Weekly Macro Themes – 20 January 2017 - Volume 2, Edition 2

1. **Q4/Dec data:** Mild improvement/stabilization in data thanks to stimulus.
2. **Property prices:** Price gains are cooling off, risk is they go from slow to downturn.
3. **Renminbi:** Continued devaluation pressure; pressure on FX reserves, treasuries.
4. **International trade:** Expect an improvement in exports in 2017, all else equal.
5. **A-Shares:** Valuations no longer cheap, but earnings outlook improving.
6. **MSCI China Index:** Contrarian sentiment signals vs valuation and fiscal impulse.

This week we have a ***China Special***. From time to time the Weekly Macro Themes will hone in on a specific related set of topics such as a region or group of asset classes, this week it's China!

It's quite fitting that we look at China as Chinese New Year approaches (28th January: note China will be shut down for holidays from the 27th through to the 2nd of February for spring festival), it also happens to be Q4/Dec data dump day, and well, China is just such an important part of the global risk and opportunity landscape that it merits a closer look.

On the topic of Chinese New Year we will be leaving the year of the monkey, an animal associated with changeability - something we got lots of in 2016, and entering the year of the rooster, an animal associated with constancy. Whether or not that means more of the same uncertainty and change or perhaps a more boring but positive year remains to be seen. But high on the agenda in China will be the teetering property price cycle, the weakening Renminbi, the perennial growth/stability vs reform tension, the traditional 5-yearly leadership transition in China, and of course, the leadership transition in America.

China still faces significant structural challenges and systemic risks that have built up over the years, but it's much-predicted and non-delivered day of reckoning has yet to come. Will it come this year? My bias would be to say no because a number of positive forces i.e. stimulus and a better global growth outlook, are more or less already baked in and will help maintain some rooster-like constancy, the other point is that when you have a leadership transition you kind of need/demand things to be stable. The main factor that would change that view would be an external shock or a collapse in property prices/the currency. Until then don't be too chicken while the henny penny's brood over things coming home to roost; you might not want to put all your eggs in one basket but there's still a few opportunities crowing out there.

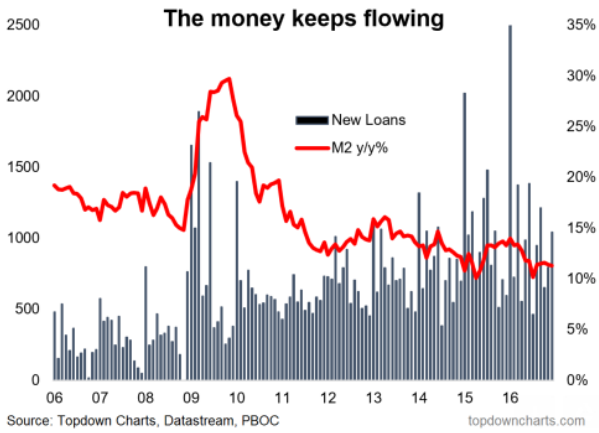
1. December/Q4 data dump: As is tradition, China's National Bureau of Statistics releases almost all of their key economic data at once, so here's a quick run down on the key charts and trends. Major data: GDP 6.8% y/y (consensus 6.7%, previous 6.7%), Industrial Production 6.0% y/y (6.1% expected, 6.2% previous), Fixed Asset Investment 8.1% (8.3% consensus/previous), Retail Sales 10.9% (10.7% consensus, 10.8% previous).

The main takeaway is that the data has improved slightly in some areas compared to earlier this year/late last year, but overall it's a case of stable vs slowing. The standouts are the turnaround in nominal GDP growth (thanks in large part to rebounding commodity prices), the rise in state driven investment, and ongoing credit growth and pump priming. Overall, I can confidently say that China's economy is looking slightly better now than this time last year. Lagged effects of stimulus and the property price recovery along with an expected improvement in exports should help underpin growth in 2017.

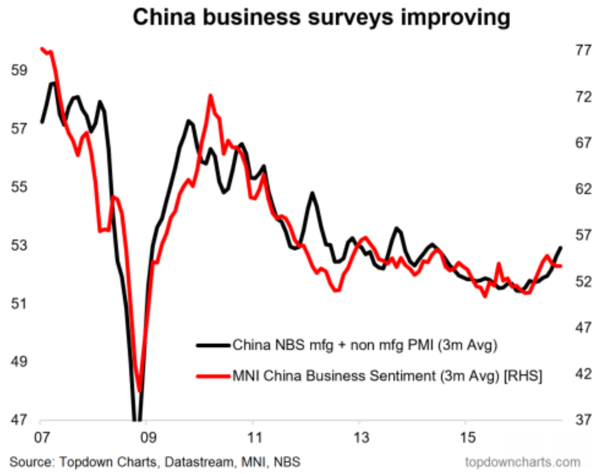
Bottom line: Thanks to stimulus efforts, the end of 2016 sees China at a better cyclical position than the end of 2015.

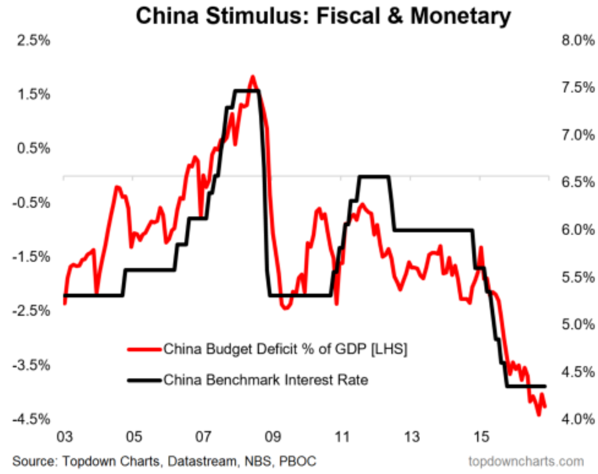
While real GDP has been 'curiously' stable, nominal GDP has turned up. Activity growth on the official stats has stabilized at low levels.

State driven investment has been pumped up with ample liquidity to offset the dearth in private investment.



The official PMIs and private MNI surveys both confirm a mild stimulus driven uptick in activity since the low point. Stimulus has been key in turning things around.





2. Property and prices: The December round of property price data showed a clear slowing in price gains. Over the past decade Chinese property prices have undergone distinct boom-bust cycles. Policy changes have been a key driver (rate cuts and macroprudential/regulatory easing at the bottom of the cycle, and tightening at the top of the cycle). It's no secret that China has already built a considerable amount of real estate, and thus the bias would be to expect slower price gains in the future, but as with all structural trends there's always a cycle around it.

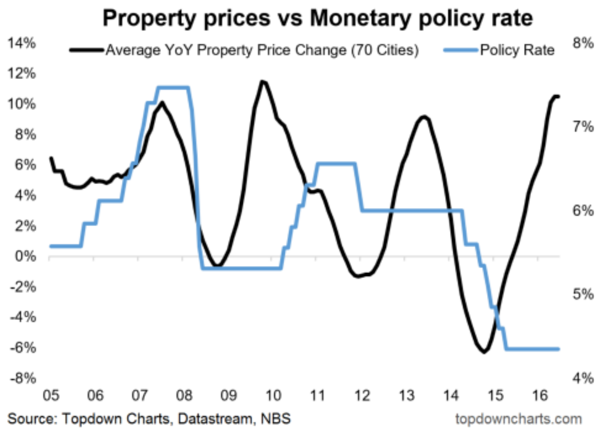
In 2015 we saw the steepest declines on record, but as usual the government stepped in to prevent a downward spiral. And when you think about China and the big risks, that is the big risk. A lot of wealth is tied up in property and a lot of bank assets are exposed to property - mostly through the corporate sector e.g. developers, rather than households as people tend to borrow relatively little to buy their own house, preferring instead to use cash/savings.

Property prices are an absolutely critical variable to watch for China's growth/risk outlook, and it's something we'll be continuing to monitor and update you on. Aside from direct risks, there's also the point that if the property market rolls over it increases the odds of further rate cuts to stabilize the market - as we'll see in the next topic, this has important implications for the currency.

Bottom line: Property price gains are beginning to cool off in China; the risk is that this turns to price falls - which would be the best leading indicator of a slowdown and increased risk outlook, so this is something we will be keeping a close eye on and would suggest you do the same.

Property prices are still rising in China, but there has been a clear slowing of momentum in the latest prints.

Property prices have a big impact on inflation, growth, and monetary policy in China - and hence and important impact on the risk outlook.



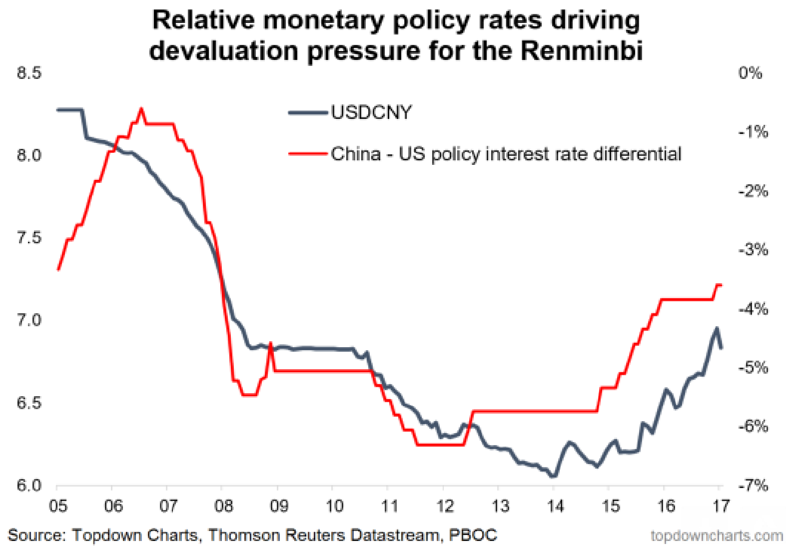
3. Currency: A logical flow-on from the implications of property prices and inflation on monetary policy is the currency. One of my key charts for the Renminbi is the USDCNY vs US/China interest rate differential chart - despite it being a managed float it still tends to roughly track the monetary policy rate differential between the two countries. This is important when you have the Fed on a hiking path.

On the PBOC side of things the outlook remains complex - on the one hand some measures of inflation are rising, but with a fragile, stimulus-driven, recovery underway it wont be in a hurry to hike rates. Again, the key variable for the interest rate outlook will be property prices - renewed gains will tip the balance towards tightening, while further weakness will keep the PBOC at least on hold if not prompt further easing (note: the PBOC is already undertaking substantial non-traditional easing measures, the policy rate is more of a blunt tool and signaling mechanism).

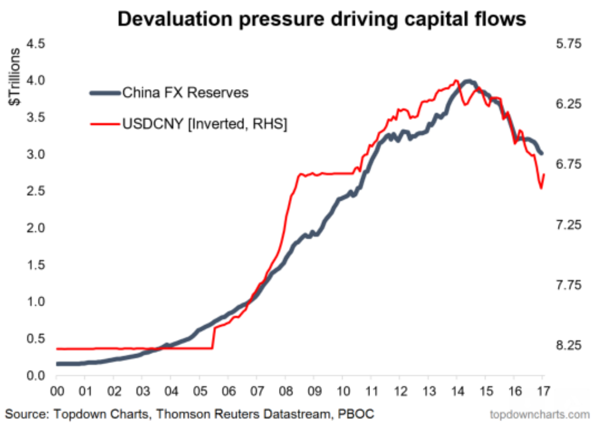
As for capital flows, any further or sharper falls in the CNY increase the risk of a more desperate move to get capital out of the country and will place increased pressure on FX reserves, which in turn will increase selling pressure on US treasuries. (hmm, so I guess that makes rate hikes directly bearish duration and indirectly bearish duration...)

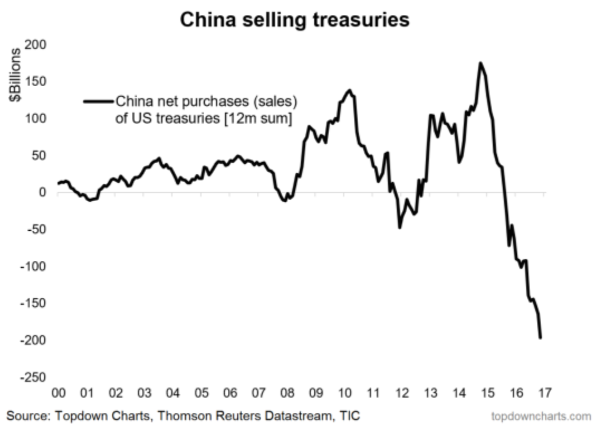
Bottom line: Fed rate hikes will likely continue to place pressure on the USDCNY (and thus capital flows).

The USDCNY exchange rate is sensitive to changes in the US-China interest rate differential.



The USDCNY is still the key benchmark and the main rate of reference for the average zhou on the street, thus when devaluation pressures step up capital flight pressures also step up, and long story short you get pressure on FX reserves, and since China still holds about $1 trillion of US treasuries then you also see selling pressure on treasuries as the chart below shows.





4. Trade: Aside from the risks to China and global markets from a weaker currency, one typical impact of a weaker currency is improved export competitiveness. This has historically been the case with the annual change in the BIS Real Effective Exchange Rate index for the Renminbi serving as a semi decent leading indicator for Chinese exports.

At present this indicator would suggest a surge in export growth to circa-30%. That's probably a bit of a stretch, but with global trade set to improve in 2017 based on my leading indicators we should see some improvement. That is of course unless someone goes and pulls the rug out from under it all by starting a trade war. I'm on the optimistic side, i.e. that we probably will see some protectionist measures, but that cooler heads will prevail in the end. But it is a fundamental source of uncertainty - we still don't know for sure what exactly will get translated from the campaign trail to policy in terms of willingness and ability.

At least the macro pulse is positive at this point, and that's something that we do know, so until I know any better I would run with a cautiously optimistic bias. Separately, believe it or not, but Xi Jinping's dream of reviving the old silk road has actually become a reality with the first train arriving in London from Yiwu. Over time this economic corridor will help lift non-US trade.

Bottom line: Chinese exports should improve in 2017.

China should have a better time on the export front in 2017 as the weaker currency improves export competitiveness (or at least a less strong currency will be less of a headwind) and global growth improves - recall my previous call that trade should improve in 2017, all else equal (of course, with the prospect of a Trump Trade War all is not equal).

Also, remember OBOR? (one belt one road) - It's actually a thing, last year 1702 freight trains made the journey from China to Europe, and the first train from Yiwu to London [just arrived](). (note: rail cuts about 2 weeks off travel time vs sea)

Speaking of freight, here's a chart I really enjoyed putting together because the movement was dramatic and I couldn't explain it: domestic freight turnover -- note the rebound in rail traffic. Honestly not sure what it is, whether it's getting mixed up in the OBOR activity or related to infrastructure investment.

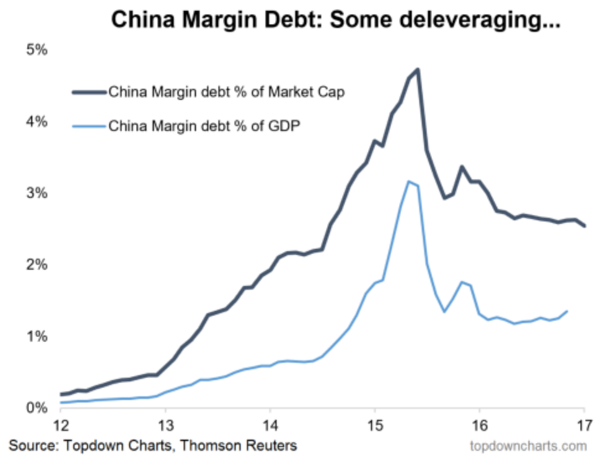
5.A. China A-Shares: With a generally improved cyclical macro backdrop, it's worth taking a look at China A-shares (even though the market is notorious for being retail driven, and often impervious or ambivalent of what's actually going on in the economy).

First stop is valuations, and at present the forward PE is trading around it's long term average; certainly much higher than where it was trading prior to the start of the 2015 bubble. On a similar note, margin debt as a percentage of market cap has come down from extreme levels, but remains somewhat elevated.

Where it gets interesting is on the earnings side of things, where we're starting to see upgrades come through after a period of persistent and deep downgrades. Looking at the composite leading indicator for earnings (producer prices, MNI business sentiment, property prices) points to potential big league upside for earnings growth. So if the earnings do pull through we could actually see a rise in A shares driven this time by earnings rather than valuation expansion.

Bottom line: If improvement in the earnings leading indicator can translate to improved earnings then we could see improved Chinese equity market performance driven by earnings for a change.

For China A-shares there remains a couple of obstacles such as valuation and margin debt - these things can always go higher, but at this point they remain elevated.



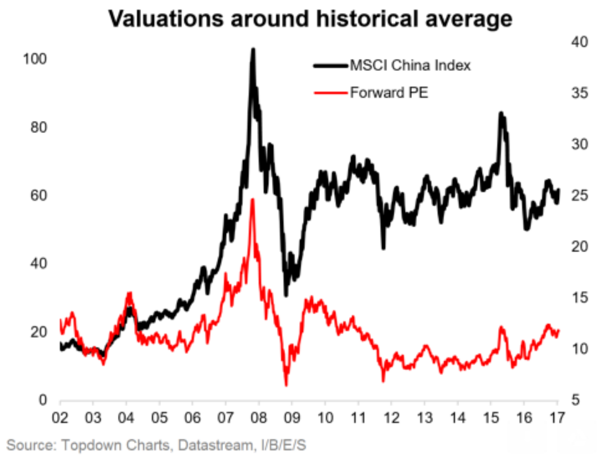
However there are signs of life on the earnings front with revisions rebounding and one lead indicator pointing to improvement.

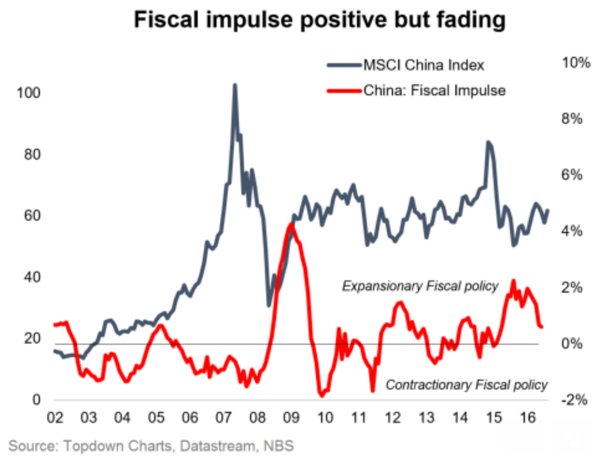
5.B. China H-Shares: This analysis looks at the MSCI China Index (which covers various forms of non-domestic listed Chinese stocks i.e. H, B, red chip, p-chip). Similar to their onshore A-share counterparts there is a set of negative and positive factors for the MSCI China Index. The main negative is the fact that valuations have risen slightly above their long term average and (largely as a result of weaker earnings) now trade around the highs of the 2015 bubble. So while this is not necessarily a road block it's not the same valuation tailwind that prevailed previously.

Similarly the fiscal impulse indicator has turned from very supportive to less supportive - again it's not a reason to get beared up but it's one less reason to be long. On the sentiment side of things is where it gets interesting. The Economic Policy Uncertainty Index for China is at all time record highs - I refer to this as a cloud hanging over the head of the market, so in that sense if/when the cloud lifts it should be a positive for the market. Another angle is the ETF flows chart which shows a wave of outflows - in the past this has often provided a signal of a short-term bottom in the market. So while valuation is not supportive, and fiscal policy is now less supportive, sentiment is currently generating contrarian bullish signals.

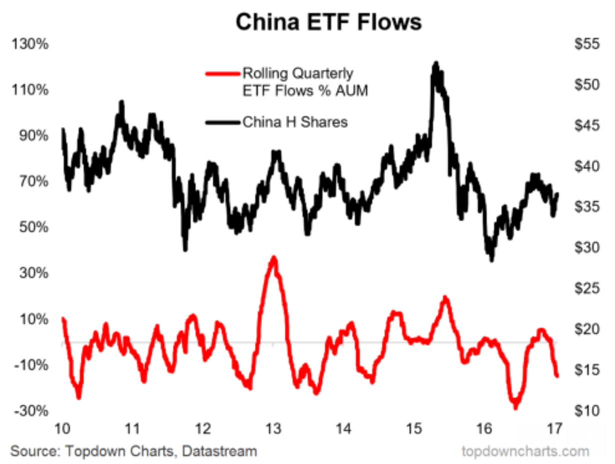
Bottom line: There's no longer the same valuation argument for MSCI China, but fiscal policy remains a mild tailwind and sentiment is sending contrarian bullish signals.

MSCI China valuations are likewise slightly higher than average and after a deterioration in earnings forward PE ratios are as high as during the 2015 bubble (which only had limited spillover from the mainland/A-share mania). The other point to note is that while the fiscal impulse remains positive it has eased off.





There are two possibly positive spins you can put on it from sentiment: you could say that the China economic policy uncertainty index is so bad it's good (in the sense that there is a cloud that *can* be lifted, i.e. once the cloud lifts it will open the way for higher prices). Likewise on ETF flows, there have been bigly outflows from China H-share ETFs, which is often a signal of a short-term bottom in prices.



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