Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

Week 33: August 18, 2011

China's loan growth, the grey market, and easing into 2012: *The national leadership will meet again in October, and I expect to see support for growth and the easing of credit ahead of the presidential transition next year. Given the weak growth in the U.S. and the EU, Beijing will be forced to do more to boost domestic consumer demand and affordable housing. Agriculture will also continue to benefit from official support and finance schemes. A stronger yuan and more low-income subsidies will help offset inflation and social pressures.*

Global commodity prices and China plays will benefit. The strong growth of the grey market for loans could throw a wrench into beating inflation. Bank wealth management products, local government SIVs, and state-owned finance companies have all been officially implicated in grey-market lending.

For the past year, I have argued that China would continue its tightening bias and fight inflation vigorously ahead of next year's big political transition. The problem with administered interest rates is that Beijing can only control the money supply through loan allocation and rationing. In 2009, the massive surge in loans probably saved the global economy from disaster as the demand for resources continued to support global growth. Since then, loan allocation has been tightening. Targeted loan allocation has only had some modest impact.

Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

It has taken more than a year for Beijing to cool property prices and real-estate companies are seeing inventory building, though prices haven't started to correct in a meaningful manner. According to one estimate, accumulated real-estate inventories might be worth as much as $49bn. In 2009, Beijing allowed banks to lend to companies to build up their commodity inventories and fueled middlemen and speculators—especially in energy and copper. That loophole closed early this year, but anecdotal evidence suggests that bank lending is still finding its way to such activities.

China's national bank regulator, the CBRC, has estimated that CNY 3 trillion of official loans have found their way into grey-market lending. These grey-market loans are in high demand, even as official lines of credit have been cut. Those with lines of credit are meeting grey-market demand and earning high rates of return. The PBoC estimated that in Wenshou in Zhejiang province, the composite interest rate on loans in the private market was 24.4%. That's a considerable mark-up from the official rate of 6.56% on a one-year loan. The CBRC concedes that official lenders and finance companies are also using state monies to lend on the grey market. Last month, the CBRC announced an investigation into how banks misused and abused "wealth management funds" that pooled resources for unofficial loans.

Officially, banks have been competing for deposits from governments, corporations, and individuals in order to meet the demand for loans while still complying with the 21.5% reserve ration requirement. Over the past few months, interbank-lending rates have appeared to increase

Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

at the end of each month as banks scramble for cash to meet official loan-deposit targets. Banks must now meet the target on a monthly rather than a quarterly basis.

Officially M-2 growth has been below the target of 16% for June and July. And some analysts believe that the M-2 increase of 14.7 percent in July is too low. Assuming that the grey-market lending activity is not growing even as the official lending rate is falling, the contraction of new yuan-denominated lending might be sufficient to stem inflation. Demand for electricity has increased y-o-y and while loan growth has slowed, demand for electricity—often taken as the best proxy for GDP growth—has been strong and is increasing. Growth might be more robust than loan growth would indicate.

Beijing is worried about the higher cost of living for most of its citizens. The cynical view is that Beijing is terrified of another Tiananmen Square incident as it goes through a leadership transition. But that would discount how much Beijing has done to boost wages and increase the social safety net over the past few years. Beijing might be self-serving, but Chinese workers are earning more money. There are more jobs and better infrastructure in the interior. Farmers are getting better prices for their crops and access to cheap credit for white goods and farm supplies. And now Beijing is rolling out additional subsidies to low-income families to offset the higher cost of food. The NDRC has announced that an estimated 90 million low-income families will receive additional funds to help offset the higher cost of living. The subsidy is only about $7 a month, but it's another step towards a social safety net.

Alison Adams, PhD

_617-388-9817_

research@alisonadamsllc.com

Even as Beijing is clamping down on local government debt and investigating its SIVs, the government has instructed banks to start lending to local governments to finance their affordable housing projects. The direct financing scheme should help keep demand for construction materials steady even as private real-estate prices start to cool. More importantly, over time more affordable rental housing should help bring down all rental prices.

The year 2012 may not see a repeat of the 2009 lending surge, but Beijing wants to ensure that there will be a positive economic backdrop to next year's leadership transition.

Mexico and the transfer of federal revenue to state governments. The PRI makes a move for more local power. *State governments have been pushing for a bigger share of national revenue and the PRI might be the party to deliver.*

In Mexico, the PRI leadership has made a daring proposition that could reverse years of federal centralization and consolidation. The PRI wants the federal government to give a larger share of its revenue to state governments. The ruling party—the PAN—countered that it would be immoral to give more money to state governments because they would just waste or steal the money. State governments depend on federal resources and are being asked to do more with less money. The battle against the drug cartels, more infrastructure, and more social services are a challenge. Like all emerging markets, Mexico does need to spend more at the local level, especially on infrastructure.

Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

But behind the demands for more revenue, the power of state governors is in question. Before the PAN revolution, the PRI held national power and state governors were like king makers with grassroots political machines. These political empires have waned over the past 12 years under the PAN as political competition has eroded the old machines. But political competition has meant that state and local governments must deliver more goods and services than ever before. In a country where there is no reelection, an elected official must rely on the party for his political future. And the party must promise more in the future for votes for a new candidate.

Mexico will have a national election next July, and at this time it looks as if the PRI will win, even if the one PRI candidate is not officially selected. Calderon, the current president from the PAN, cannot run for another term. Nor can any of his high-profile elected government officials. They can run for different elected offices, but not those they have already held. The PAN might look to bring back Vicente Fox. But this isn't clear nor would it be desirable from a political perspective. Markets might like the idea. But Calderon was a far better president than Fox. The PRI has won key state governorships over the past year and that will help the party get out the vote. A PRI-led state with a majority of state governorships might be the foundation for rebuilding state governments and boosting local-spending initiatives.

Back to 2009 and domestic demand in emerging markets: Global trade is not as strong as anyone had hoped. *Container shipping to the U.S. remains weak. It's falling on the Asia-*

Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

Europe route. Germany's GDP is lower than expected. Even before the U.S. downgrade, global shipping was showing signs of a slowdown.

In a follow-up to last week's section on emerging markets and a repeat of 2009's bull run, I want to highlight that there are considerable headwinds for more outperformance from Asia's export sector without a meaningful correction in commodity prices. It appears that U.S. consumer demand will remain weak, even as commodity (input prices) remain high. Building inventories in the U.S. could be delayed even longer while U.S. corporate waits for more economic certainty. Perhaps Americans will decide to spend down their savings for a proper Christmas. Or perhaps they will continue to increase their use of credit cards—after all, they have been good for awhile now.

Although U.S. inventories reached their highest level in May since January 2009, they are still below historic averages. Given high unemployment in the U.S., and consistent with our L-shaped recovery theme, it's doubtful that U.S. companies will move to build inventories further. The Asia-U.S. routes are suffering even as the peak season is upon us. I'm fairly certain that the Fed's promise of lower interest-rates through 2013 will do much to boost corporate confidence for more inventory building this year. The downgrade, debt-ceiling debacle, and political gridlock (which almost certainly will ask for more revenues) will weigh heavily on plans for expansion or more hiring. According to Bloomberg estimates, "combined inbound container traffic at Los Angeles and Long Beach . . . dropped 4.6% in June." It was the first decline in over

Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

16 months. As in 2008, container and ship contracts now have shorter duration schedules and overall rates are lower. Normal peak season surcharges have been delayed until September.

Loan growth in China might be falling, but the demand for Chinese exports is also on the decline. The slowdown is nothing compared to the near-sudden stop in 2008. But for emerging Asia, the slowdown will put more pressure on policy makers to support domestic demand. A weaker dollar is almost assured by near zero interest rates in the United States, so commodity prices will remain elevated even though consumer demand in the U.S. remains weak.

Alison Adams Research

Mobile: 617-388-9817

Office: 617-475-5295

Email: research@alisonadamsllc.com