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View on China: Good-Bye, Yellow Brick Road in the New China

Executive Summary

- The focus of the new Chinese leadership has tilted from growth to de-leveraging, with a view to sustaining longer-term growth
- In the face of a cyclical downdraft, near-term headline risks could rattle already-uncertain markets
- Investment implications for Asian portfolios:
  - **Rates:** Underweight duration
  - **Currency:** Retain small overweight
  - **Credit:** Stay defensive given investment-grade supply overhang in the state-owned sector

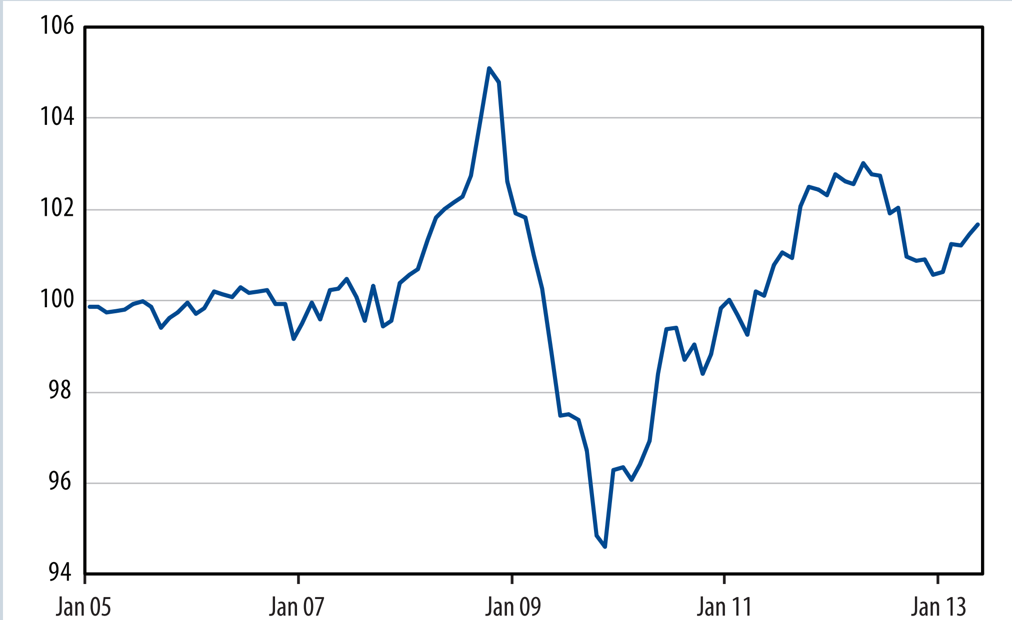
Downside risks to GDP growth in China have risen. A target of 7% is achievable for 2013 as a whole, but this will be the slowest pace of expansion since the post-Tiananmen fallout of 3.8% in 1990. Given that 1Q13 GDP growth came in at 7.7% year-over-year (YoY), this would imply a further deceleration of economic momentum in the second half of the year. Specifically of note is the possibility that the quarterly headline GDP print will likely slip below 7% YoY for the first time since the Lehman Brothers meltdown (6.8% YoY in 4Q08). Based on anecdotal feedback, Chinese corporates have turned more cautious on the near-term cyclical outlook, and are coming to terms with the fact that the Chinese-led commodity super-cycle is behind us. From a secular perspective, however, there is increased acceptance that the official tolerance for slower growth may in fact be consistent with the country's economic maturation. In the coming week, keep an eye on the official PMI slated for release on July 1, with the consensus at 50.0 in June, down from 50.8 in May. The flash estimate of HSBC-Markit PMI released last week surprised on the downside, coming in at 48.3 (versus a consensus of 49.1) in June.

A hard-landing remains a low-probability scenario for now. Using the 1990 experience as a reference point, we still view a hard-landing scenario—GDP growth of 5% and below—as unlikely. The downside risk to growth stems largely from tighter financial conditions. In turn, there has been a deliberate policy intent to tackle structural challenges emanating from a rapid buildup of financial leverage in the economy. This marks a distinct shift in addressing potential systemic stress points by the Xi Jinping administration. One potential risk though is an unintended policy overshoot on the economy, which precipitates into broader social unrest. Our view is that, while it is currently unwilling to stimulate the economy, China has the ability to limit the downside to GDP growth if the slowdown proves more malignant than intended.

While China's ability to reflate the economy is strong, policy uncertainty has increased. The new government's tolerance for a lower growth trajectory is consistent with its priority on the broader reform agenda (for example, controlling entertainment spending by public officials and accelerating environmental protection measures). In the context of the 10-year tenure of the new government, front-loading the painful but needed measures will hopefully bear fruit over the medium term. Admittedly, the cyclical soft-patch over the next six months will test the government's resolve. In particular, potential headline concerns relating to quarter-end reserve and loan-to-deposit ratio requirements and the expiration of a portion of wealth management products (WMPs) in the coming weeks would suggest continued nervousness with regard to conditions in the interbank market. Estimates of the so-called shadow banking associated with WMPs vary considerably, with one projection (by Deutsche Bank) at ¥21 trillion ($3.4 trillion) or roughly 40% of GDP.

The recent deliberate and policy-induced spikes in money market rates will reinforce the tightening trend in overall financial conditions that has been in process since the start of 2013. After a brief period of easing in the second half of 2012, financial conditions have tightened since the start of 2013 (see Exhibit 1), largely reflecting the trade-weighted appreciation of 6% in the Chinese yuan. On June 20, the overnight interbank rate rose to 13.4%, but nudged lower to below 6% a week later. Nonetheless, this is still well above the 2% to 4% range seen in recent months. There is debate as to whether the moves last week could have been better managed or communicated. It appears that interest rates will likely stay elevated for the rest of the year, given the administration's intention to curb excessive credit growth. However, we do not view the policy-induced tightening in onshore liquidity as incompatible with broad yuan stability, although admittedly the trend appreciation seen in the first half will likely be tempered. Still, given the government's commitment to a multi-year liberalization leading to the eventual convertibility of the yuan by the end of this decade, a stable regime is of paramount importance in promoting greater use of the currency. Western Asset expects the progressive internationalization of the Chinese currency—as reflected by the growth in the offshore Chinese yuan bond market—to gain traction over the secular horizon. Never in recent history has the currency of the world's second-largest economy not eventually assumed a dominant role.

Exhibit 1
China: Financial Conditions Index



Source: Goldman Sachs. As of 01 May 13

In terms of strategy in Asian portfolios, we are underweight duration, we hold a small overweight in the Chinese yuan, and we recommend a defensive posturing on Chinese USD-denominated credits. Over the course of the first half of 2013, we have tactically trimmed our yuan exposure from a high of +5% versus the benchmark to +1% presently. Our current stance primarily reflects our secular view of the yuan playing a dominant role internationally. We are cognizant of the fact that yuan forwards are vulnerable to the vagaries in emerging markets (EM) fund flows, but we are positioned to add on further weakness. We recommend a defensive positioning on Chinese USD-denominated credits. The supply glut given a slew of investment-grade issuance by Chinese state-owned enterprises has led to market indigestion, and the impact will be further exacerbated by the weak broad tone in EM. For accounts looking for Asian high-yield exposure, we continue to emphasize the need for fundamental credit differentiation. Our preference is to stay within the short-dated 2014-2016 bonds issued by high BB rated corporates.