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# Asia Insight

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## MARKET REVIEW

The MSCI AC World Index rose by 2.9% in April. The MSCI Japan Index had another good month (+3.5%) but not as good as the MSCI Asia ex Japan Index (+7.2%) which powered ahead courtesy of MSCI China's 16.7% surge. Most other regional markets also advanced but India (-6.5%), Indonesia (-9.8%) and the Philippines (-2.7%) bucked the regional trend. These large relative moves did not suit our regional portfolios. Financials, property, energy and materials all rose by over 10%. The consumer sector (+2.9%) was a notable laggard.

*All returns above are stated in US Dollar terms.*

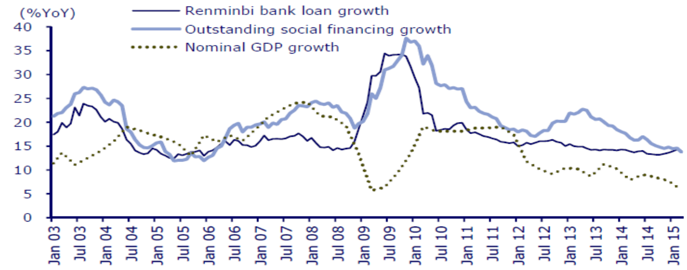
## BAD NEWS IS GOOD NEWS

Momentum in China's economy continues to ebb away. First quarter real GDP growth was reported at 7.0% y-o-y, more importantly nominal GDP growth slid to 5.8% y-o-y (see chart below). Nominal growth in the manufacturing sector was just 1.9% y-o-y. Residential sales and completions fell 10% y-o-y in 1Q15, new starts fell 21%. A handful of 1Q15 earnings reports illustrate the slowdown; (1) Angang Steel reported a 19% fall in revenues and 93% fall in profits. CAPEX doubled! Net debt/equity sits at 50%. (2) Maanshan Iron saw revenues fall 14% and reported a loss. Net debt/equity 75%. (3) China National Materials - flat revenues, loss making. Net debt/equity 90%, CAPEX +40%. (4) Petrochina suffered a 22% fall in revenues and an 82% fall in net profit. Net debt/equity 36%. The April flash *Markit* manufacturing PMI fell to 49.2 suggesting weakness continued into the second quarter.

The better news is that the tertiary/service sector continues, at least partially, to offset the underlying weakness in the industrial sector. Real disposable income continues to grow at a high single digit rate and this, together with steady employment trends, is supporting growth in consumption. Rebalancing rolls on.

Mckinsey estimate that China's total government, corporate and household debt totalled $28tr in mid 2014 (282% of GDP). Standard & Poor's estimated that corporate debt hit $14.2tr at the end of 2013 - larger than total US corporate debt. The China News Service recently reported that provincial authorities have liabilities of $2.6tr, a 47% increase from June 2013. On 21st April Baoding Tianwei became the first SOE (state owned enterprise) to default on an onshore bond (although it now appears that China Construction Bank is being pressed into a little national service by extending a loan to the company).

China credit growth and nominal GDP growth




Source: CLSA, CEIC Data, PBOC

The Chinese Government is not sitting on its hands. The so called One Belt One Road initiative is an imaginative programme to extend China's economic and political influence westward while the enormous infrastructure required will usefully absorb part of the excess capacity in China's infrastructure-centric industries. Meanwhile the anti-corruption campaign continues apace. The latest high profile "victim" is Sinopec Vice Chairman Mr Wang Tianpu who is under investigation for "severe violations of discipline". Perceived as a decent proxy for corruption, Macau's gross gaming revenues fell 37% y-o-y in 1Q15. Elsewhere the recent State Council proposal to cut import duties on various consumer goods, including apparel and cosmetics, is another positive for domestic consumption although it hammers another nail into the coffin of Hong Kong's beleagued retail sector.

The debt crisis alluded to earlier, however, remains the key headache for China's leadership. The PBOC has cut interest rates twice and has also reduced the reserve ratio requirement. Further cuts and reductions lie ahead. More interestingly it appears that the PBOC is considering expanding the Pledged Supplementary Lending programme. Initiated last year, the PSL appears to be a Chinese version of the ECB's long term refinancing operation (LTRO) according to CLSA's Eric Fishwick. The view is that an enlarged PBOC PSL programme could be used to purchase newly issued local government bonds which in turn will fund the repurchase or restructuring of a large chunk of the off-balance sheet local government financing vehicles (LGFVs) issued during the recent credit boom. It is a moot point whether this is QE or not but it would certainly be a step down the road of unconventional monetary policy.

Of course the easiest way to solve excessive debt is to replace it with equity. Ramp the local market and then issue a shed load of paper - perhaps the plan is that simple. The mid month announcement by the CSRC of tighter margin requirements was followed within 24 hours by a clarification that the measures would not hurt the market. Did the CSRC receive a call? According to Macquarie, margin lending now stands at 8% of the outstanding free float. The same metric for the US has never exceeded 2.5%! It is not surprising that the A share market excitement has rubbed off on H shares, neither is it surprising that financials have been the prime beneficiaries as the PBOC eases. Just don't look too hard at 1Q15 earnings reports where bad debt charges are rising and net interest margins shrinking. Concentrate instead on the prospect of SOE reform where consolidation from 112 to 40 is on the cards. Interestingly the proposed merger of China's two biggest rolling stock producers, CSR and CNR, will result in no job losses. Our portfolio of Chinese consumer stocks posted an average gain of 10% during April.

## OUTLOOK

The failure of QE in Japan and in the West is unlikely to sway Chinese policymakers and more volatile markets appear the likely result.

*HT&SD*