Heartwood Investment Management

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Investment Insight

Weekly Insight

China: Coming back into focus

China has not been a source of concern for investors in 2017 as perhaps might have been feared. In fact, economic growth came in better than expected in the first half of the year and data has been on an expected gently slowing trend since. Investors have perhaps being lulled into a false sense of security, given how well China's equity and currency markets have behaved. Nonetheless, we believe that as the Chinese authorities continue to deleverage specific areas of the economy, these actions may have the capacity to create pressure points in 2018, leading to potentially more volatility in economic data and, crucially, in markets - albeit from very low levels.

Deleveraging has been a policy priority for China's authorities over the last 18 months and will continue to be a key focus for investors. Efforts to rein in risks in the credit markets have not been achieved by conventional means – i.e. lowering interest rates – but instead through an emphasis on regulatory reform; the impact of which is starting to be felt in China's bond market. Ten-year government bond yields in China broke through 4% at the end of November for the first time since 2014.

A significant driver of the move higher in yields over the past couple of months has resulted from the reduction in bond purchases from small banks and asset management funds. These institutions have been expanding their balance sheets to a lesser extent, evidenced by a lower take-up of newly issued government bonds. Demand for bonds is likely to be further undermined by the latest proposals from the People's Bank of China (PBOC) to limit the use of leverage in the 102 trillion yuan asset management industry.

With new regulations and reduced bank demand pushing up borrowing costs, market concerns around liquidity may pick up over the coming weeks and months. In the near term, these concerns could be accentuated by banks hoarding cash in December ahead of year-end reporting. Higher borrowing costs could also place pressure on those large institutions, such as China's Development Bank and local government investment vehicles, which need to refinance maturing debt in 2018.

Hitherto, China's authorities have stepped in with sizeable injections to support liquidity and there is little to suggest they will change their behaviour. It is worth emphasising that the PBOC has made sure that volatility in the much watched seven-day repo market – the effective rate at which banks lend to one another – remains low by historical standards.

The slowdown in housing is expected to be moderate

As well as the financial system, we have also seen deleveraging measures take effect in China's housing market. These measures have been targeted at the largest Tier 1 cities – Beijing, Shanghai and Shenzen. Annual growth in property sales in both volume and value terms has contracted and the trend may deteriorate further owing to base effects.

While housing construction activity is expected to slow, there are reasons to believe it will be only a moderate slowdown as opposed to anything more sinister. In smaller cities, where the focus is on destocking inventories through favourable policies, prices have continued to increase on a month-to-month basis, albeit at a slower pace. In fact, overall levels of housing inventories are at their lowest point since 2013. Further support to construction activity in 2018 is likely to result from strong land sales to developers in 2017. And while housing

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starts have seen a steady slowdown since the summer, the trend appears to be bottoming.

None of the above changes our view of expecting a moderate slowdown in Chinese growth together with targeted tightening measures. However, after what has been a relatively benign 2017, investors may see more market volatility next year from very low levels.

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