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# A DEEPER LOOK INTO JAPAN AND CHINA'S DEBT PROBLEMS

I have previously written about investing in the Asia Pacific region and why it is crucial that investors take a balanced and comprehensive long-term investment view (see 'Capitalising on the Pacific Decade'). The prevailing market view on the region remains negative, mainly centring on China's debt problem and general doubts about Abenomics. This article focuses on some aspects of this negativity from a sovereign balance sheet perspective and concludes that the potential dangers are overstated.

When analysing stocks, investors consider both balance sheet and income statements. But when it comes to sovereign analysis, analysts often focus more on the latter, which consist of 'flow' related economic data (such as GDP, trade, employment, production, capital flow, government budget) but place less importance on the former. Regarding a sovereign's balance sheet data (national debt, current account), there is a tendency to focus solely on the government itself, ignoring the household or corporate sectors. Focusing on flow data makes sense for an open economy such as the US, where most of the productive sectors of the economy are held in the private sector via capital markets. The government plays a limited role on the asset side of the aggregate balance sheet. However, it can lead to incomplete or misleading conclusions in the cases of Japan and China.

## Japan: the misconception of too much debt

One of international investors' major concerns regarding Japan is the government's high debt level, without taking into account the household and corporate sectors. However, Japan's national wealth largely resides in the household and corporate sectors, which makes the government's heavy debt less of a concern. It also means that Japan is much less vulnerable to the sort of capital flight by offshore investors that often triggers financial crises.

As of 2014, the household sector's financial net worth stood at 280% of GDP[1], which represents one of the highest levels globally and compares well with US at 260%. In contrast, the government's debt to GDP ratio has risen significantly over the past two decades, from 67% in 1990 to 248% in 2015[2]. In effect, the government has been forced to borrow to stimulate its economy because the household and corporate sectors refuse to consume and invest, instead choosing to save. So while the income statement of the country has remained flat for the best part of a decade, the national wealth is strong and Japan is able to export those savings to finance other countries' deficits[3].

It's not just the household sector that has accumulated significant wealth, the corporate sector also has a significant savings glut. Japanese companies are well known for sitting on large cash positions and being reluctant to invest. Japan's listed companies hold over USD 1 trillion in cash and 56% of these companies are totally debt-free, i.e. net cash[4].

Japan's economy has effectively become similar in position to a wealthy, ageing rentier, living off years of accumulated savings. The country's strong balance sheet position allows the government room to experiment as it aims to change the deflationary mindset of an entire population and stimulate private demand. A bank run scenario is highly unlikely in Japan, which is why comparable debt analysis for heavily indebted countries is not relevant.

Most sovereign analysis on Japan ignores the wealth residing outside the government sector and over-emphasises the government's deficit spending. The push for a higher sales tax, due to concerns about the government's high debt ratio, was the wrong prescription for Japan. Prime Minister Abe's first consumption tax hike was a costly policy error for Abenomics as it unwound the momentum and positive early effects from the government's stimulus programme. The recent decision to postpone the second hike was the right call.

The country's strong balance sheet also explains the 'safe haven' status of the Japanese Yen and its recent strength. Other reasons for Yen strength include the country's surging current account as a result of a significant change in the net trade balance from 2014 2016 due to lower oil imports and because declining inflation expectations, not nominal interest rates, are driving foreign exchange rates. Real interest rates in Japan have actually been rising more than the US, because expected inflation rates are collapsing[5].

Abenomics was initially quite effective for the economy and the Nikkei until the first sales tax hike took place in 2014. The

[1] Household financial net worth and GDP per capita data sourced from OECD and IMF, respectively.
[2] IMF Japan general government gross debt as percentage of GDP, sourced from Bloomberg.
[3] Japan has the second-highest net international investment position, according to a BCA report, 8 January 2016.
[4] Data as of end of FY 2015, according to a report by Nikkei Asian Review, 11 June 2016: "Japan Inc.'s cash holdings expand to record $1tn".
[5] Measured by JPY Inflation Swap Forward 5Y5Y, as tracked by Bloomberg. Expected inflation declined from 0.71% at the beginning of 2016 to zero on July 6.

BOJ's 'Halloween easing' in 2014 further pushed the Yen from USD 110 to 120 and the Nikkei up to 20,000. However, without further action, the Yen strengthened for the reasons stated above and the Nikkei retreated to 2014 levels.

In our view, the Yen will tend to strengthen unless BOJ Governor Kuroda's resolve to raise inflation expectations regains credibility. Unfortunately, the BOJ's monetary policy has been doing much of Abenomics' heavy lifting over the past couple of years and has few bullets left. Further bond buying and even more negative rates have lost their potency because these monetary signals are not affecting the demand side of the economy. What is required now is even stronger fiscal policy. The combination of strong fiscal and monetary policies should help to raise inflation expectations and lower the Yen.

The question is not if the BOJ and the government will act, but when and how. Recently, market participants have been openly debating the possibility of debt monetisation or 'helicopter money' in Japan. In my view, when quantitative easing and NIRP are coordinated with a stronger stimulus programme, the effect on the economy and general inflation expectations will be similar to more controversial forms of monetary policy. The difference between this and the BOJ deciding to directly underwrite the debt incurred by the Ministry of Finance is merely a matter of semantics.

## China saves too much, which leads to poor asset allocation decisions

The market has been deeply worried about China's ongoing debt problem and rightly so. China's total debt to GDP has risen to 240%, up from 160% a decade ago[6]. Given the speed of the increase, many analysts fear that it will lead to financial turbulence. However, they are ignoring the asset side—the problem of too much debt also can also be interpreted as a problem of 'too much savings'[7]. China is one of the world's largest savers, with an extraordinarily high savings rate of almost 50% of GDP[8]. It is the high savings nature of the Chinese economy that is the source of its over-investment and over-lending. Because the capital system is closed, investment flows out of China are strictly controlled.

Fears of a hard landing based on a debt crisis are, in my view, over-exaggerated and misunderstand how China's economy operates. Because of this gigantic pool of savings, China is able to finance its investment programmes itself with little assistance from foreign capital. Currently, foreign participation in domestic equity and bond markets is fairly limited. Since most of China's liabilities are domestically held and matched by domestic assets and the financial system is not market-driven, a Lehman scenario is highly unlikely. This is particularly true because the majority of corporate debt lies with the centrally controlled state-owned enterprises (SOEs).

Much of the increase in corporate debt has been directed by the central government as part of its execution of fiscal policy. Due to poor asset allocation decisions, there are a significant number of 'zombie' enterprises. However, rather than remaining in denial, Beijing is at least acknowledging the problem. Although progress is slow, it has embarked on a process of improving the competitiveness of SOEs by reforming those burdened by debt, mismanagement or overcapacity. In an effort to reduce excess capacity, the government has stated that it will close some of the 'zombie' enterprises (with a primary focus on the coal and steel sectors) that it believes are weighing down the economy.

Another area of focus for Beijing is non-performing loans (NPLs). Analysis conducted by Peter Monson, a senior equity analyst on Nikko AM's Asian equity team, suggests that China's NPL ratio could actually be significantly higher than official numbers suggest, at somewhere between 10-15%. Chinese banks are still amongst the most profitable in Asia on a pre-provision basis and, as such, their ability to absorb fresh NPLs remains relatively robust. At the lower end of our range, we estimate that it would take Chinese banks two years of pre-provision operating profits to cover the losses, or fresh capital equivalent to 15% of GDP. At current levels, Chinese banks do have the earnings capacity to absorb up to 20% NPL formation over a five-year period.

However, in this event it is likely that earnings would come under pressure from other drivers such as slower loan growth, interest spread compression and/or lower non-interest income. Under this scenario, we would likely see some form of state bail-out or capital injection. To put this in perspective, the 1999 banking bailout required the central government to provide a cash injection equal to 25% of GDP. Although the NPL situation is hardly ideal, we do not expect it to lead to a Lehman-type scenario. With its strong liquidity, current account surplus and centrally controlled credit system, China can well afford even the more pessimistic of our scenarios and ensure the pace of NPL formation remains manageable.

Beijing is still trying to figure out the path forward but it is clearly focusing on reform as its main tool, trying a number of solutions simultaneously, such as a debt-for-equity swap, SOE clean-up, securitisation of NPLs and selling bad loans to asset management companies. In the meantime, however, defaults are ticking up and bankruptcy is happening with higher frequency. The extent to which China is successful in implementing structural reforms will be a decisive factor in terms of its debt resolution. It needs to be proactive in dealing with rising bad debt, rather than ignoring or hiding it. Pursuing supply-side structural reform rather than further stimulus policies should provide more sustainable growth in the long term, although the road may be longer and harder.

It is also important to note that the government must balance social stability alongside this supply-side reform and this is one of the main reasons why there cannot be any quick and easy solutions. Beijing will want to avoid the sort of wide-scale

[6] China's total debt as a percentage of GDP as tracked by Bloomberg.
[7] Similar views were expressed in an article from BCA's China Investment Strategy, 15 June 2016.
[8] Gross savings (% of GDP) data sourced from the World Bank.

unemployment that occurred in the last round of major structural reforms in the late 1990s and early 2000s. Nevertheless, if the government is able to achieve these necessary, but painful reforms and resolution of NPLs, it would be a positive catalyst for China's markets.

## If interest rates re-price higher, equity markets in Japan and China may surprise

Many countries in Asia Pacific, including Japan and China as highlighted in this article, benefit from having strong national wealth and household balance sheets. Developed countries with sufficiently strong balance sheets have been experimenting with monetary policy in a manner and to an extent that was unimaginable even a few years ago. However, what central bankers may be starting to realise is that these policy experiments have reached a limit. No matter how low rates are, corporations and household sectors alike continue to save. Worse still, these extreme forms of monetary policy have distorted wealth distribution and caused such income inequality that voters are revolting. The UK's 'Brexit' referendum result should serve as a warning that political risks may be starting to dominate economic considerations.

Current political debate ranges from the need to provide a coordinated fiscal response to the global slow growth problem to more populist and isolationist movements in a number of countries. Given the combination of this geopolitical instability and slow global growth, market consensus is that interest rates will remain low to negative for a long time to come. This belief is driven by deflationary fears and the saving-over-spending mindset seen in many of the world's households and corporations, compounded by central banks' market-distorting behaviours. This uncertainty is leading to questions over the 'cost of money', which is fundamental to all asset-pricing decisions.

The fragility of the global economy's unstable equilibrium has been made clear in 2016 as fears about China in January and the Brexit result in June unsettled the market. The uncertainty of Japan's next policy move, China's resolution of its NPL problem, Europe's solution to its identity crisis, and America's choice of leader all reinforce the 'cost of money' conundrum facing investors. In this environment, I'm wary of duration risk from long bonds, which are pricing only one outcome, while the opposite scenario may be increasing in probability.

If interest rates do start to re-price higher, it may mark an end to the 35-year bull market for bonds. The implications for equity are not as straightforward. Normally, when the discount factor in the present value calculation of future earnings rises, the stock price will decline. But, if the market concludes that the unstable equilibrium and slow growth are actually a result of artificially low rates and that higher rates will lead to more normal inflation expectations, higher consumption and better corporate earnings, then it may actually lead to a stronger bull market in equities. That would be especially true where inflation expectations are lowest (Japan), or earnings prospects and valuations most depressed (China). This is why, in my view, we should be prepared for higher equity prices in Japan and China if we start to see success from Japan's fiscal measures and China's bad debt resolution programme.

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