



China: fight the flight

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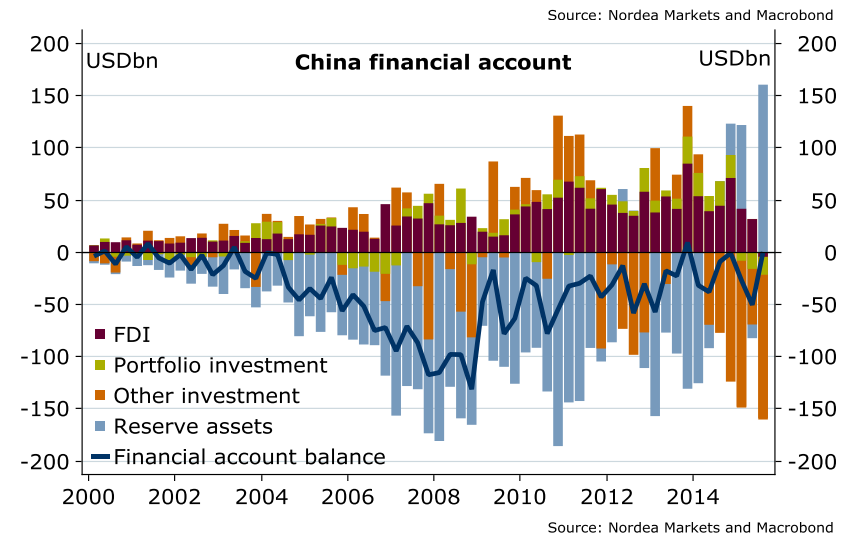
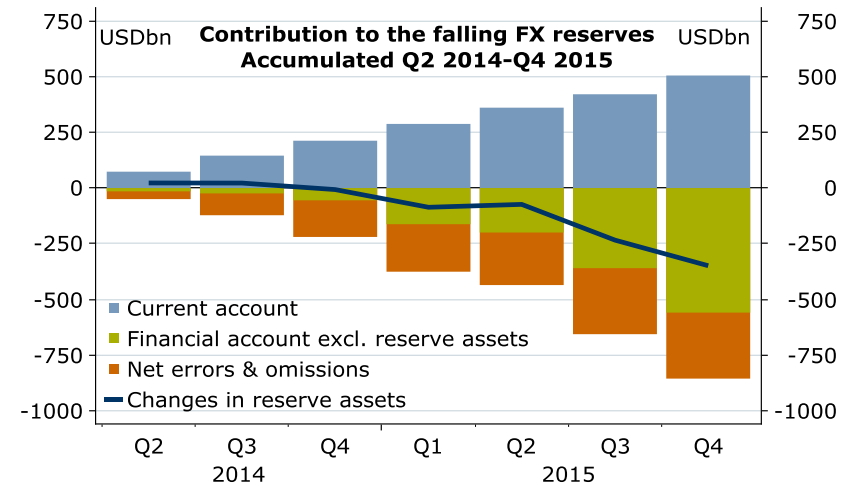


Executive summary

- The sell-offs in the Chinese stock market and uncertainties related to the currency are not a concern for financial market participants but becoming a headache for Beijing.
- As Chinese corporates and households are expecting more CNY weakening versus the USD, they have changed behaviour to optimise their balance sheets. FX liabilities were reduced, ie. FX loans were repaid, and FX assets, cash or deposits, were increased.
- This has led to unprecedentedly large capital outflows from China. A total of USD 850bn is estimated to have left the country since mid-2014. About USD 500bn of the outflows were offset by the current account surplus. Still, it left a funding gap of USD 350bn to be covered by selling the FX reserves.
- To mitigate the outflows, and hence the pressure on the FX reserves, the PBoC has utilised a number of tools, which we expect to succeed in the coming months. However, the risk of failure exists and then Beijing would face the dilemma between imposing stricter capital controls and a one-off devaluation. We expect capital controls to be preferred to devaluation.
- On the real economy, we still expect a soft landing as the most plausible scenario for 2016. This is mainly because of the very loose economic policy. We see largest risk for a hard landing on a 3-5 year horizon, triggered by a burst of the credit bubble.

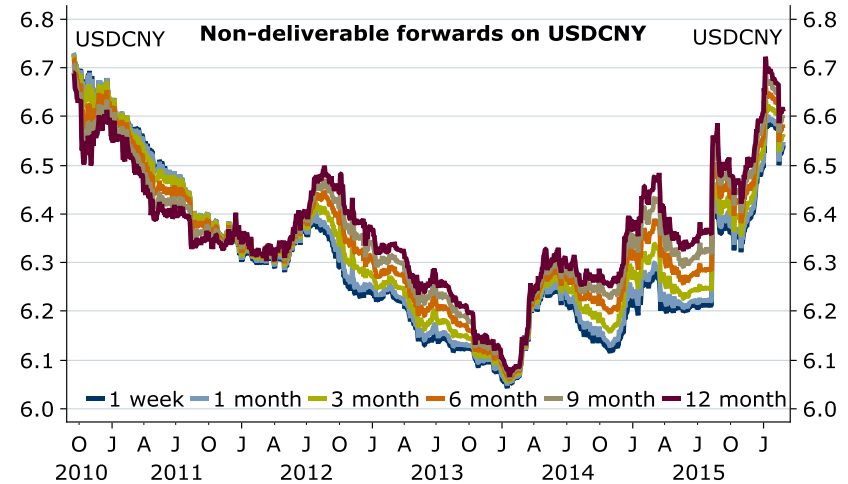
Unprecedented capital outflows

- Capital is flowing out of China at an unprecedented pace. USD 850bn is estimated to have left the country since mid-2014.
- The main source of outflows is Chinese residents moving capital out of the country rather than foreign capital leaving China. This makes China's current situation different than most earlier experiences from EM.
- Three main areas of capital outflows were:
 - *Chinese borrowers' external debt deleveraging*: Chinese companies rush to repay FX loans to avoid the additional cost related to weaker CNY.
 - *Chinese residents' increased FX holding*: households and companies' would rather hold FX given weaker CNY.
 - *Net errors & omissions*: when large, it could indicate illicit capital outflows.

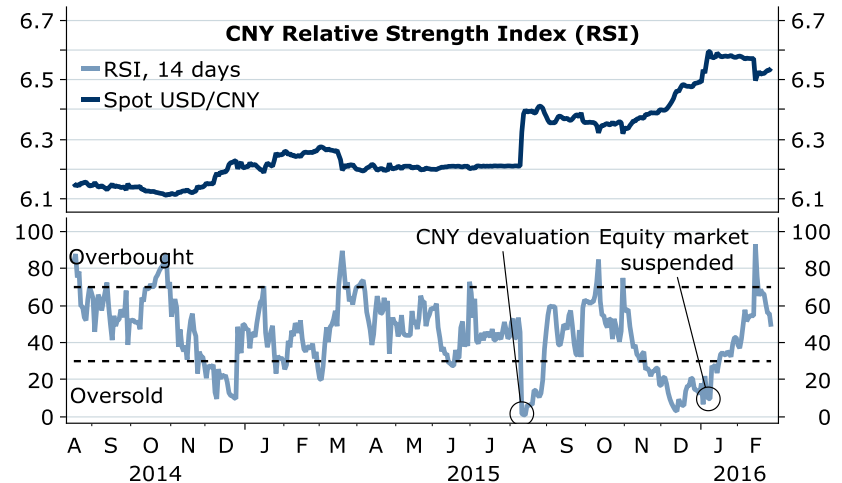


Outflows triggered by changing FX expectations

- The key reason behind the capital outflows from China was domestic players' changed expectations regarding the exchange rate.
- Since the CNY stopped its one-way appreciation against the USD in early 2014, the currency expectations have changed from strengthening to weakening, reflected by the forward rates of the USD/CNY.
- In order to optimise their balance sheets, households and corporates started to hold foreign currencies and corporates were motivated to repay FX loans at a faster pace to avoid extra cost.
- This behaviour has caused the CNY to be oversold in several occasions during the past two years and further intensified the depreciation pressure on the CNY. It is exactly the self-reinforcing effect of the depreciation pressure that Beijing is worried about.



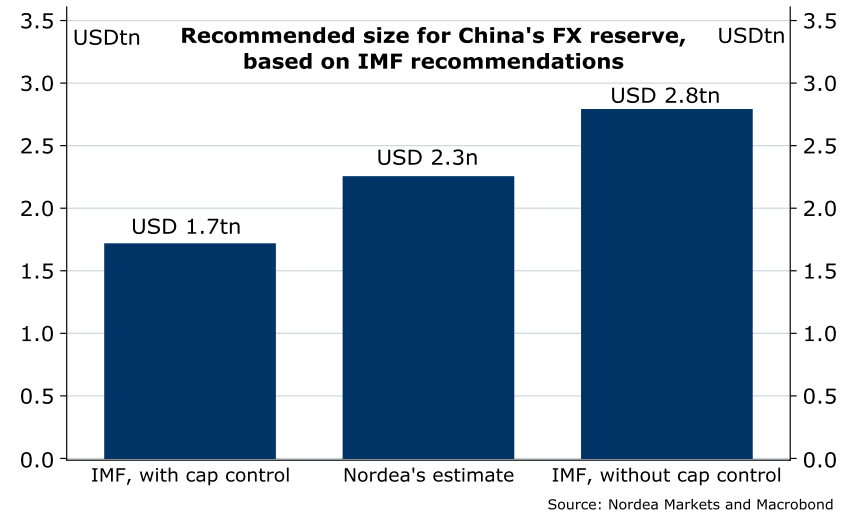
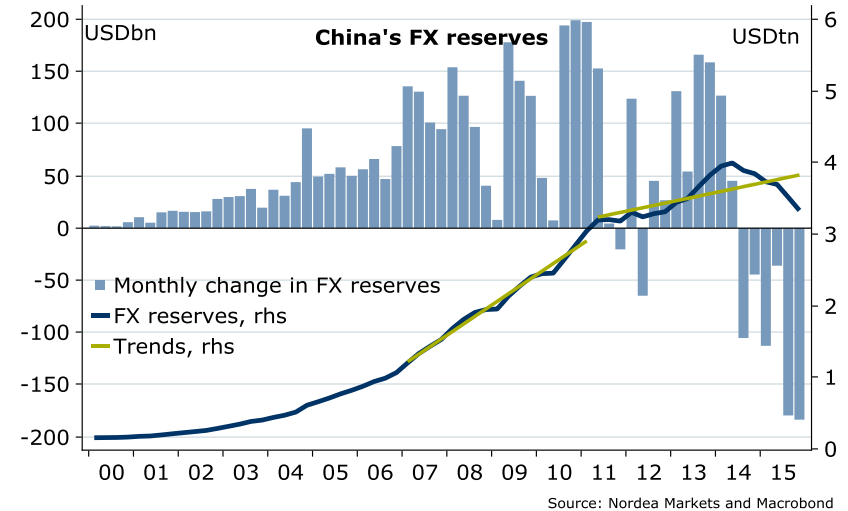
Source: Nordea Markets and Macrobond



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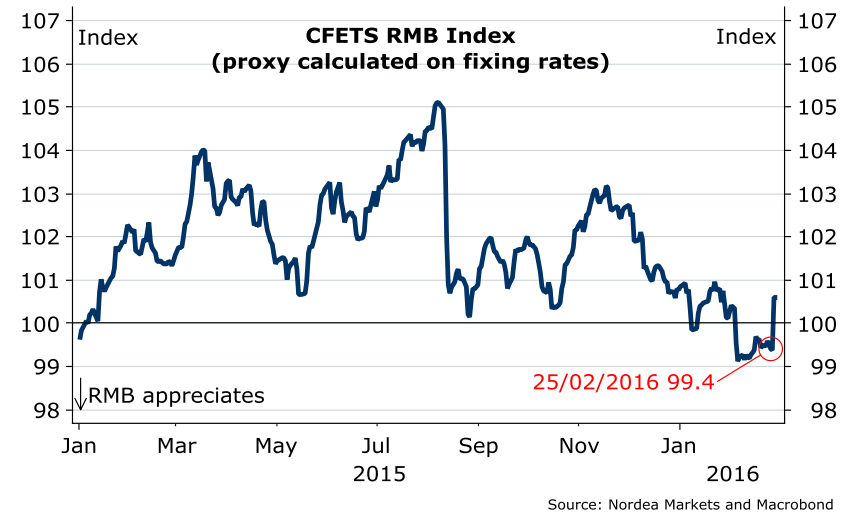
The FX reserves are not unlimited

- The roughly USD 750bn decline in China's FX reserves since mid-2014 has raised concerns. While the so-called valuation effects (strong USD) have contributed to the fall, a bigger reason was the PBoC selling foreign assets to cover the huge capital outflows.
- According to the IMF, a country with managed exchange rate should hold FX reserves no less than 10% of the exports, 5-10% of the broad money, 30% of the short-term external debt and 20% of other liabilities. This gives us that China should hold FX reserves of USD 2.3tn to meet the IMF's recommendation.
- In addition, President Xi would likely allocated some of the reserves on the One-Belt-One-Road initiatives. Thus, we see USD 3tn to be a threshold, in which Beijing does not want the reserves to fall below.



CNY: time for Beijing to prove itself

- As stated in the previous pages, the current depreciation pressure on the CNY and the rapid depletion of the FX reserves are alarming for Beijing.
- Thus, the PBoC has proven itself ready to go to a great length to avoid excess CNY depreciation. It has several tools: 1) stricter enforcement of the capital regulations; 2) clearer market guidance through the fixing rate; 3) verbal support from senior officials and; 4) support the equity market.
- In all above-mentioned tools failed to reduce the depreciation pressure, then Beijing has likely two options left: 1) imposing stricter capital controls on Chinese entities as they are behind the outflows; 2) one-off devaluation.
- We see capital controls more likely than devaluation because devaluation would most likely be counterproductive.

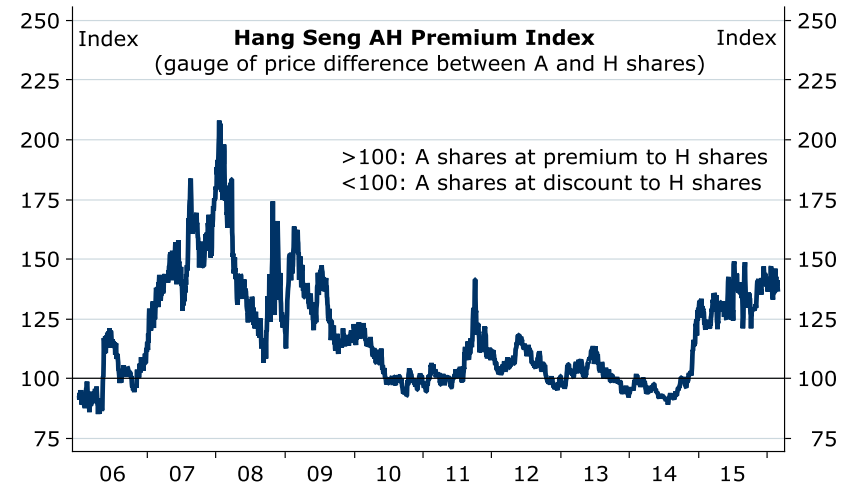


Equity: a new storm cannot be avoided

- After a very short time of some calmness in the Chinese stock market, we have seen a few days of large falls at the end of February. On the 25th February, the CSI300 index fell more than 6% without major triggers.
- The high volatility, reflecting high degree of investor nervousness, and the relative expensive valuation of the domestic A shares, are the reasons why we have taken a cautious stand on the Chinese domestic A shares.
- The high volatility exists despite most of the government stabilisation measures, brought in last summer, remain in place. Some of these measures are against the principle of a free market and therefore have to be scaled back at some point.
- When the measures are scaled back, the risk of new sell-off could return, triggering more price declines.



Source: Nordea Markets and Macrobond



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Further growth decline in the Year of the Monkey

- Apart from continue high uncertainties in the currency and equity markets, the real economy remains at status quo. The citi economic surprise index, measuring the degree in which macro data have disappointed market expectation, has not deteriorated dramatically.
- The latest macro data suggest still strong headwinds for the economy. Structural as well cyclical challenges will likely pressure the GDP growth rate further down. Beijing will announce the growth target for 2016 at the annual People's Congress, starting on 5 March. Rumours say a range of 6.5-7% is target rather than a fixed number.
- We maintain our view that although growth continues to trend downwards, the risk of an outright economic crisis this year is very small, due to accommodative policy.

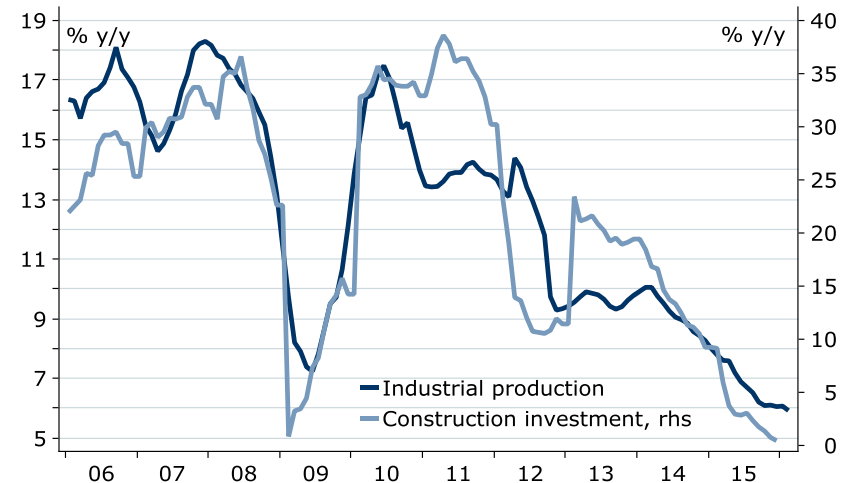


Manufacturing and exports struggle

- The latest data have confirmed that the manufacturing and export sectors will remain between a rock and a hard place in 2016.
- Hardships for the export sector is almost universal. The slowing global economy, with rising concerns about a new global recession, and discouraging signs of more protectionist measures are not speaking for a remarkable rebound in trade growth.
- Sluggish external demand is not the only downside factor for Chinese manufacturing. Domestic demand, so far led by the housing and construction boom, will be much lower than in the previous decade.
- Finally, the manufacturing sector, notably the heavy segments, is still suffering from excess capacity and large inventories. Both will take years to be brought down.



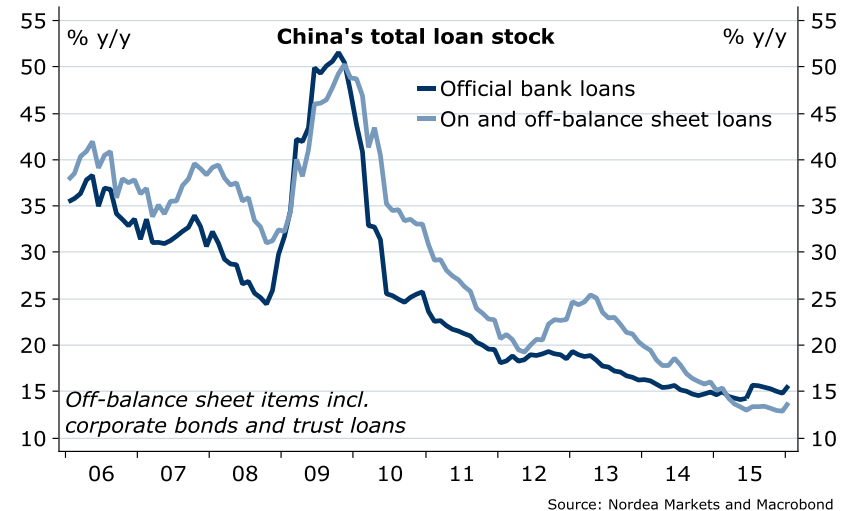
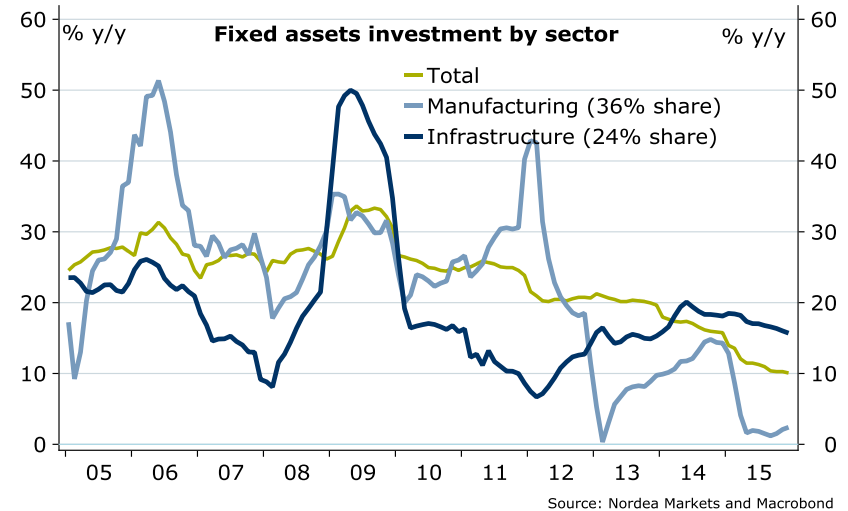
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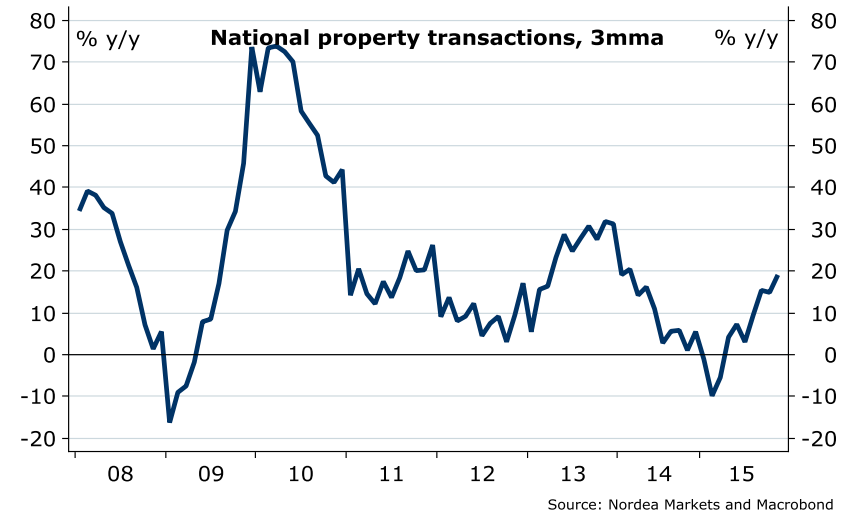
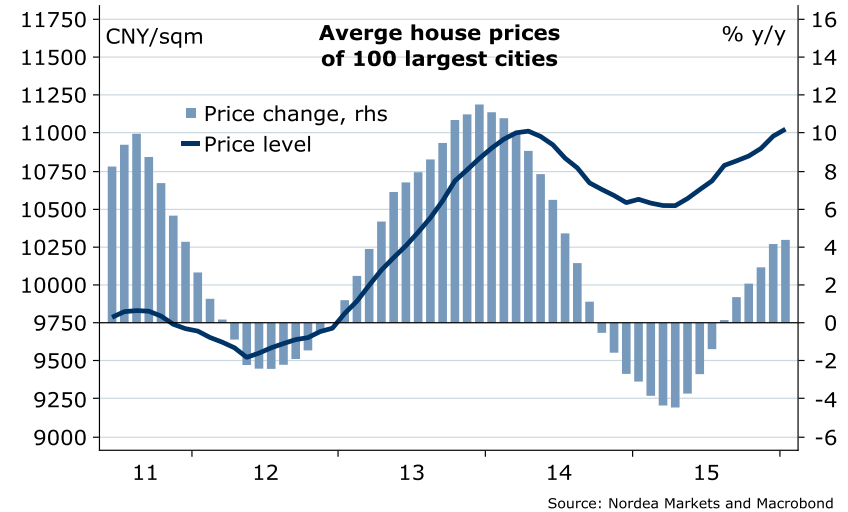
Large tailwinds from accommodative policy

- Although Beijing's tolerance for lower growth has increased, a gradual transition from high-growth phase to medium to high-growth phase is still high the agenda.
- Therefore, all form for economic policy will be kept very loose to support growth and prevent a too sharp slowdown.
- Fiscal easing is likely to be the dominant policy driver this year, with particular focus on public infrastructure investment in transport and utility.
- Infrastructure investment is expected to continue growing faster than 10%, while manufacturing investment growth would linger around zero. This is important to boost the share of infrastructure investment in overall investment.
- Credit will be abundant to support the investment projects.



Housing market also points upwards

- As we have argued during H2 2014 and H1 2015, the housing market would rebound once the house purchase restriction and other limitation were removed.
- Currently, the housing market is in tailwinds. During the just-concluded Chinese New Year holiday, house sales rose by 6.9% y/y for 15 tier one and two cities. This was remarkably better than the same period in 2015.
- Having said that, China's housing market contains some fundamental problems, for instance large differences between cities.
- Tier one housing markets are close to be overheated, with prices rising by 15-20% and demand far exceeding supply. In contrast, tier three and four cities have oversupply of housing and appetite from migrant workers returning for the holidays has been disappointing.



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