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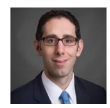
ON FIXED INCOME

Chinese Economic Weakness Elevating Investor Concerns

China's core financial system seems insulated from recent stress.

August 2023



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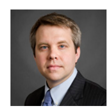

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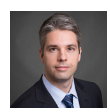

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KEY INSIGHTS

- Despite areas of weakness, we do not anticipate significant stimulus from the Chinese government.
- China's policymakers have the tools and capacity to prevent a systemic issue stemming from stress in the nonbank financial sector.
- While unlikely, notable weakening in China's growth could affect developed market central banks' decisions.

China's slowing economic growth, stresses in the shadow banking sector, and continued defaults in the property developer sector have raised concerns around the country's ability and willingness to engineer improved near-term growth and the impacts this may have on the global economy.

While the Chinese economy has struggled to rebound from pandemic-related restrictions, we do not believe recent stresses in the property sector and shadow banking system pose an immediate systemic risk as the government continues to pursue its Common Prosperity agenda, intended to bolster prospects for lower-income citizens. At the same time, we are mindful that with second-quarter gross domestic product (GDP) growth of just 0.8% quarter over quarter, and recent trade activity coming off cyclical highs, China faces a period of below-trend growth. Inflation is also persistently running below policymakers' target band of 2%–4%.

Major Property Developer and Large Trust Company Miss Payments

In the property sector, Country Garden, the country's largest private property developer, missed paying a USD 22 million coupon on a dollar-denominated security in early August. While the issuer has a 30-day grace period to early September to make the coupon payment without triggering an official default, bond prices had fully priced in a default.

Country Garden has received various forms of government support in recent months, including access to credit lines from large state banks and guarantees on recent onshore bond issuances. However, balance sheet liquidity has worsened given that the company's significant inventory of housing projects carries higher exposure to smaller, lower-tier cities where housing prices and sales volumes have been much weaker than in the top tier cities.

Separately, one of China's largest trust companies, Zhongrong International Trust Co., reportedly missed payments on products to several wealth management clients as it deals with broader liquidity stresses. Developments at Zhongrong are the latest signs of strains in a shadow banking system that over the past three years has seen a small number of trust companies require government intervention.

Stresses in the shadow banking sector, particularly smaller trust companies, do not yet present a systemic risk to China's core financial system. The shadow banking sector has come under increased scrutiny since 2017, when China's central government started taking stronger regulatory efforts and providing local governments with the tools to contain the industry. As a percentage of GDP, trust assets have fallen from 31% in 2017 to 17% today, and much of the lending activity has been replaced by traditional banks. In recent years, the Chinese regulators have stepped in to ringfence failing financial institutions on a case-by-case basis with a view to containing more systemic risk; they will likely follow this playbook again.

China's Leaders Focusing on Long-Term Policy Objectives

Market expectations for government stimulus similar to measures adopted in 2016 or 2020 have proved to be mistaken. Forecasting an improvement in growth and impactful government support requires understanding the government's long-term goals and the economic trade-offs policymakers face between core and periphery financial institutions. With strains thus far most acutely felt in non-core segments, we are not yet expecting a significant stimulus response.

Since 2018, the central government's objectives have focused on monetary deleveraging to move China's economy into a more sustainable long-term model, Common Prosperity to ensure equitable growth and social cohesion, and national security.

The country is attempting to engineer a structural shift in its economy away from excessive credit creation, urbanization, and property development and toward advanced manufacturing and consumer demand. The careful balance of encouraging a reduction of overall debt levels in the financial system while supporting growth and employment requires small adjustments. This process has involved an inevitable slowing in long-term growth trends, with the government seeking to manage the pace of the slowdown by spreading the adjustment over several years to avoid a deep recession that could lead to broad social unrest.

Stability of State-Owned Banks Imperative to Chinese Monetary Policy

Policymakers are also less willing to tolerate stress in the core financial system, which comprises China's large state-owned onshore banks. China conducts monetary policy through a monetary aggregate framework, using a variety of tools focused on total money supply, whereas most countries use a policy rate-based transmission mechanism, using central bank interest rates to achieve their goals. The stability of the state-owned banking industry is imperative to its policy transmission model.

The costs associated with supporting these goals have often been borne by the periphery financial sectors, including offshore high yield bonds and smaller trust companies. When such institutions act to counter policymaker objectives, they can face significant regulatory headwinds and financial losses. Recent examples include the real estate sector's difficulties amid an emphasis on monetary deleveraging and private education companies running afoul of the Common Prosperity efforts.

We do not expect that recent regulatory easing from the Chinese government will have an immediate impact on the real estate sector's weak trajectory, with the focus remaining on the completion of housing projects over saving developers from bankruptcy. Lower down payment requirements and looser home purchase restrictions would likely only marginally support struggling companies.

Factors that could trigger a more aggressive response from the Chinese government include a disorderly depreciation of the renminbi against a basket of global trading partner currencies. Policymakers fear that currency weakness could accelerate capital outflows that would be highly disruptive to China's core domestic banking institutions and balance of payments position.

Nuanced Impact on Global Growth

The impact on global growth is more nuanced. We have started to see a de-linking of China's longtime role as emerging markets' primary driver of growth. This is due, in part, to the resilience of services in domestic economies, which has lessened the impact of a slowdown in Chinese manufacturing. In addition, several frontier countries, such as Bangladesh and Vietnam, have been well placed to increase manufacturing and global exports amid China weakening. Significant weakening in China's growth could prompt developed market central banks to pause policy tightening.

WHAT WE'RE WATCHING NEXT

Lower Odds of Economic Stimulus Leave Us Cautious on Offshore Bonds

The real estate sector's prospects for significant regulatory relief remain modest, and we do not see attractive risk-adjusted return opportunities today. The government has prioritized the completion of construction projects, which has resulted in more than USD 115 billion of bond defaults across 2021 and 2022, or more than 70% of the high yield China property bond market.

Select investment-grade issuers may offer opportunities where regulatory risks associated with policymaker objectives are low, but yields on many of these bonds are not particularly compelling today.

China's local government bond market, on a FX hedged basis,[1] is the more interesting opportunity, in our view. Weak economic growth and low inflation leave room for policymakers to further ease monetary policy.

[1] FX hedging involves using instruments or techniques in an effort to reduce the impact of currency fluctuations. Examples could include derivatives such as currency forwards.

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