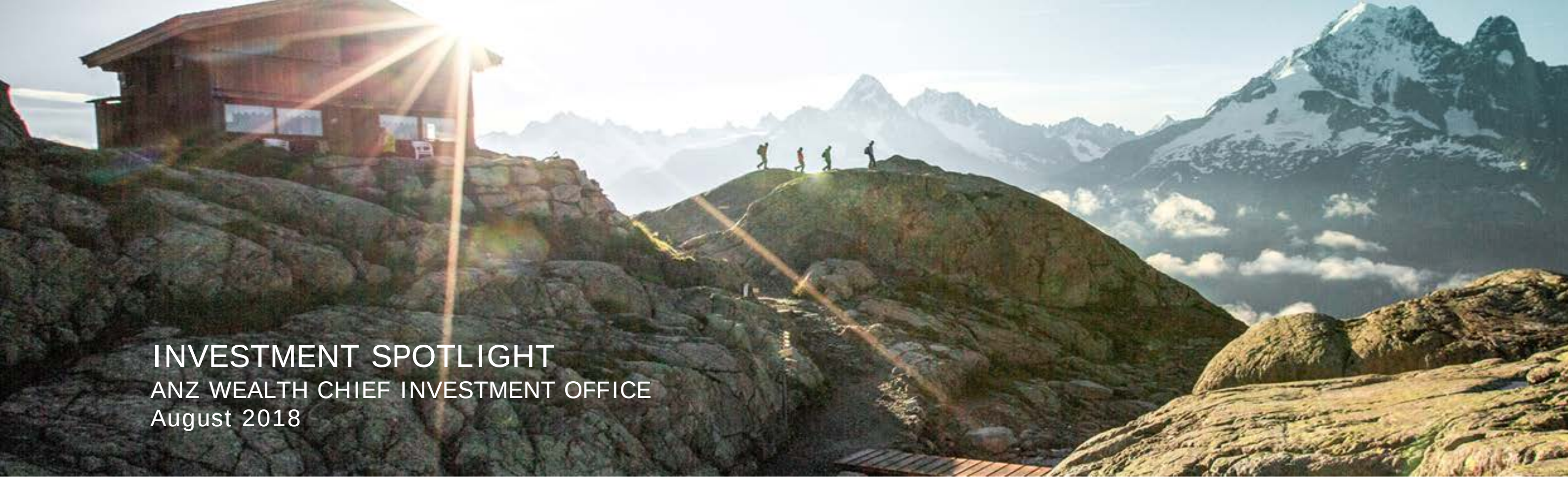


INVESTMENT SPOTLIGHT
ANZ WEALTH CHIEF INVESTMENT OFFICE
August 2018

CHINA DIALS BACK ON DEBT - WHAT DOES THIS MEAN FOR MARKETS?

China built up huge amounts of debt after the Global Financial Crisis (GFC) and this acted as a locomotive to drive post-GFC growth. But the rapid growth in debt has now slowed in China. What's next? Read on for more.

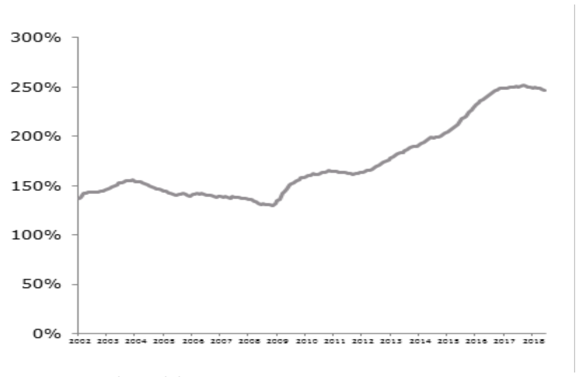
CHINA LEVERAGED UP POST GFC

China, the world's second biggest economy, built up huge amounts of debt after the GFC and this helped prop up post-GFC growth and supported investment markets.

CHART 1: CHINA CREDIT GROWTH

Source: Emerging Advisors Group

CHART 2: CHINA CREDIT AS SHARE OF GDP



Source: Emerging Advisors Group

Chart 1 shows that credit growth leapt to an annual pace of over 30% in 2009, providing a huge boost for the economy. While the pace of growth has slowed since then, it has still outpaced the growth rate of the economy. As a result, the stock of debt has doubled to a little under 250% of GDP (Chart 2).

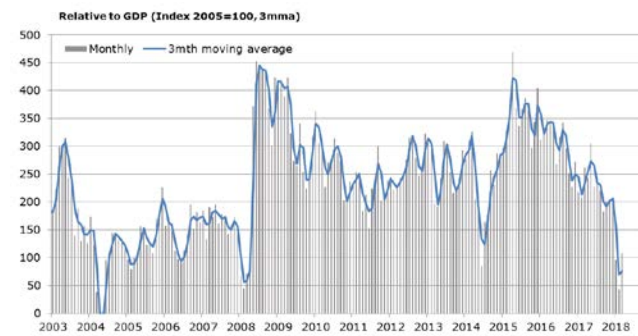
LEVERAGING COMES TO AN END

China's government has acknowledged that the earlier pace of credit growth was unsustainable. After undertaking another economic stimulus program in 2015 that pushed credit growth to over 20%, it has now more than halved to 8%.

Such dramatic swings in credit growth will inevitably be important for the economy and markets. We find the best way to look at this is how much the growth of credit changes, rather than simply the pace of growth. This is commonly referred to as a "credit impulse" measure.

Jon Anderson of Emerging Advisors Group, a specialist research house on emerging market economies, calculates a series for China that looks at the changing growth of credit relative to the size of the economy (Chart 3). It shows a dramatic rebound in growth in 2008, followed by a slowdown that troughed in 2014 before another dramatic rebound and sharp slowing in recent years.

CHART 3: CHINA CREDIT IMPULSE

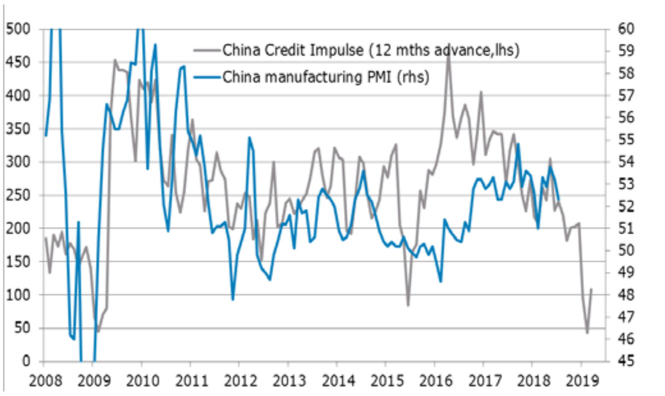


Source: Thompson Reuters Datastream, ANZ Wealth, Emerging Advisors Group

The current reading puts the credit impulse at its weakest in a decade but with some signs of stabilisation beginning to emerge. However, credit leads the economy by around a year and flags a weakening in momentum for a while yet (Chart 4).

But the impact appears to extend well beyond China's shores.

CHART 4: CHINA CREDIT IMPULSE AND GROWTH

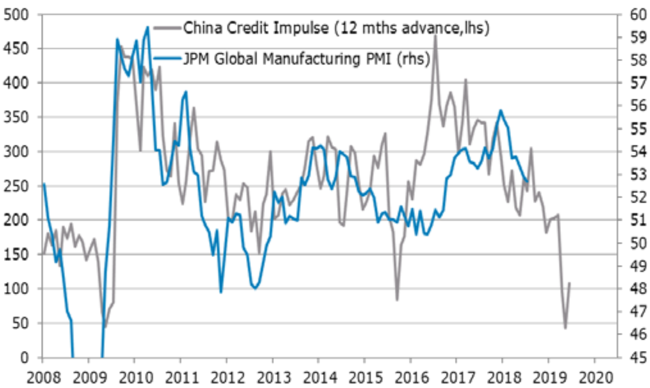


Source: Thompson Reuters Datastream, ANZ Wealth, Emerging Advisors Group

THE GLOBAL IMPACT

The China credit impulse series, with a lead of around a year, has correlated reasonably well with the Global Manufacturing Purchasing Managers Index series (PMI) since the GFC period (Chart 5).

CHART 5: CHINA CREDIT IMPULSE AND GLOBAL MANUFACTURING

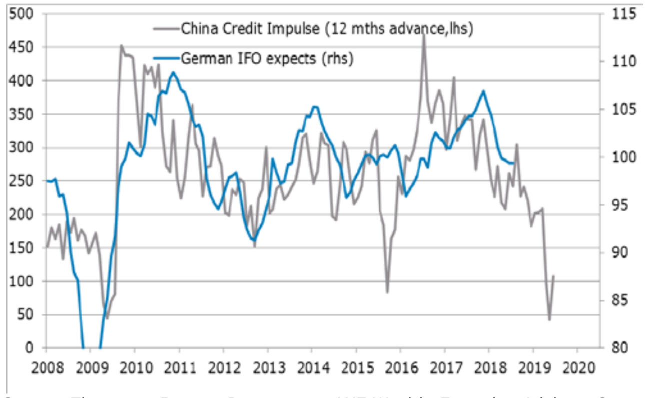


Source: Thompson Reuters Datastream, ANZ Wealth, Emerging Advisors Group

In a world where most economies were reducing their debt burden, China's aggressive leveraging has made it a locomotive for growth. The relationship is particularly evident for trading nations such as Germany in the well-known IFO sentiment survey for German industry (Chart 6). It warns a sharp slowdown in global manufacturing may eventuate if China's weak credit impulse series is maintained for a period of time. Fortunately China has undertaken a range of easing measures in recent months, with some recovery underway, but it is still early days.

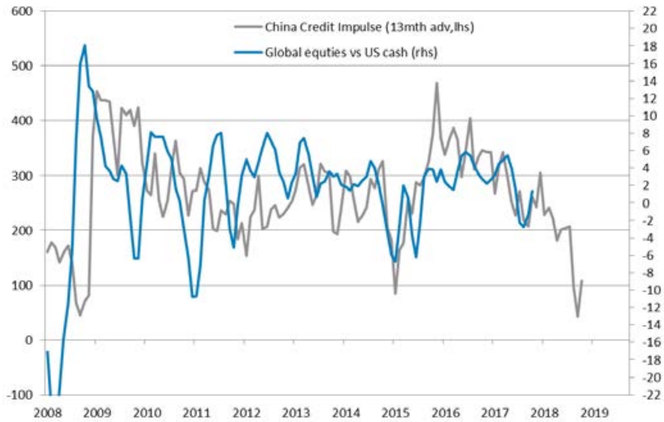
Given the close link with economic growth trends, it's not surprising that we also find a correlation between the credit impulse and the returns of global equities with a lead of a year (Chart 7). The moderation in equity returns so far this year is consistent with this trend of a fading credit impulse.

CHART 6: CHINA CREDIT IMPULSE AND GERMAN IFO SURVEY INDEX



Source: Thompson Reuters Datastream, ANZ Wealth, Emerging Advisors Group

CHART 7: CHINA CREDIT IMPULSE AND % GLOBAL EQUITY RETURNS



Source: Thompson Reuters Datastream, ANZ Wealth, Emerging Advisors Group

CONCLUSIONS

The two largest economies – the United States and China - both have policy settings pointing to a slower economy. In the last Investment Spotlight we looked at the flattening trend in the US yield curve and the slowdown it flags. This edition we focus on the Chinese economy and its efforts, and consequences, of reining in its rapid growth in debt.

Pulling this all together, I believe an economic slowdown and weaker investment returns in 2019 look highly likely. But just how much is unclear at this point in time. The US's large tax cuts and increased government spending may hold up US growth for longer than expected. And limited further tightening from the US Federal Reserve would point to only a moderate slowdown in growth.

For China, there's been a sharp weakening in the credit impulse which can't be ignored. The current policy easing underway may limit the downside, but it's early days and we'll have to monitor it closely to gauge its effect.

Mark Rider, Chief Investment Officer

Mark is responsible for delivering an overarching investment strategy, including asset allocation, investment themes, investment manager and product selection and monitoring for ANZ Wealth in Australia. Before joining ANZ in 2013, Mark spent 15 years at UBS and 10 years at the Reserve Bank of Australia, making him a well-recognised and respected member of the Australian investment community.