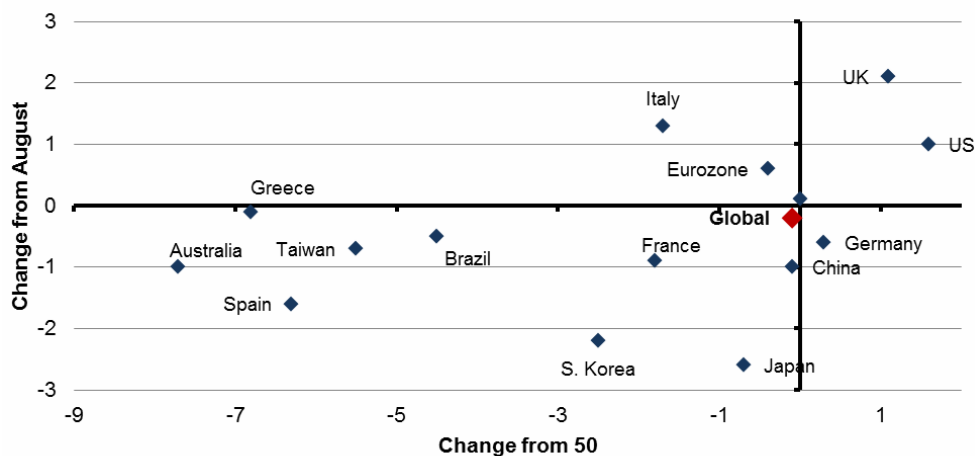


## Global Economics & Strategy

### The End is Nigh, But Watch China Credit Stress...

- Of the current slump in global risk assets that is, not the world. While groping for a bottom is something fund managers are generally safer doing in Wan Chai nightclubs than markets (and it can prove expensive in both), the near-term risk/reward ratio is likely to become compelling later this month as central banks flood markets with liquidity and Europe delivers a very belated 'shock and awe' stabilisation effort. **My views coming into Q3 were that investors should be defensively positioned, avoid commodity exposure, expect the USD to surprise to the upside and DM to continue outperforming EM.** For instance, back in the 25<sup>th</sup> May Weekly, I noted that: *'The second derivative changes we're seeing in most leading economic indicators are not enough to generate a deep reversal just yet...however, by historical standards we're entering the later stages of the cyclical bull that began in March 2009 and further rallies should be used to reduce portfolio risk until the extent of stagflation pressures in H2 becomes clear.'* Even though the slowdown in the BRIC economies was already evident, **downside risks were amplified once Italian yields spiked above 6% in July** and EU policy makers proved impotent to firewall credit risk contagion; the one big macro surprise in recent months has been just how fast the euro zone crisis has gathered pace.

### Manufacturing PMIs Still Weak in September



Source: Markit, HSBC, ISM

- Growing evidence that China's credit and real estate booms are reversing (also clearly evident back in Q2 and China remains likely to slow to 7-8% trend growth by mid-decade) have exacerbated the downside pressure on risk assets. However, a confluence of negative and unquantifiable risks has now created opportunities for those who entered what was always going to be a high risk period cautiously. **The JPM Global Manufacturing PMI fell to 49.9 from 50.1 in September** but while new orders remain weak, the free fall evident in early summer (and a key reason for my caution at the time) is decelerating. The US ISM manufacturing PMI recovered to 51.6 in September against expectations of contraction. **Car sales were an important factor in maintaining the ISM in positive territory;** they increased to an annual rate of 13.1m in September, their best level since April, compared with 12.1m units in August. The US services PMI also held up at 53 in September, in contrast to that in the euro zone tumbling to a 26mth low. **With both the housing and auto sectors**

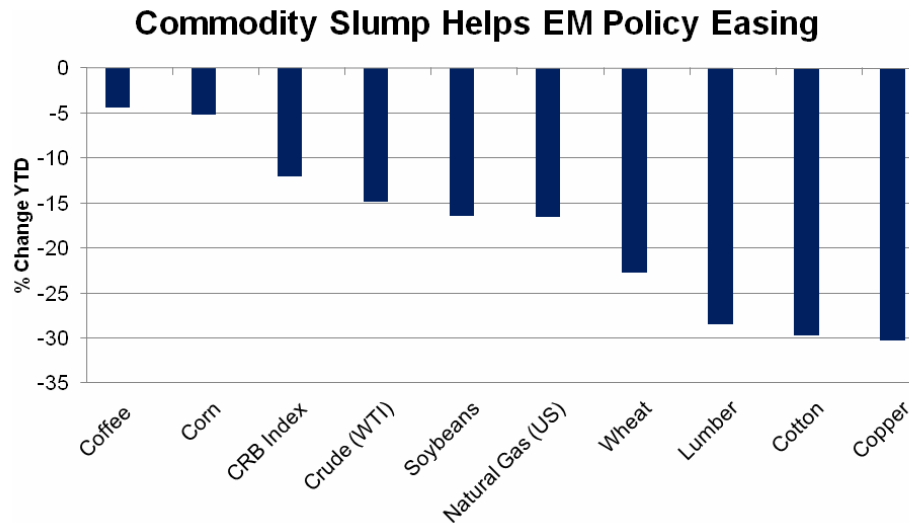
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showing stability, the recent data supports the 'muddle through' sluggish growth scenario for the US through year-end, absent financial sector contagion from Europe.

- China was the major disappointment as the CFLP manufacturing PMI only managed to rise by 0.3 percentage points to 51.2 in a month that is normally very seasonally strong, but the HSBC index fell to 49.9. The gap between the official and HSBC data suggests that SMEs and exporters are being particularly hard hit, reflecting the disproportionate impact of a tighter credit environment I discuss below. **Growth in India's manufacturing sector slowed sharply, while the contraction in Taiwan, South Korea and Australia deepened.** Among the big Ems, Russia and South Africa held up reasonably but the contraction in Brazil's manufacturing sector quickened. **As investors stumble into Q4 with their nerves shattered, we're likely in the capitulation stage of the reversal since May and I'd now begin positioning for recovery in the last couple of months to the year.** The global growth outlook has certainly deteriorated since Q2 alongside growing political uncertainty, particularly the existential crisis in the euro zone, but a large part of the rush to safety in recent weeks is simply a classic example of **herding behaviour in markets, as crowded consensus trades in EM assets and commodities have been crushed in a stampede for the exit.** Against a backdrop of on-going deleveraging, demographic decline and hence modest trend growth in the developed world, this sort of macro and asset volatility is simply something investors have to get used to over the course of the decade, which I've always maintained would be more like the roller coaster 1968-82 experience than the subsequent 'Great Moderation' bull market.

## Commodity Price Reversal Helps Growth Outlook...

- A key downside growth risk I highlighted early this year was **the surge in commodity inflation, and its adverse impact on US real consumer incomes and EM policy.** After an initial 'flash crash' in May, we've since seen a more sustained reversal with food prices latterly succumbing to the trend elsewhere, and that's net good news for the real economy. **One of the biggest errors in launching QE2 was not to simultaneously tighten non-commercial positions in commodity markets.** Despite the recent selloff, **commodities remain very expensive versus their historical trend,** with most up 3-4x over the last decade, and as new supply comes belatedly on stream while the nature of Chinese growth evolves in a less resource intensive direction, **the 'super cycle' thesis will come under growing scrutiny.** Back in the May 5<sup>th</sup> Weekly, I noted that: *'Copper is a window into the speculative distortions endemic in China, and a lead indicator of tighter liquidity. As the Chinese authorities clamp down on the practice of using copper as collateral to bypass tighter bank lending criteria, speculators are finding it harder to roll over inventory funding; metal being used as collateral for loans has been accumulating in bonded warehouses in Shanghai and is now being dumped back into the global market. The April number for net copper exports is worth watching as a further signal that funding is drying up around the speculative fringes of the Chinese economy.'* Which is exactly what's happened since, with much hyped copper leading a brutal reversal in commodity markets; as I highlighted in the September monthly, this helps policymakers recalibrate the growth versus inflation trade-off across Asia and the wider EM universe, and we've already seen moves from Turkey, Brazil and Israel.

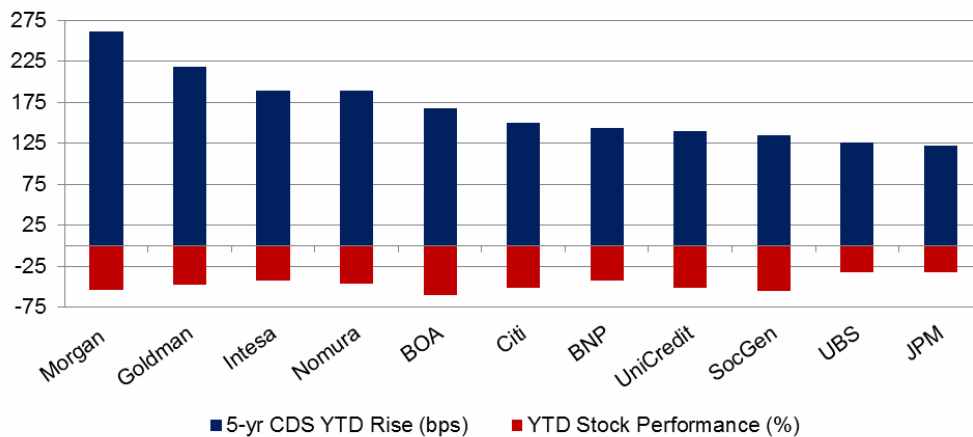


Source: FactSet, as at 5th October

- Back in May, liquidity was ebbing and investors were overweight risk; now, investors are now slightly underweight equities according to the Merrill Lynch survey and there has been clear margin related selling in recent weeks by hedge funds. **By early November, the worst fears of a US recession should be passing, the euro zone will have reached a decision on Greek default and backstopping wider peripheral bond markets, probably via the ECB balance sheet, and global excess liquidity will be rising again and looking for a home while EM policy will be easing at the margin.** Nonetheless, the structural issues remain daunting going forward, particularly related to DM credit risk and global structural capital flow imbalances. But we can worry about all that next year...a **substantial counter-trend risk rally is likely by early November post the G20 summit**, assuming that the data confirm that US recession fears have been overblown and we have by that stage a near-term resolution to the euro zone peripheral solvency crisis.
- Extremes in positioning and sentiment will force a mountain of sidelined cash back into the market as performance anxiety overwhelms the macro variety.** A 25-30% rally from the October lows in most key indices by early 2012 is perfectly feasible. **It will be important to capture performance in periodic sharp rallies like this, because the next few years will be a grind.** The euro zone may well belatedly surprise markets with a credible roadmap to preserve EMU, involving major debt and economic restructuring for Greece, a major recapitalisation of the euro zone financial system, and the outlines of a coherent core euro zone which has members whose productivity and fiscal discipline are compatible. The only alternatives are immediate full fiscal union, or unlimited unsterilized monetisation by the ECB.
- A counter trend rally in risk assets would come as a relief to investment bankers; **it's been a tough year for most in financial markets, but who would want to be a banker this year getting paid a deferred stock bonus, particularly at Morgan Stanley?** Credit default swaps have surged across the global financial sector (particularly for Chinese banks), but global investment banks have been hit harder than even Italian institutions loaded up with fast depreciating domestic bonds. One factor is that fixed versus variable employment costs have surged since 2009, as regulatory changes to bonus structures have seen base salaries typically double, which will now drive brutal headcount reductions amid a drought in IPO and M&A activity, and poor trading volumes in FICC divisions. **The days of investment banking generating a**

pretty consistent 20% ROE are over for good, and the sector retains vast overcapacity relative to its shrunken revenue potential in a volatile, slow growth global economy and an on-going regulatory squeeze on balance sheet risk and further securitisation innovation. **The powerful rise of the finance sector versus the wider economy in the developed world since the mid-1980s, particularly in the US and UK, has run its course** for political as much as economic reasons and the only question is how fast a mean reversion in total employment, salaries and sector profitability will take place.

### Investment Banking Sector Under Pressure



Source: Fed, BLS

## China's RMB Policy Distorting its Backward Financial System...

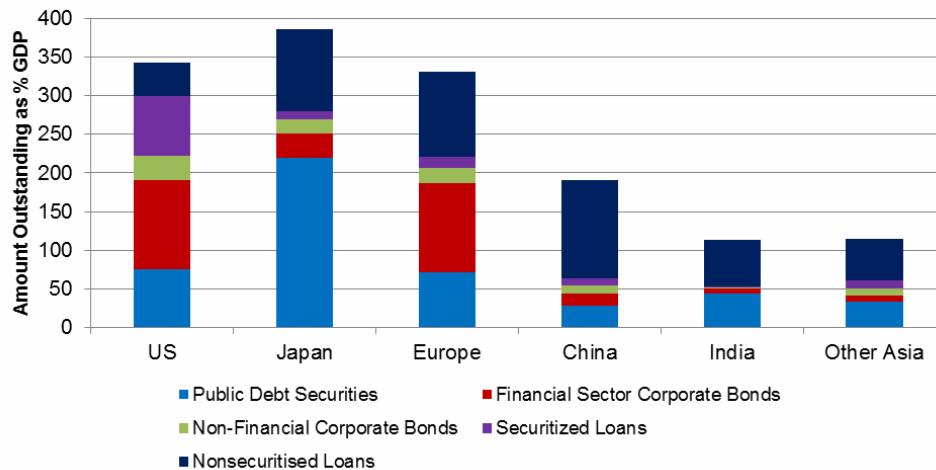
- Emerging Asia remains one place where capital markets remain underdeveloped and in China's case, where bank finance predominates, this both reflects and exacerbates its current structural problems;** for instance, had the post-crisis stimulus been financed via local government bond issuance rather than the banking system, the knock on impact this year of credit tightening on SMEs etc would not be anything like as damaging. **Equally a deep corporate bond market offering fast growing private companies to circumvent the asset focused state banks would help rebalance growth away from capital intensive heavy industry.** The underdevelopment of capital markets is in many ways the flipside of the country's RMB policy, which has led to the reserve pile growing to \$3.2trn as of June. **The implicit tax on the banking system associated with China's reserve holdings** (widely assumed to be in bonds and deposits with about a 2 year maturity, largely in dollars and euros) **is passed on to Chinese households in the form of depressed rates of interest on savings deposits.**
- The interest rate earned on these reserves is significantly below the rate of interest paid to finance them (the classic monetary 'Trilemma') and their value in terms of RMB is declining over time, notwithstanding the windfall Treasury rally this year. To pay for these foreign exchange reserves, the central bank must sell other assets, borrow in local markets, or raise the required reserve ratio for banks. **The cost of financing foreign exchange reserves by selling other assets is the foregone interest on those assets versus holding short-term government bonds currently yielding about 3.5%.** The cost of borrowing is the interest rate paid on central bank bills, currently about 3% while the cost of required reserves is the interest rate paid to banks, currently 1.6%; all of these compare to yields on 2-year developed world paper more like

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0.3%, so the cost of sustaining the current system is becoming huge and is now **in the region of 3-5% of GDP annually directly in interest differentials, and far more indirectly via the destabilising impact on domestic credit growth and inflation.**

- **The squeeze on the Chinese SME sector from credit rationing via a rising reserve ratio was something I focused on back in Q1.** It was clear late last summer (as covered in August 2010 monthly) that the real estate market was approaching a peak and that as the stimulus related credit boom reversed, **the only surprise was that proxies for speculative excess like copper took so long to collapse.** The country's already dysfunctional credit system is under stress, and Beijing is becoming paranoid that its attempts to cool the housing market are having unintended consequences, which is the nature of monetary policy anywhere but particularly in a country with as underdeveloped a capital market as China. **The issue was brought home to nervous investors by China's Wenzhou city setting an upper limit on the interest rates that private non-bank lenders can charge borrowers in an effort to control risk in the city's banking industry.**

### Chinese Capital Markets Underdeveloped



Source: BIS, 2010 data

- Private non-bank institutions in Wenzhou can now only lend at an interest rate that doesn't exceed four times the country's benchmark lending rate, a policy likely to be repeated nationally given growing concern in Beijing, but which will most likely lead to a further withdrawal of credit. **Given huge disguised leverage at all levels of the Chinese economy, defaults on private borrowing could trigger a negative chain effect throughout the lending system nationally;** the informal lending system is estimated to amount to \$600-800bn. Anecdotal evidence suggests that **mainland owners of apartments in Hong Kong are turning net sellers to raise cash, even at a discount. Demand for cash will rise significantly as we approach the year-end and a significant downturn in property prices would aggravate the liquidity crunch** and create havoc among highly indebted local governments.
- Like Europe, China has reached a critical and very dangerous moment in facing up to long overlooked structural economic frailties and faces some hard choices in tackling them. Firstly, it can continue on the current **tightening path into 2012 using the crude tools at its disposal to manage an increasingly dysfunctional credit system driven by a hybrid capital allocation system**

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and the monetary imperatives of the RMB peg, but risk a far bigger reversal in luxury property prices and growth than expected. Secondly, it can loosen policy by year-end, using the cyclical inflation peak as an excuse, and attempt to buy time for a structural overhaul of its banking system and currency peg, but **at the risk of further inflating the asset bubble and adding further fixed investment weight to an already top heavy economy**, which then becomes vulnerable to collapse by 2013/14. Thirdly, and most likely near-term, **it can try to pragmatically weave between these poles until a political consensus forms** on a new and more sustainable growth model. The latter two options would encourage near-term investor relief that a hard landing can be averted, but actually increase the odds of its ultimate occurrence.

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## KT ZMICO RESEARCH – RECOMMENDATION DEFINITIONS

### STOCK RECOMMENDATIONS

**BUY:** Expecting positive total returns of 15% or more over the next 12 months

**TRADING BUY:** Expecting positive total returns of 15% or more over the next 3 months

**HOLD:** Expecting total returns of between -15% and +15% over the next 12 months

**SELL:** Expecting negative total returns of 15% or more over the next 12 months

**AVOID:** Expecting the stock to be materially affected by fundamental changes in the future (i.e., regulatory changes, etc); however, the impact cannot be assessed/reflected in the current forecast

### SECTOR RECOMMENDATIONS

**OVERWEIGHT:** The industry, as defined by the analyst's coverage universe, is expected to outperform the relevant primary market index by at least 10% over the next 12 months.

**NEUTRAL:** The industry, as defined by the analyst's coverage universe, is expected to perform in line with the relevant primary market index over the next 12 months.

**UNDERWEIGHT:** The industry, as defined by the analyst's coverage universe, is expected to underperform the relevant primary market index by 10% over the next 12 months.