

## Extended growth momentum with contained financial risk

Thursday, June 15, 2017

## Highlights:

- China's financial de-leverage started to take effect driving funding demand from shadow banking back to on-balance sheet.
- The inefficient long funding chain has been shortened in the interbank market as a result of de-leverage. Slower M2 growth could be a new normal.
- Property tightening measures started to bear the fruits
- However, the negative impact of de-leverage and tightening has been well offset by the still resilient growth momentum.
- The stable private investment, together with improving manufacturing activities, shows that the recent recovery is genuine and the momentum is likely to last longer than initially expected.
- Nevertheless, our view on the growth has peaked in 1Q has not changed.

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"Extended growth momentum with contained financial risk." This is the picture painted by the latest May economic data in China, possibly the best scenario for China's policy makers.

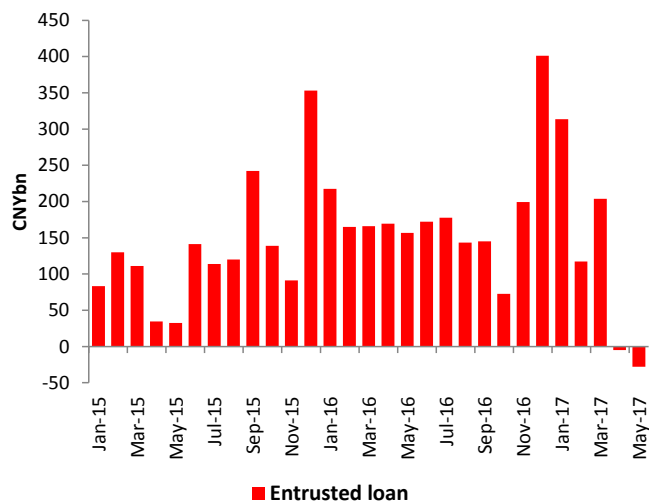
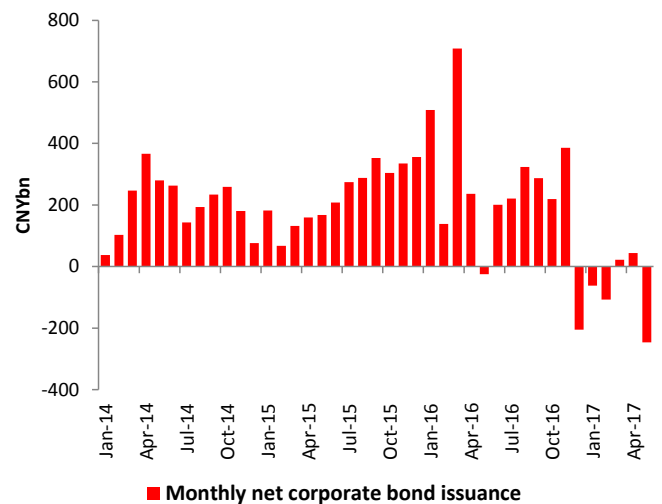
Below are our four key takeaways from the data. **First**, China's financial de-leverage started to take effect driving funding demand from shadow banking back to on-balance sheet (eg, new Yuan loan higher than aggregate social financing). **Second**, the inefficient funding chain has been shortened in the interbank market as a result of de-leverage. (eg. M2 fell to new record low). **Third**, property tightening measures started to bear the fruits (eg, property investment slowed). **And fourth**, the negative impact of de-leverage and tightening has been well offset by the still resilient growth momentum (eg, private investment remains steady while manufacturing activities continued to climb up)

**Financial de-leverage taking effect**

New Yuan loan grew by CNY1.11 trillion in May beating market expectation of CNY900 billion. The composition of loan growth looks healthy with medium to long term demand from household and corporate remains strong. Medium to long term loan to household sector increased by CNY432.6 billion, less affected by property tightening measures while medium to long term loan to corporate increased by CNY439.6 billion.

The stronger than expected on-balance sheet loan expansion was probably the result of China's de-leverage efforts to curb the off balance sheet and shadow banking activity, which may drive loan demand back to traditional loan. This explains why aggregate social financing fell short of new Yuan loan in May, which grew by CNY1.06 trillion. Although trust loan remain sizable at CNY181.2 billion, entrusted loan and undiscounted bankers' acceptance fell by CNY27.8 billion and CNY124.5 billion. The decline of entrusted loan, in particular, was at its record high level. This is probably due to China's de-leveraging push.

The bond market, however, became the unintended victim of recent financial de-leverage. As a result of sharp surge in yields, which resulted in the cancellation of bond issuance in May, total net issuance of corporate bond in May fell by record high of CNY246.2 billion.

**Chart 1: Entrusted loan fell by record in May****Chart 2: Record decline of net bond issuance in May**

Source: Bloomberg, OCBC

M2 growth is another witness of China's de-leveraging. M2 growth decelerated to 9.6% yoy, below 10% for the first time in history. According to PBoC, the entire lending chain has been shortened significantly in May as a result of de-leverage. M2 from financial sector only grew by 0.7% while M2 from non-financial sector grew steadily by 10.5%. The lower M2 growth is likely to be the new normal going forwards.

### Property tightening yields results

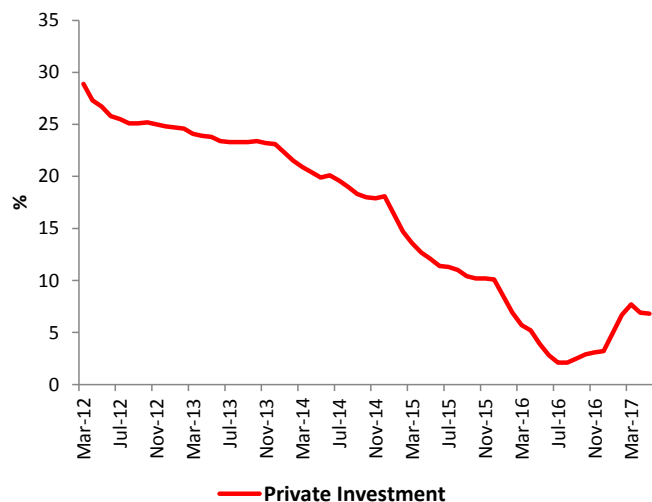
Most growth data exceeded the market expectation in May with the exception of fixed asset investment, which decelerated to 8.6% yoy in the first five months from 8.9% yoy in the first four months. The deceleration of fixed asset investment was mainly the result of slowdown in infrastructure investment as well as property investment. Investment in real estate decelerated to 8.8%, down from 9.3% while property sales also slowed down to 18.6% from 20.1% due to tightening property measures.

### Growth momentum remains steady

The negative impact of property tightening measures and volatile money market on growth has largely offset by steady private sentiment and improving manufacturing outlook. Private investment remains stable expanding by 6.8% in the first five months.

The stable industry production was partly driven by the rebound of mining production, which grew by 0.5%, first positive growth since Sep2016. Manufacturing production remained relatively stable at 6.9% yoy. In addition, fixed asset investment in manufacturing accelerated to 5.1% in the first five months.

**Chart 3: Private investment remains steady**



**Chart 4: Manufacturing output continues to outperform**



Source: Bloomberg, OCBC

The stable private investment, together with improving manufacturing activities, shows that the recent recovery is genuine and the momentum is likely to last longer than initially expected despite rising volatility in the money market as a result of financial de-leverage.

Nevertheless, our view on the growth has peaked in 1Q has not changed. We still expect the growth to slow in the coming quarters for two reasons. First, the higher funding costs in the money market will be partially passed to the real economy, which will slow the growth down. Second, the tug of war between driving financial de-leverage and ensuring the financial stability will continue which may lead to volatility in both capital market and real economy periodically.

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