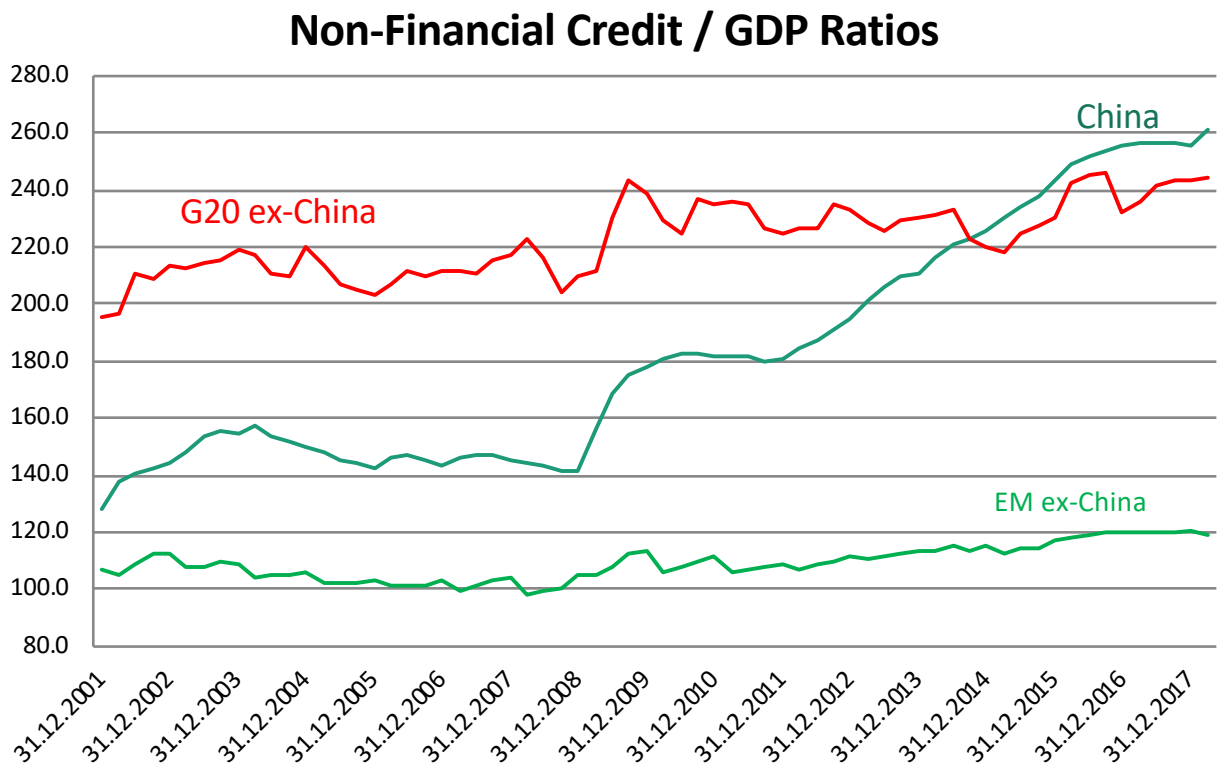
Ponzi Dynamic: Bad Investment is Rolled to Infinity



- Each round of stimulus requires more and more credit just to keep nominal growth stable

Source: China NBS via Bloomberg

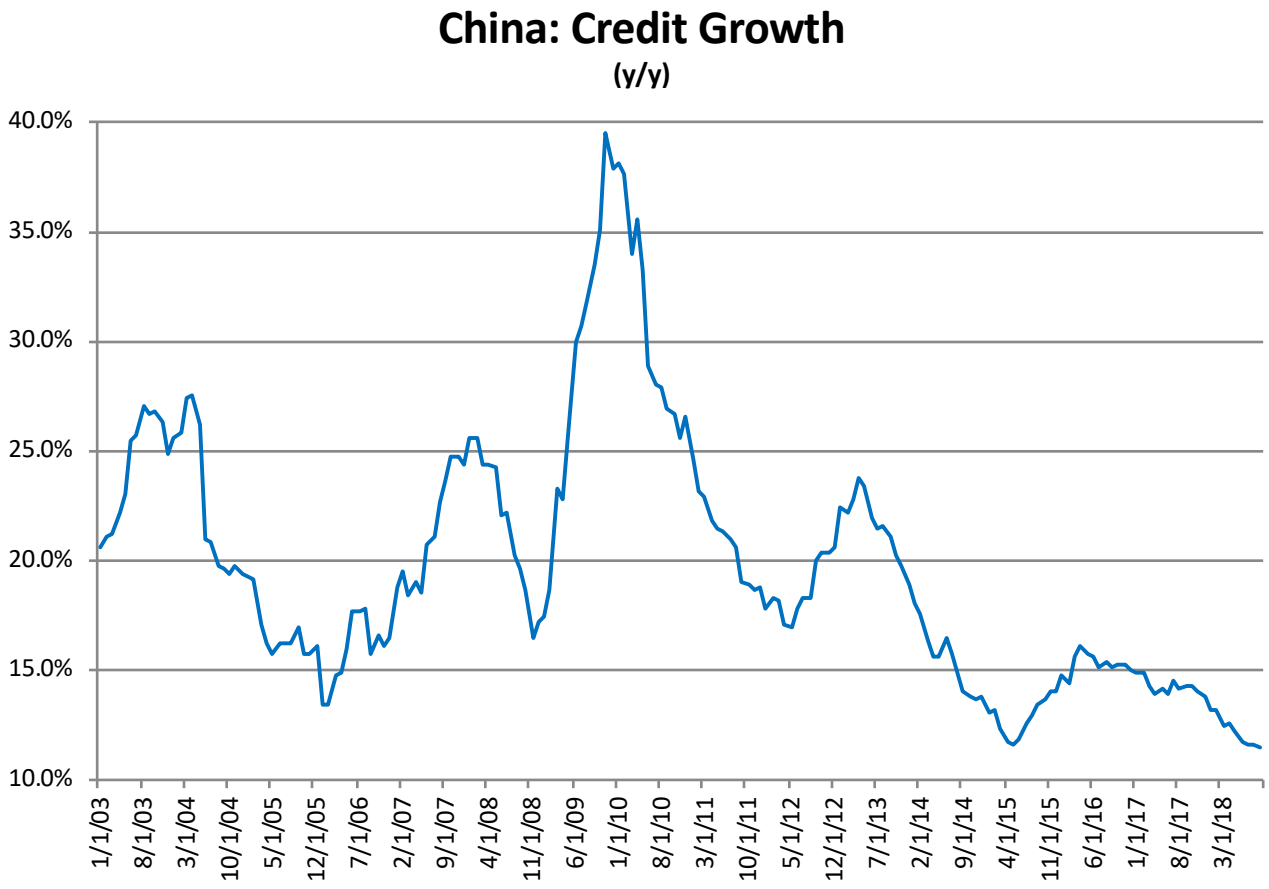
China's Debt Ratio is Exploding



- China's debt-GDP ratio has risen 120 ppts in less than a decade

Source: BIS

Addicted to Credit



- ***Credit outstanding has compounded at a 19% rate over the past decade!***

- 11-12% credit growth is crisis-inducing

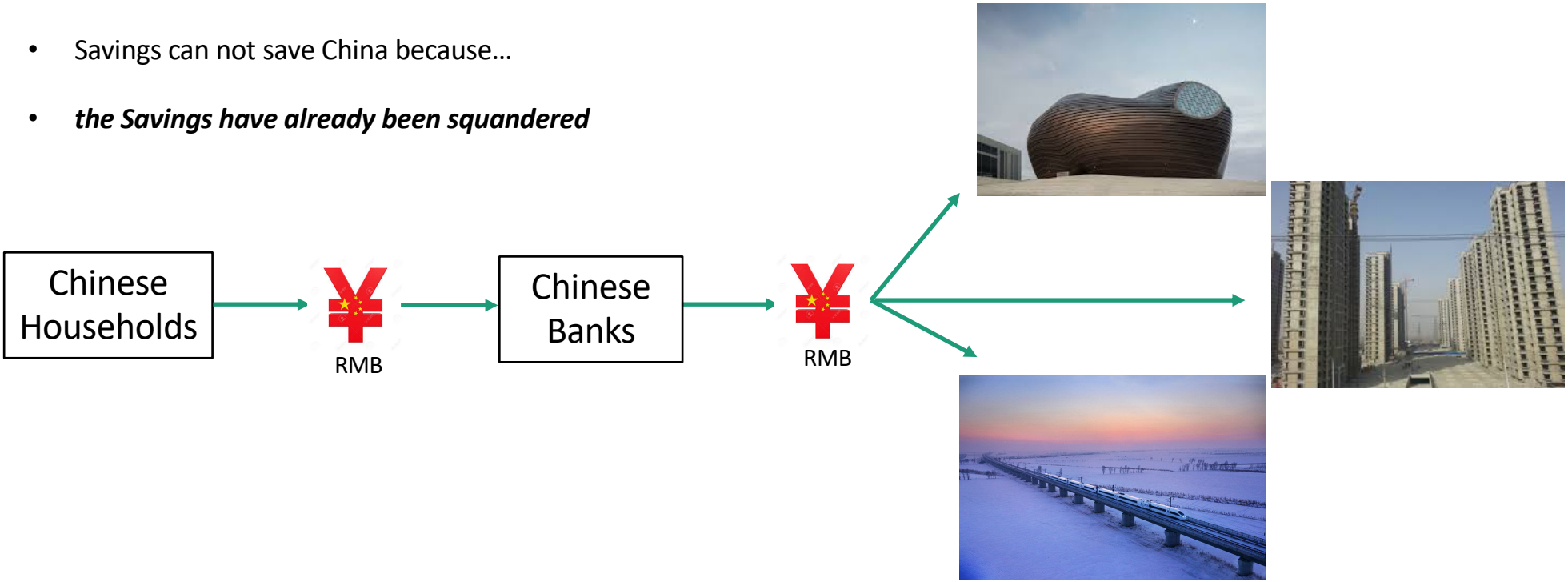
Source: PBoC / Macrolens Calculations

"Rebalancing to Consumption" is a Myth

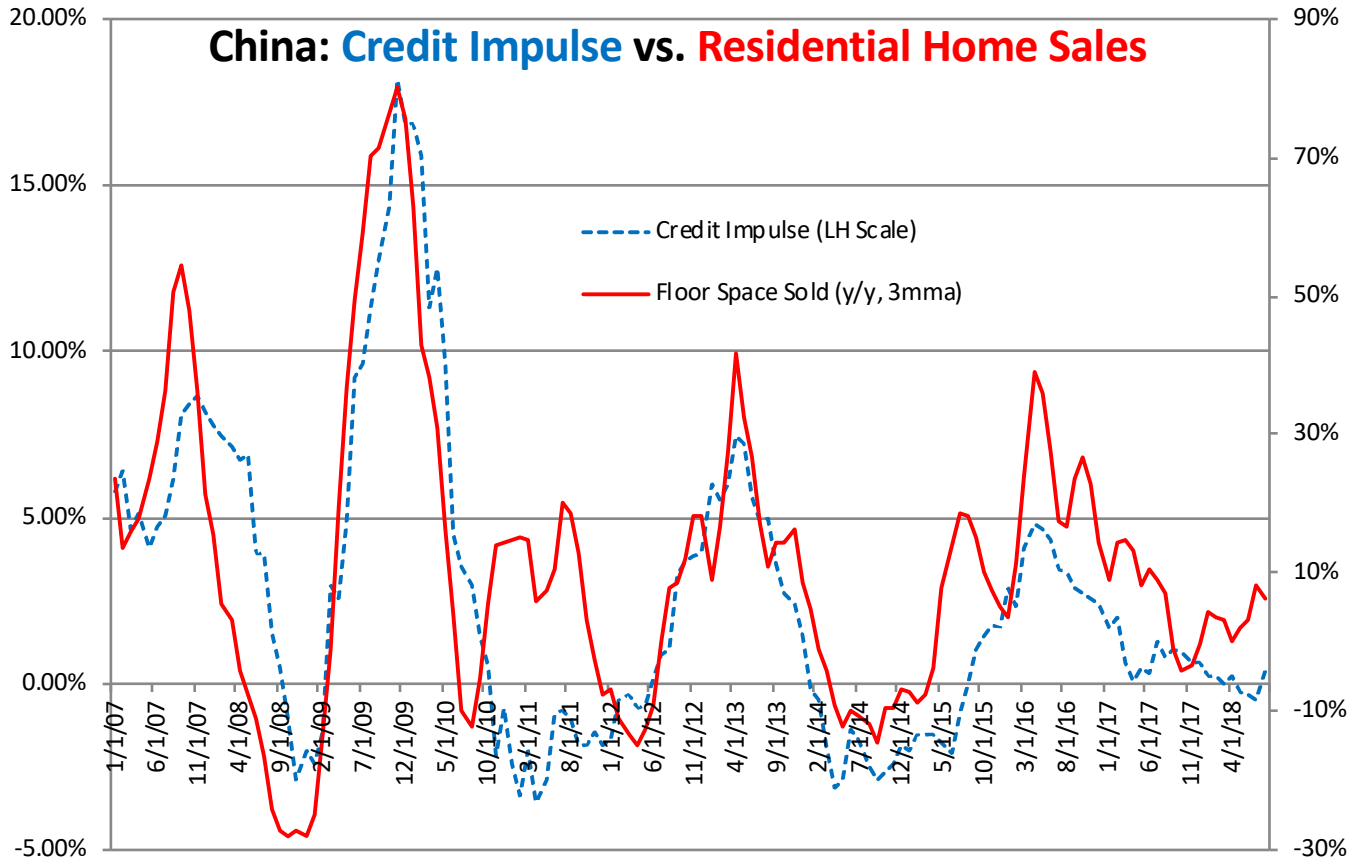
- China's "lack of consumption" results from ***forcing high levels of investment***
- "Rebalancing" requires allowing market forces to guide investment towards the fulfillment of consumer wants and needs
- In other words, if they were to STOP DOING ALL THIS…
    - Forced Investment
    - Central Planning
    - Moral Hazard
    - Capital Controls
    - Easy Credit Conditions
- …the system would require less investment and enjoy more consumption
- ***"Rebalancing to consumption" requires a transition to market capitalism…*** and that's not happening

China's High Savings are a Curse, Not a Blessing

- If the Government …
  - forces a Current Account Surplus (via export subsidies, import barriers)
  - and forces a high investment rate (to meet GDP targets)
- …then ***Household Savings must necessarily be high***
- Household savings are not a choice, they're a system command
- Savings can not save China because…
- ***the Savings have already been squandered***



Bubble Dynamic: Credit Flows Drive Real Estate Activity



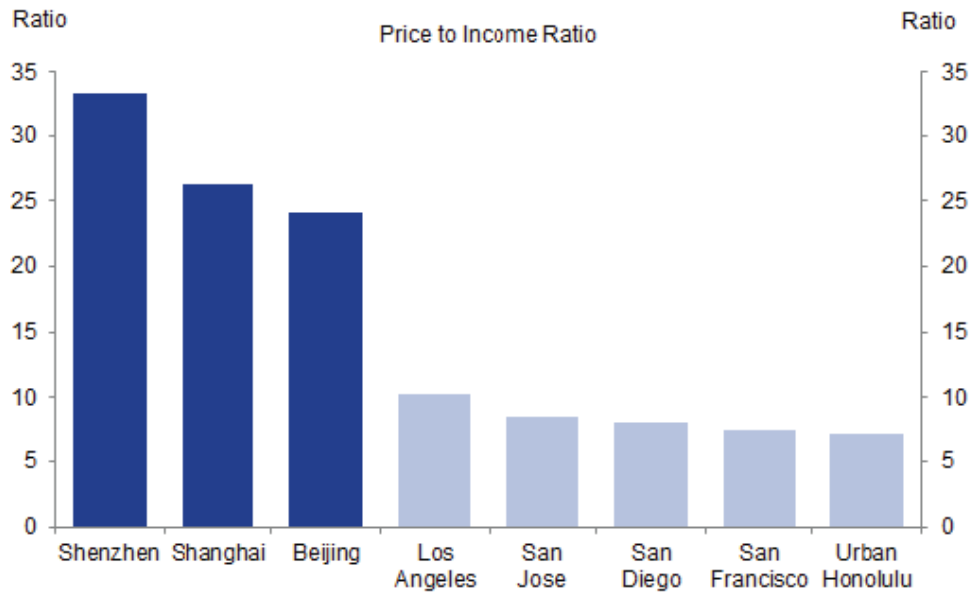
- Credit Impulse = Change in annual credit *growth* as a percentage of total outstanding credit
- ***The "fundamental" driver of China's Real Estate bubble is high credit growth***

Source: China NBS, PBoC, Macrolens calculations

Housing Affordability is Off-the-Charts

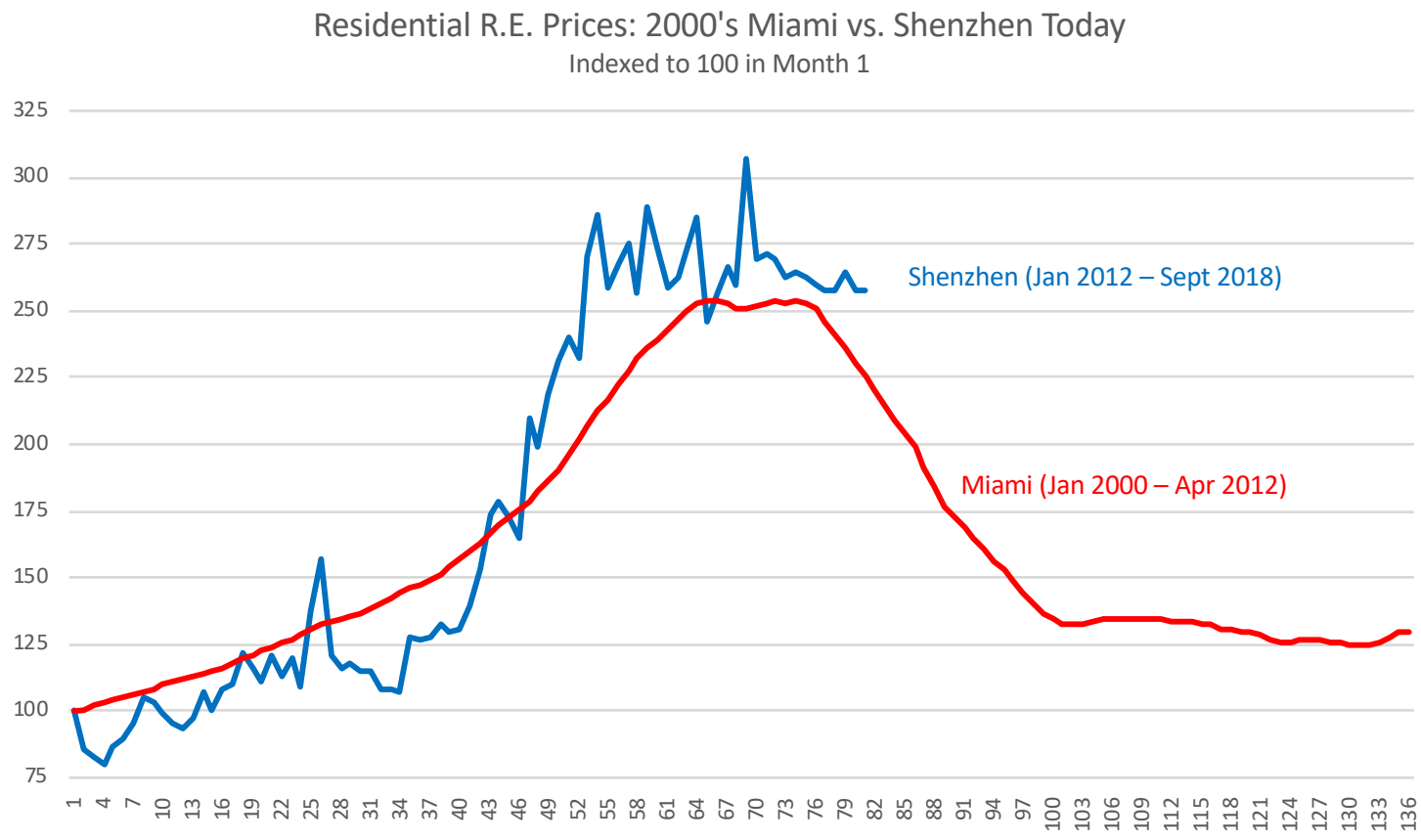
- How much higher can it go?

Exhibit 8: Affordability has become stretched in certain cities in China



Source: Zillow.com, NAHB, NBS, Soufun, Goldman Sachs Global Investment Research

When the Credit Machine Breaks Down…



Source: S&P/Case-Shiller, China Real Estate Investment Corp

A Housing Market Correction is Politically Untenable

10/10/18: Social media photos show angry Chinese homebuyers across China protesting sudden price drops…..

Source: The Epoch Times, October 10.2018

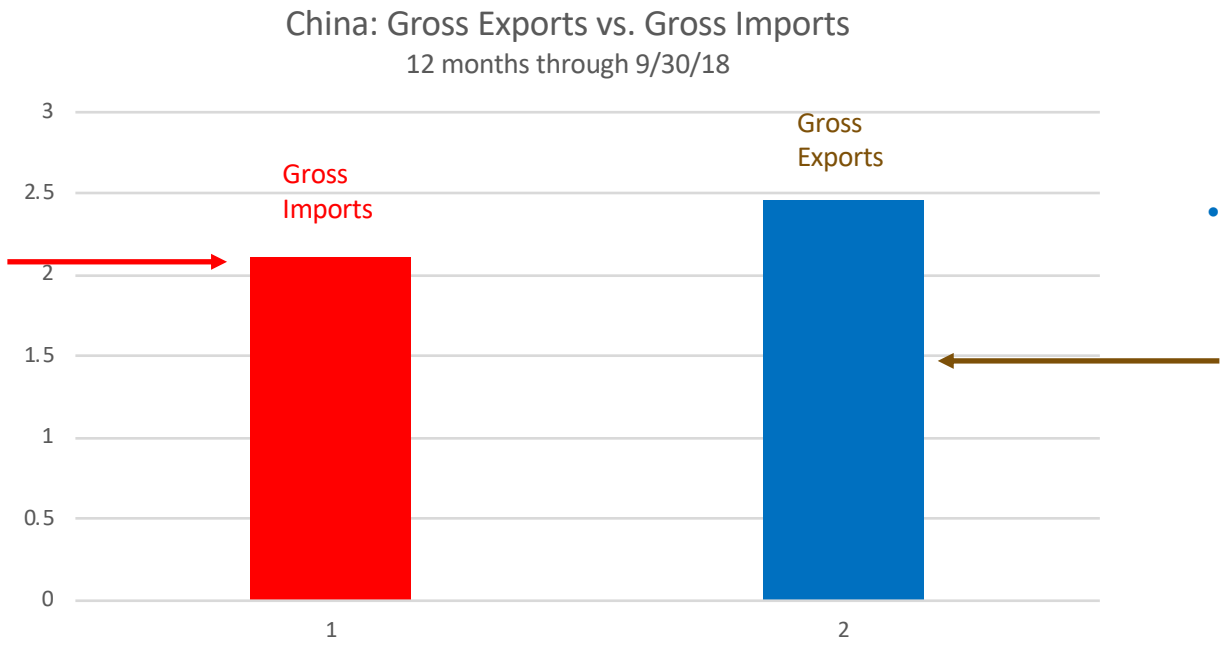
Capital Controls Are Not a Magic Fix

- In practice, "capital control" has taken the form of ***quotas on FX availability…***
- …because ***Capital & Current Account flows are impossible to disentangle***
- Persistent restrictions on market access to FX is incompatible with Xi's vision of a global role for China
- The increasing economic isolation required to "control capital" ***plays right into Trump's hands***

Capital Controls Are Not a Magic Fix

- Even if the government were to completely close the FX market…
- ***…China's balance of payments could still go pear-shaped…***
- …if export proceeds don't return to the country

- $2T in FX **must** leave China to run import businesses…



- …but the offsetting $2.4T in ***export proceeds might not all come back***

Source: China Customs Administration

Changes in Export Proceeds Conversion Can Swing the BoP a Lot

- A 20% swing in the export conversion ratio could swing China's BoP by $500bn annually
- ***The only fool-proof capital control is to retreat from International trade***

- Bounce = SAFE "shakedown" of exporters hording USD in Hong Kong

Source: China SAFE (Export Conversion Ratio = Sale of FX, trade of goods & services / Receipts, trade of goods & services)

China Knows: Credit Bubble + Strong Currency = Big Trouble

- In 2017, Lie Hu, Xi's top economic deputy, commissioned a study on Japan's boom, bust, and lost decades
- One key conclusion was that ***agreeing to the Plaza Accord was a really bad idea***
- In declaring that the RMB must be addressed in any trade deal ***Trump has added another impossible ask***

Bloomberg

Economics

China Looks to Historic Foe for Lessons on Handling Trump

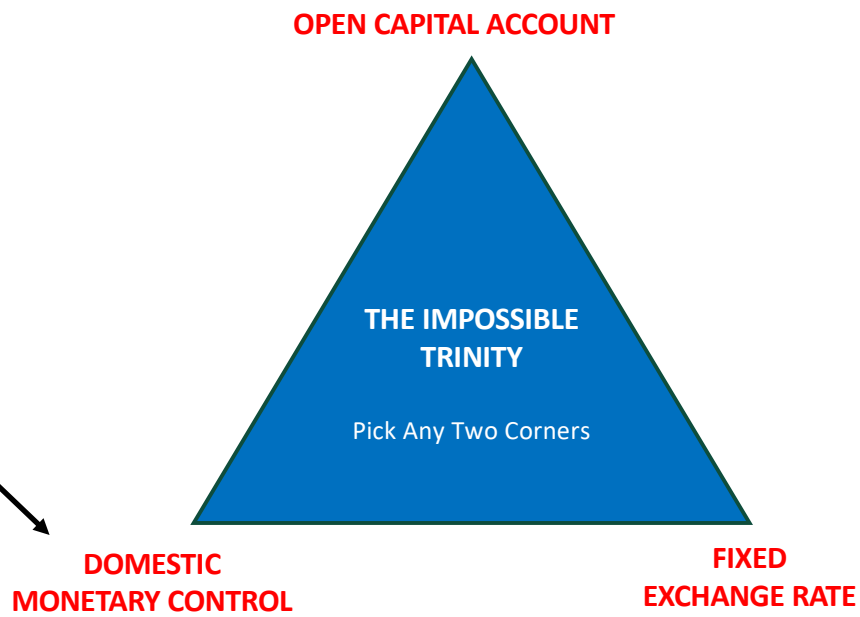
By Connor Cislo
October 21, 2018, 4:00 PM EDT

- It's studying how Japan managed 1980s trade friction with U.S.
- Beijing won't make FX concession as Tokyo did in Plaza Accord

Source: Bloomberg News, October 21, 2018

Impossible Trinity: Two out of Three Ain't Good Enough for Xi

- Abandoning this corner puts China on a path to North Korea-like isolation



- This corner is an existential political necessity

- ***Exchange rate slippage remains the point of political least resistance***

Trade War is a Prelude to Cold War

- If a $12T non-market economy sits at the center global trade ***you no longer have a market-based global economy***
- ***Trump's trade policy is designed to disengage from and isolate China***

THE WALL STREET JOURNAL.

Former White House strategist Steven Bannon said the Trump strategy from the outset was to pull investment out of China and remake global supply chains, but then the effort got thrown off track when administration deputies battled over steel and other trade issues and the U.S. launched fights with Europe, Canada and other allies.

One provision of the new Nafta says that if any of the nations conclude a free trade deal with a "nonmarket economy"—meaning China—the others can pull out of the North American pact.

Source: Wall Street Journal, October 1, 2018

U.S. Demands Are Sweeping

Leaked list of demands from May 2018 Beijing Meetings

- *Cut its trade surplus by $100 billion in the 12 months starting in June, and by another $100 billion in the following 12 months*
- *Halt all subsidies to advanced manufacturing industries in its so-called Made In China 2025 program. The program covers 10 sectors, including aircraft manufacturing, electric cars, robotics, computer microchips and artificial intelligence.*
- *Accept that the United States may restrict imports from the industries under Made in China 2025.*
- *Take "immediate, verifiable steps" to halt cyberespionage into commercial networks in the United States.*
- *Strengthen intellectual property protections.*
- *Accept United States restrictions on Chinese investments in sensitive technologies without retaliating.*
- *Cut its tariffs, which currently average 10 percent, to the same level as in the United States, where they average 3.5 percent for all "noncritical sectors."*
- *Open up its services and agricultural sectors to full American competition.*

Sources: New York Times, *U.S.-China Trade Talks End With Strong Demands, but Few Signs of a Deal,* May 4, 2018

No Deal

- The Communist Party of China will never agree to fundamental changes to the economic system

South China Morning Post

Picking a fight: Is Trump's hawkish behaviour towards China the start of a new cold war?

Wednesday, 17 October, 2018

"The Trump administration's tariffs are aimed at changing China's fundamental economic model. You are not going to change their model just because of tariffs," he said. "The state-dominant Chinese economic model is hard-wired into the system, and American pressure is hardly going to change it.

"This is going to lead into a much more prolonged, tense, competitive confrontational relation. This is not going to pass. It will polarize the relationship and polarize Asia."

- David Shambaugh, a professor of political science and international affairs at George Washington University.

Source: South China Morning Post, October 17, 2018

No Deal

- The Status quo ante is economically and geopolitically unacceptable the the U.S.
- U.S. demands are politically unacceptable to China
- The objective is not a deal at all – ***its China's disengagement from the global economy***

Trade wars: China fears an emerging united front

Beijing welcomed American disputes with Tokyo and Brussels but now faces isolation as G7 allies begin to co-ordinate policy

"People in the administration now understand that Trump may be flexible on so much stuff, but the hill he's willing to die on is China," says Mr Bannon. "Trump's focus is shifting the supply chains out of China."

Source: Financial Times, September 11, 2018

Supply Chain Exodus is Underway

- Tariff avoidance is easy: move production activities to another low-cost jurisdiction
- Companies incur a one-time cost to move and perhaps a marginal decraase in productivity
- But the entire stock of U.S. corporate investment in China is only $256bn[1]

Chinese companies flee overseas to avoid US tariffs
AFP, 11 September 2018

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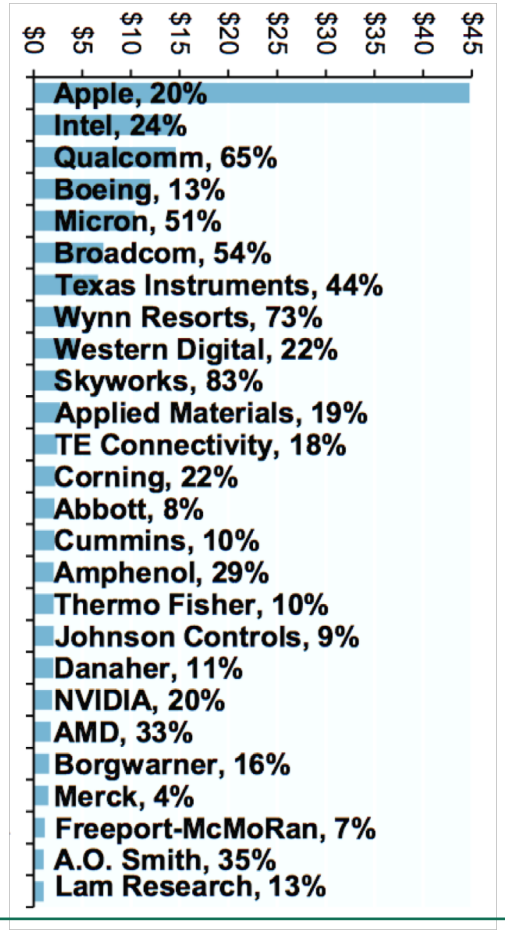
Trade war pushes Japanese supply chains out of China
Asahi Kasei and Komatsu juggle global production to avoid US tariffs
Nikkei Asian Review, August 28, 2018

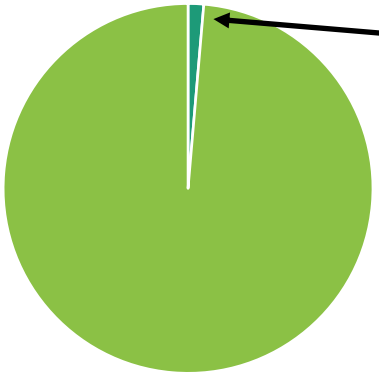
China's "Friends" in the U.S. Can't Halt the Trade War

Select U.S. Corporates Sales in China
(US$ bn and % of total sales)[1]



- There is a a ***deep-pocketed constituency*** for the status quo ante…
- But U.S. Corporate profits generated in China are ***not macroeconomically significant:***

U.S. Business Sales (2015)[2]

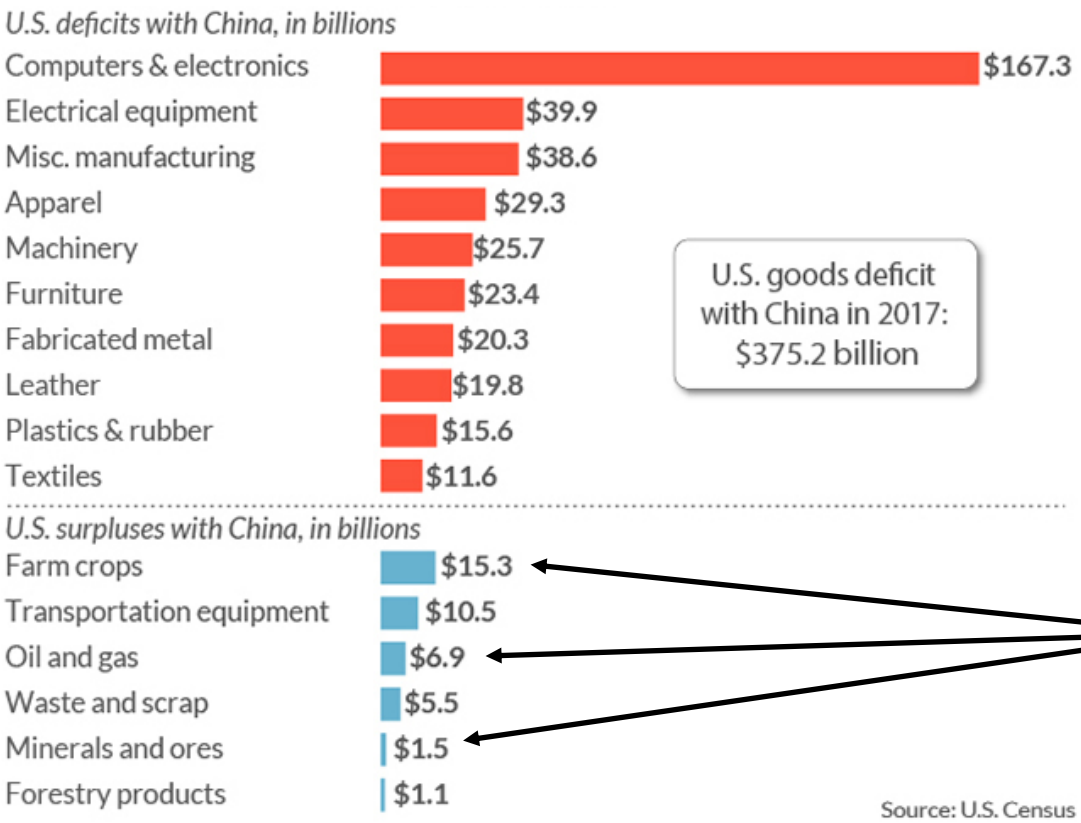


- To China: $222bn
- Total: $16.29T
- China as a % of total: ***1.36%***

- …and ***most of what U.S. companies sell in China is made in China***

Sources: 1. JPM Research via Yahoo News: (https://finance.yahoo.com/news/375-billion-us-china-trade-deficit-can-totally-misleading-173908781.html); 2. Financial Times, *Trump forgets that US companies in China are doing a roaring trade,* June 20, 2018 / U.S. BEA via FRED

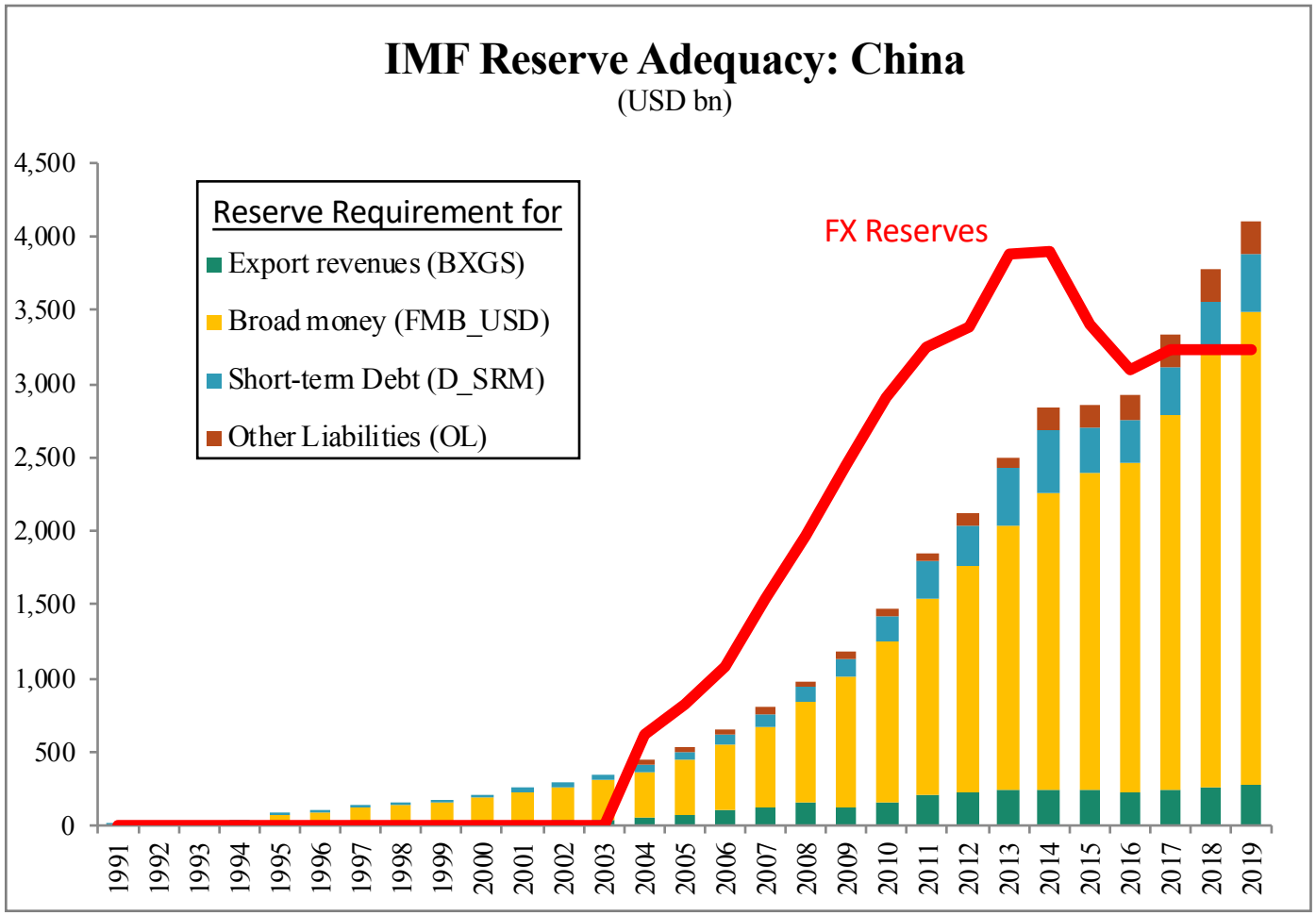
China Has Little Means of Retaliation



- Lower value-added processes will quickly be moved out of China
- Fungible commodities are an ineffective means of retaliation

https://www.marketwatch.com/story/heres-all-the-stuff-the-us-imports-from-china-thats-causing-a-huge-trade-deficit-2018-03-23

FX Reserves Are No Longer Confidence-Inspiring



- A ballooning domestic financial system has rendered ***China's FX reserves inadequate***
- Blowing through another $1T+ as in 2015-16 is not an option

An Existential Threat to the Crediblity of Chinese Policymakers

South China Morning Post

Trade war may undermine China's whole basis for future development

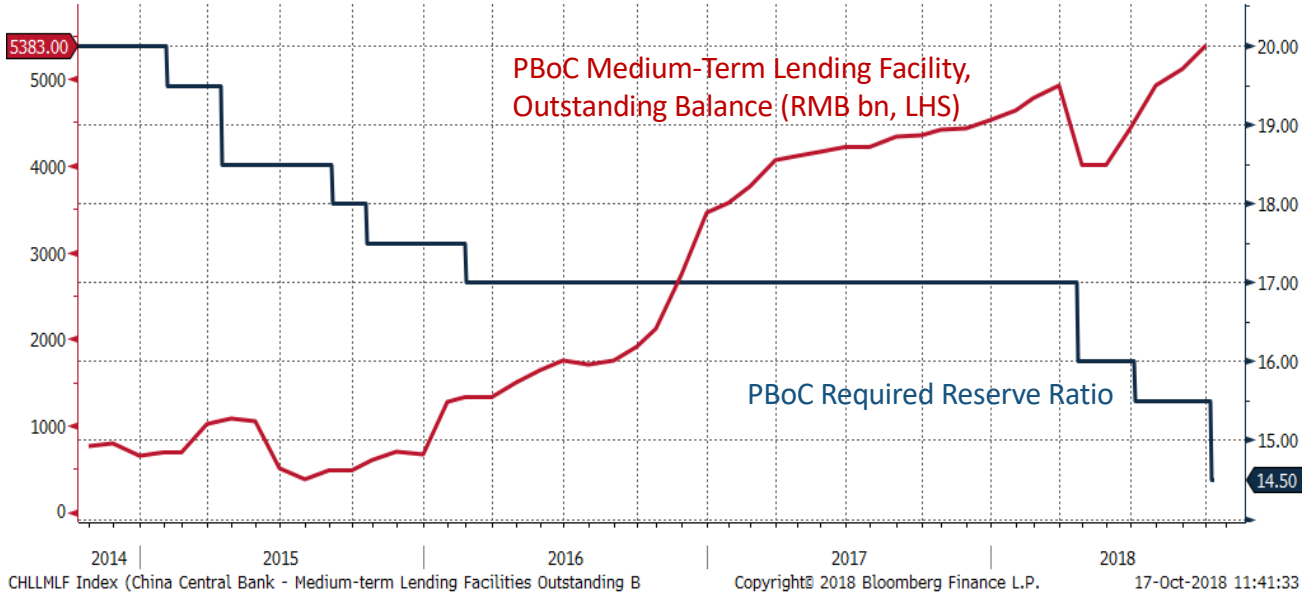
Tensions over structure of the Chinese economy are not confined to the US, with Europe and Japan also concerned about technology transfer

Monday, 15 October, 2018

- ***Implicit guarantees support untold Trillions in Chinese credit*** and R.E. assets
- The ***credibility of these guarantees rests on a net of propaganda***:
  - Indefinite high rate of growth
  - The dream of "deleveraging" yet still "growing out of the debt"
  - The inevitability of "moving up the value chain" to global technological leadership
  - The infallibility of Chinese leadership
- This story is now ***badly exposed***
  - Xi has been politically outmaneuvered by Trump
  - Trade war casts serious doubt on China's technological aspirations
  - The "deleveraging campaign" is ending in retreat to a broken growth model

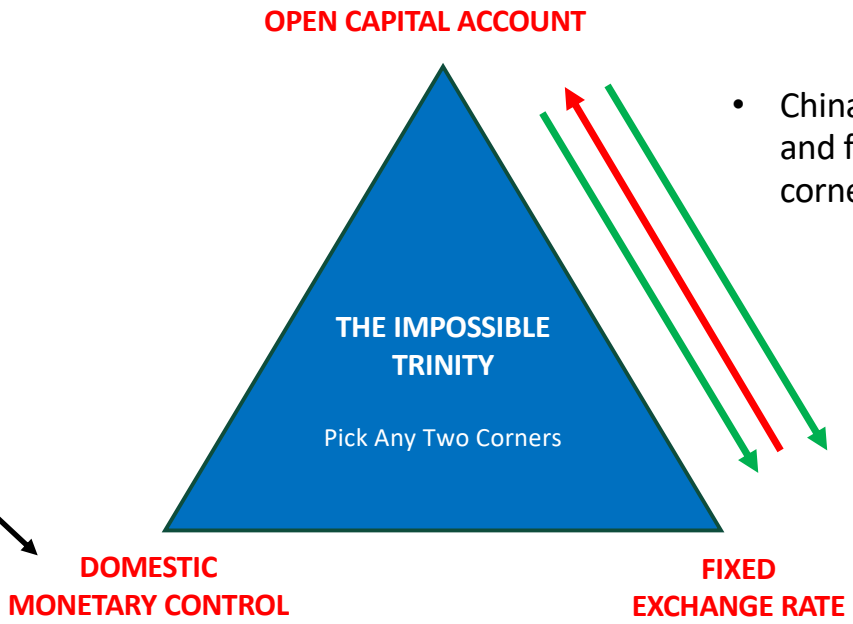
Domestic Liqudity Crisis is Unlikely

- Despite highly unstable balances sheets with acute asset / liability mismatches…
- The end-game ***will not take the form of a 2008-style liquidity crisis***
- The Chinese banking system is a direct extension of the PBoC…
- …and "shadow banking" is largely an extension of the banks.
- ***Shadow-banking assets will be brought on balance sheet and PBoC-funded if necessary***



- ***The PBoC will print to infinity*** before allowing a liquidity crisis to unfold

So How Does it End?



- China has been bouncing back and forth between these two corners since 2015

- Domestic liquidity demand requires full monetary control

- ***Indefinite control of capital flows is untenable*** short of NK-like isolation

- China has learned Japan's lesson on agreeing to a fixed exchange rate

- ***As domestic pressures build…***
  - ***Necessitating ever more divergent monetary policy…***
    - ***Controlling the Exchange Rate becomes impossible…***

How Does it End?

- **The "Japan Scenario"**
  - ***A*** strong currency and the collapse of domestic asset prices…

    … is politically impossible
- **The "North Korea Scenario"**
  - Deepening isolation to control flows and maintain the RMB…

    …is incompatible with Xi's vision of China as a great power on the global stage
- **The "RMB Devaluation Scenario"**
  - RMB flotation to maintain perma-stimulus domestically while remaining internationally relevant…

    …is by far the ***least damaging option***
- The "Japan Scenario" and the "North Korea Scenario" subject China to a ***permanent state of under-performance***
- ***RMB Devaluation is the only outcome that holds out the hope of eventual re-set and recovery***

The Million Dollar Question: WHEN Does it End?

- ***The key is confidence*** in the system
  - More confidence: liquidity fuels asset bubbles
  - Less confidence: liquidity increasing leaks via capital outflows

- Confidence erodes the same way the Hemingway character went bankrupt: ***"gradually, then suddenly"***

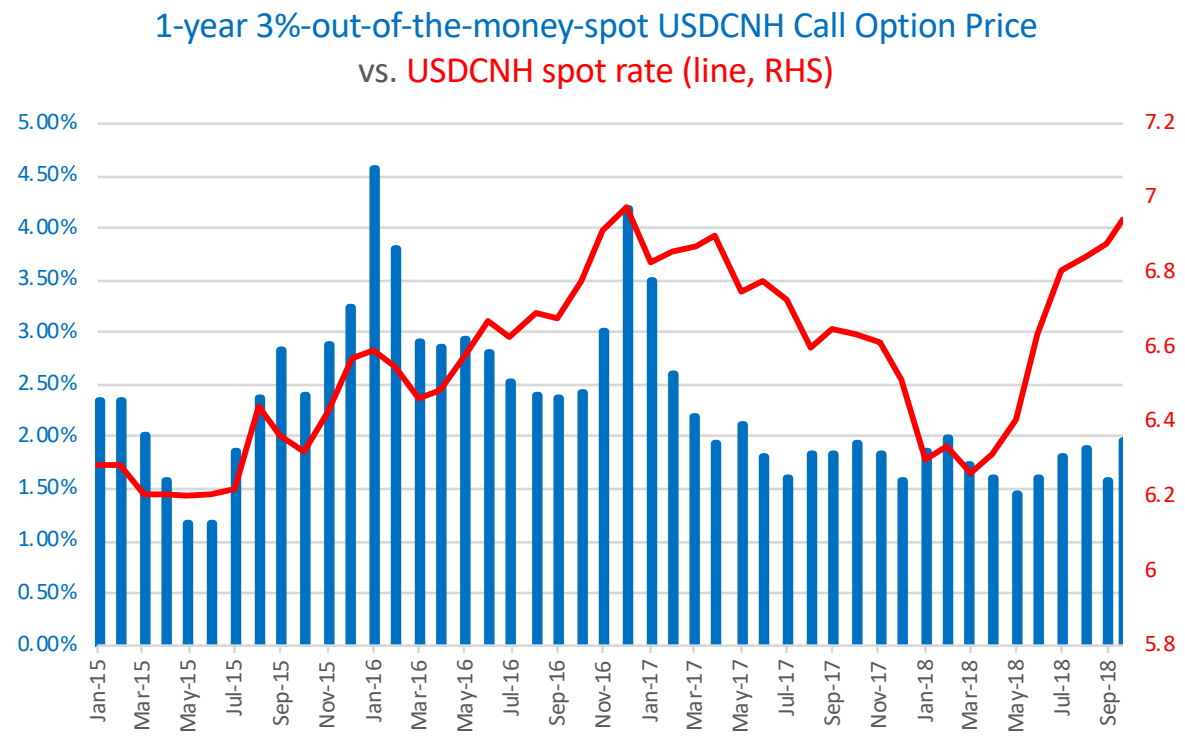
- ***The loss of confidence is a self-reinforcing process***…
- …as fading policy traction necessitates more aggressive and less credible policy choices:
  - Reversal of de-leveraging
  - Quotas on FX supply
  - Ham-fisted intervention in equity markets

- Measures necessary to defend the RMB are becoming increasingly extreme and decreasingly credible

- ***RMB devaluation occurs when Xi Jinping decides that the cost of avoiding it exceeds the costs of doing it***

Uncertain Timing is Reflected in Depressed Option Premium

- Despite the sharp move in USDCNH spot, ***call option prices embed little premium for near-term risks***



- A 1-year 3% OTMS USDCNH call sells for less than 2% of face…
- …less than half of 2016 peak prices

- **USDCNH call option strategies are an attractive portfolio hedge**

Source: Bloomberg

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Markets in High Resolution

About Macrolens

Macrolens is an investment advisory formed in 2018 to provide macro strategy and investment management services to institutional investors including asset managers, hedge funds, family offices and pension funds. We apply a classical approach to global macro investing, with a focus on monetary dynamics and the interplay between the U.S. and China.

Engage with us for global macro guidance, real-time value-added market strategy, and in-depth analysis of Chinese economic and political trends.

Brian McCarthy

From 2011-2018 Brian served as Chief Strategist and Portfolio Manager at the hedge fund Emerging Sovereign Group where he managed the Nexus Fund, a China-focused macro fund. Brian is a regular traveler to China where he has met with hundreds of individual in all walks of financial life including local and national government officials, economists, entrepreneurs, real-estate speculators and developers, and operators in the official, “shadow,” and “underground” banking sectors. The experience has left him with a bearish bent towards financial risks in China.

Brian has also had roles in asset management (fixed income strategist at Alliance Capital, fixed income Portfolio Manager at AIG) as well as in sales and trading, having held senior positions in FX sales at Barclays, UBS and RBS.

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