Global Asset Management

BlueBay Asset Management

China on Borrowed Time

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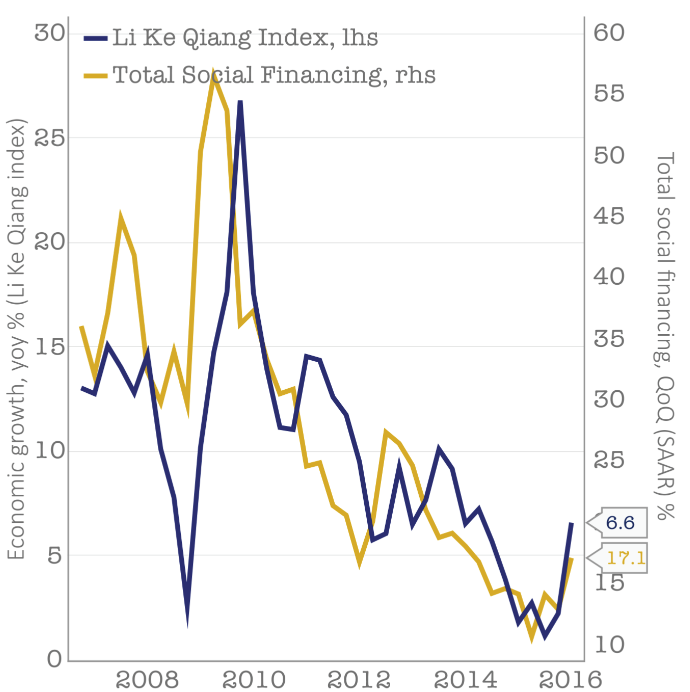
Investors should be careful not to ignore developments in China simply because the near-term risk of a 'hard landing' and big currency devaluation has diminished. The acceleration in credit growth and investment is driving a pick-up in economic activity from the trough at the turn of the year. But it is predominantly the 'old China' economy dominated by industrial state enterprises as well as the property sector that is benefiting from policy stimulus. Short-term relief is at the expense of rising indebtedness, excess capacity and a greater risk of a more painful correction to come. In our opinion, China remains a key source of global macroeconomic uncertainty and potential market volatility.

Total social financing (TSF) – a broad measure of credit that captures bank and non-bank lending as well as corporate bond issuance – grew in the first quarter by 17% year-on-year (seasonally adjusted), more than twice the pace of nominal GDP. In the chart below, the year-on-year (yoy) change in TSF (gold line) is plotted against a monthly index of economic growth based on changes in bank lending, rail freight and electricity production (an index named after Premier Li Ke Qiang).

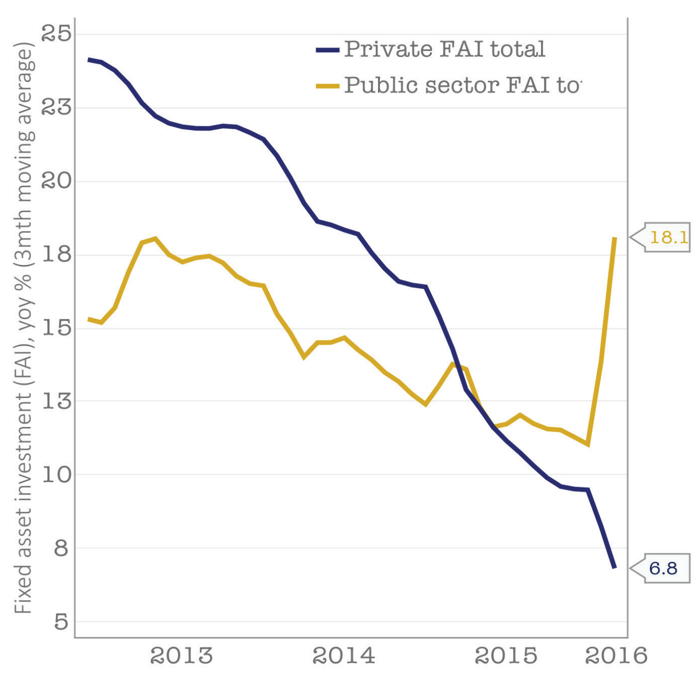
Exhibit 1
Credit Growth Drived Cyclical Upturn



Source: Macrobond; Bloomberg, BlueBay calculations; data at 2016 Q1. 2016 Q1

The policy easing was in response to the marked slowing of economic growth during the first half of 2015 and began to take effect with an upturn in property and car sales in the latter months of the year. The pick-up in new bank lending – up 14.8% year-on-year in the first quarter – combined with increased corporate bond issuance and government spending supported a dramatic pick-up in public (including state owned enterprises) investment growth, though not for private investment. The lag between policy-induced credit growth and increased economic activity is around six months suggesting that in the absence of further easing and rapid credit expansion, the economy will begin to slow in the second half of 2016.

Exhibit 2
Public and Private Fixed Asset Investment, Yoy%



Source: Macrobond; BlueBay calculations; data at 03/2016, 03/2016

Although domestic policy easing – aided by lower expected US interest rates and a weaker U.S. dollar – has supported a cyclical upturn in the Chinese economy, the stimulus measures that were unaccompanied by substantive structural reform exacerbated the underlying imbalances in the economy. The efficiency of investment is declining and the volume of credit required to generate growth is rising. China risk will return as a key concern for global investors sooner or later.

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RBC Global Asset Management (U.S.) Inc.
Minneapolis | Boston | Chicago
800.553.2143 | **us.rbcgam.com**