

EMERGING MARKETS

Pricking the bubble

INVESTMENT CONCLUSION

China's moves to tighten credit mean that it is now ahead of the Fed in taking action to curb 2009's government-induced boom (Figure 1). The Chinese credit bubble is now set to burst and that will hit global growth and the commodity boom this year.

We would be underweight global equities (holding only defensive sectors), including Asian equities. And we would be short industrial commodities from here.

ANALYSIS

The Chinese authorities have started to tighten monetary policy in response to growing fears that the economy is overheating and inflation is accelerating. On Tuesday, China's central bank, the People's Bank of China (PBoC), raised the reserve requirements of China's commercial banks by 0.5% pts, effective 18 January. The ratio refers to the proportion of deposits that the banks are required to hold at the PBoC.

This came on top of the PBoC raising the yield on its own paper for one-year securities by 8bp to 1.834%, the first time there has been a rise in 20 auctions. At the same time, it increased the size of the auction for this paper to Rmb20bn (\$3bn). This is the largest single drain of liquidity via the repo auctions seen for over two years. Overall, the PBoC is taking about Rmb600bn out of the banking system with these two measures.

In effect, it has removed any excess reserves that the commercial banks still had and attempted to compensate for the massive expansion of new bank loans. In the first week of January alone, new bank lending rose Rmb600bn. From now on, the banks can only lend at the same rate that their deposits rise.

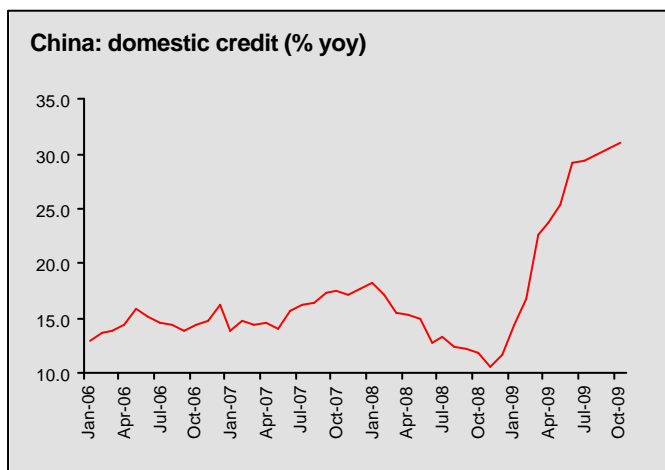


Figure 1. Source: Datastream

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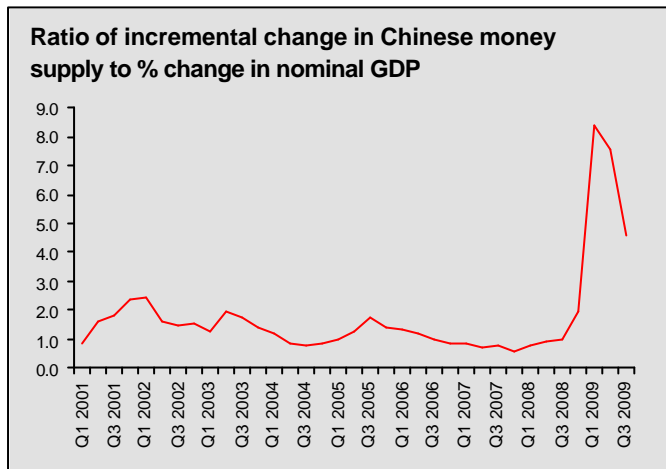


Figure 2. Source: Datastream, Independent Strategy

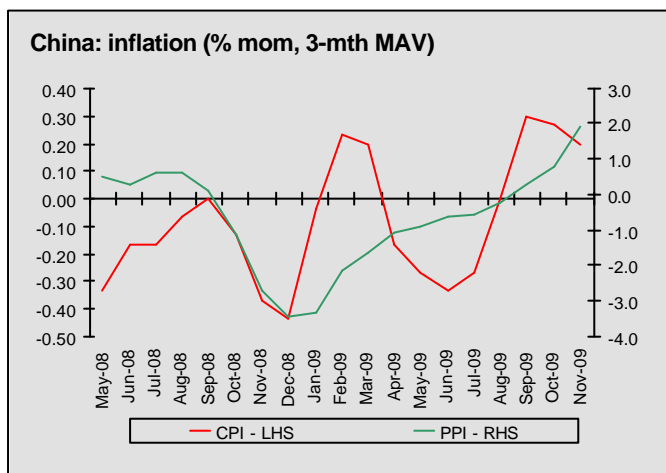


Figure 3. Source: Datastream

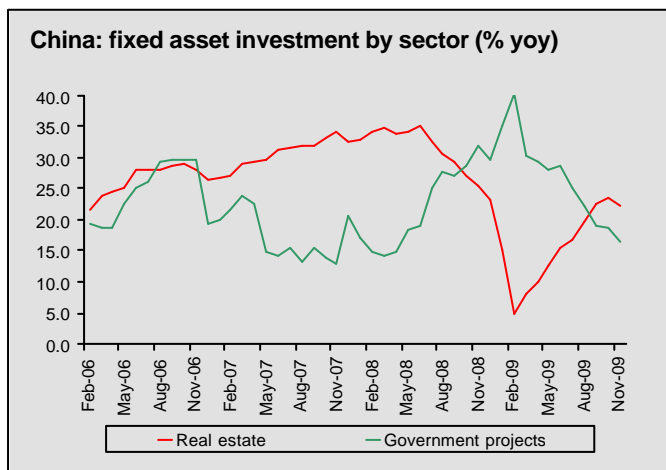


Figure 4. Source: Datastream

As we explained in our two reports on China last year, *Wonton China*, 12 August 2009 and *Bubble, bubble, toilet trouble*, 17 November 2009, the Chinese growth ‘miracle’ in 2009 was really just a product of massive fiscal and monetary stimulus ordered by government *dictat*. A Rmb4trn (\$600bn) fiscal stimulus programme was backed up by a rise of over Rmb9trn (\$1.3trn) in new bank loans used to boost investment and infrastructure.

But increasingly, much of this injection of liquidity has gone into stockpiling commodities and raw materials, increased overcapacity in industry and a real estate bubble. Increased productivity in industry, which could sustain economic growth without inflation and overheating, was missing. Indeed, the incremental increase in credit relative to GDP growth reached record proportions, revealing the fall in capital productivity (Figure 2).

Now the signs of overheating are becoming obvious even to the one-eyed views of the Chinese authorities and the optimists of a benign global recovery in the West. Imports are now rising at a much faster pace than expected as China continues to suck in commodities.

Inflation is accelerating: consumer prices rose 0.6% yoy in November from a fall of 0.5% yoy in October, while the yoy decline in producer prices in November was just -2.1%, easing from -5.8% yoy in October. Monthly rises are now racing upward (Figure 3).

At the same time, the property boom is out of control with investment in real estate outstripping even government infrastructure spending (Figure 4), while M1 money supply has soared to 35% yoy, faster than M2 deposits for the third consecutive month. China is awash with liquidity that is fuelling asset bubbles.

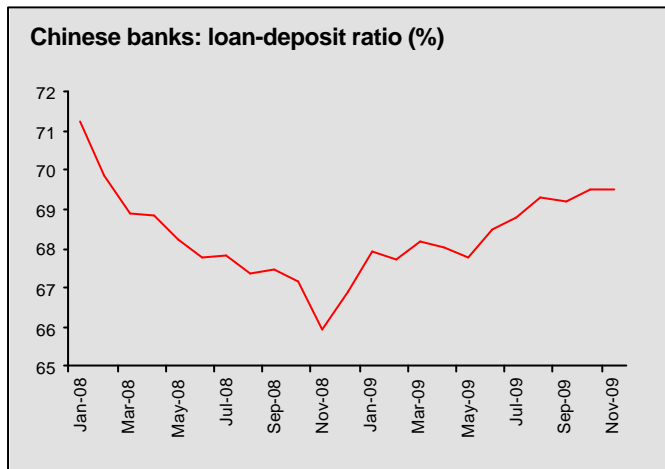


Figure 5. Source: Datastream

These moves by the PBoC are the first signs that the authorities intend to clamp down on these excesses. The trouble is that bubbles don't usually deflate, they burst. If the commercial banks can no longer lend without increasing deposits, new lending will stall fast.

Whereas bank deposits were growing at an annualised rate of over 40% this time last year, deposit growth has now slowed to a single-digit rate. The loan-deposit ratio is also at its highest level for two years and was heading towards the 75% limit set by the Chinese Banking Regulatory Commission (Figure 5). So there is little room for expanding loans from here.

Squeezing lending will mean China's already weak consumer will find it more difficult to buy. And the demand for commodities will fall away. Many are hoping that this will lead China to allow an appreciation of the renminbi so that exporters to China can gain from an increased purchasing power of Chinese consumers. But it's more likely that China will simply restrict domestic demand, while keeping the renminbi weak to help its own exports. The mercantilist model will remain and the great consumer revolution will be postponed.

If so, China's credit tightening in 2010 will be a major hit to global growth this year.