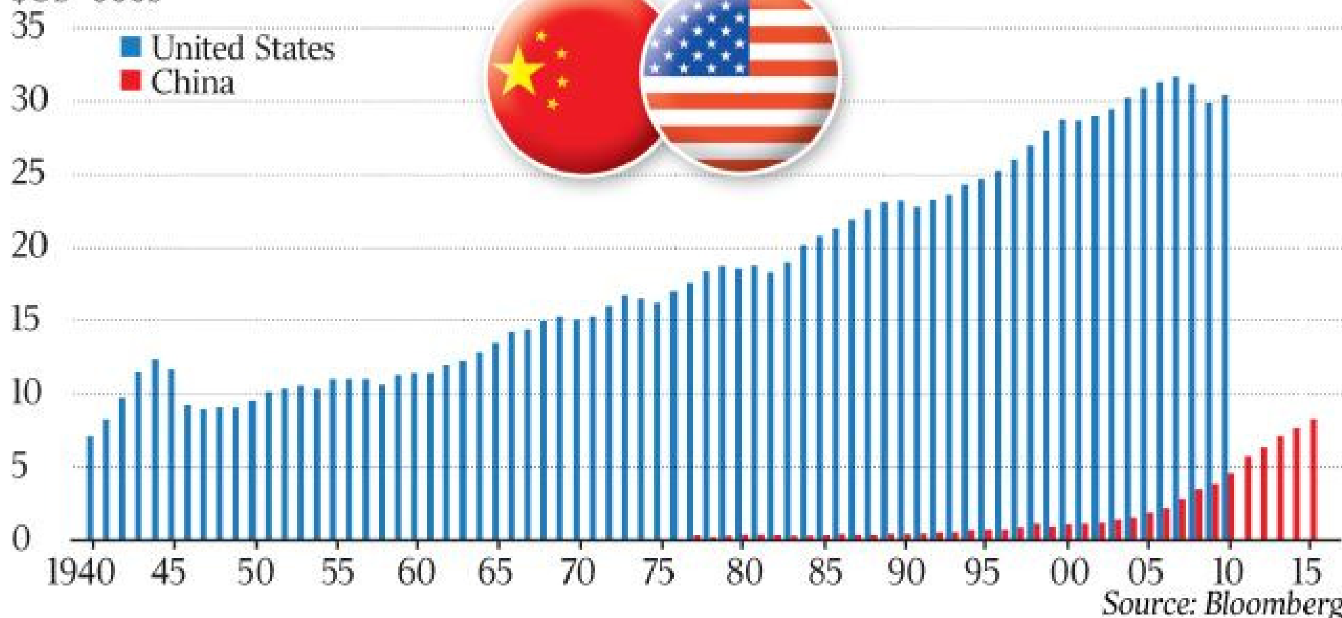
THE AUSTRALIAN

China misses MSCI but economy is making up for lost decades

STIRLING LARKIN THE AUSTRALIAN 12:00AM JUNE 18, 2016



GDP

China's President Xi Jinping remains resolute about a plan to double the size of China's economy under his premiership before his secession in 2022.

The news this week that MSCI (the global stock indices), for a third consecutive year, excluded China's A-shares from the internationally significant MSCI Emerging Market index really does not concern Xi or the ruling Communist Party.

Even with China's nominal or actual growth metrics nearer those of the US on an annualised basis, as this week's graph clearly emphasises, the Chinese economy itself still has a century of development to catch up to that of America's scale. Australian ultra high net worth investors, many of whom have held both Chinese A-share and US-quoted American depository receipts, or ADRs, in company holdings including Alibaba (BABA: US) and (BIDU: Nasdaq), have been paying China more attention over the past fortnight due to:

1) What, if any, consequences will be seen by China's 2016 MSCI index exclusion.

2) Equity, bond or currency volatility spikes, triggered by a June 23 Brexit "Leave" outcome.

3) The precarious greenback-yuan ongoing foreign exchange tensions.

China's recent CSI300 market performance has been driven by an expectation of additional policy support and not by fundamentals that would see a cyclical recovery in earnings growth.

Given the increasingly obvious nexus, or close market correlations, between Australia's ASX200, China's CSI300 and Hong Kong's "Redchips" — mainland Chinese companies incorporated internationally and listed on the Hong Kong Stock Exchange — Australian global and domestic equity investors would be wise to pay close attention to valuations, expectations and perspectives in the People's Republic. According to the International Monetary Fund's 2016 Global Financial Stability Report, JPMorgan believes that:

• When the EBITDA interest coverage ratio falls below one and net debt to EBITDA goes above five times, the average non-performing loan ratio goes up to 12-14 per cent.

• When debt service drops below two times, the average non-performing loan rises to 18-20 per cent.

Following this, financial reports from listed Chinese companies suggest that we are within the direct range of these two scenarios.

Nonetheless, so long as China has a relatively insulated financial system and low levels of foreign debt, a serious financial crisis seems unlikely to materialise.

According to market analysts Gavekal Dragonomics, there are three broad ways China's excessive leverage can be unwound:

1) Default: A clean break with bad debt followed by restructuring is usually the most efficient approach as losses get shared between creditors and borrowers.

2) Nationalisation: The danger with governments taking over banks is that bureaucrats run credit allocation but then again the clean-up gets funded at a "sovereign" rate of interest, leaving banks with repaired balance sheets.

3) The "stealth" option: This approach seeks to buy time, or kick the can down the road, by having inflation erode the real value of the bad debt.

Regardless of which path China pursues, it remains imperative that Australian investors remain wary of excessive levels of leverage but focus on how and where China continues to grow.

Larkin Group is an ultra high net worth wealth team focusing on high-yielding global investments.

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