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China's tricky transition

Signposts to watch in its economic evolution

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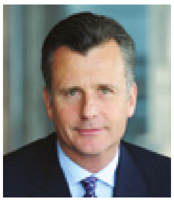

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China's debt-driven growth model is starting to reach limits. Yet the country is also transitioning into a high-tech, more consumer-driven economy. Investors tend to only focus on China when they perceive trouble, but we believe now is a good time to consider the opportunities. Drawing on the insights of BlackRock's investment professionals, we assess the economy's state of play and give a framework for understanding its challenges.

Our bottom line: China's rapid debt buildup is a risk, but we see the current cyclical upswing as mattering more for investment performance in the near term.

Summary

We see scope for China's cyclical rebound to strengthen. Our proprietary GPS gauge is pointing to a positive growth outlook in China, just as supply-side reforms and capacity cuts improve industrial profitability. We like Chinese equities and see the yuan steadying on a trade-weighted basis.

We believe the risk of a debt crisis is limited in the short run. We dig into the factors driving China's debt dynamics and outline reasons why the country could avoid a crisis in the next year or two. We do see the problem only getting worse the longer it drags on.

We do see other near-term risks. First and foremost, a potential trade war with the US could undercut the recovery. Second, risks of temporary credit crunches are rising as China's central bank has started a targeted policy tightening to curb financial system leverage.

We score China's reform progress and provide a framework for assessing whether it is getting on a sustainable economic path. We highlight three key signposts: China's ongoing capital outflows, potential interbank financing strains and the rising share of consumption in economic growth.

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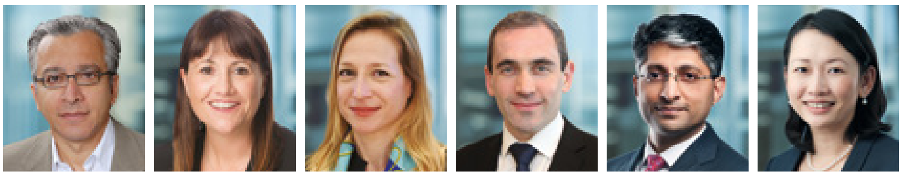

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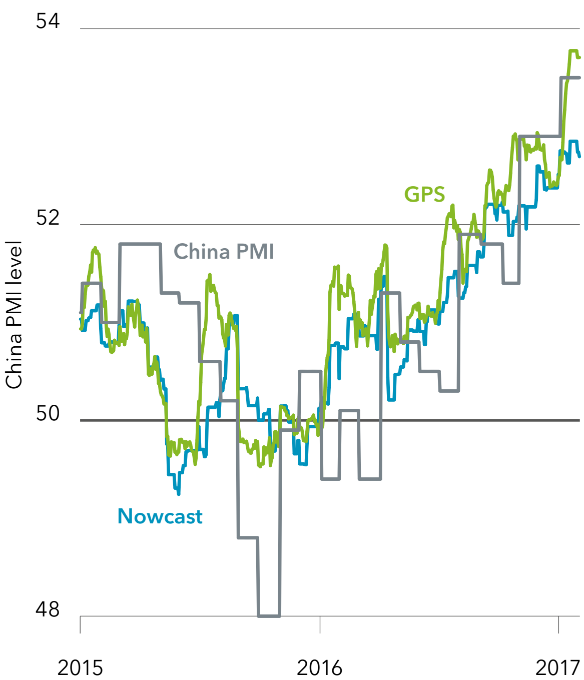
Broadening rebound

Mini-shocks emanating from China dealt investors a series of body blows just a year ago. Yet just as China slipped from the headlines, a steady recovery started to build momentum. We take the pulse of China's economy and find a positive near-term outlook with clear risks.

We are optimistic about China's near-term growth outlook in what is the year of the Fire Rooster in the Chinese zodiac. Our proprietary ***BlackRock GPS*** signals more upside to China's composite PMI, even if housing activity and auto sales cool this year. With the GPS near its highs, this upswing looks to have room to run. The difference between the GPS and its nowcast, based on traditional indicators, gives a sense of how our big data signals are helping drive the overall GPS higher. Those signals come from text mining the mentions of China in corporate earnings calls and the descriptions about activity by Chinese executives. In hindsight, the China GPS suggests that the late-2015 economic worries were overdone and the recovery began early in 2016.

Upbeat outlook

BlackRock China GPS vs. PMI, 2015-2017



Sources: BlackRock Investment Institute, Caixin/Markit, February 2017.
Notes: the green line is the GPS showing where the Caixin composite PMI (the grey line) may stand in three months' time. The blue line shows our nowcast.

The improving growth outlook is one reason why we are upbeat on Chinese equities near term as a global trade pick-up reinforces the domestic momentum. The surge in industrial metals goes beyond local speculation as underlying demand has improved. Some capacity cuts are making a difference in coal and steel, and we expect similar cuts to spread to more sectors including cement, glass and aluminium refining. Higher commodity prices and a weaker yuan have boosted industrial profits while easing some bad debt risks, just as improved global demand is feeding into stronger export growth. The sharp rise in Chinese wholesale prices after sliding for five straight years shows that deflation risks have faded.

Supply-side reform remains the prime goal heading into the late-2017 Communist Party congress. Major reforms are likely to be on hold through that key meeting at which President Xi Jinping is expected to consolidate power as he starts a second five-year term. We see supply-side reform and lifting private sector returns as top near-term priorities. China's main arm for industrial strategy is now expanding the sectors to be included in supply-side reform while also looking to promote mergers and acquisitions and better recognition of non-performing loans (NPLs). Taking out supply is now seen to be as powerful as stimulating demand, especially with reform benefits filtering through. We are watching what Xi prioritises after the party congress, with China also seeing an opportunity to play up its role on the international stage. We do not expect any currency surprises after authorities successfully intervened at the end of 2016 to curb speculative bets on yuan depreciation. Capital outflows and the resulting foreign reserve drain are a concern – but a smaller one – and China's foreign exchange (FX) reserve buffer remains large. For both growth and the yuan, stability will be the watchword all year.

A familiar growth booster

China's recovery has been very broad. Everything from export orders to industrial profits has improved – partly because the corruption crackdown has mostly run its course and local officials started to deliver on growth targets again. The heat map below charts the improvement, with the green bands showing an increase in activity relative to history.

China has resorted to a tried-and-true method to achieve the return to steady growth and reduce some of the anxiety around its policies: juicing the economy via credit growth.

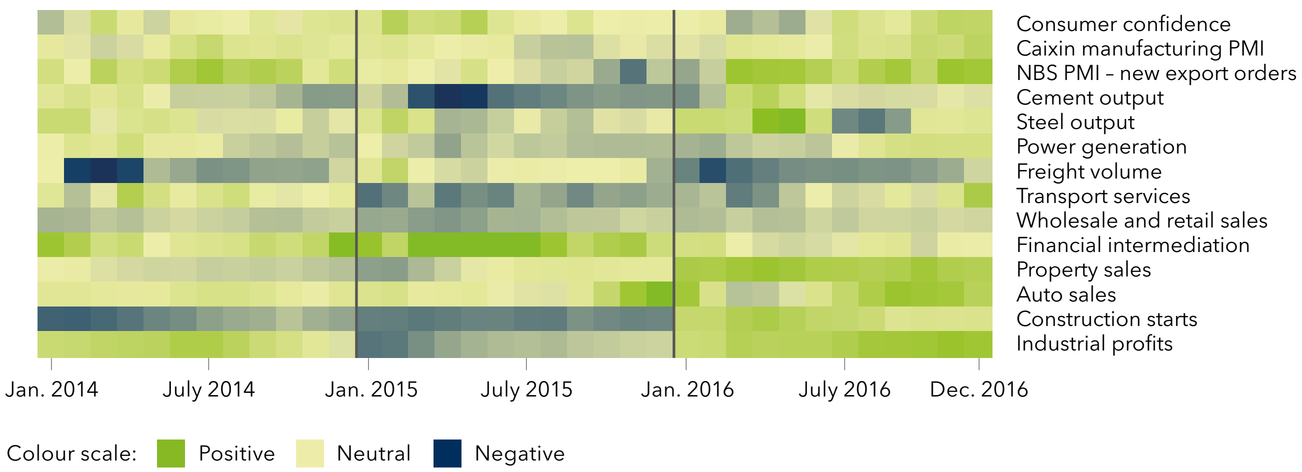
We are worried about the build-up of debt in the economy – to more than 250% of GDP by mid-2016, according to Bank for International Settlements (BIS) data – and dig into the risks on pages 6-7. We believe official fiscal spending can play a greater role and stands ready to do so if needed, as detailed in our February 2017 ***Global Macro Outlook***. The surge in bank claims on non-bank financial firms underscores the reliance on large credit growth for China to achieve its lofty growth target. Government-run policy banks are doing more to lead infrastructure lending, while local governments remain a source of fiscal-like borrowing and spending.

The upturn in Chinese exports shows that the global recession in trade has run its course and US reflation is having positive spillovers. But we do see the threat of a trade war as the biggest near-term risk: China Customs data show its exports to the US make up almost a fifth of the total at the end of last year. A trade war could undercut the recovery while likely delaying China's reform drive. US President Donald Trump has surrounded himself with advisers who appear to have China in their sights. His head for a newly created National Trade Council, Peter Navarro, has authored a book titled "Death by China". The president has much leeway to set trade policy without Congress.

So far, the Trump administration has stopped short of taking unilateral actions against China or calling it a currency manipulator. Trump's first call with Xi was reportedly fairly courteous, with a reaffirmation of the One China policy that was key for the relationship. Trump's initial flurry of trade actions have focused on scrapping the Trans-Pacific Partnership and renegotiating the North American Free Trade Agreement. Other potential China risks include the People's Bank of China's (PBOC) targeted liquidity tightening causing a debt accident (see page 10). Efforts to cool the property market could lead to a sharp pullback.

Broad rebound

China activity heat map, 2014-2016



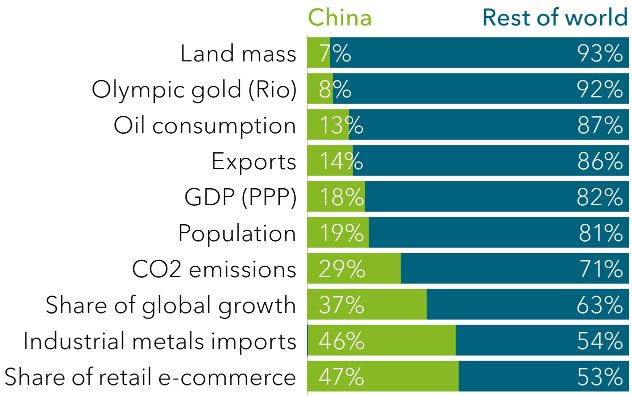
Sources: BlackRock Investment Institute, Bloomberg, Markit & China's National Bureau of Statistics, February 2017.
Notes: we score each activity indicator based on its standard deviation from the average since 2000; the table is then colour-coded based on the period 2014-2016 to show relative performance.

Understanding China

Selected Chinese and global metrics, 2013-2016

Click for interactive data

	China	US
Population (millions)	1,371	321
GDP per capita (PPP)	$15,424	$57,294
High speed rail (km)	22,000	45
Internet users (per 100 people)	50	75
Cellular phones (per 100 people)	93	118
Military spending (share of GDP)	1.95%	3.3%
Number of aircraft carriers	1	19
Life expectancy (years)	75.8	78.9
Car production (millions)	21.1	4.2
Equity market cap (% of GDP)	74	139



Sources: BlackRock Investment Institute, World Bank, European Commission EDGAR, eMarketer, BP, OICA, EIA, Thomson Reuters and IMF. Notes: the GDP and e-commerce data are for 2016, with GDP based on IMF forecasts. Population, oil consumption, exports, GDP growth share, car production, market capitalisation, cellular subscriptions, internet users and military expenditure are based on 2015 data. Metals imports, CO_2 emissions and life expectancy are based on 2014 data. China high-speed rail distance are based on 2016 reports by China Railway Corp. US high-speed rail distance are based on sections of the Acela Express where speeds exceed 120 mph. China's first aircraft carrier was reported as combat-ready in late 2016.

China in context

We like to think of China as a continent more than a country. That allows us to better grasp the sheer scale of its development transformation. What is clear: how China evolves will have major ramifications for the global economy. Data from the International Monetary Fund (IMF) show that China accounted for a quarter of world GDP growth over the past 20 years, yet its share of world GDP is smaller than it was two centuries ago, according to the academic ***Maddison Project***. The map and tables above put China in context. Its hunger for global commodities and major pollution problems are well known. But the heft of China's digital economy is less familiar: E-commerce revenues now make up nearly 50% of the world total, while mobile payments were 50 times those in the US at $5.5 trillion (38 trillion yuan) in 2016, according to China's iResearch and Forrester Research.

Greater urbanisation is one of China's top growth goals, with the aim that nearly 70% of its 1.37 billion population live in urban areas by 2030, compared with 52% in 2010, according to a 2014 ***World Bank report***. This ongoing urbanisation should feature vital reforms: revamping the *hukou* household registration system to allow a greater rural shift to cities, improving land rights, offering more government pension and health care benefits, and adopting more green technology. Thus, infrastructure spending will still play a key role driving growth, especially in the less developed central and western regions of the country as part of Xi's One Belt, One Road initiative to boost ties with Eurasia along old Silk Road routes. China can reorient its vast consumer base in unique ways: Bernstein Research highlights an 11-fold surge in hybrid and electric auto sales in three years to nearly half a million by the end of 2016.

Seeking a better balance

China's debt troubles are well known and endlessly debated – even within BlackRock. How big is the risk? We believe big enough for a potential home-grown financial crisis. We give parameters for thinking about the debt balancing act and detail key reforms to watch.

China's debt stock is huge. Its non-financial debt has soared above 250% of GDP according to 2016 BIS data, well above any level considered tolerable by most economists. The pace of growth is more disturbing. Countries where debt has risen this far, this fast have historically faced crises followed by painful clean-ups, as the chart on the bottom right shows.

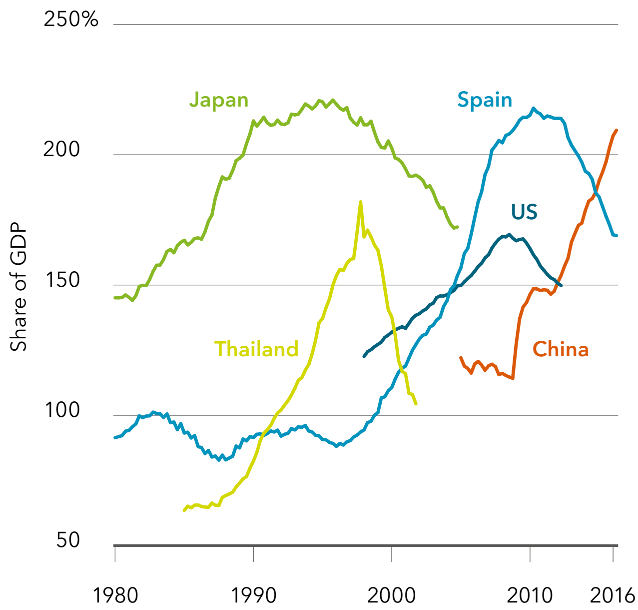
China's problem? Reducing credit growth to more sustainable levels would hurt economic growth and undermine its leadership's ambitious GDP targets. Stabilising China's debt level would require cutting credit growth from the roughly 15% annual pace now to something closer to China's nominal growth rate of about 8%, based on 2016 BIS data. The problem isn't new. In 2007 then-Premier Wen Jiabao listed the economy's woes back when leverage was much lower: unbalanced, unstable, uncoordinated – and unsustainable. Fast forward a decade and China's leadership shows little appetite for disruptive changes to the growth model.

What is the anatomy of any crisis? Think of it as a corporate train wreck in slow motion: falling revenue growth, rising financing costs and eroded financial buffers mean debt gets harder to roll over. Thus a liquidity crisis morphs into a solvency crisis – more late-1980s Japan than a classic emerging markets crisis. That's the risk in the private and state-owned enterprises (SOE) where the debt has built up, debt that investors often hold with an understanding of implicit government support. China has strengths: a lack of external debt and large FX reserves. Household and government debt levels are limited, and both sectors are receiving a bigger share of new credit growth. The 2016 BIS data show non-financial corporates, some of which play a quasi-fiscal role like local governments, hold two-thirds of the debt. So China is different in important ways.

The good news: on paper, a rise in NPLs from current levels near 2% of outstanding loans should be manageable for the large state-owned banks, perhaps with government support. But big questions remain about the strength of the mid-sized and joint-stock banks, as well as the 'shadow' linkages beyond the banks winding through the financial system. China faces a balancing act. The longer its debt problems are not addressed, the more the risks grow. High growth targets lead to excessive credit growth and misallocated resources. Ballooning credit and money supply create the risk that liquidity seeps out through the capital account, pressuring the yuan. Yet a soft economy due to weak credit growth could also result in capital outflows if local investors seek better returns abroad.

Unprecedented buildup

Private credit as share of GDP, 1980-2016



Sources: BlackRock Investment Institute and Bank for International Settlements, February 2017.
Note: the lines show total credit to private non-financial sectors as a share of GDP; lines have been cropped to show periods of high credit growth.

Striving for sustainability

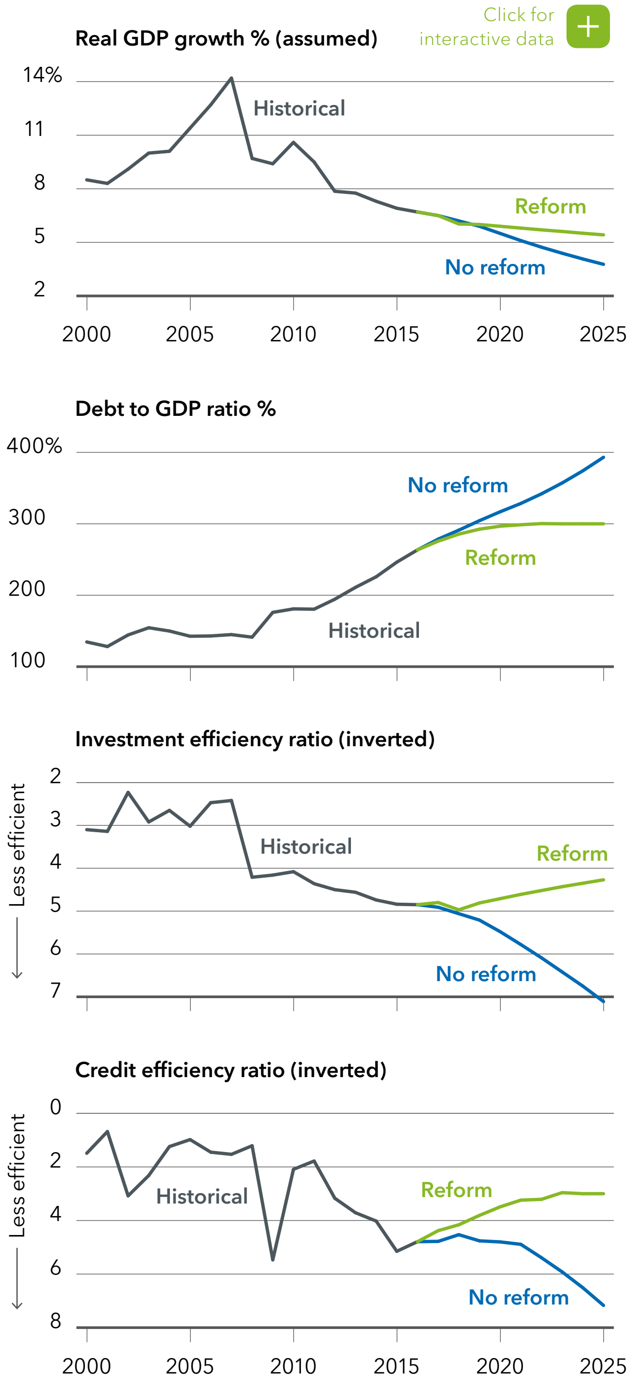
We took a deeper dive into China's growth and debt dynamics to get to grips with the reform challenge that China faces to put itself on a sustainable path. The charts show the potential outlook for China's GDP, debt-to-GDP ratio, investment and credit efficiency under two scenarios. The blue line is based on a 2016 IMF 'no reform' scenario, while the green line is a 'reform' scenario based on the IMF's central forecast where credit efficiency is improved, debt stabilises and growth moderates more gradually – a big change from current trends.

What stands out is how such a debt-driven investment boom has wasted precious capital with inefficient allocations. The deterioration began with China's 2009 stimulus injections to limit the damage from the global financial crisis. It has accelerated since then, more in infrastructure than the traditional sectors with excess capacity such as coal and steel. The reliance on new credit and debt to prop up growth is clear. The different potential outcomes for credit and investment efficiency in these scenarios – inverted on the charts to show the scope for further deterioration – quantifies the reform challenge. The reform scenario sees a big economic restructuring: a hypothetical 3 percentage point shift of GDP to consumption from investment, a slowing of debt growth from over 15% today to eventually expanding in line with nominal GDP near 8% – with all other variables held constant. Ultimately, this means stopping money from being thrown at an increasingly inefficient capital stock.

More efficient capital investment – what successful supply-side reforms should achieve – is a critical part of the equation. Also implicit in this scenario is an improvement in productivity growth to help GDP growth stay near a 6% annual rate. If China fails to reform, the greater use of debt to stoke growth in already bloated sectors may lead to an even greater deterioration in investment and credit efficiency. That could cause GDP growth to slow sharply. The crux for China getting debt under control? It must achieve these tricky reforms while maintaining a certain level of economic and income growth to deliver on promised prosperity. It is a challenging balancing act.

China's debt-growth dance

China GDP growth and credit metrics, 2000-2025



Sources: BlackRock Investment Institute, IMF, Bank for International Settlements, February 2017. Notes: the chart shows China growth and credit metrics, based on annual data and projected based on scenarios created by the IMF as part of its 2016 *Article IV review*. The IMF no reform scenario assumes that the investment share of GDP remains constant. The stabilisation scenario uses the IMF's GDP forecast from the World Economic Outlook and assumes the investment share of GDP falls by 3 percentage points by 2021 and we extrapolate that same pace of decline to 2025 while keeping the debt-to-GDP ratio constant. All other variables are held constant. The investment efficiency chart shows how much investment is needed to generate a unit of GDP growth. A higher number shows that the capital stock is growing by more than GDP, thus depicting inefficient investment. The credit efficiency chart is the same but with credit (non-financial debt) relative to GDP.

Reform scorecard

Making the transformation a reality

Cyclical gain	Score	Cyclical pain	Score
Relaxing one-child policy	■■■■	Anti-corruption	■■■■■
Tax reduction	■■■	Interest rate liberalisation	■■■■■
Price reform	■■■	Debt nationalisation	■■■■
Urbanisation/hukou reform	■■	Debt restructuring/breaking implicit guarantee	■■■
Capital market innovation	■■	Supply-side/SOE reform	■■
Intellectual property protection	■■	FX reform	■■
National safety net/pension reform	■■	Capital account opening	■■
Healthcare reform	■■	Environmental protection	■■
Land reform	■	Deleveraging	■

Source: BlackRock Investment Institute, Chinese government and media reports, February 2017.
Notes: this table ranks various reform measures based on whether they support near-term cyclical growth or are a drag. We score how much progress China has made on these reforms on a scale of 0-5, with 5 being complete progress. These scores represent the views of BlackRock's investment teams relative to the government's planned reforms .

The bullish case

By Christian Carrillo, Asia Pacific Fixed Income team

GDP growth should hold around 6.5% or higher, with the share of GDP going to investment shrinking to about 35% from the current 42% and consumption and other activity taking up a larger part of GDP. In practice, this means services output should grow between 1.5-2.0 percentage points faster than industrial production and the latter will likely hold at a 5-6% growth rate – very much the experience of the past few years. This also means that the GDP deflator cannot crash like it did in recent years, and thus reform needs to happen at a pace that reduces excess capacity and supports commodity prices. The tone of reforms will be set after the party congress and should be critical for determining how this plays out. A slow deceleration of debt growth, from 12% per year to 10%, should moderate the rise in the debt-to-GDP ratio and eventually stabilise it if inflation picks up. One implication is that the PBOC doesn't need to slam on the brakes to slow credit. If credit and investment efficiency both improve as the investment share of GDP declines, we don't need productivity gains out of line with historical experience.

The bearish case

By Mihail Calinescu, Multi-Asset Strategies team

The reform scenario requires improvements in credit and investment efficiency to be realised instantaneously and painlessly. But growth is path-dependent. An economy based on investment-led growth, fuelled by ever-increasing credit, does not change overnight and is vulnerable to any credit slowdown. If credit cools, authorities will face tough choices: 1) roll over bad debts in the inefficient old economy and potentially starve the new economy of credit, thus collapsing growth; 2) socialise the losses via inflation or taxation and undermine the consumption shift; or 3) realise losses and face a financial crisis. History shows that credit slowdowns usually end in crisis, from South Korea and Taiwan to Japan. China may be past the point of avoiding a crisis: the longer credit expands faster than GDP, the more pain China will likely face. Reforms may be too late to fix the problem. Transitioning to a consumer-based economy requires the market, not the state, to allocate resources. Current SOE reforms only increase the role of the state. This makes the transition as much a political challenge as an economic one.

Signposts and implications

We assess China's progress in three signposts and charts: the yuan and capital outflows, the interbank market and the GDP make-up. These show whether risks are being dealt with in ways that would allow investors to focus on bigger-picture opportunities.

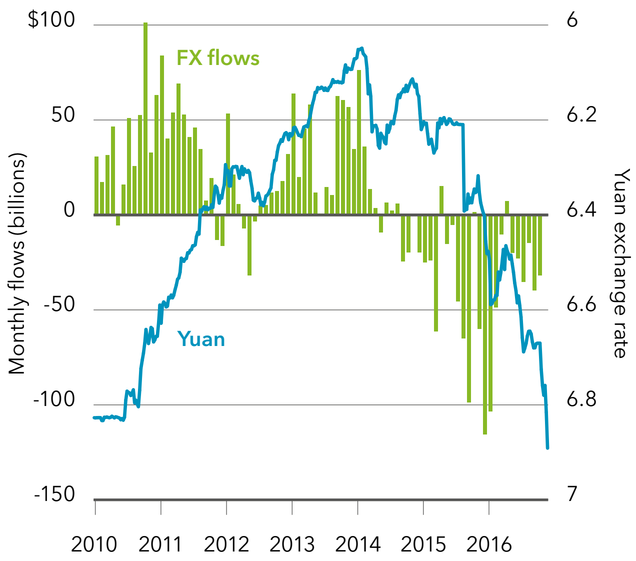
The big question used to be when China would open up its capital account and join major economies in having a more free-floating currency. The sudden shift towards a weaker yuan (also known as the renminbi) in 2015 after the mini-devaluation and move to join the IMF's Special Drawing Rights basket changed that picture. Since then, China has sought to plug holes its capital walls due to persistent outflows that have drained FX reserves, even if they remain sizable near $3 trillion, as at January 2017. Outflows have moderated but remain around $30-50 billion per month, as the chart on the right shows.

For now, the policy response has been typical: clamp down on money leaking out of the country, regain some control over the currency to push back against speculators and try to limit expectations for further yuan depreciation. In an ideal world, China could now attract foreign investor inflows to find a better two-way balance on the currency and move toward something more floating compared with what remains a highly managed exchange rate. The risk is that the PBOC's reserves may eventually dwindle to the point that it decides a more freely traded currency is preferable to defending the yuan and burning through its FX war chest.

China threw open the doors to its bond market last year but received a lukewarm reception. We see a possibility that some major global bond indices announce China's inclusion this year. This could herald greater foreign appetite for the world's third largest government bond market. MSCI appears closer to including China mainland-traded A-shares in its main EM equity indices, also a step towards China opening up more to the world after previous moves to allow share trading between the Hong Kong, Shanghai and Shenzhen exchanges.

Stubborn outflows

China foreign exchange flows and yuan, 2010-2016



Sources: BlackRock Investment Institute, Thomson Reuters, China's State Administration of Foreign Exchange and the PBOC, February 2017.
Notes: flows are a three-month moving average of three different gauges of net foreign exchange (FX) flows in mainland China: the PBOC's FX on its monetary balance sheet, its foreign reserves and its measure of net FX settlements by commercial banks on the mainland. A negative number suggests net currency outflows, or buying of foreign exchange and selling of yuan.

A weaker currency has had its benefits. The yuan dropped as much as 8% on a trade-weighted basis between August 2015 and September 2016 before steadying, BIS data show, helping China regain competitiveness and pull the economy away from its flirtation with deflation.

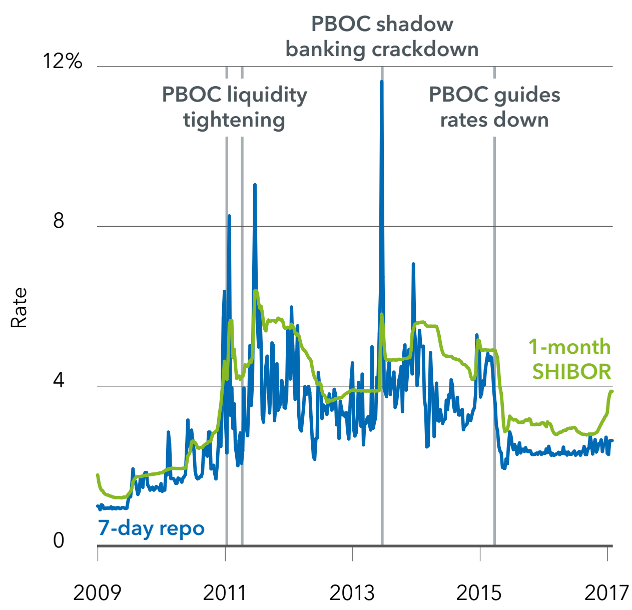
How China will manage the yuan in the future is dependent on whether it can stop or reverse the current capital outflows, in our view. Further outflows may hurt domestic confidence in the currency and remain a vicious circle driving it down – no matter how much the US complains. We don't expect a one-off devaluation but see authorities trying to limit outflows and pushing back against bets on further currency depreciation for now.

Interbank connections

The recent growth pickup is such that the PBOC appears to feel comfortable tightening its liquidity stance, if only marginally – with one eye on inflation and another on currency speculators. In January, the central bank raised its medium-term lending facility rate, a relatively new but key policy tool for pumping cash into the system, by 10 basis points. It followed up with a similar increase on other facilities a few weeks later. Arguably, the shift began when the PBOC fired a shot across the bow of leveraged market participants in early November, sparking a rout in the bond market. Some of this is trying to curtail leverage that has built up in the shadow banking sector, where financial firms rely on the repo market for financing securities that are repackaged. We see potential risks that the large and opaque shadow banking system could suffer a credit scare and liquidity freeze-up that causes a spike in interbank rates. The benchmark seven-day repo rate has been steady, reflecting the targeted PBOC tightening move, but other interbank rates are rising. We see the PBOC treading carefully, given the leverage in the system.

Watching for stress

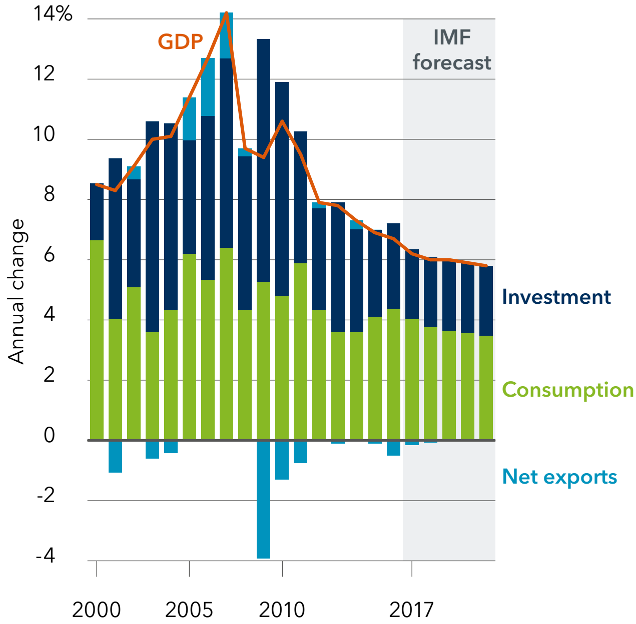
Chinese interbank interest rates, 2009-2017



Sources: BlackRock Investment Institute, Thomson Reuters and People's Bank of China, February 2017.
Notes: the chart shows key Chinese interbank rates for the local fixed income market and the impact of various PBOC actions to change policy.

Consumption takes lead

China real GDP breakdown and forecasts, 2000-2021



Sources: BlackRock Investment Institute, Chinese National Bureau of Statistics, IMF Article IV Report (2016), February 2017.
Notes: the chart shows the historical breakdown of China GDP between the three main expenditure categories (consumption, investment and net exports) along with overall real GDP and the IMF's forecasts.

Making the GDP shift

We believe China is taking appropriate steps to become a more services-driven, consumption-based economy. Achieving a smooth hand-off to households and consumers from an industrial-led growth model is never easy. There is a reason why Japan, South Korea and Taiwan are rare examples of economies that avoided the so-called middle-income trap and successfully made the transition to become wealthy and services-oriented. The fall-off in investment has caused Chinese growth to slow and means that consumption holds the key to overall growth going forward, as the chart above shows.

From a credit perspective, a shift is under way: some 30% of new lending is going to households, thanks to mortgage demand, the 2016 BIS data show. Urbanisation should play a major role, which is why Premier Li Keqiang has prioritised it. So will taking the next big steps in shoring up a public pension and health system. This should encourage more spending, instead of rainy-day savings that get channelled into unproductive investment.

Investment implications

We are positive on China in the near-term due to its cyclical growth recovery further fuelled by the global upswing. While the surge in China's PPI above zero signalled fading deflation risks, the export rebound shows how global reflation has more room to run absent any external shocks. Our BlackRock GPS points to more upside for China's broad composite PMI. Other key points:

- We believe officials are seeing the economic and corporate benefits of cutting capacity in bloated industrial and SOE sectors. We see investment opportunities as the cleanup spreads to sectors beyond steel and coal, which would be positive for commodity prices and industrial profits.
- We expect controlled defaults, recognition of bad debts and progress in letting financial markets play a bigger role in capital pricing and allocation.
- We believe China will slowly press ahead with opening up its markets, with mainland equities and bonds likely joining major global indices as soon as this year. Capital inflows could follow, especially if pessimism on China starts to fade.

We recognise the multifaceted challenges that China faces. The matrix below shows how we think about these interconnected risks and judge whether the core problems are being tackled or deferred. We view this and our signposts as a good prism for understanding whether China is getting on a more sustainable economic path or is stuck on its old one. Yet we also believe that investors shouldn't only focus on the risks:

We are positive on Chinese equities. See our February 2017 ***Global Equity Outlook*** for more. The shift to more consumer-led growth opens up opportunities for both domestic companies and global ones tapping into the Chinese market. We see opportunities on the near-term investment horizon, whether in SOE reform, the booming e-commerce sector or the fast adoption of green technologies to address environmental woes. Our bottom line: we believe it would be unwise to ignore China's possibilities given the sheer scale of its tricky transition. The country is undergoing an transformation where the consumer is playing a greater role, supported by a unprecedented rate of urbanisation. For all the risks, we believe the potential within China should not be underestimated.

Interconnected risks

How China's risks could play out: kicking the can, biting the bullet or a mix of both

Defers		Accelerates
Lower rates make debt more affordable. Lower foreign rates curb capital outflows.	Interest rates	Higher rates lift burden of debt stock. Higher foreign rates spur outflows.
Weaker US dollar reduces pressure on capital account.	US dollar	Stronger US dollar heightens pressure on capital outflows.
Slower capital outflows reduce pressure on FX reserves and yuan.	Capital flows	Faster capital outflows drain reserves and add to depreciation pressure.
Looser capital requirements and regulation boost credit creation.	Capital requirements and regulation	Stricter capital requirements can limit banks' ability to roll over debt.
Allowing expansion of shadow banking increases credit creation.	Shadow banking sector	Clamp-down on shadow banking puts debt roll-over burden on banks.
Slower reform means fewer realised NPLs and smaller near-term growth hit.	Structural reforms	Faster reform means more realised NPLs and a hit to near-term growth.
Faster reform improves efficiency and reduces NPL proportion.	Structural reforms	Slower reform means bad debts build up faster as growth slows.

Source: BlackRock Investment Institute, February 2017. Notes: the table shows how BlackRock's investment professionals view the risks that could defer or accelerate the risk of a crisis. The opinions expressed may change with future conditions.

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