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Ashmore

The transformation of Chinese banks

By Jan Dehn

The world should pay more attention to China's banks. Four of the largest seven banks in the world are Chinese and the next few years will usher in dramatic changes that will put them on track to compete directly with the largest Western banks. Brazilian economic data points to a trough, while Modi makes good progress in cutting red tape in India. Greece rejects austerity as Europe comes face to face with the consequences of its denial of the debt overhang issue.

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	13.6	–	-1.38%
MSCI EM Small Cap	20.4	–	-2.81%
MSCI Frontier	10.9	–	-0.14%
MSCI Asia	12.3	–	-1.16%
MSCI EMEA	12.9	–	-1.23%
MSCI Latam	22.3	–	-2.16%
GBI-EM-GD	6.76%	–	-0.38%
ELMI+	4.22%	–	-0.53%
EM FX spot	–	–	-0.61%
EMBI GD	5.77%	335 bps	-0.03%
EMBI GD IG	4.55%	206 bps	0.07%
EMBI GD HY	7.86%	561 bps	-0.17%
CEMBI BD	5.53%	336 bps	-0.09%
CEMBI BD HG	4.47%	230 bps	-0.08%
CEMBI BD HY	7.50%	535 bps	-0.12%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	18.3	–	-1.16%
2 year UST	0.59%	–	0.07%
5 year UST	1.57%	–	0.23%
10 year UST	2.31%	–	0.24%
30 year UST	3.12%	–	-0.25%
US HY	6.91%	544	-0.35%
European HY	4.71%	467	-0.40%
Barclays Ag	–	441	0.22%
VIX Index*	16.79	–	2.78%
DXY Index*	96.31	–	1.52%
CRY Index*	224.55	–	0.21%
EURUSD	1.1051	–	-1.44%
USDJPY	122.67	–	-0.17%
Brent	59.0	–	-4.79%
Gold spot	1164	–	-1.25%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

Emerging Markets

- **China:** Amidst ongoing concerns about recent volatility in the Chinese stock market, far too little attention is being paid to the prospect of a dramatic transformation of China's banks over the next few years. The outdated view of Chinese banks is that they provide long-term loans for local governments to implement infrastructure projects. For decades this activity did indeed dominate Chinese bank activity and saddled China's banks with some RMB 11trn of largely non-tradable local government loans on their balance sheets.

For some time, Chinese policy-makers have been engaged in a complete overhaul of the banking system. This has become necessary, because without a reduction of the banks' large exposure to local government loans China's ambition of becoming a consumption-led economy cannot be fulfilled. Room needs to be made for conventional consumer and corporate finance activities to stimulate the consumer economy.

The transformation of China's banks into providers of consumer credit and private sector corporate finance is now well underway. Banks are also emerging as providers of more sophisticated asset management services and more diversified savings products. In short, China's banks are becoming much more like conventional, Western-style banks.

This transition is ambitious and not without risks. To unclog their balance sheets, Chinese banks have started to swap their non-tradable local government loans into tradable 'muni' bonds of various maturities. So far, RMB 2trn of swaps have been undertaken, with more to come although the bonds have not yet been set free to trade. Eventually, the muni bond market in China will reach USD 1.7trn, making it larger than the entire dollar-denominated Emerging Markets (EM) corporate debt market and roughly half the size of the US muni bond market. These bonds on the bank balance sheets will likely be off-loaded into a rapidly growing asset management industry within which China's banks themselves will play an important role. As such, China's banks will be instrumental in 'discovering' the appropriate market price for individual muni bonds as they become tradable. Muni bond spreads will gradually come to reflect the quality of individual local governments' management, transparency, etc. The process will initially mean higher borrowing costs for local governments and potential losses for banks to the extent that the loans are not marked at fair value.

Another challenge is that China's long-term savings industry – pensions and insurance – is still immature. These savings institutions will eventually form the backbone of the savings industry due to their very long-term investment horizons, but in the interim the market will still be dominated by banks and other short-term investors that at times can generate plenty of volatility.

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Emerging Markets

Despite these challenges, banks are likely to benefit hugely from the emergence of China's fixed income market. Chinese savers have far too little fixed income in their portfolios, because fixed income has either been unavailable or has offered unattractive yields due to the suppression of interest rates. But China is now liberating interest rates and the sheer scale of China's reforms is causing the economy to slow. Temporarily, this renders returns in both property and equity markets somewhat less reliable than those in fixed income. In this environment, bonds will gain in relative attractiveness as they enter the savings pools and help to stabilise them (more stable savings pools will stimulate consumption by reducing the level of precautionary savings).

Chinese banks are likely to exploit what we believe will prove to be a secular demand for Chinese fixed income from domestic investors as well as rising interest from overseas investors as the RMB becomes a global reserve currency. They have huge first-mover advantages, because so few foreign firms have invested enough resources in onshore research capabilities. Banks will also play a pivotal role in the conventional corporate fixed income market. Differentiation will also emerge in the performance of Chinese corporates as interest rates are liberated; there will be a competitive advantage for those investors who have local research knowledge and an active approach to management.

Chinese banks will also be big players in the market for central government bonds and senior policy bank bonds. These bonds will occupy the role of 'risk free' securities, not just within China, but increasingly also among global fixed income investors. In our view, there is no such thing as a 'risk free' market, but at least China's government bonds have the distinct advantages over government bonds in developed economies that: (a) they pay a much higher real yield (200bps for 5 year); (b) China's central government is far less indebted (about 26% of GDP); (c) the Chinese economy is growing much faster (about 7% real GDP growth; (d) the central bank has nearly USD 3.9trn in FX reserves; and (e) China is pro-actively reforming to keep ahead of events. Hence, for Chinese banks the future not only promises enormous changes to how they do business, but also a heady mix of new risks and opportunities. The world ought to pay more attention. Four of the seven largest banks in the world are Chinese, including the two largest. Ultimately, we believe that China's banks will succeed in their transformation to modern private sector lenders and major asset management entities, which will make them extremely influential on a global scale. They will, in our view, directly challenge the very largest European and US investment banks across many lines of business.

- Brazil: Recent economic indicators may be pointing to early signs of a trough. Brazil racked up a USD 4.5bn trade surplus in June. This was stronger than expected (USD 4.0bn) suggesting that the measures implemented to contain domestic demand are beginning to bite. Imports declined 21% yoy in June. There are two downsides from the economic pain. Firstly President Dilma Rousseff's approval rating has declined to just 15% – though from a market perspective this is positive, because it forces the president to continue to rely on support from the pro-adjustment centrist PMDB party. Secondly, the fiscal deficit now stands at 7.9% of GDP.

- India: Fresh data from the government reveals that the Modi administration is making good progress in cutting red tape and executing previously stalled projects. At the start of the Modi administration the equivalent of 8.4% of GDP worth of projects had been stalled due to various issues. Since that time, the percentage has fallen to 6.6% of GDP. We expect further improvement in the coming year, a pickup in new project implementation and finally a pickup in private sector investment as well. This is one of the reasons we remain bullish on the Indian growth story.

Snippets:

- Argentina: A new poll shows that Daniel Scioli leads Mauricio Macri in the race for president by a margin of about 8%.

- China: Services PMI declined to 51.8 in June from 53.5 in May, but remained above the 50 level associated with expansion. HSBC's manufacturing PMI rose to 49.4 in June from 49.2 in May. Official PMI was unchanged in June at 50.2. In response to recent stock market volatility – the market is up 76% over the past 12 months but also down 29% since early June – the government has launched a number of measures, including suspension of the IPO pipeline, a stabilisation fund for 21 stock brokerages, capital injections for the regulator's unit that provides margin lending and higher trading costs. China also recently cut rates and eased reserve requirements.

- Ghana: The government is preparing to pass legislation that would allow municipal administrations to issue debt to finance capital projects. Similar legislation applies to the central government. The restriction that funding can only be used for projects has not prevented Ghana from running massive fiscal deficits and accumulating mounting debts. We suspect a similar objective may lie behind the proposal to allow muni bonds.

- Malaysia: The current account surplus in May was MYR 5.5bn. This follows a trade surplus of MYR 6.9bn in April. Ratings agency, Fitch, affirmed Malaysia's A- rating and revised the outlook to stable from negative.

- Mexico: Credit to the private sector rose 7.3% yoy in May in real terms. The demand side in Mexico has recently been picking up slowly. The benefits of Mexico's recent reforms will now reveal themselves as Mexico will be able to grow for longer before encountering inflation.

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Emerging Markets

- **South Korea:** The government has responded to the outbreak of MERS by enacting a fiscal stimulus package worth about 1% of GDP. The package will primarily provide additional resources to the health and tourism sectors that have been impacted by the outbreak. The current account surplus was impressive in May. At USD 8.7bn, the cumulative surplus year to date now stands at USD 40.2bn, despite the pressure from a weaker JPY.
- **Turkey:** Headline inflation fell 0.5% mom in June, but the decline was principally due to food prices. Core inflation remains high at around 9% on a three month annualised basis. The central bank's unorthodox monetary policy framework has never won credibility, which means that headline inflation tends to impact core inflation asymmetrically. Lower than expected headline inflation does not reduce core, while higher than expected headline inflation adds to core.

Global backdrop

The policy of denial of debt overhangs in the developed economies has now come to a head as Greek voters overwhelmingly rejected further austerity measures, even at the risk of flunking out of the Eurozone. Ironically, the scale of the popular mandate given to SYRIZA's populists to stand up to Europe now gives them considerable political capital to avoid a Greek exit from the EUR. The resignation of Finance Minister Varoufakis suggests that Prime Minister Tsipras is willing to compromise heavily to stay in the club, in our view. The Greek situation retains a surreal quality as European politicians refuse to recognise the futility of trying to rectify an unsustainable debt burden with austerity and no debt relief. Focus now shifts to the ECB, which must decide on collateral haircuts and the scale of Emergency Liquidity Assistance, while German Chancellor Merkel and French Prime Minister Hollande will meet to discuss what to do next. ECB President Mario Draghi will be listening carefully to the outcome of this meeting, which will determine whether he must cut funding to Greek banks or not. We believe Draghi has the tools to support the rest of the periphery, so we do not see a big immediate risk of wider contagion, though beneath the surface most of these countries remain too heavily indebted for comfort and thus entirely dependent on ECB 'life support'. It ought to trouble investors that developed countries are struggling with debt-related problems at a time of hyper-easy monetary policies. Greece is not the only country in trouble. Puerto Rico's governor also announced that Puerto Rico's debts are not payable. Other entities in the US have also defaulted.

As for the prospect of tighter monetary policies, the probability of a rate rise from the Fed as early as September declined last week following weaker than expected labour market data. Participation rates declined, earnings were soft and payrolls were revised down. Initial jobless claims, vehicle sales, Chicago PMI, Case Schiller home prices and factory orders also disappointed, but personal consumption spending, ISM manufacturing, ADP and construction rose more than anticipated. US growth is now tracking 2.2% for Q2 following -0.2% growth in Q1. Even a further pickup in H2 2015 is unlikely to bring the growth rate for the year much higher than 2% for the year as a whole, in our view.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.74%	2.29%	-6.70%	3.07%	3.95%
MSCI EM Small Cap	-1.02%	7.20%	-1.57%	7.27%	5.26%
MSCI Frontier	-0.19%	-3.68%	-15.04%	12.24%	7.26%
MSCI Asia	-0.40%	5.10%	2.14%	9.06%	7.95%
MSCI EMEA	-1.24%	2.80%	-15.21%	-2.08%	1.84%
MSCI Latam	-1.11%	-7.29%	-24.75%	-8.95%	-4.71%
GBI EM GD	-0.23%	-5.09%	-15.31%	-4.15%	0.69%
ELMI+	-0.05%	-1.27%	-10.23%	-2.11%	-0.19%
EM FX Spot	-0.45%	-7.40%	-19.53%	NA	NA
EMBI GD	0.33%	2.00%	0.89%	4.32%	6.84%
EMBI GD IG	0.20%	0.74%	2.53%	3.20%	5.90%
EMBI GD HY	0.50%	3.65%	-2.68%	6.06%	8.20%
CEMBI BD	0.12%	3.82%	2.47%	5.22%	6.23%
CEMBI BD HG	0.01%	2.28%	3.16%	4.73%	6.03%
CEMBI BD HY	0.30%	6.72%	0.68%	6.45%	6.82%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.69%	1.93%	7.34%	17.47%	17.67%
2 year UST	-0.01%	0.88%	1.24%	0.63%	0.78%
5 year UST	-0.07%	1.34%	2.70%	0.89%	2.46%
10 year UST	-0.24%	0.31%	3.30%	0.89%	3.64%
30 year UST	-1.10%	-5.78%	2.82%	-0.39%	4.56%
US HY	0.21%	2.97%	-0.57%	6.91%	9.03%
European HY	0.44%	2.83%	2.66%	11.38%	11.52%
Barclays Ag	-0.40%	-3.47%	-6.86%	-0.97%	1.78%
VIX Index*	-7.90%	-12.55%	62.69%	0.78%	-44.26%
DXY Index*	0.86%	6.69%	19.98%	15.51%	14.54%
CRY Index*	-1.15%	-2.35%	-26.79%	-23.27%	-11.76%
EURUSD	-0.91%	-8.67%	-18.78%	-10.09%	-12.56%
USDJPY	-0.45%	-2.31%	-16.98%	-35.06%	-28.72%
Brent	-7.16%	2.98%	-46.64%	-39.87%	-17.37%
Gold spot	-0.84%	-2.02%	-11.57%	-26.51%	-2.50%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.

Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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