



MORNING BRIEFING

May 9, 2017

China Down

See the [collection](#) of the individual charts linked below.

(1) Bulls and bears in china shop. (2) China's credit tightening is #1 concern currently. (3) Chinese stocks mixed. (4) Chinese officials go to war against shadow banking system. (5) Are Wealth Management Products weapons of mass financial destruction? (6) Lots of yuan in grey areas. (7) Don't trust entrusted investments. (8) Shadow banks account for almost 1/3 of "social financing." (9) China isn't as fragile as some fear. (10) Plenty of growth in exports and imports. (11) Capital outflows still a problem.

China I: Bear in a Bullish Market? Urban Dictionary defines "A bull in a china shop" as "a simile used to describe an extremely rough or dangerous person in a place where gentleness is a must. It brings to mind the image of a huge rodeo bull exploding into a tiny curio store and throwing his weight around in a berserk rage, annihilating every last teacup."

When I ask our accounts lately which major threat to the bull market in stocks they most fear, the number-one reply is a meltdown in China. That's the bear that could trip up the bull market in the US and around the world. Of course, there are other concerns, such as a rebound in inflation, a stalling of US economic growth, and the failure of Washington to implement President Trump's tax reform agenda. However, China is the number-one concern, especially since the second half of April, when Chinese officials started a new round of credit tightening.

The Shanghai Stock Price A-Share Index peaked last month on April 11, and fell 5.7% through Friday ([Fig. 1](#)). That's a minor decline so far, especially compared to the 48.6% plunge from its record high on June 12, 2015 through January 28, 2016. Meanwhile, both the Hong Kong Hang Seng China Enterprises Index and the China MSCI stock price index are above their April highs, and up 11.3% and 14.8% ytd, respectively ([Fig. 2](#)).

So why the long face (as the bartender asked the horse, who stepped up to the bar for a drink)? Here is the recent litany of worrisome developments in China:

(1) *War on debt.* A 5/5 [WSJ article](#) titled "China's War on Debt Causes Stocks to Drop, Bond Yields to Shoot Up and Defaults to Rise" summarized the recent woes nicely: "A wave of regulations aimed at cutting risk in China's financial system is rippling through the country's markets and sending banks and companies scrambling for funds. During the past month, Chinese shares have fallen nearly 5%, draining almost half a trillion dollars out of the country's markets. Bond yields have shot up to their highest levels in two years, and bond defaults hover at record levels. The uncertainty has also weighed on metals and commodity prices, already hurt by doubts around China's growth momentum. The price of iron ore plunged 8% on Thursday, the daily trading limit."

(2) *Xi's ultimatum.* Chinese President Xi Jinping recently called for greater stability, warning finance regulators not to miss "a single risk" or "hidden danger." The message was heard loud and clear. For example, the chairman of the China Banking Regulatory Commission (CBRC) said, "Strong medicine must be prescribed. If the banking industry gets into a mess, I will resign." More likely, he will be fired.

(3) *Lurking in the shadow.* The problem in China is a huge shadow banking system that sells so-called “wealth management products” (WMPs) to the public and then lends the money to risky companies without setting aside any capital for possible losses. WMPs are debt or debt-like instruments that pay out higher interest rates to investors. Banks have kept them off their balance sheets. However, the People's Bank of China just put them on its macroprudential assessment of banks' risks.

The *WSJ* article cited above reported, “Such grey-area investments reached nearly 20 trillion yuan (\$2.8 trillion) at the end of last year, says Fitch Ratings, or about 26% of China's gross domestic product in 2016, up from less than 10% three years earlier. They now represent an average of 19% of small and midsize banks' total assets, compared with about 1% for big state banks, according to Fitch.” Fitch says total debt reached 258% of China's GDP last year, a ratio it expects will grow this year and next.

(4) *Not so trusted.* The CBRC is also cracking down on the practice of banks' lending to external managers money for “entrusted investments.” Banks have been lending to brokerage firms with high interest. The brokerages then lend to customers, often allowing leverage to be extended to customers if they have a problem. The brokerages make their money from trade execution and sharing in returns. So, they get paid first.

(5) *Deadbeats.* During the first four months of this year, 12 companies, including steelmakers and construction firms, defaulted on their corporate bonds because they couldn't refinance their debts. That matches the record hit during the same period last year, when China was under great stress from accelerating capital outflows.

(6) *Dimon sounds alarmed.* On May 1, Jamie Dimon, the CEO of JPMorgan, told a crowd at the Milken Institute's Global Conference that China has him worried. What scares Dimon is that China's latest campaign to rein in credit excesses, if done too quickly, may drain too much liquidity from the system, killing smaller players and grinding things to a halt.

China II: By the Numbers. Not surprisingly, there isn't much data on China's shadow banking system. However, some insights can be gleaned from the monthly release of “social financing,” which includes bank loans and lots of other categories. Consider the following:

(1) Bank loans as a percentage of total social financing fell from 91.9% at the start of 2003 to 68.1% during March of this year ([Fig. 3](#)). This implies that the shadow banking system's share of social financing has increased from just 10.3% at the start of 2003 to 31.9% currently ([Fig. 4](#)).

(2) In US dollars over the past 12 months through March, social financing totaled a whopping \$2.7 trillion ([Fig. 5](#)). Bank loans increased \$1.9 trillion over the same period, while all social financing excluding bank loans was \$795 billion ([Fig. 6](#) and [Fig. 7](#)).

(3) Entrusted loans totaled \$336 billion over the past 12 months through March ([Fig. 8](#)).

China III: CorningWare. Debbie and I aren't too concerned about China just yet, though we are paying more attention to developments over there. Yes, the price of iron ore in China has plunged 37% since February 21 ([Fig. 9](#)). However, our trusty CRB raw industrials index is down only 3% from its recent high on March 15 ([Fig. 10](#)). China's economy isn't as fragile as fine dinnerware china. It's at least as strong as CorningWare. While banking regulators may be pumping on the brakes, the government is proceeding with lots of huge building projects.

The latest one was announced in early April as [reported](#) by theguardian.com: “A hitherto anonymous

region near China's smog-choked capital has been overrun by house buyers after Beijing unveiled 'historic' plans to build a new city there in a bid to slash pollution and congestion. Plans for the Xiongan New Area, a special economic zone that authorities say will eventually cover an area nearly three times that of New York, were announced by the Communist party's top leaders on Saturday with a flurry of government propaganda."

Official news agency Xinhua exuberantly [reported](#), "In terms of national significance, the area parallels the Shenzhen Economic Zone and Pudong New District, China's successful test beds for reform and opening up. The area will operate as a new growth pole for the country's economy, and also aim to curb urban sprawl, bridge growth disparities and protect ecology. It is unprecedented to have a special zone with such inclusive development value. It is of huge significance as coordinated and sustainable growth is so important for the country. The area is about 100 km southwest of downtown Beijing and will become home to facilities not related to the capital that were relocated from Beijing, where breakneck urban growth has given rise to 'urban ills' such as traffic congestion and air pollution."

Meanwhile, the latest batch of economic indicators shows that China's economy continues to expand at a reasonably solid pace:

(1) *Purchasing managers*. The official M-PMI and NM-PMI both edged down last month, but remained solidly above 50.0 with readings of 51.2 and 54.0, respectively ([Fig. 11](#) and [Fig. 12](#)). The Caixin/Markit measures were weaker with readings of 50.3 and 51.5, respectively.

(2) *Trade*. In yuan and on a seasonally adjusted basis, Chinese exports and imports both edged down in April, but their y/y growth rates were in the double digits at 15% and 19%, respectively ([Fig. 13](#) and [Fig. 14](#)).

(3) *Reserves & capital flows*. Our capital flows proxy shows that China continues to have significant outflows, though the situation isn't worsening as it had during most of 2014 and 2015. The country's non-gold international reserves rose by \$32 billion in the three months through April to \$3.0 trillion, after declining for seven consecutive months. The trade surplus stopped narrowing ([Fig. 15](#)). Consequently, the proxy showed 12-month net capital outflows of \$653 billion through April, the same as in the previous two months ([Fig. 16](#)).

(4) *Hedge clause*. One day, there could be a China Syndrome event in China. However, rather than a definitive meltdown, China could follow the path of Japan. Both have similar issues with aging populations and rising debt burdens, which are weighing on their economic growth rates. Both owe much of their debt to themselves. China's bank loans are more than covered by the country's M2. Both depend on exporting to others. Both really need to focus more on reviving their fertility rates and improving standards of living for their citizens.

CALENDARS

US. Tues: NFIB Small Business Optimism Index 103.8, JOLTS, Wholesale Inventories 0.2%, Kaplan, Kashkari. **Wed:** Import & Export Prices 0.1%/0.1%, Treasury Budget, MBA Mortgage Applications, Atlanta Fed Inflation Expectations, EIA Petroleum Status. (Bloomberg estimates)

Global. Tues: Germany Industrial Production -0.7%/m/m/2.6%/y/y, Germany Trade Balance (euros) 21.5b. **Wed:** China CPI & PPI 1.1%/6.7% y/y, China New Yuan Loans 800b, China Aggregate Financing 1127.5b, China M2 10.8% Y/Y, Japan Leading & Coincident Indexes 105.5/114.7/ Draghi. (DailyFX estimates)

STRATEGY INDICATORS

YRI Weekly Leading Index ([link](#)): Our Weekly Leading Index (WLI)—a good coincident indicator that can confirm or raise doubts about stock market swings—slipped 0.5% during the final week of April after rebounding 3.1% the prior four weeks. It's only fractionally below its record high recorded nine weeks ago. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB retreated by 1.2% the past two weeks after rebounding 5.5% the prior three weeks; it's within 1.8% of its record high recorded during the final week of February. Jobless claims edged up to 243,000 (4-wa) after falling from 254,500 to 242,250 the prior four weeks; it remains close to its recent low of 239,750 in late February—which was the lowest since 1973. The CRB raw industrial spot price index—another BBB component—is falling again. Meanwhile, the WCCI rose four of the past five weeks by a total of 2.4%.

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose last week to record highs for all three indexes. The yearly change in forward earnings is up from six-year lows in early 2016 for all three indexes as y/y comparisons have eased. In the latest week, LargeCap's forward earnings rose to a 64-month high of 10.0% y/y, which compares to a six-year low of -1.8% in October 2015; MidCap's edged down to 11.4% from a 31-month high of 11.5%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's dropped to 11.7% from 12.6%, which compares to a 34-month high of 12.8% in mid-March and a six-year low of 0.3% in December 2015. Growth rates now expected for 2017 and 2018 before the impact of tax-rate changes: LargeCap 11.4% and 11.9%, MidCap 10.5% and 13.6%, and SmallCap 9.8% and 19.8%.

S&P 500/400/600 Forward Valuation ([link](#)): Valuations were steady for LargeCap and MidCap last week, but edged down for SmallCap. Forward P/E ratios have improved from their more than five-month lows in mid-April, but remain below their multi-year highs in early March. P/Es have melted up since the election, but the "E" still remains low as analysts await legislative changes to the tax rate and its impact on corporate earnings. LargeCap's forward P/E of 17.5 remains near the 13-year high of 17.8 in early March. That's up from a 15-month low of 14.9 in January 2016 and the post-Lehman-meltdown P/E of 9.3 in October 2008, but remains well below the record high of 25.7 in July 1999. MidCap's forward P/E of 18.4 compares to a 15-year high of 19.2 in late February and the record high of 20.6 in January 2002, but is up from a three-year low of 15.0 in January 2016. SmallCap's weakened to 19.5 from 19.7; that's up from a three-year low of 15.5 in February 2016 and compares to a 15-year high of 20.5 in early December, when Energy's earnings were depressed, and a record high of 20.9 in April 2002. Looking at their forward price/sales ratios since data became available in 2004, valuations are similarly elevated for the three indexes: LargeCap's P/S of 1.92 and MidCap's 1.32 are close to their recent record highs of 1.94 and 1.37, while SmallCap's 1.04 is down from 1.15 in July 2015 and a record high of 1.17 in November 2013.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): Q2 earnings estimate revisions activity tilted to the downside as expected last week despite a sizeable increase in the positive earnings surprise hook for Q1. The Q2 consensus rose w/w for two of the 11 S&P 500 sectors, was steady for one, and fell for eight. Energy's Q2 forecast rose 1.8% w/w, followed by a 0.3% increase for Telecom and a flat performance for Real Estate. Sectors with the biggest w/w decline in their Q2 forecast: Utilities (-2.5%), Consumer Discretionary (-0.8), Tech (-0.8), and Materials (-0.8). The S&P 500's Q2-2017 EPS forecast fell 5 cents w/w to \$31.73, but is down just 1.1% from \$32.04 at the end of Q1. That represents a forecasted pro forma earnings gain for Q2-2017 of 8.6% y/y, down from Q1's blended 14.7%, which is the strongest growth since Q3-2011 owing mostly to easier comps for Energy. The Q2-2017 forecast is down from 9.3% a week earlier and 11.9% at the end of Q4. Since the end of Q1, Q2 estimates are higher for two sectors and lower for nine. Real Estate's Q2 forecast has risen 1.6%, followed by a 0.3% gain for Utilities. Energy has dropped 5.4% for the worst decline, followed by Telecom (-3.1) and

Materials (-2.2). The S&P 500's Q2-2017 forecasted earnings gain of 8.6% y/y would be its fourth straight gain after four declines. Ten of the 11 sectors are expected to record positive y/y earnings growth in Q2-2017, but only three are expected to beat the S&P 500's y/y earnings gain of 8.6%. That's because analysts expect Energy to report a large profit jump in Q2 relative to very low earnings a year ago. That matches the 10/11 sectors that rose y/y on a blended basis during Q1-2017. The latest forecasted Q2-2017 earnings growth rates vs their blended Q1-2017 growth rates: Energy (769.6% in Q2 versus a return to a profit in Q1), Financials (9.9% vs. 21.3%), Tech (9.8, 18.6), S&P 500 (8.6, 14.7), Materials (7.0, 19.1), Real Estate (3.8, 2.7), Consumer Staples (3.6, 3.3), Consumer Discretionary (2.5, 3.9), Health Care (2.5, 6.9), Telecom (1.7, -4.9), Industrials (0.9, 3.0), and Utilities (-2.6, 2.6).

S&P 500 Earnings Season Monitor ([link](#)): With 83% of the S&P 500 companies finished reporting Q1-2017 results, their revenue and earnings surprise metrics are stronger than at the comparable point of the Q4 season, but Apple's results have impacted the y/y earnings growth results. Of the 419 companies in the S&P 500 that have reported, 75% exceeded industry analysts' earnings estimates by an average of 6.7%; they have averaged a y/y earnings gain of 8.6%, down from 10.8% before Apple reported. Ex-Apple, S&P 500 Q1 earnings growth improves 4.0ppts to 12.6%, and Tech's growth rate rises 15.8ppts to 10.3% from -5.5%. At the same point in Q4-2016, a lower percentage of companies (69%) in the S&P 500 had beaten consensus earnings estimates by a smaller 4.0% and ex-Apple earnings were up a lower 10.1% y/y. On the revenue side, 65% beat sales estimates so far, coming in 0.6% above forecast and 8.5% higher than a year earlier. During Q4, a lower 49% were above forecast, which exceeded estimates by a smaller 0.3% and rose a lower 4.3% y/y. Q1 earnings results are higher for 64% of companies versus a higher 70% at the same point in Q4, but revenues are higher for 77% versus 71%. The S&P 500's earnings beat is the highest in eight quarters, and the revenue surprise is the best in nine quarters. These figures will change as more companies report, but the results to date are encouraging and bode well for future estimate revision activity. However, y/y growth is likely to slow in the coming quarters as comparisons become less easy.

US ECONOMIC INDICATORS

US Merchandise Trade ([link](#)): The real merchandise trade deficit in March was little changed at \$60.0 billion after narrowing dramatically in February from \$65.0 billion to \$59.9 billion. The average monthly deficit last quarter was \$61.7 billion, slightly below Q4's \$62.1 billion, confirming that trade had little impact on real GDP growth last quarter. In March, real exports fell 1.5% after climbing the prior three month by 4.2% to a new record high; real imports fell for the second month, by a total of 3.5%, from January's record high. March's decline in exports was driven by autos (-6.2%), industrial supplies (-4.5), and consumer goods ex autos (-3.7), partially offset by gains in exports of food (1.8) and capital goods less autos (-1.7). The decline in real imports was widespread, with food (-2.9), industrial supplies (-2.2), capital goods ex autos (-1.9), and consumer goods ex autos (-1.1) all in the red; only auto imports (3.9) was in the plus column.

GLOBAL ECONOMIC INDICATORS

Global Composite PMIs ([link](#)): Global economic activity in April remained robust. The J.P. Morgan Global Composite Output Index (C-PMI) was unchanged at 53.7—holding near January's cyclical high of 53.9. The M-PMI slipped to 52.8 from its cyclical high of 53.0 the prior two months; the NM-PMI was unchanged at 53.6, holding near January's recent high of 54.0. C-PMIs for the Eurozone (56.8), the UK (56.2), and the US (53.2) showed solid growth. Within the Eurozone, C-PMIs for Ireland (58.7) and Spain (57.3) finished first and second, while those for Italy (56.8), Germany (56.7), and France (56.6) weren't far behind. According to the report, the spread between the Big Three was the "joint-narrowest" in Eurozone survey history. Growth in the Eurozone, the UK, and the US offset weaker growth in Japan

(52.6) and in larger emerging markets like China (51.2) and India (51.3). Russia's growth (55.3) has slowed since peaking in January, though remains strong, while Brazil's (50.4) returned to expansion after contracting for 25 months.

Germany Manufacturing Orders ([link](#)): German factory orders rebounded 4.6% in the two months through March after contracting in January at the fastest pace in eight years. March's 1.1% increase in orders was entirely driven by a 4.8% jump in foreign orders; domestic orders remained in a very volatile flat trend, contracting 3.8% after a 7.9% gain and a 9.6% loss the prior two months. The increase in foreign orders reflected gains from both inside (6.8%) and outside (3.5) the Eurozone. The increase in the former was the first this year, led by a 20.5% surge in consumer goods orders (24.8% nondurables, 7.7% durables); capital and intermediate goods orders expanded 7.1% and 3.0%, respectively. The 3.5% increase in foreign orders from outside the Eurozone followed a 2.2% gain in February. March's advance in these orders was entirely driven by a 6.4% jump in capital goods orders; intermediate (-2.2), consumer nondurable (-1.6), and consumer durable (-1.0) goods orders fell. March's drop in domestic orders was broad-based, with intermediate (-7.1), capital (-1-1), and consumer durable (-0.4) goods orders falling and consumer nondurable goods orders (0.9) only slightly higher.

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