Monthly Comments – Emerging Markets

MacroFinance Research – July 2020

Key Messages

Country Focus – China: successfully exiting the worst economic shock in recent history, but with significant increase in corporate, banking and political risks

China was first to enter and is now first to exit the epidemiologic stress related to Covid-19. Notwithstanding repetition of localized clusters of infections and remaining uncertainties on possible health development, the country has so far successfully lifted most restrictions on movements of persons and is returning rapidly to a "normal economic path", with positive year-on-year industrial growth as soon as April. Despite such a V-shape profile, the loss in aggregate output will not be fully erased before the end of 2021, implying higher unemployment and a significant increase in corporate difficulties and bankruptcies, more intense difficulties for financial institutions and an irregular (and modest) depreciation of the currency over the next 18 months. In this background, fiscal and monetary policies will remain very supportive. Such developments over the next 18 months clearly point to a need for more caution and higher discrimination among projects / partners / investments, with a clear credit preference for the sovereign, though in a context of complex political development, at home and on the international scene.

Read more on page 2…

Country Focus (in-depth) – China Barometer

Monitoring recent economic and financial developments in China illustrated with selected monthly and daily indicators.

View more on page 5…

Dashboard & Heatmap – Credit risk & Covid-19 Heatmap

Our updated Heatmap looks at performances and risks through each country's growth sensitivity to the pandemic / health situation, their financial risks and their ex ante vulnerabilities.

View more on page 7…

As always, readers are most welcome to come back to us for further details or clarifications.

Completed on July 10, 2020.

Country Focus – China: successfully exiting the worst economic shock in recent history, but with increasing corporate, banking and political risks

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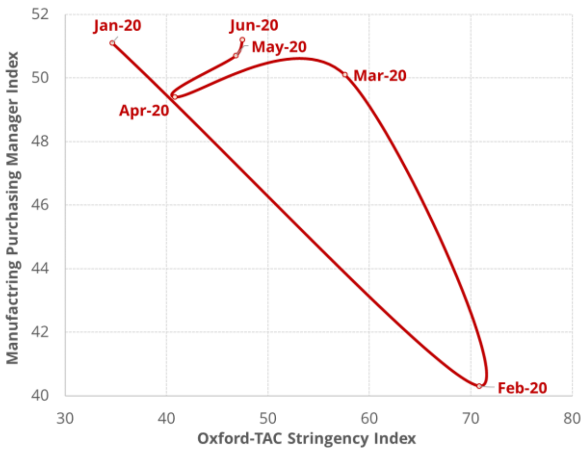
Asymmetric V-shape recovery under way

China's GDP contraction in 2020Q1 was by far the largest on record since China's reforms, with a contraction of -6.8% y/y (equivalent to a staggering -33% in annualized quarter-on-quarter data), a direct result of the strict lockdown measures implemented in January-March 2020. This was accompanied by a collapse of most cyclical indicators, from retail sales to fixed investment and international trade.

China: V-shaped collapse and recovery
TAC ECONOMICS Stringency Index and NBS Manufacturing PMI



Source: TAC ECONOMICS, Datastream, Oxford University

The lifting of confinement created mechanic conditions for a sharp rebound in economic activity and improved expectations. Using our own combination of Oxford University's indicators of restrictions on movements of persons, we see a very clear relation with the Manufacturing PMI index: after collapsing to 40 in Feb.2020 - coinciding with the most stringent moment of confinement and lockdowns -, the PMI reverted back above the 50-level in May and June. Similarly, industrial production registered positive y/y growth as soon as April (+3.9%, followed by +4.4% in May).

The current economic rebound is supported by a range of fiscal and monetary policies designed to provide emergency liquidity as well as support aggregate demand. They include a supplementary budget spending program amounting to 4% of GDP, liquidity injections from the central bank (CNY 5.7tr), increase in lending facilities (CNY 1.7tr), cuts in interest rates and reserve requirements for banks. The PBoC is also allowing more lenient criteria for banks' reporting on NPL and encouraging financial institutions to continue lending to SMEs. Overall, the total amount of funding (Total Social Financing) has substantially accelerated in April and May.

The currency has modestly depreciated since January 2020, from USD/CNY 6.85 then to 7.17 at a peak at the end of May, before a partial retracement to 7.02 on July 7, with an irregular path reflecting the state of trade and financial relations between the US and China. Our own projections point towards a further depreciation towards USD/CNY 7.20-7.25 between now and the end of 2021.

In parallel, China is continuing its structural policy towards relocation of upstream inputs in supply chains: after a negative contribution of external trade to GDP growth in Q1, figures for April/May suggest a sharp reduction in imports (respectively -14.2% and -16.7%) when exports stabilize (respectively +3.4% and -3.3%).

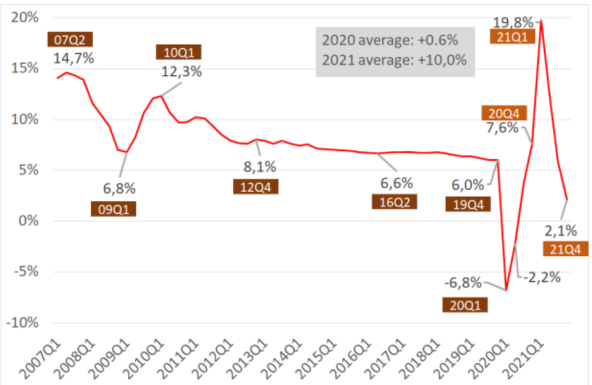
A more subdued outlook is for consumers' final demand, which is recovering at a lower speed, as household confidence is affected by (localized) epidemic waves while income is dented by the increase in unemployment. Unofficial estimates including job losses for migrant workers point to a plausible 20% unemployment rate. On top of these headwinds are renewed upward pressures on food prices (related to health-related constraints on Chinese imports of pork and a correlated 42% increase in pork prices for consumers since a low point in May). Retail sales are still negative on a year-on-year basis though they recovered in April and May 2020.

Overall, our quantitative models suggest a year-on-year (y/y) economic growth still negative in Q2 and an overall average barely above 0% for 2020, but with a recovery profile leading to +10% growth in 2021.

By the end of next year, the actual level of GDP would still be 3% below the expected level without the Covid epidemic.

China: quarterly GDP growth

y/y % change in real GDP



Sources: TAC ECONOMICS, Datastream

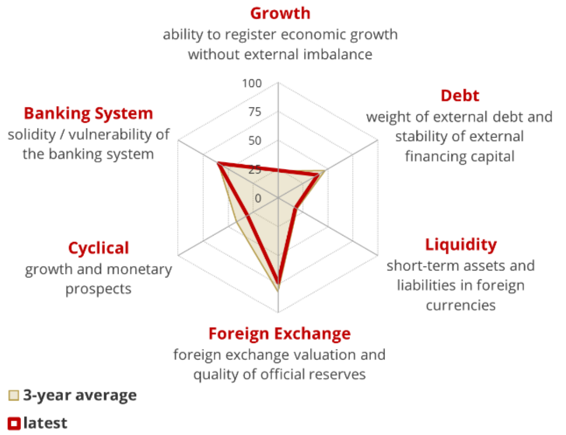
Excess leverage to be unsustainable and requiring serious treatment

China's pre-Covid risk situation showed increasing vulnerabilities, with a currency overvaluation and an excessive aggregate credit leverage being the weakest points, and two WatchList Indications, one on economic activity and the other on the exchange rate.

Considering the acuteness of the economic shock and the time required to go back to the pre-Covid path, the likelihood of much higher corporate difficulties, bankruptcies and financial restructuring is very high, coupled with a further but limited depreciation of the CNY, and rapidly deteriorating quality of financial institutions' balance sheets.

Scores on Fundamental Balances

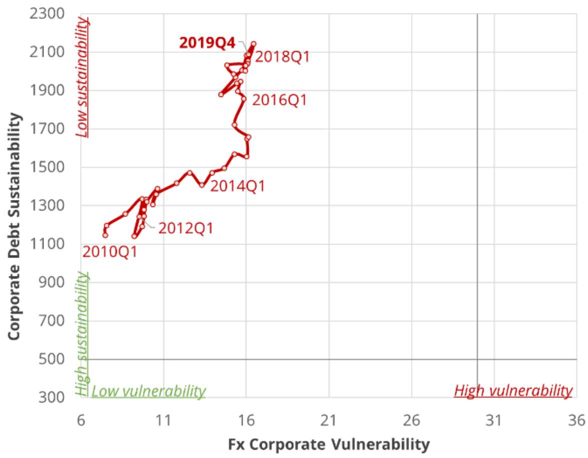
From 0 (lowest risk) to 100 (highest risk)



Source: TAC ECONOMICS

This is highlighted by China's move on our Corporate Balance, a fundamental approach to the overall strength or weakness of the aggregate corporate sector. The Corporate Balance combines an indicator of corporates' vulnerability to exchange rate depreciation (horizontal axis; the higher the value, the higher the risk) with an index of aggregate debt sustainability (vertical axis). A median value across a large set of Emerging Markets and Developing Economies (EMDEs) for this Corporate Debt Sustainability Index is at 500.

China – Corporate Balance



Source: TAC ECONOMICS

Back in 2010, China's position on the Balance was already showing the excess corporate leverage, with a Sustainability index twice the median value; from 2010 up to 2019, China's trajectory registered a dual-deterioration, with another doubling of the Corporate Sustainability Index and a visible deterioration in the (Fx) Corporate Vulnerability Index. The latter reflected the increasing use of international funding by large Chinese corporates, both for their international acquisitions and for overall long-term funding.

In this fragile position, the Covid-related cyclical shock is (and will continue to be) accompanied by sharply rising defaults and financial reengineering in the corporate sector. This will be associated with "unpleasant surprises" regarding the exact nature of guarantees and support to individual companies as well as the creditor / debtor relations, including from China's subsidiaries in Hong Kong[1].

In turn, this will significantly weaken the quality of Chinese banks' credits and other assets. Though Non-Performing Loans officially registered so far show only a minor deterioration from their 2019Q4 levels and remain below 2%, this results mostly from the administrative guidance to banks and regulatory leniency. Historical / international comparisons would suggest an "internationally comparable" ratio of NPLs above 10%. In parallel, strains are multiplying in the non-banking financial system. Midsize / non-state banks appear particularly vulnerable; the rating agency Fitch singled-out Minsheng, Hua Xia and Guangfa as likely to see their tier-one capital base drop below minimum regulatory level when / if the overall ratio of NPL move above 3.5%.

Political equation becoming more complex for foreign investors

The political context is characterized by a dual movement: on one side, there is a clear a domestic trend towards a more authoritarian, personalized and nationalistic pattern under President Xi Jinping. It is coupled with a tighter grip of the Communist Party on the economy with the objective of strengthening the state-owned sector far more important than fostering the private sector development. It also implies a growing assertiveness on the international scene and a willingness to test reactions and impacts of both Asian and Western nations to China's worldwide policies.

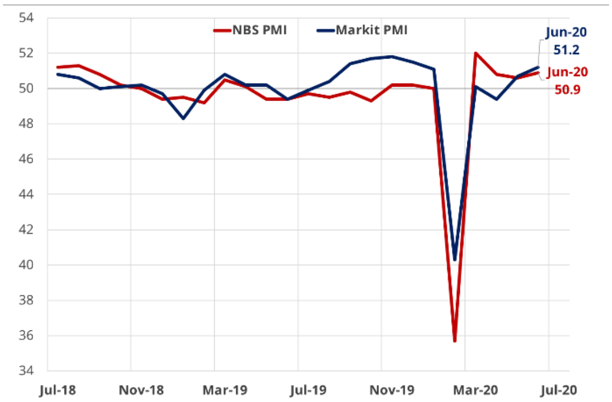
On the other side, the strategic rivalry between the US and China will remain a dominant feature of international relations for years to come. Though none of the two protagonists believes the other one is likely to create a truly confrontational situation, domestic dynamics could lead to repetition of moments of heightened tensions, as seen during the past months. The bilateral tensions were enhanced by a progressive stiffening of other mature economies vis-à-vis China, notably the European Union and Australia. Such tensions are due to have consequences on international companies and investors who have a dual exposure in the US and in China. In parallel, we see a growing threat of "financial weaponization" in this international relation, including pressures and constraints on US investors to limit or reduce their exposure to China. This would suggest thinking about mechanisms able to separate more strongly activities or investment in these two dominant regions of the world.

Overall, China will remain a highly attractive area for industrial or financial investment over the long-run because of its size and speed of development, but the cost of risk, or what we call the global country-risk premium, should be commensurate with much deeper uncertainties, as indeed blatantly shown by our Risk-Related Extra Cost of Capital (RRECC): at around 450 basis points, it is almost ten times the observed premium for China's Credit Default Swaps (CDS), at 46bp early July 2020.

[1] A clear illustration was given recently by difficulties in the debt restructuring for Peking University Founder Group, a state-backed company linked to the university, when the administrators in charge of restructuring said they would not consider so-called keepwell deeds (a form of letter of comfort issued when Chinese group raise Fx funding) as a guarantee.

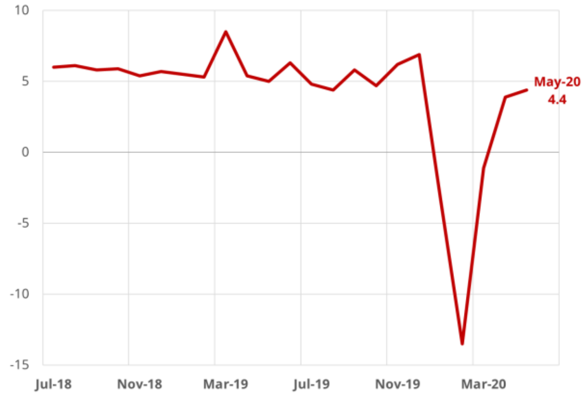
China Barometer

Purchasing Manager Index



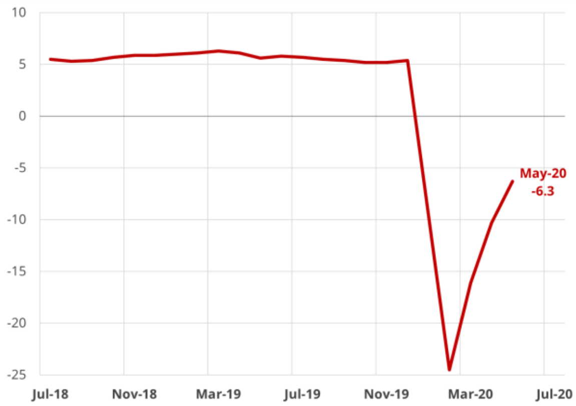
Industrial Production

y/y, %



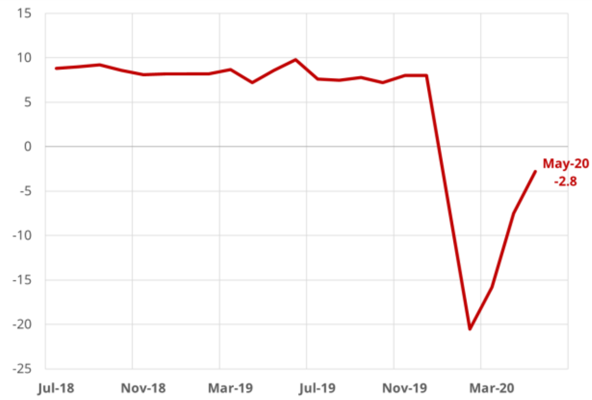
Investment in fixed assets, urban areas

y/y, %, cmlv



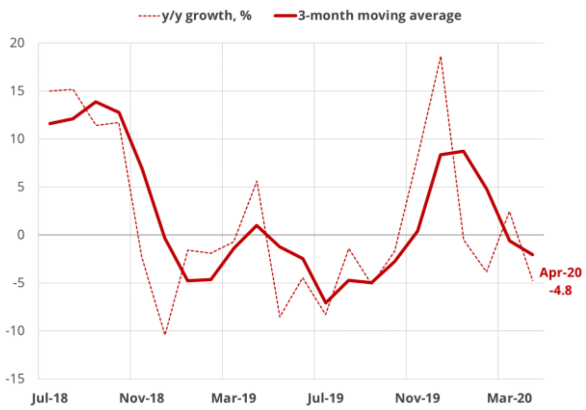
Retail sales

y/y, %



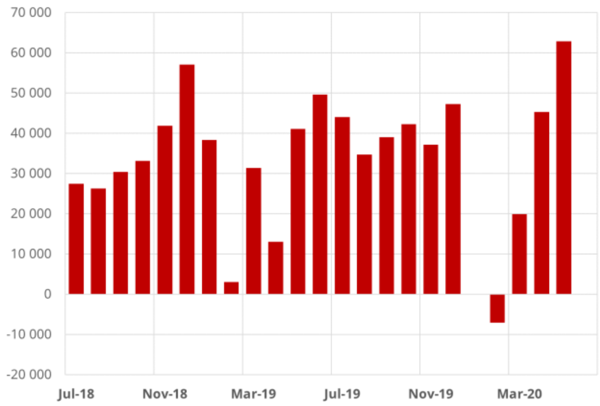
Merchandise imports

volume, y/y growth, %



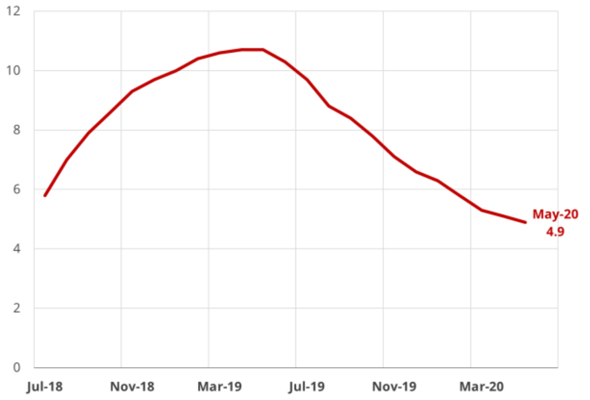
Trade Balance

mn$



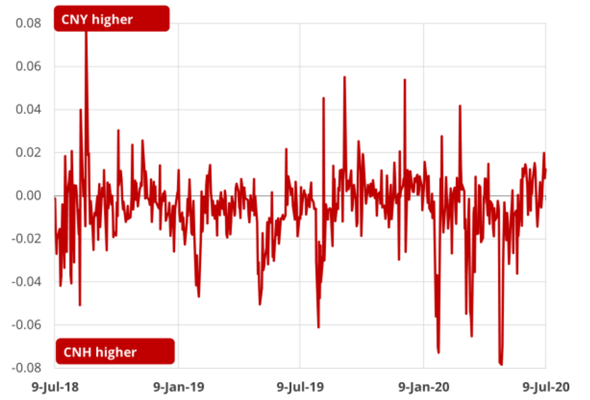
Source: TAC ECONOMICS, Datastream

New House prices
y/y, %, 70 medium & large cities

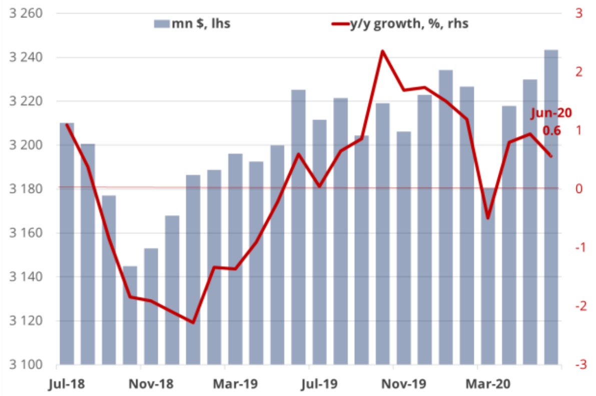


CPI Inflation
y/y, %

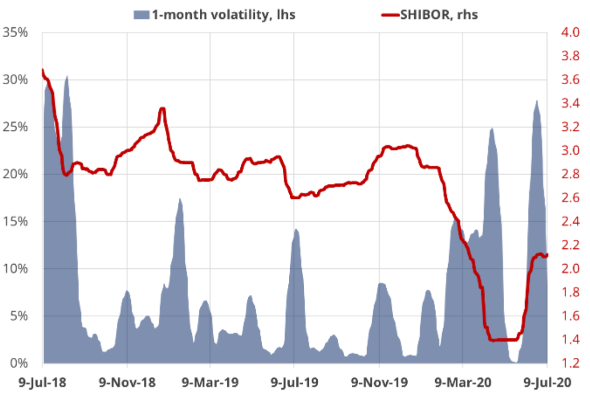
Difference between CNY and CNH exchange rates



Fx reserves



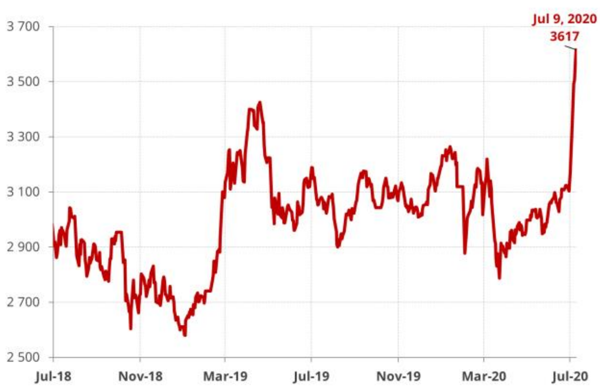
Shibor



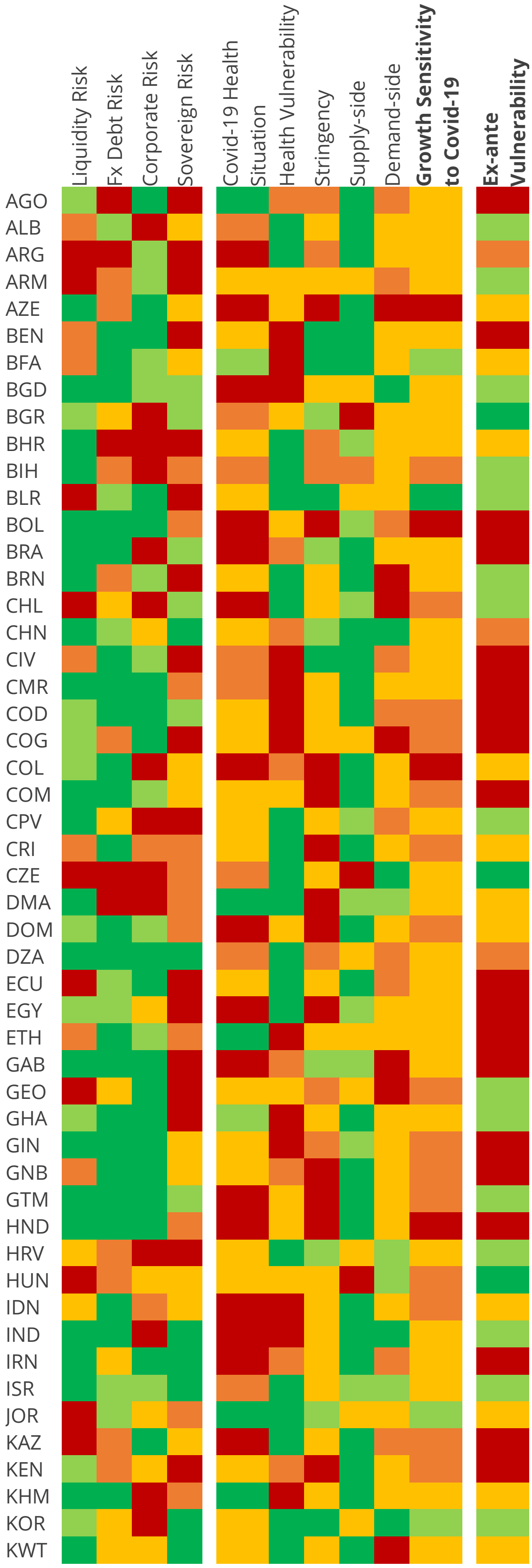
Aggregate Social Financing Growth, y/y, %

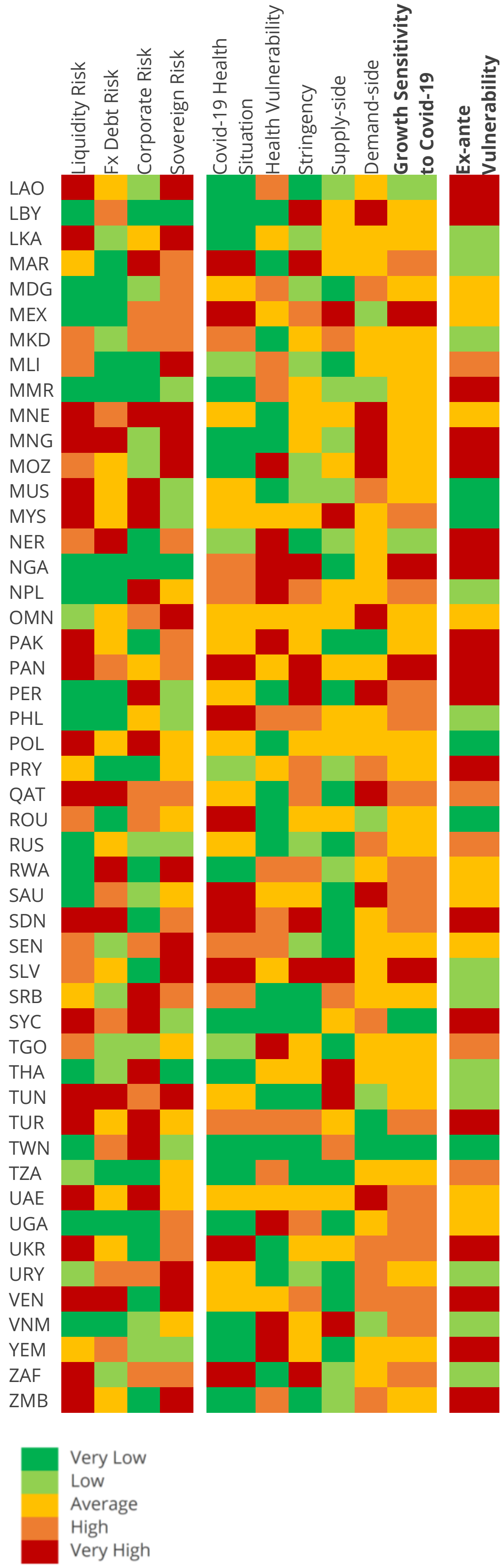
Credit Default Swap 5 year

Shanghai SE Index



Credit Risk & Covid-19 Heatmap





Appendices

Appendix 1: List of 100 countries by ISO3 Code alphabetic order

ISO 3 Code	Country Name	ISO 3 Code	Country Name	ISO 3 Code	Country Name
AGO	Angola	GHA	Ghana	OMN	Oman
ALB	Albania	GIN	Guinea	PAK	Pakistan
ARG	Argentina	GNB	Guinea Bissau	PAN	Panama
ARM	Armenia	GTM	Guatemala	PER	Peru
AZE	Azerbaijan	HND	Honduras	PHL	Philippines
BEN	Benin	HRV	Croatia	POL	Poland
BFA	Burkina Faso	HUN	Hungary	PRY	Paraguay
BGD	Bangladesh	IDN	Indonesia	QAT	Qatar
BGR	Bulgaria	IND	India	ROU	Romania
BHR	Bahrein	IRN	Iran	RUS	Russia
BIH	Bosnia	ISR	Israel	RWA	Rwanda
BLR	Belarus	JOR	Jordan	SAU	Saudi Arabia
BOL	Bolivia	KAZ	Kazakhstan	SDN	Sudan
BRA	Brazil	KEN	Kenya	SEN	Senegal
BRN	Brunei	KHM	Cambodia	SLV	El Salvador
CHL	Chile	KOR	Korea	SRB	Serbia
CHN	China	KWT	Kuwait	SYC	Seychelles
CIV	Cote d'Ivoire	LAO	Laos	TGO	Togo
CMR	Cameroon	LBY	Libya	THA	Thailand
COD	DR Congo	LKA	Sri Lanka	TUN	Tunisia
COG	Rep. of Congo	MAR	Morocco	TUR	Turkey
COL	Colombia	MDG	Madagascar	TWN	Taiwan
COM	Comoros	MEX	Mexico	TZA	Tanzania
CPV	Cape Verde	MKD	N. Macedonia	UAE	UAE
CRI	Costa Rica	MLI	Mali	UGA	Uganda
CZE	Czech Rep.	MMR	Myanmar	UKR	Ukraine
DMA	Dominica	MNE	Montenegro	URY	Uruguay
DOM	Dominican Rep	MNG	Mongolia	VEN	Venezuela
DZA	Algeria	MOZ	Mozambique	VNM	Vietnam
ECU	Ecuador	MUS	Mauritius	YEM	Yemen
EGY	Egypt	MYS	Malaysia	ZAF	South Africa
ETH	Ethiopia	NER	Niger	ZMB	Zambia
GAB	Gabon	NGA	Nigeria		
GEO	Georgia	NPL	Nepal		

Appendix 2: List of 100 countries monitored by region

Eastern & Central Europe, CIS (19)			
ALB	Albania	KAZ	Kazakhstan
ARM	Armenia	MNE	Montenegro
AZE	Azerbaijan	MKD	N. Macedonia
BLR	Belarus	POL	Poland
BIH	Bosnia	ROU	Romania
BGR	Bulgaria	RUS	Russia
HRV	Croatia	SRB	Serbia
CZE	Czech Rep.	TUR	Turkey
GEO	Georgia	UKR	Ukraine
HUN	Hungary		

Latin America (18)			
ARG	Argentina	SLV	El Salvador
BOL	Bolivia	GTM	Guatemala
BRA	Brazil	HND	Honduras
CHL	Chile	MEX	Mexico
COL	Colombia	PAN	Panama
CRI	Costa Rica	PRY	Paraguay
DMA	Dominica	PER	Peru
DOM	Dominican Rep	URY	Uruguay
ECU	Ecuador	VEN	Venezuela

Asia (18)			
BGD	Bangladesh	MNG	Mongolia
BRN	Brunei	MMR	Myanmar
KHM	Cambodia	NPL	Nepal
CHN	China	PAK	Pakistan
IND	India	PHL	Philippines
IDN	Indonesia	LKA	Sri Lanka
KOR	Korea	TWN	Taiwan
LAO	Laos	THA	Thailand
MYS	Malaysia	VNM	Vietnam

Middle East & North Africa (15)			
DZA	Algeria	MAR	Morocco
BHR	Bahrein	OMN	Oman
EGY	Egypt	QAT	Qatar
IRN	Iran	SAU	Saudi Arabia
ISR	Israel	TUN	Tunisia
JOR	Jordan	UAE	UAE
KWT	Kuwait	YEM	Yemen
LBY	Libya		

Sub-Saharan Africa (30)			
AGO	Angola	MDG	Madagascar
BEN	Benin	MLI	Mali
BFA	Burkina Faso	MUS	Mauritius
CMR	Cameroon	MOZ	Mozambique
CPV	Cape Verde	NER	Niger
COM	Comoros	NGA	Nigeria
COG	Rep. of Congo	RWA	Rwanda
COD	DR Congo	SEN	Senegal
CIV	Cote d'Ivoire	SYC	Seychelles
ETH	Ethiopia	ZAF	South Africa
GAB	Gabon	SDN	Sudan
GHA	Ghana	TZA	Tanzania
GIN	Guinea	TGO	Togo
GNB	Guinea Bissau	UGA	Uganda
KEN	Kenya	ZMB	Zambia

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