20 December 2016

China no longer top creditor to the US

China sells T-Bills worth $40 billion. Beware the consequences of a trade war. GDP should increase by +6.7% in 2016. Outlook is more favourable for equities in 2017.

Key points

- US Treasury announces unprecedented decrease in funding from China
- Currency reserves drop to lowest since 2011
- A trade war would have consequences
- Chinese GDP will close the year up +6.7%
- Leading indicators increasingly positive for 2017
- Surprising new dynamic for imports and exports
- Stabilisation in the housing market will have limited effects on GDP
- Beijing hopes to attract foreign investors with its 'Connect' programmes
- Better outlook for equities in 2017

US Treasury announces unprecedented decrease in funding from China

China has scaled back its dependency on the US by reducing its stock of US federal debt by some 15% in 2016 and has reinforced the upward trend in long-term rates by selling close to $150 billion of US Treasuries in the latter part of the year mainly. Donald Trump's trade war may not be a foregone conclusion but positions are already hardening, and we will certainly see a continuation of this trend in the next few months.

This is hardly a new phenomenon: China has consistently reduced its USD bond holdings since 2011 (1,300 billion) by gradually selling down its holdings of US Treasuries. In October, however, China's methodical withdrawal amounted increased to over $40 billion, clearly accelerating since the beginning of the year. Indeed, this is the figure put forward by the US government, which has confirmed the downward trend, bringing the total of T-Bills held by China to $1,115 billion, i.e. some 150 billion less than at the beginning of the year. Japan, which had been the US' primary creditor for a long time, had been overtaken by China, which recycled a large part of its trade surplus with the US in this way and thus indirectly financed the consumption growth of one of its main clients. Now however, despite this month's reduction in the level of federal debt held by Japan (approx. $4 billion), Japan has regained its position as top creditor and financial backer of the US federal deficit, with holdings of $1,132 billion. China thus now finances around 15% of US foreign-held debt, which only represents 5% of the total US federal debt, estimated at approximately $20,000 billion. The US' third creditor, the Cayman Islands, is far behind the two main ones with only $265 billion in US Treasuries held by the countless hedge funds based in that jurisdiction.

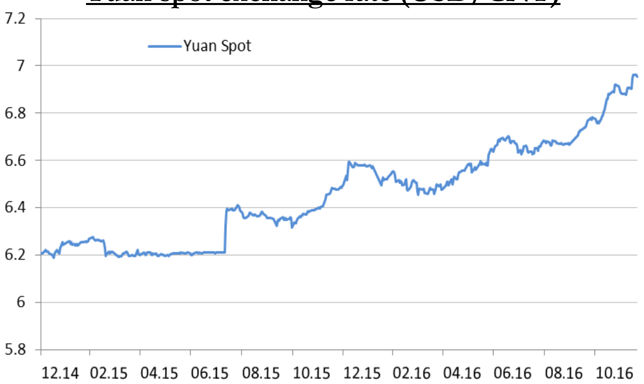
US T-Bills held by China and Japan (M USD)

Sources: Bloomberg, BBGI Group SA

Currency reserves drop to lowest levels since 2011

This disengagement should probably not be seen as the first sign of a future retaliatory strategy from the Chinese authorities in response to a hardening of US policy towards China. The sale of US bonds is probably nothing more than the Chinese authorities' best way to manage the yuan exchange rate and to fight its depreciation, initially perceived (incorrectly, we believe) as the sign of an economic downturn in China. Indeed, in the last few months, this perception has weakened the yuan and contributed to the outflow of capital, which in reality has once again improved the competitiveness of China's exports, increasing the likelihood they will increase. In our minds, it was not in the direct interest of China's authorities to weaken the yuan, especially just as the Chinese currency was effectively joining the IMF special drawing rights. On the contrary, the aim is to stabilise the yuan to reduce the outflow of capital from China. The devaluation of the yuan does not appear to be justified by a non-existent economic slump, since China's GDP will certainly end the year up +6.7%.

Yuan spot exchange rate (USD/CNY)



Sources: Bloomberg, BBGI Group SA

According to China's central bank, currency reserves have dropped to their lowest point since 2011 ($3,052 billion). Reserves contracted by 70 billion in November, following the interventions in foreign exchange markets required by Donald Trump's election. It is likely that the trend will continue, in order to defend the current level of the Chinese currency.

A trade war would have consequences

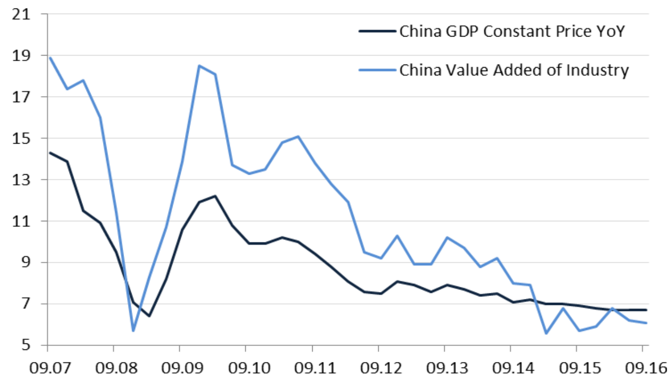
A trade war with China would have damaging consequences for the US.

Despite his impetuous declarations, it is not unlikely that the American President may ultimately be sensitive to the risks that a serious power struggle with China might have on the development of long-term interest rates and growth in the US. An acceleration of the disengagement process by China through massive and sudden sell-offs of Chinese positions could indeed cause a rise in interest rates that would be harmful to the current cyclical upturn. The introduction of a 45% tax on Chinese imports, as mentioned by Donald Trump, could well prove to be counter-productive for US consumers, especially since China could also take a tougher stance. Nevertheless, it is very likely that relations may become tense in 2017 with an increase in contentious issues and economic tensions, reflected by the US' request for arbitration to the WTO regarding the support granted by Beijing to its wheat and corn producers, which China recently blocked.

Stabilisation of GDP around +6.5% in 2017

Chinese GDP should end 2016 up between +6.5% and +7%. Indeed, the Chinese economy is still expected to grow +6.7%, supported by domestic activity that is finishing the year on a strong note. Indeed, retail sales increased by +10.8% in November, i.e. significantly better than in the previous month and exceeding expectations. We may thus estimate that the increase in consumption will continue at a sustained pace of about +10% in 2017. Industrial production also increased during the same period by +6.2%. Overall, it may be noted that China's economy is clearly ending the year with strong momentum that hints at a continuation of the current trend in 2017. We are far from the economic downturn heralded by doomsayers at the beginning of the year, which had given rise to exaggerated investor concern and a sharp decline in the equity markets.

Growth rates for GDP and industrial production



Sources: Bloomberg, BBGI Group SA

China's economic growth in 2017 should contribute positively to global growth.

Despite the future US President's harsh stance towards China, we do not expect any reckless decision that may radically affect trade relations between the two fundamentally linked partners.

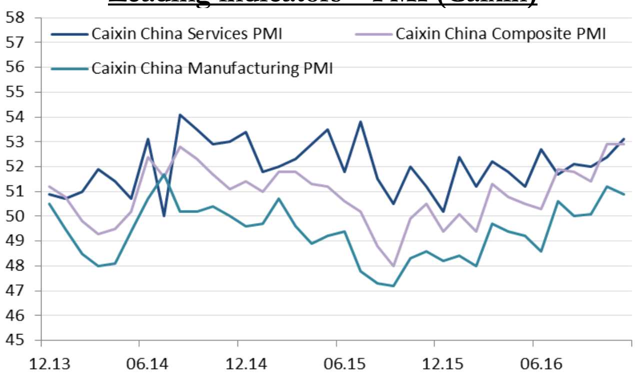
Leading indicators increasingly positive for 2017

Manufacturing activity has experienced modest growth, if we are to believe the Manufacturing PMI index released for the month of November, which is up from 51.2 to 51.7. The indicator is still above 50, indicating a moderate growth trend, which is nevertheless at its highest since 2014.

The weakness of the yuan has certainly contributed to the improved conditions in the manufacturing sector by enhancing its competitiveness. The situation is even better in the services sector, for which the indicator accelerated from 54 to 54.7 in November. China can thus still count on its service sector in particular to compensate for the absence of momentum in export sectors.

A divergence that emerged between official indicators and those published by the private firm Caixin (53.1 services; 50.9 manufacturing) suggests that major public companies may be benefitting a little more than private entities from the current economic upturn. The manufacturing sector is performing somewhat better, which should improve profit growth for industrial companies already up +9.8% in October year-over-year. Profits had reached around $90 billion thanks to more robust sales and rising prices.

Leading indicators – PMI (Caixin)



Sources: Bloomberg, BBGI Group SA

Surprising new dynamic for imports and exports

In October, Chinese exports benefitted from the devaluation of the yuan though much less so than from the global economic upturn in the US and Europe. Indeed, they increased by a small +0.1% yoy in November (revised to -1.6%), while most economists had anticipated a -5% fall.

The lower external demand that triggered this fall had compelled Chinese authorities to support growth through a rise in public expenditure and increased loans to banks. Imports also surprised with a +6.7% yoy growth (revised to +4.7%), partly due to an increase in the demand for commodities. Chinese customs have confirmed a trade surplus of $44.23 billion.

Trade balance, exports and imports (% yoy USD)

Sources: Bloomberg, BBGI Group SA

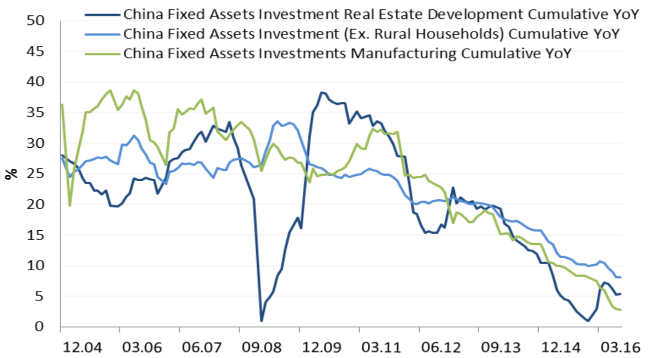
Stabilisation in the housing market will have limited effects on GDP in 2017

Real estate is still performing well in most urban areas in China according to the National Statistical Bureau's latest publication. Prices rose +12.6% yoy in November, even exceeding +25% in major cities (Beijing, Shanghai, Shenzhen). China's economy certainly benefitted from this factor in 2016 but it is encouraging to note a slowdown in sales and new projects in the last few months, following the government's stabilising measures, which should ultimately reduce the risks of a property bubble bursting.

The restrictions that a large number of Chinese cities adopted should curb the increase in prices and the sector's momentum by introducing limitations in terms of loans and financing for real estate acquisitions. Prices in Shenzhen in particular, often considered the driving force of real estate prices for all of China, fell -0.5% in October for the first time since 2014, showing possible signs of the beginning of a desired stabilisation of the market, which would likely have no major effect on expected growth for 2017, due to its limited weight of 15% of China's GDP.

Government spending has increased as expected and makes up for weaker growth in the private sector. The investment and public deficit-increasing policy supports growth but does not represent a major risk due to the relatively low budget deficit in relation to GDP (approx. 3%).

Investment growth in real estate, infrastructure and manufacturing (%)



Sources: Bloomberg, BBGI Group SA

Beijing hopes to attract foreign investors with its 'Connect' programmes

A significant new step in opening up Chinese capital markets was taken, which will certainly benefit China's equity markets in 2017. Foreign investors can now participate more easily in the growth of China's equity market thanks to the launch of the Shenzhen-Hong Kong Stock Connect. Indeed, since 5 December, it has become even easier to invest in renminbi-denominated shares thanks to the so-called Shenzhen-Hong-Kong Stock Connect programme, which completes the system already in place for stocks on the Shanghai Stock Exchange. These two programmes now give access to almost half of China's market capitalisation.

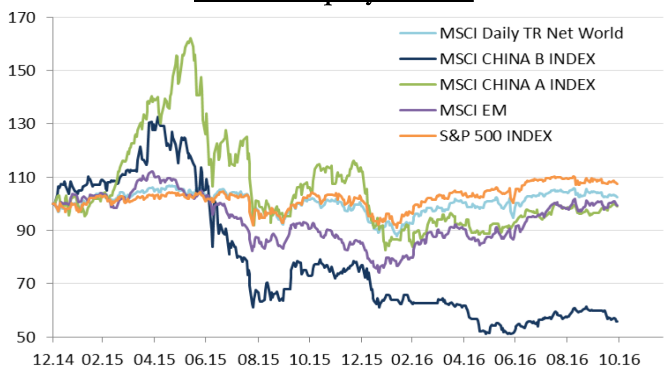
Let us not forget that the Chinese market represents one of the largest market capitalisations in the world. Transactions carried out in Shanghai and Shenzhen represent approximately 20% of all transactions worldwide.

Scarcely 1% of this market capitalisation is foreign-held, which provides a considerable margin for expansion for those who might also wish to share in the development prospects of the largest emerging market.

Better outlook for equities in 2017

China's equity market will probably not be able to make up for all the losses posted at the beginning of the year and will thus certainly end the year down, far behind the performance of the US. If Donald Trump's election has clearly suggested a change of attitude towards China's government and economic policy, leading to fears of tense relations and risks of economic warfare, we believe that 2017 should not witness any major effects on commercial transactions with China. Donald Trump's economic policy should have some positive effects on global economic growth and most likely on the demand for Chinese products. The equity market might initially benefit from a substantial change in pro-corporate profit growth predictions.

Chinese equity market



Sources: Bloomberg, BBGI Group SA

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