Damien Wood, Principal

Spectrum Insights

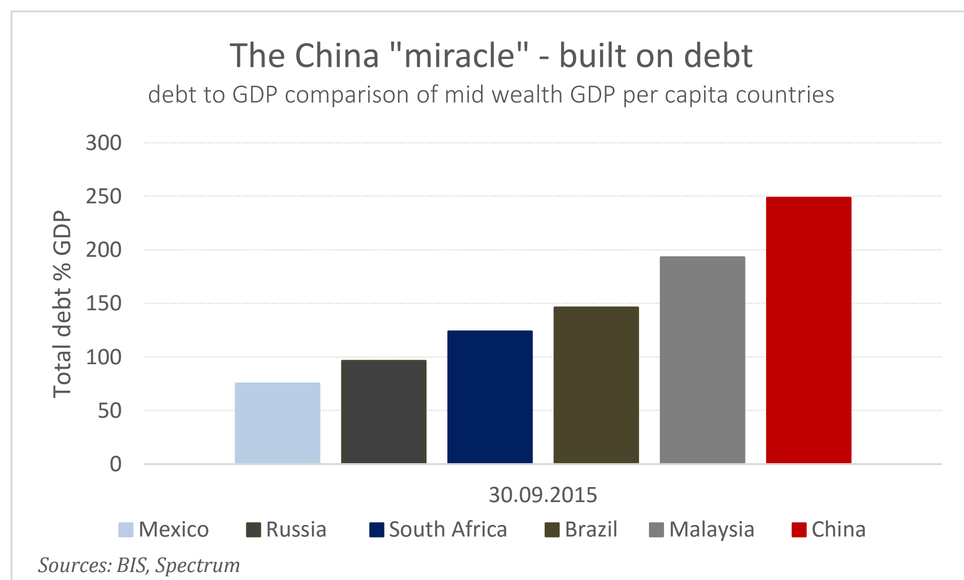
JUNE 2, 2016

Not another China bust story

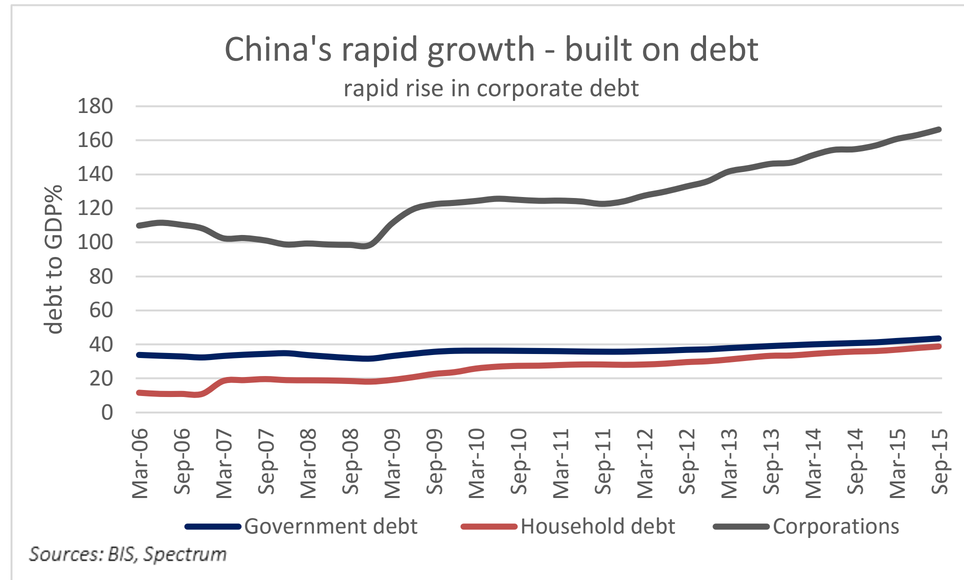
Readers of recent financial media are regularly exposed to China Doomsters assuring us that a China economic crash is just around the corner. We agree that the Chinese economy has too much debt that was built up too quickly. This has promoted excess capacity in its economy causing large levels of (unreported) bad debts at banks. Does that mean an imminent crash for our largest trading partner? Spectrum does not think so. Our base case is for China to have a prolonged period of far slower growth than its recent past. The government has the political will, tools and ability to avoid a banking crash-induced recession. Spectrum believes that the A$ will absorb much of the pain from a lower than expected level of exports. Interest rates will remain near or lower than current levels. Bond default risk will increase moderately but credit spreads will be supported by investors chasing returns in a low yield environment. The bottom line - A$ corporate bonds should continue to be a solid investment for domestic investors delivering better returns than deposits over the coming year.

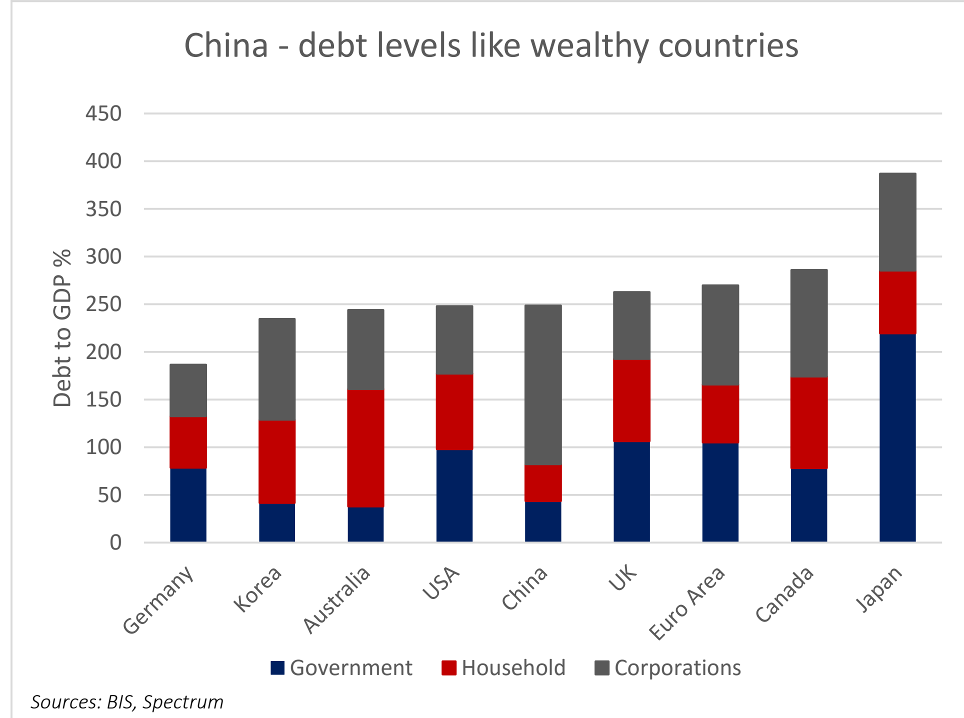
The problem

Australia's largest trading partner, China, has the classic pre-conditions of a banking crash; that is, years of rapid credit growth fueling excess capacity which, in turn, causes a large chunk of borrowers to struggle to repay debt.



The graphs above and on the following page show China's total indebtedness. We use total debt to gross domestic product (GDP). In layman's terms, this can be broadly compared to your total debt compared to your after tax income.



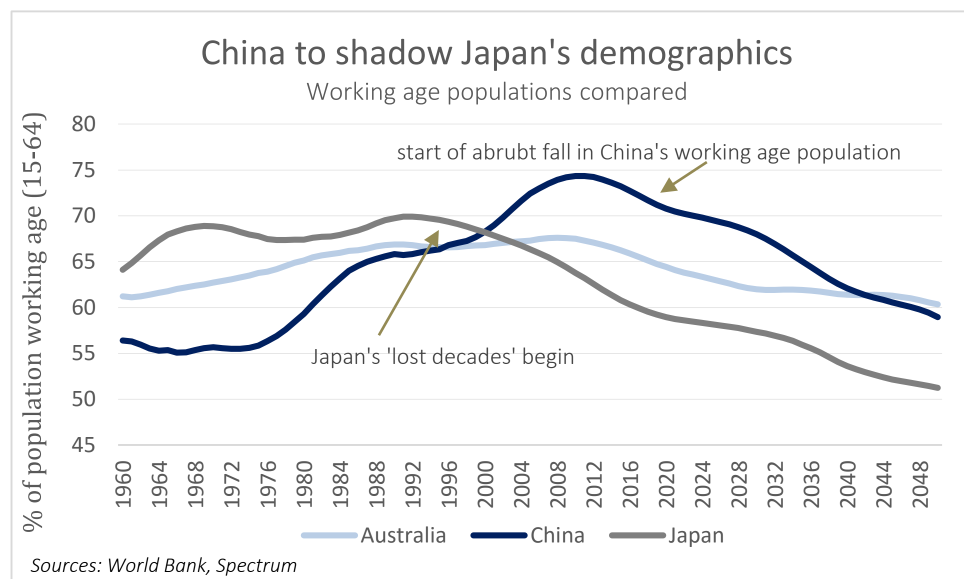


There are a few startling observations about China's debt to GDP:

- It has built up quickly over the past couple of decades.
- It is similar to countries with far higher wealth per capita.
- It towers above other similar wealth mid income countries.

In theory, this high level of debt would be fine if China could sustain the rapid growth of its past. But that's where there are some key challenges for China.

First, its working population is starting to shrink. If you want to know how that can impact on GDP growth, consider Japan's weak economic performance over the past three decades.



Second, there is excess production capacity in sectors such as steel, aluminium and shipbuilding. China Inc. has undertaken a huge investment program over the past decades on the premise of ever growing demand. This "Field of Dreams" growth policy is now rapidly running out of steam. At present, many sectors face wide spread financial stress. Moreover, Chinese investors and lenders may soon put the brakes on further investment activity to stop the situation from getting worse. If so, the Chinese economy will then face challenging transition issues. The high level of indebtedness, at best, will become a drag on the economy. At worst, it will result in huge losses in its financial system.

This much we agree with the China doomsters. Where we differ is on how China's funding landscape and likely recapitalisation process can smooth the impact on the overall economy and help avoid a sharp recession.

China now and banking crashes of the past

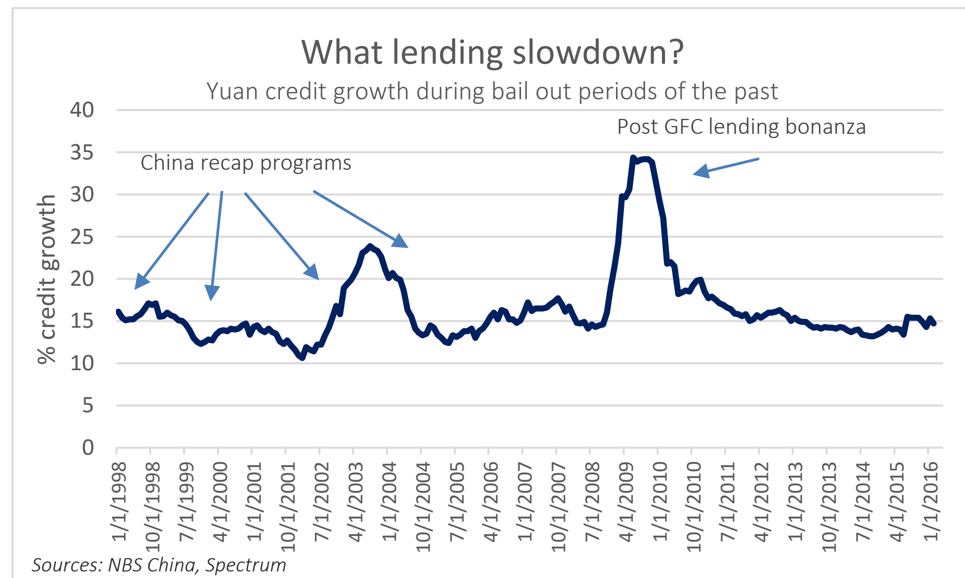
China's rapid current indebtedness situation and how it got there rhymes with aspects of many of the great banking crashes in recent history: Japan and the U.S Saving & Loans crisis of the late 1980's and early 1990s, Sweden in early 1990s, China's own in the 1990s, Thailand and Korea of the late 1990s and even the recent U.S led global financial crisis of 2008-9.

Mountains of bad debt at lenders can have serious implications for the economy. There are, of course, investment and lending losses. Sometimes more serious is the fallout from a sudden withdrawal of funding to financial institutions. This can cause banks to shrink their balance sheets. The result can be acute credit rationing which can push many normally sound borrowers to the wall.

What is unique to the China story when compared to most of the banking crises of the past is the strong influence of the Chinese government over the funding of the financial sector. Foreigners lend very little to Chinese banks. Local depositors and bank bond

investors have little reason to fear for the safety of their investments due to the implicit government support for the major banks. And, if the major banks need new capital, these investors can take comfort from the fact that the government recapitalised the banks in the 1990s and early 2000s. Note that the banks had bad loans of 25%-50% but no depositor or bond holder incurred any repayment issues.

Then, the Chinese banks kept their lending taps on during the recapitalisation processes. Now, China has moderate fiscal capacity and ample FX reserves to help fund the recapitalisation of the banks. We believe the government will remain financially supportive of its major financial institutions.



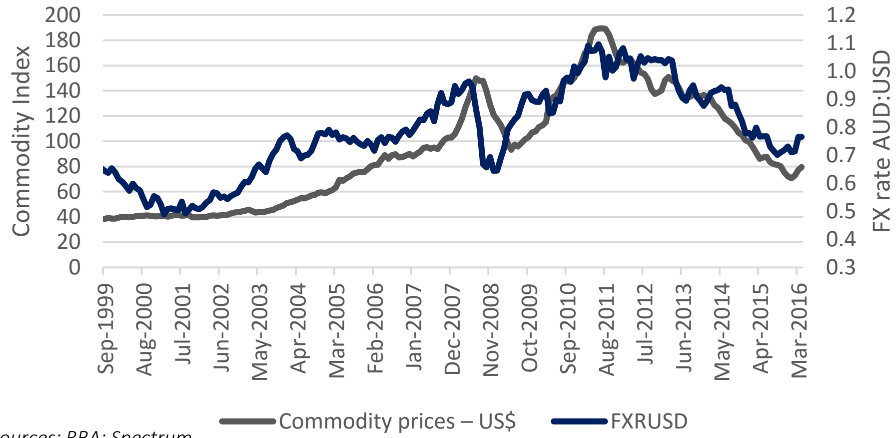
As a result, we believe that even if there is a surge in reported bad loans in China, there need not be a forced large retreat in lending. The key banks will not be in survival mode. Creditworthy borrowers will still be able to get finance. The economy can keep functioning. And if this scenario plays out, the chances of large shocks to Australia's credit markets from China appear modest over the next year.

China's transitioning economy

China's policy makers appear to be changing tact as well. A recent article in China's People's Daily compared the debt-fueled expansion to "growing a tree in the air". Its government is attempting to shift from an investment and export-driven economy to one more reliant on services and consumption. Again, the People's Daily report projected an "L" shaped recovery to last more than 2 years.

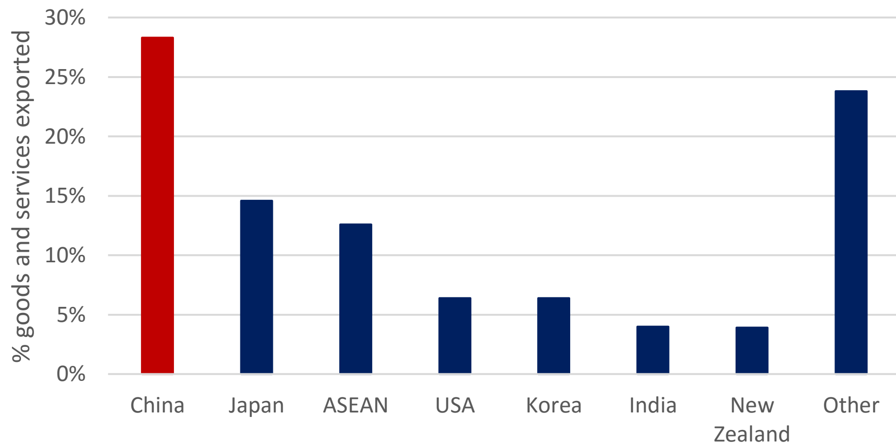
The new normal – slower growth

China's past heady economic growth of 7-8% p.a. looks like becoming a distant memory. Australia, too, may have to settle for less than expected demand for its commodity exports. If so, it may be felt acutely by the currency (see graph below). Interest rates, too, may remain under pressure. Both of these conditions will act as a buffer to a slump in the domestic economy. In turn, this will help avert a notable jump in A$ corporate bond default rates.



What to do?

The next time you read a China Doomster proclaiming the end is near, look for their analysis of how the government will respond. If there is none you are only getting half of the story. Spectrum foresees many challenges for China's economy and its high level of indebtedness. We believe it is more likely to result in a far slower growth rather an uncontrolled financial implosion. This is not disaster for Australian investors but is likely to keep a lid on returns for most domestic asset classes. Most A$ corporate bond issuers have robust financial profiles enabling them to weather prolonged slower domestic growth. This should enable the asset class to continue to deliver steady returns in line with its low to mid-risk description.



Spectrum Asset Management manages the Spectrum Strategic Income Fund. This fund invests in AUD corporate securities of which the majority are floating rate notes. The intention is to make this portfolio relatively immune from the bond yield volatility which can, in turn, hit equity and fixed income markets. The fund is also designed to deliver an income stream while generating capital gains from time to time. For more information and how to invest please go to our website http://spectruminvest.com.au or contact your mFund broker http://www.asx.com.au/mfund/foundation-members.htm#tabs-218. Spectrum and the author have investments in either securities mentioned in this report or comparable securities

DISCLAIMER

- This report has been prepared by Spectrum Asset Management Limited
- (ABN 31 096 442 198, AFSL 225069).
- It is for information purposes only and does not constitute or form part of, and should not be construed as, an offer, invitation or inducement to purchase or subscribe for any securities or funds nor shall it or any part of it form the basis of, or be relied upon in connection with, any contract or commitment whatsoever. It also does not constitute a recommendation regarding any securities or funds.
- The information in this document has been obtained from sources believed to be reliable but no representation or warranty, express or implied, is given hereby as to the fairness, accuracy or completeness of the information or opinions contained herein. This presentation reflects the information available as of the date this presentation was prepared and is subject to change without notice to the recipient.
- Past performance may not necessarily be repeated and is no guarantee or projection of future results.
- This report is intended solely for the information of the person to whom it has been delivered. It is not an advertisement and is not intended for public use or distribution. No part of this report may be reproduced or distributed in any manner without prior written permission of Spectrum Asset Management Limited.