



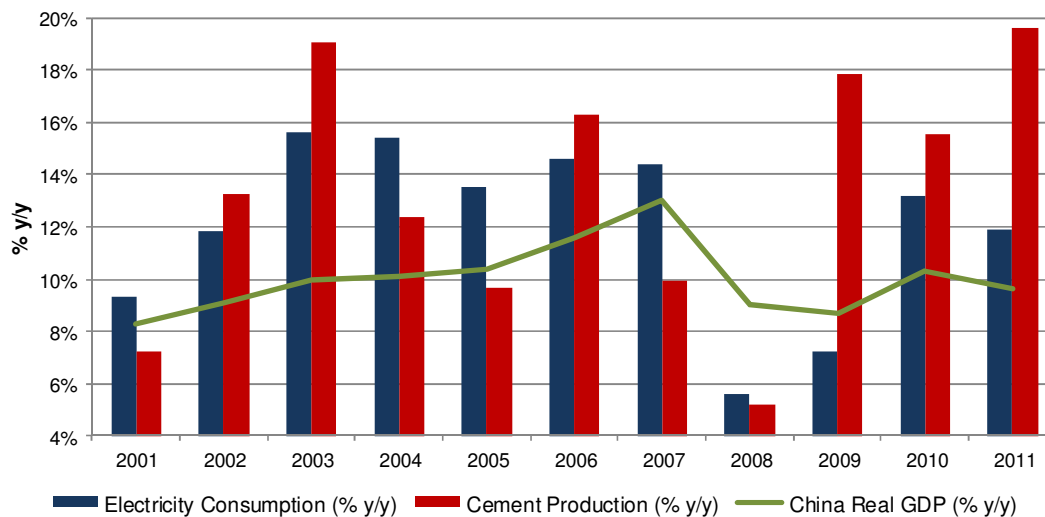
Fortnightly Economic Snapshot

03 October 2011

China Facing Construction Materials Glut

- September and October are normally strong consumption periods for steel in China but ongoing credit tightening and delays to rail investment have hurt demand; the boost from the government's 10m unit social housing project (which always flattered to deceive in terms of actual new units built) is waning, **leaving rebar prices sliding amid fears of a glut**. The cement sector looks even more vulnerable to a reality check; **China's cement output increased 19.2% y/y to 1.13bn metric tons YTD**, or 1.8 percentage points higher than that in the same period of 2010.
- It's hard to see how a slowing construction sector can absorb this output**, as the gap between floor space started and sold widened to 850m square meters on an annualised basis in H1, from 600m in 2010, and a pre-stimulus historical average of 200m. Developers are facing growing difficulty in obtaining offshore funding, while prices are being slashed by 15-20% on many new developments to generate cash flow. **This backdrop has driven the recent slump in industrial metal and particularly copper prices, which fell by 25% in September.**

China Cement Production Boom Unsustainable



Source: NBS, NDRC, 2011 GDP H1, other data YTD August

- China has doubled its loan ratio from below 100% of GDP before the Lehman crisis to roughly 200% today on IMF estimates, including off-balance sheet lending. Fitch Ratings have estimated that in July that **credit growth was still running at a 38% y/y, including off-balance sheet financing such as letters of credit, trust loans and loans from HK banks**. About 55% of all new lending now comes from outside the banking system, or three times the level in 2006. China's credit boom is significantly bigger relative to GDP than that in the US before the sub-prime crisis, or even in Japan in the late 1980s.



- As ever, **the law of diminishing marginal returns applies; the incremental return on credit in terms of GDP growth and cash flow has declined rapidly.** Ratings agency Fitch believes that non-performing loans could rise ten-fold from 2% of GDP last year. The PBoC is now belatedly targeting the methods used to circumvent monetary controls, and **aims to remove \$150bn in credit over the next six months, further pressuring construction activity sponsored by China's local governments,** which have built up \$1.7trn in liabilities in a wild building spree.

Emerging Market Currencies Slump As Bond Spreads Surge

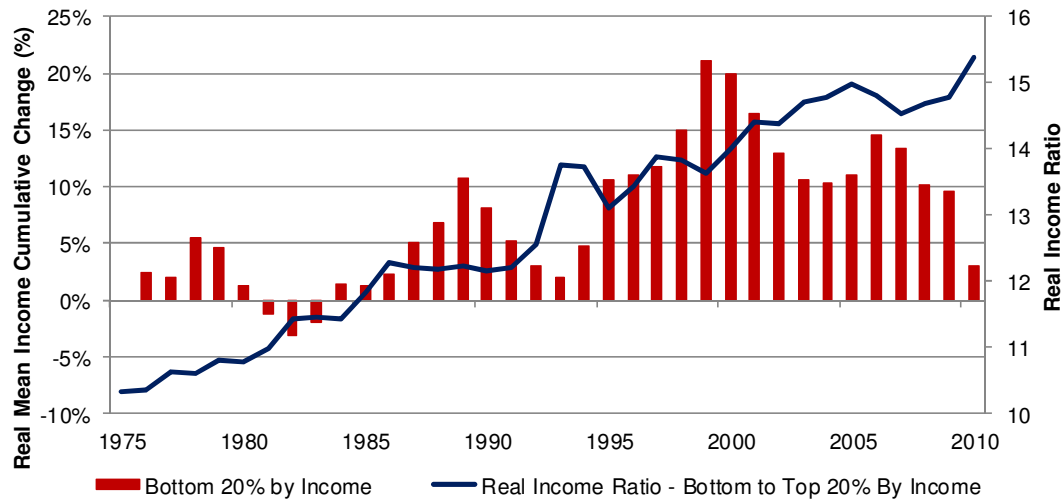
- The MSCI Emerging Markets share index has fallen for five consecutive months, but EM sovereign and corporate bonds have also seen accelerating portfolio outflows in recent weeks and as a result, **Asian currencies had their worst month since the 1997 crisis.** All major emerging market currencies fell against the USD in September, **with the Brazilian real tumbling over 14%, the South African rand 13% and the Russian ruble almost 11%.** For all the 'decoupling' hype, Asia in particular remains acutely vulnerable to the euro zone crisis, as Europe is both its largest export market and funding source.
- **The JPMorgan EMBI Global Diversified index of sovereign and corporate bond yields for emerging markets jumped to a one-year high of more than 6.3% last week,** and the spread over US Treasury yields has reached 460bps. EM debt had become a dangerously crowded consensus trade, with **30% or more of local issuance in foreign hands from Korea to Malaysia and Indonesia.** Longer term, a stronger dollar and weaker EM currencies **runs contrary to the global growth rebalancing narrative,** and if sustained into 2012 would generate rising trade tensions as well as sustaining regional inflation momentum.
- A sustained reversal of the huge portfolio capital inflows seen into EM debt **would result in significantly higher borrowing costs for countries most reliant on foreign bond buyers.** It could rapidly **become a real growth headwind, particularly if associated with a simultaneous withdrawal of funding by euro zone banks** which have 4x the balance sheet exposure to Asia as US; EM corporates have about \$1trn to refinance over the next 12 months.
- In the 2008 financial crisis, **European banks (which were relatively insulated overall from the US subprime crisis) cut lending to Asia by 20%, and that could be a lot worse this time if decisive action isn't taken to alleviate funding pressures in the euro zone.** In response to downside growth and funding risks, we've seen Brazil, Turkey, Israel and Russia reverse policy and cut rates recently and more EM central banks look set to follow, despite ongoing inflation pressures.

Record Income Inequality Becoming Political Focus

- Perhaps the most politically contentious aspect of President Barack Obama's new proposed legislation to boost the still-struggling US economy is **\$1.5 trillion in tax increases, much of it aimed at wealthy Americans.** The White House is calling this "the Buffett rule", named for investor Warren Buffett's complaint that he pays a lower tax rate than some of his most menial wage employees. **The legislation would be designed to ensure that anyone making more than \$1 million per year will pay at least the same rate as middle-income taxpayers.**
- **Income inequality in the US is now at levels now seen since the 1920s** (with the top 1% doubling their share of income since the 1970s), **a period also defined by huge credit and asset bubbles.** Between 1913 and 1928, the ratio of private credit to the US economy nearly doubled as households tried to compensate for depressed real wages with debt, with clear parallels to the recent experience. **The ratio between the real mean earned household income of the bottom and top 20% of American households has reached over 15x in recent years; that between the top 5% and bottom 20% has reached over 26x.**



Real Income Growth Negligible Since 1970s for Bottom 20% of US Households



Source: US Census, BLS

- In fact, many of the country's wealthiest investors such as hedge fund manager Jim Chanos have joined Buffet in pointing out the regressive nature of marginal tax rates in the US, when various deductions and loopholes open to the highest income groups are taken into account. **Academic economists are beginning to study the parallels between the 1920s and the last decade to try to understand why both periods ended in financial chaos.**
- Early evidence suggests that when productivity growth runs far ahead of real median wages, as it did in both periods, we end up with **an economy which experiences sustained and extreme levels of income inequality, and inherently one where credit bubbles and macro instability become an ongoing feature.** Signs of a backlash against blatant inequality now abound, from a US and European crackdown on offshore tax havens to Beijing banning luxury goods billboards on its streets as well as the crackdown on luxury real estate speculation.
- China's Gini-coefficient, a standard economic measure of income inequality, is the highest of any major emerging economy apart from South Africa and the country's relatively backward income and consumption tax system so far has done little to redress this divergence. Ultimately, **the US economy can't sustainably recover nor China's rebalance without addressing the structural issue of skewed wealth and income distribution.**

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