

HEDGEYE

STRUCTURAL ECONOMIC HEADWINDS WITHIN THE CHINESE ECONOMY

DARIUS DALE: MACRO TEAM

SEPTEMBER 14, 2017

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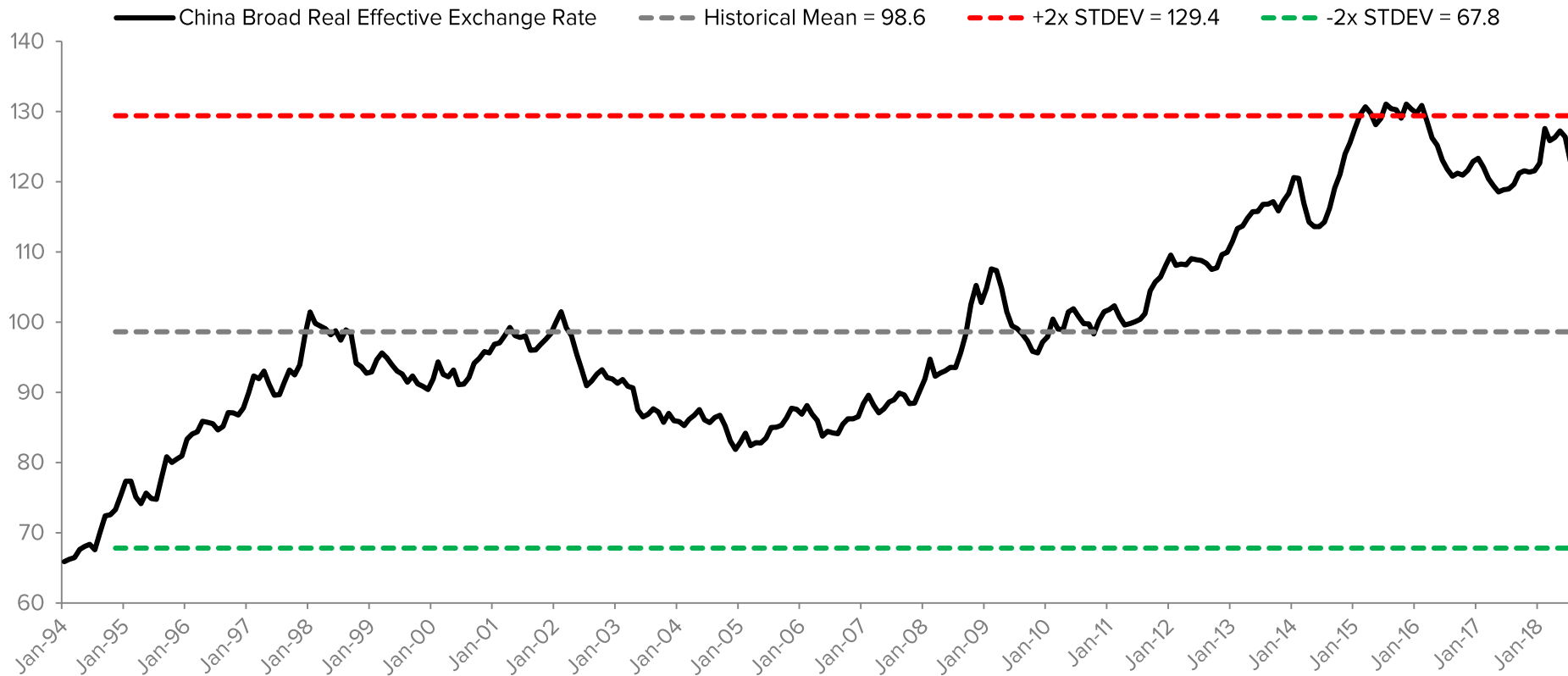
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BROKEN: INT'L COMPETITIVENESS

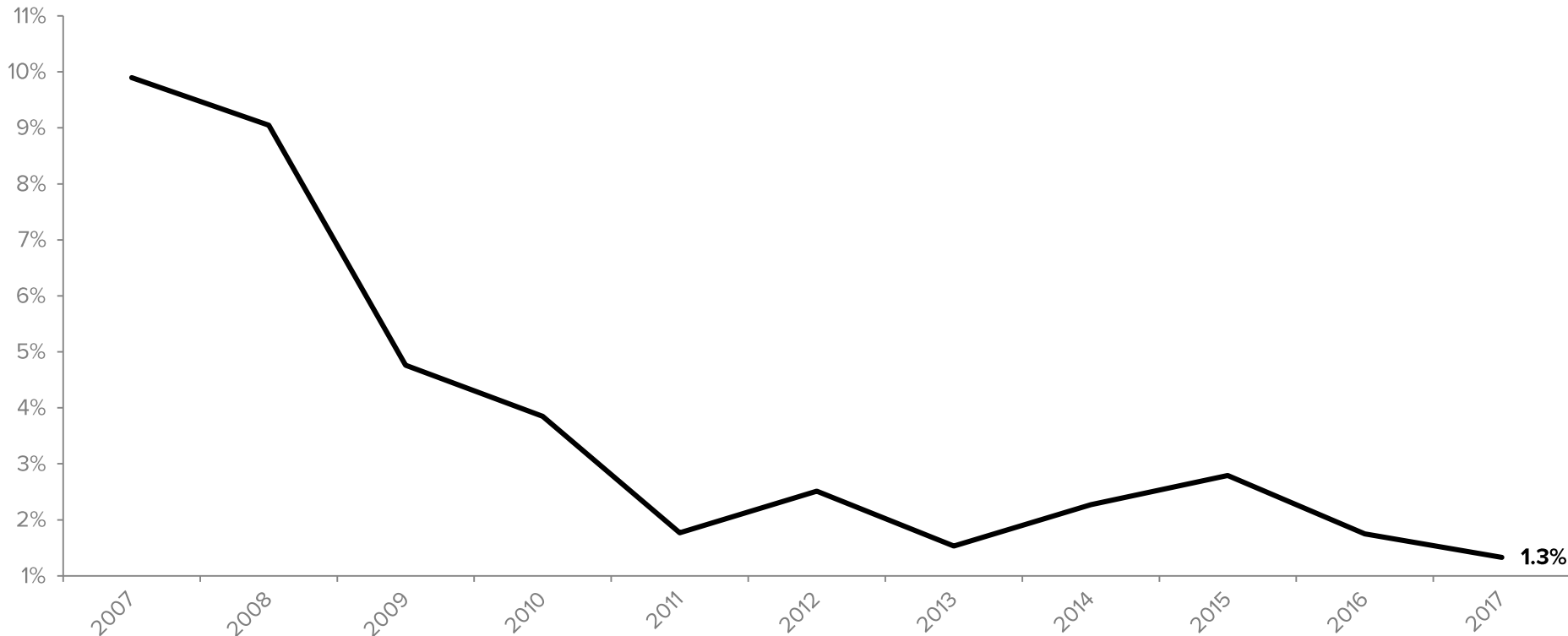
THE CHINESE YUAN HAS APPRECIATED TREMENDOUSLY ON A REER BASIS, CALLING INTO QUESTION THE SUSTAINABILITY OF CHINA'S EXPORT-LED GROWTH MODEL.



BROKEN: MERCANTILIST GROWTH MODEL

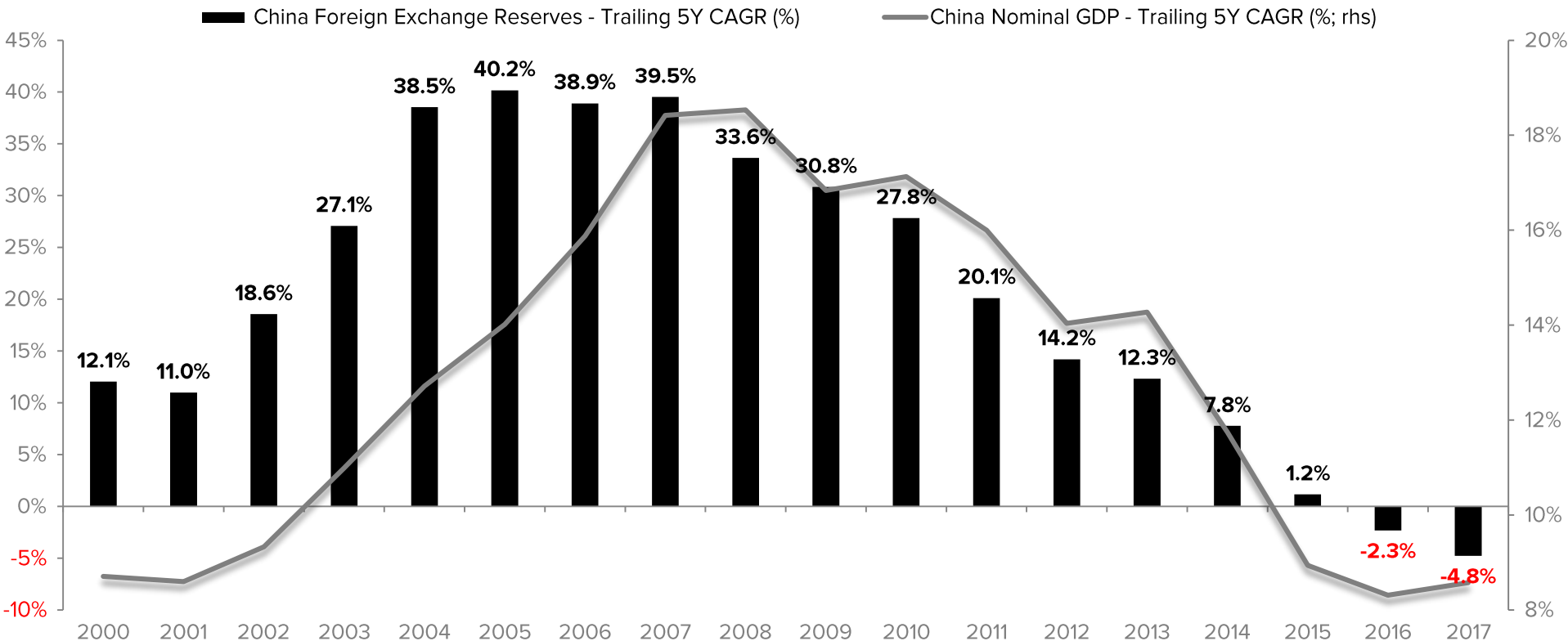
THE CONFLUENCE OF SECULAR CURRENCY APPRECIATION AND TEPID GLOBAL DEMAND HAVE PERMANENTLY SUPPRESSED CHINA'S CURRENT ACCOUNT SURPLUS.

— China Current Account Balance as a % of GDP



BROKEN: KEY SOURCE OF LIQUIDITY

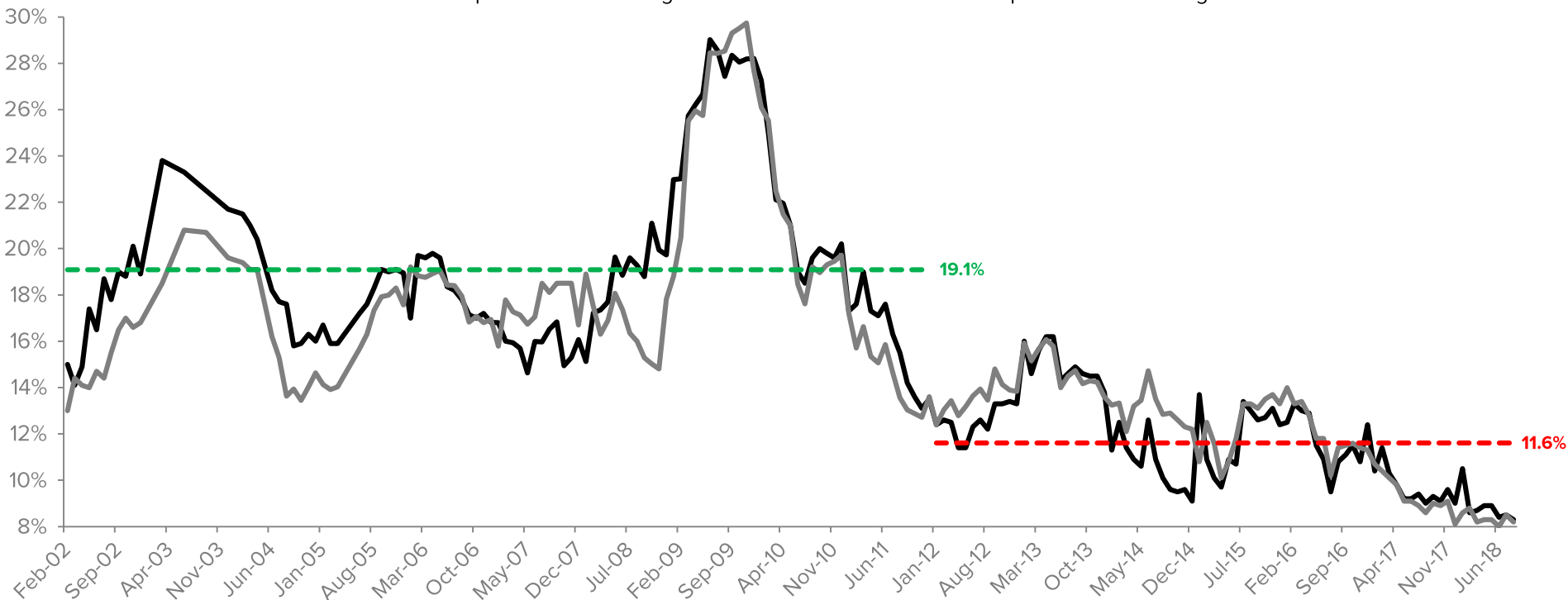
THE MOST IMPORTANT ASPECT OF CHINA'S MERCANTILIST GROWTH MODEL WAS NOT THE EXPORT INCOME IT PROVIDED TO MANUFACTURERS, BUT RATHER THE [NOW TEPID] CNY LIQUIDITY IT PROVIDED TO THE BANKING SECTOR AS A RESULT OF THE CLOSED CAPITAL ACCOUNT.



BROKEN: BANK DEPOSIT RECYCLING

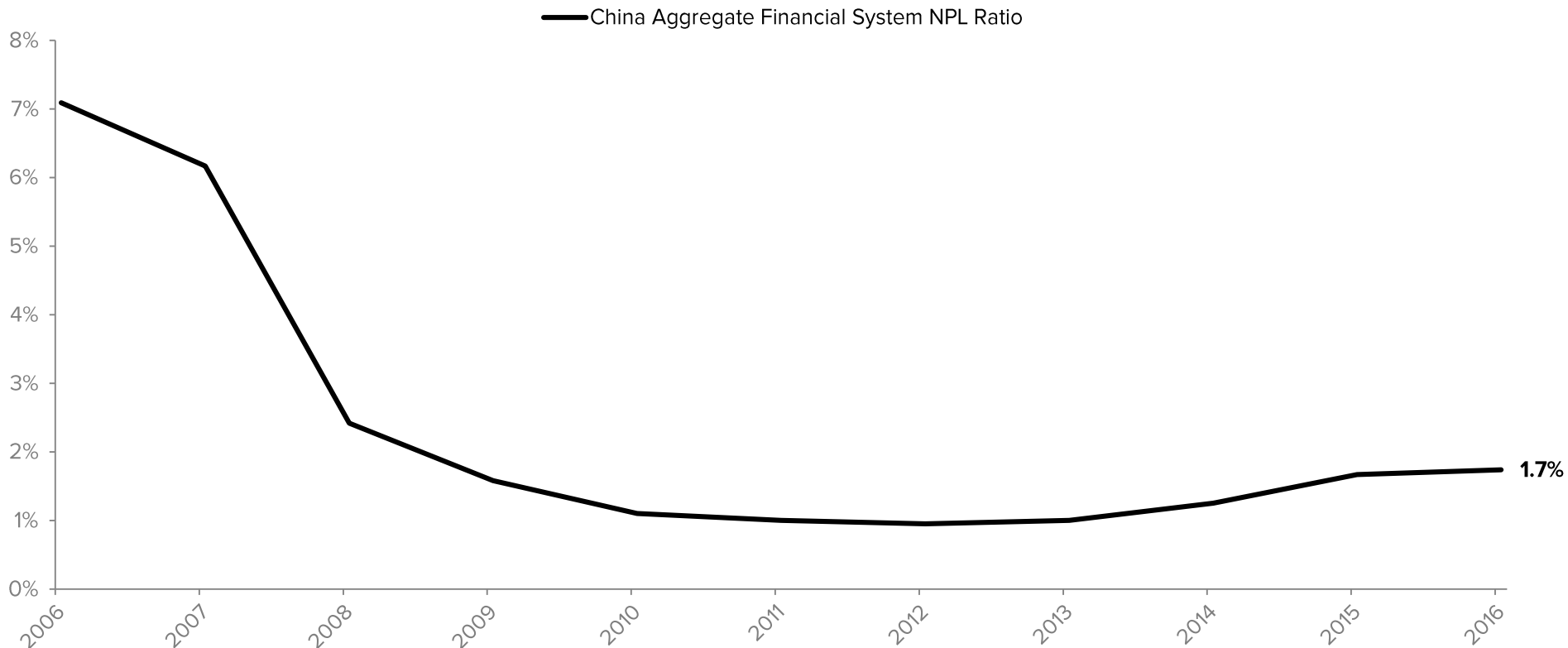
THE NEED TO MATCH BANKING SECTOR LIABILITIES WITH COMMENSURATE ASSETS HELPED PERPETUATE BUBBLES IN CHINESE INDUSTRIAL CAPACITY AND REAL ESTATE.

— China Total CNY Deposits - YoY % Change — China M2 Money Supply - YoY % Change
- - - 2002-11 Deposit Growth Average - - - 2012-Present Deposit Growth Average



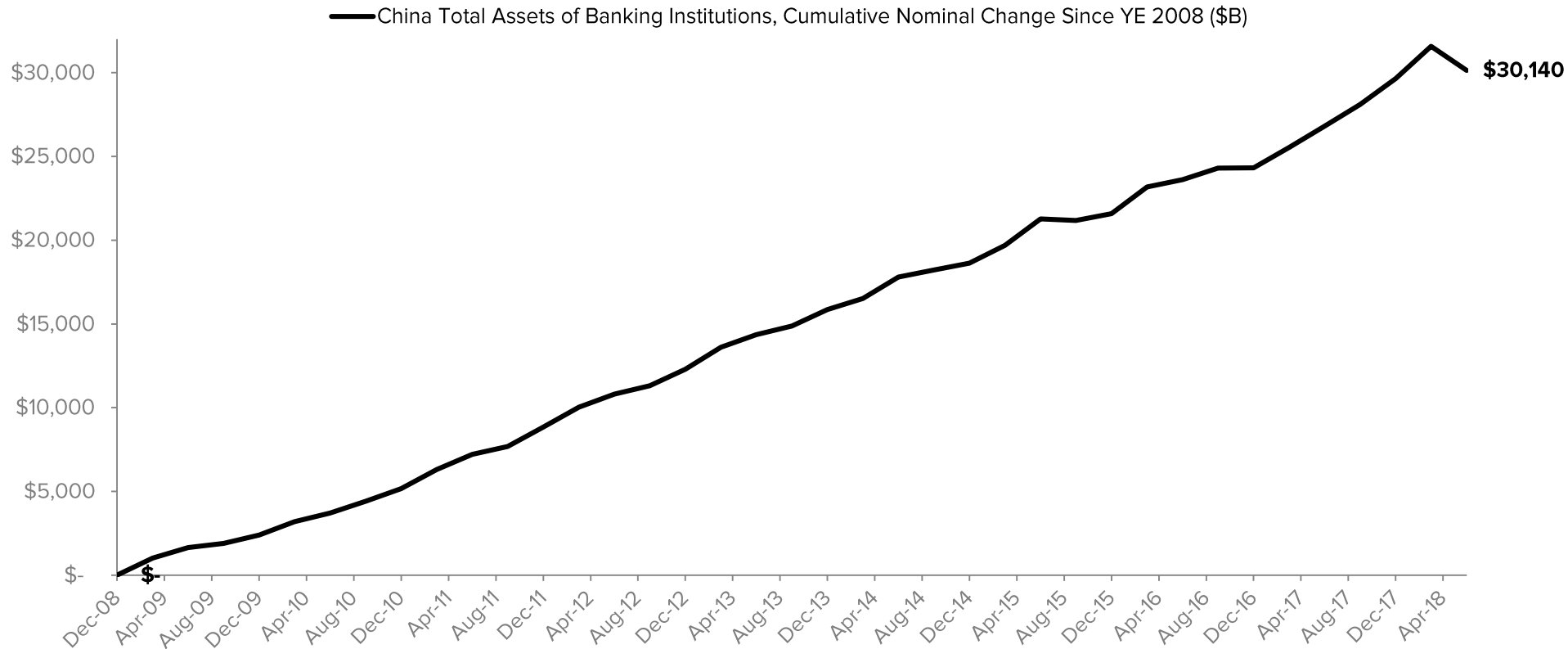
CHINA'S CREDIT CHANNEL IS CLOGGED

THE INEFFICIENT (I.E. FINANCIAL REPRESSION) AND ADMINISTRATIVE (I.E. MOSTLY TO SOE BORROWERS) NATURE OF CREDIT ALLOCATION IN CHINA ARE COMBINING TO SUPPRESS DEFAULTS, WHILE STRICT REGULATORY TARGETS LIMIT THE SCOPE FOR INCREMENTAL ASSET GROWTH.



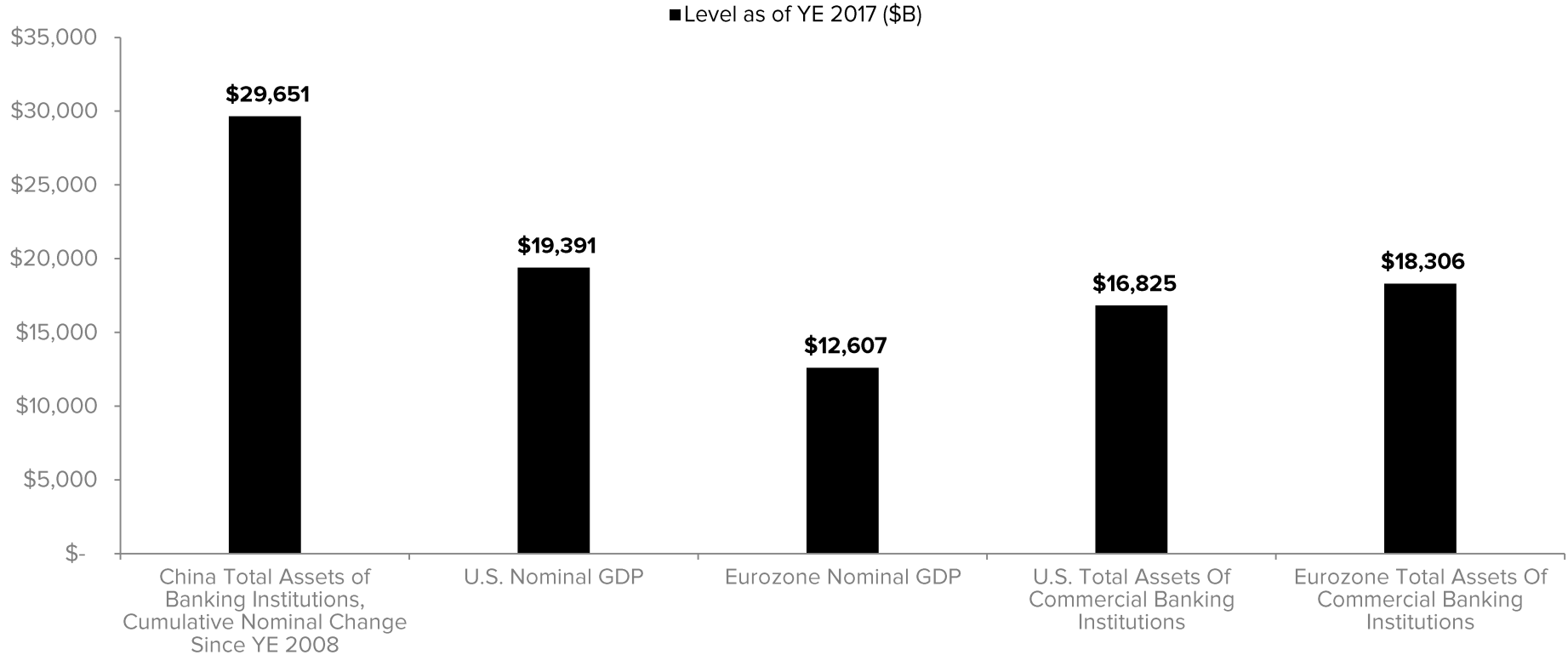
CHINA'S \$30 TRILLION DOLLAR PROBLEM

SINCE THE END OF 2008, CHINA'S BANKING SYSTEM HAS GROWN BY OVER \$30 TRILLION DOLLARS!



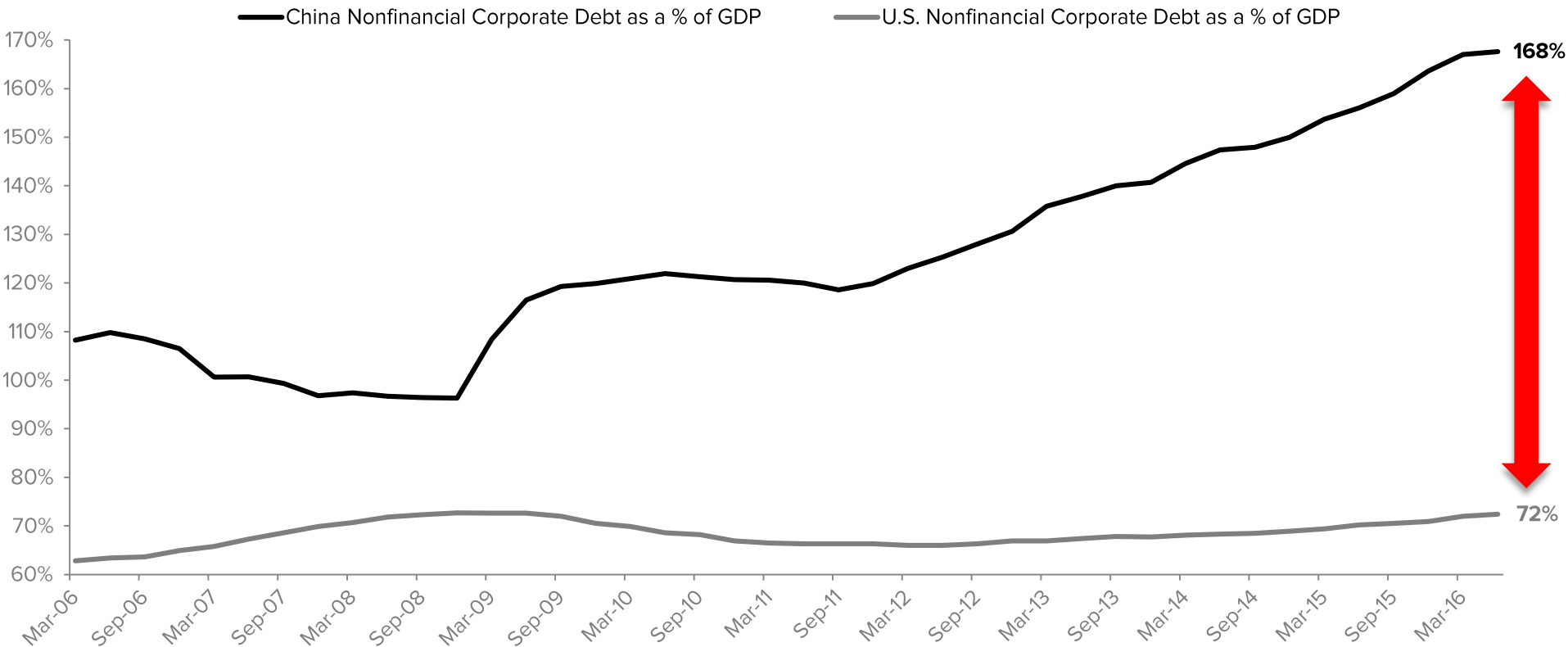
WHAT CAN \$30 TRILLION BUY?

A MORE APPROPRIATE QUESTION IS WHAT CAN'T \$30 TRILLION BUY. CHINA'S CREDIT EXPANSION OVER THE PAST EIGHT YEARS IS LARGER THAN THE ENTIRE U.S. BANKING SYSTEM!



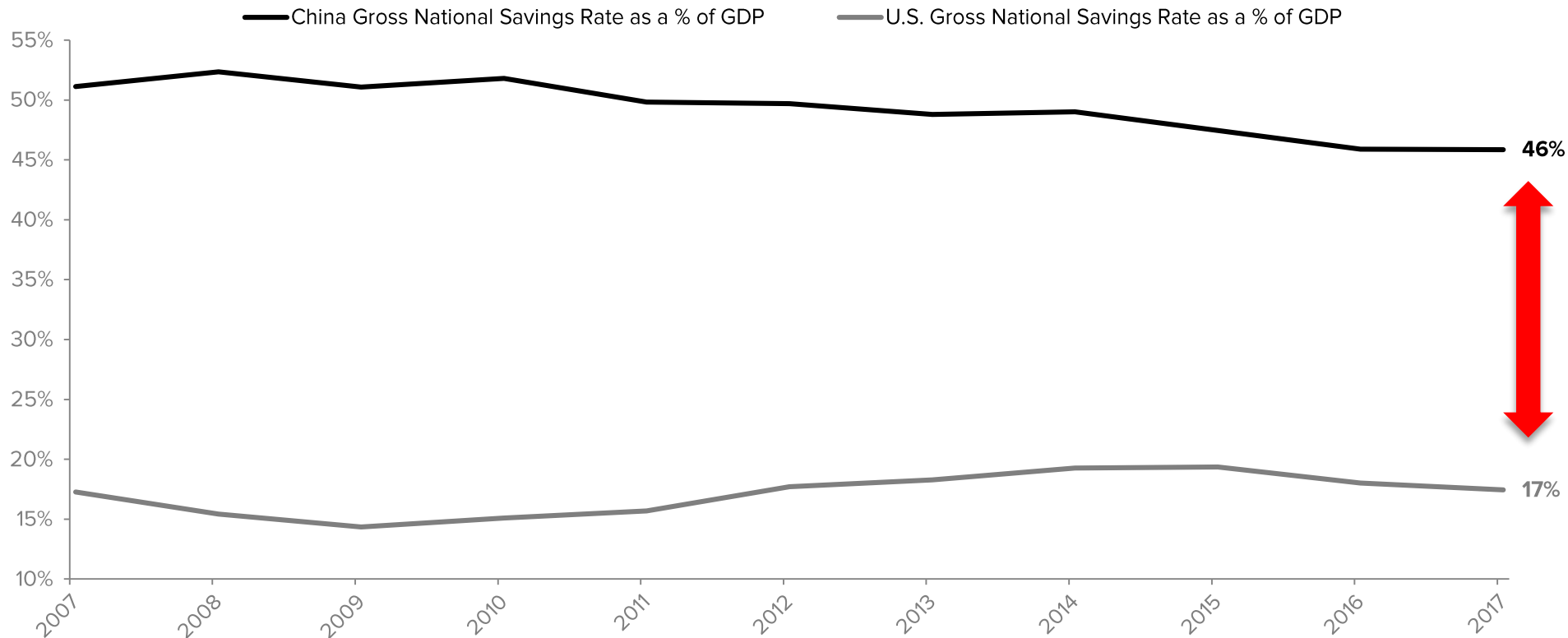
MIND THE GAP

LEVERAGE AMONG CHINESE NONFINANCIAL CORPORATIONS, AS A RATIO TO THE ECONOMY, HAS ACCELERATED DRAMATICALLY IN RECENT YEARS. THE SPREAD BETWEEN CHINA AND THE U.S. IS AS WIDE AS IT'S EVER BEEN.



MIND THIS GAP TOO

MANY INVESTORS HAVE BECOME INFATUATED WITH CHINA'S DEBT BUILDUP IN RECENT YEARS, BUT NOT ENOUGH INVESTORS HAVE FOCUSED ON THE DRIVERS – AND SUSTAINABILITY – OF THAT LEVERAGE. SAVINGS = INVESTMENT IN A [MOSTLY] CLOSED ECONOMY LIKE CHINA'S.



“AWASH WITH LIQUIDITY”

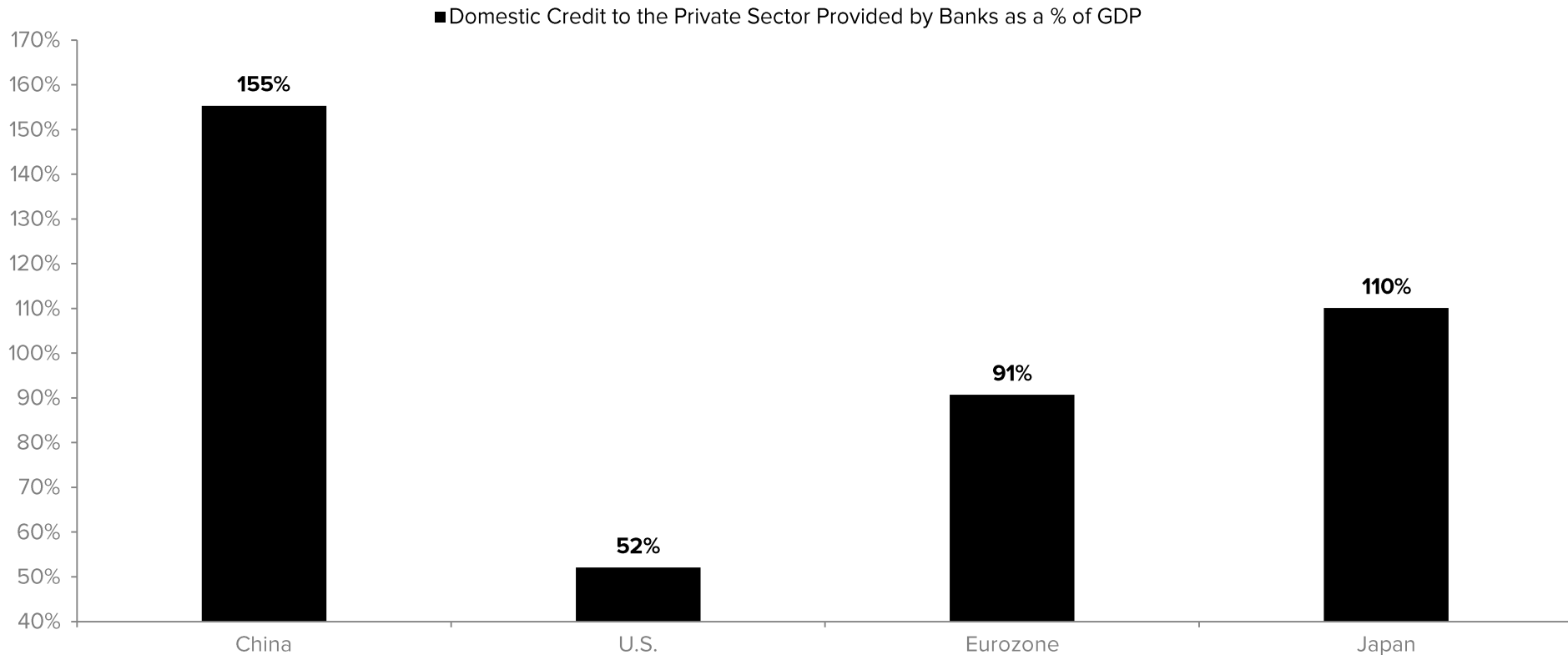
LARGELY THANKS TO THE LACK OF AN IMPACTFUL SOCIAL SAFETY NET, CHINESE HOUSEHOLDS ARE CULTURALLY PREDISPOSED TO SAVE. IN ADDITION TO THAT TAILWIND, A LARGE CURRENT ACCOUNT SURPLUS HAS BUTTRESSED WHOLESALE BANK DEPOSITS.

■ Total Banking System Deposits as a % of GDP



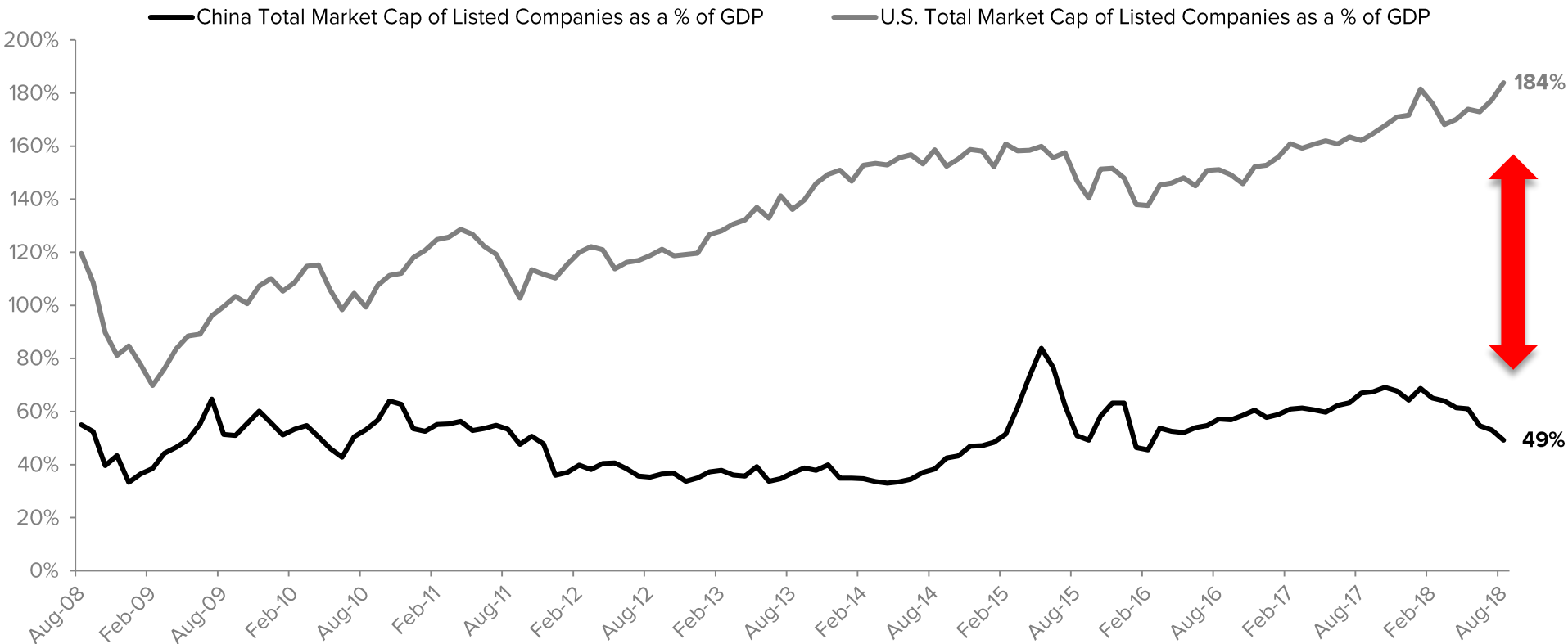
MANY WAYS TO SKIN THE CREDIT “CAT”

CHINA IS A COMMUNIST ECONOMY, SO ITS PREFERENCE FOR ALLOCATING CAPITAL IN A LARGELY ADMINISTRATIVE MANNER THROUGH POLICY BANKS IS VERY MUCH IN LINE WITH ITS POLITICAL OBJECTIVES. CAPITAL MARKETS – WHICH INCREASE ECONOMIC VOLATILITY – ARE INHERENTLY HARDER TO DICTATE.



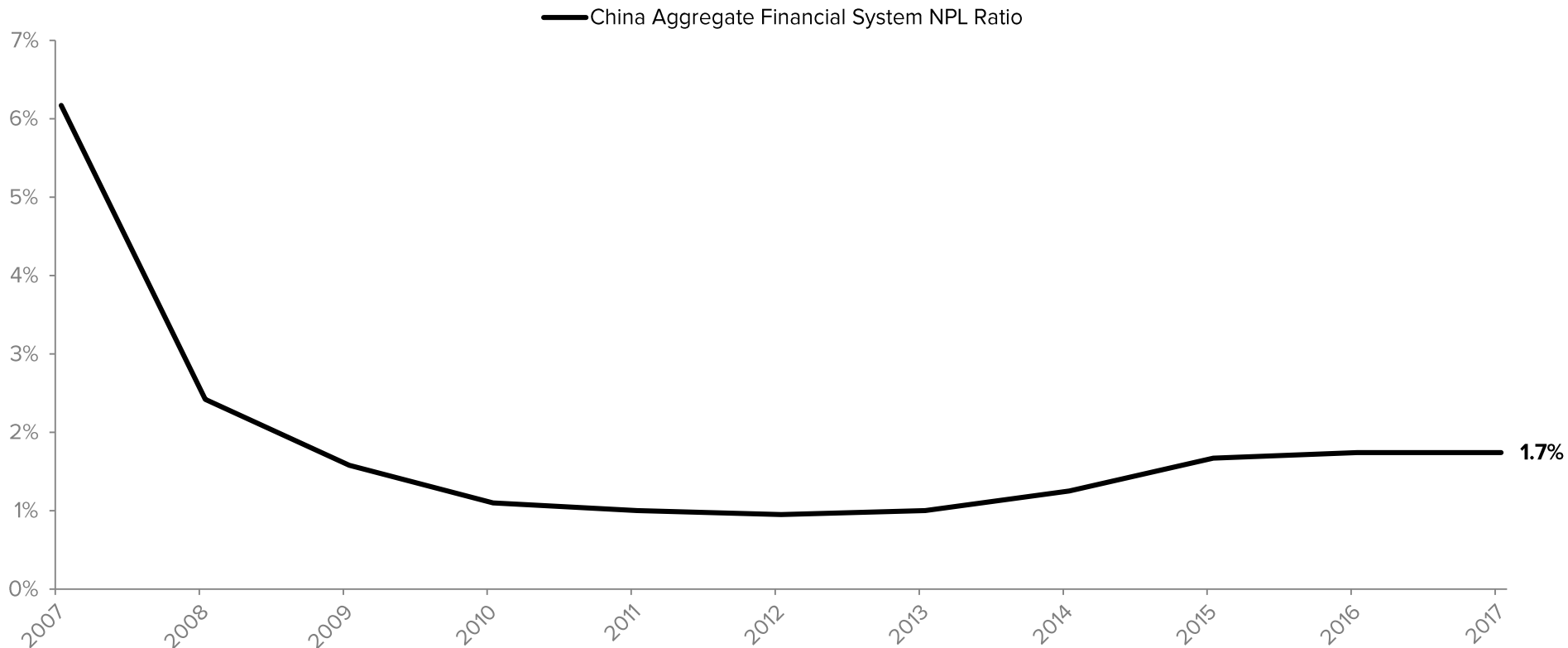
CHINA IS A DIFFERENT “CAT” ALTOGETHER

DUE TO THE LACK OF FUNCTIONING CAPITAL MARKETS THE FINANCING OF ECONOMIC ACTIVITY IN CHINA HAS LARGELY BEEN DONE THROUGH THE CREDIT INTERMEDIATION CHANNEL. THIS IS MOSTLY BY DESIGN SO THAT BEIJING CAN ALLOCATE CAPITAL AS IT SEES FIT.



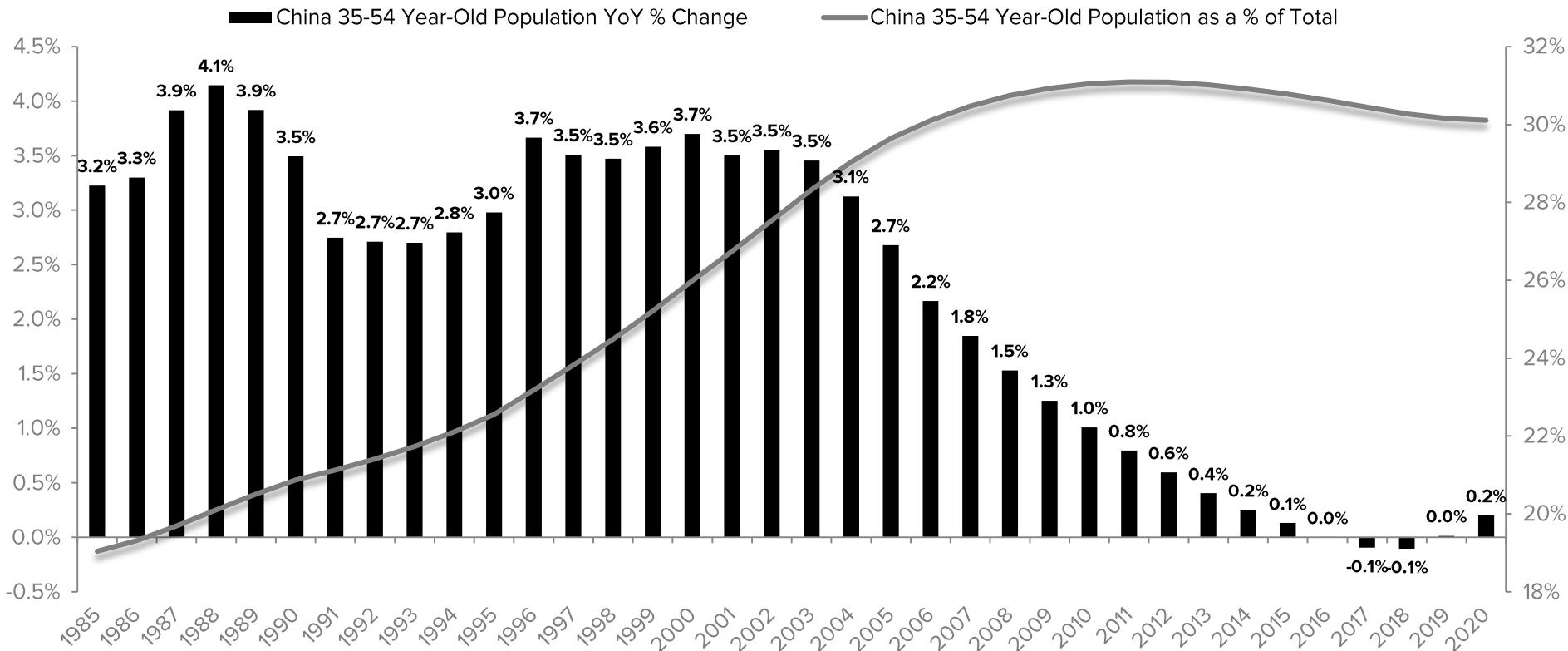
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DON'T FORGET DEMOGRAPHICS!

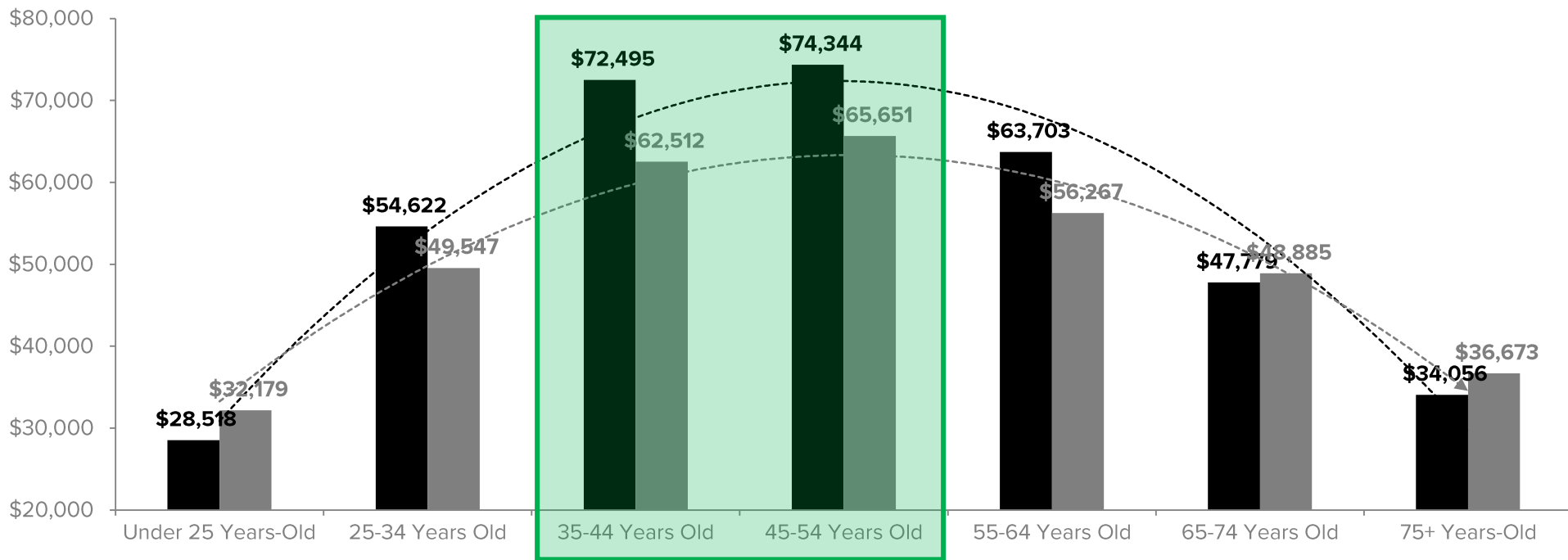
LET US NOT FORGET THAT CHINESE OFFICIALS ARE ATTEMPTING TO TRANSITION THEIR ECONOMY TO A CONSUMPTION AND SERVICES-LED GROWTH MODEL AMID THE SHARPEST DECELERATION OF GROWTH IN ITS CORE CONSUMPTION DEMOGRAPHIC EVER. GOOD LUCK WITH THAT.



WHY DO 35-54 YEAR-OLDS MATTER?

BECAUSE ACCORDING TO BOTH EMPIRICAL EVIDENCE AND LIFE-CYCLE ECONOMICS THEORY, THIS IS THE WORLD'S CORE END CONSUMPTION DEMAND DEMOGRAPHIC.

■ U.S. Average Annual Disposable Income by Age Bracket ■ U.S. Average Annual Expenditures by Age Bracket
-----▶ Poly. (U.S. Average Annual Disposable Income by Age Bracket) -----▶ Poly. (U.S. Average Annual Expenditures by Age Bracket)

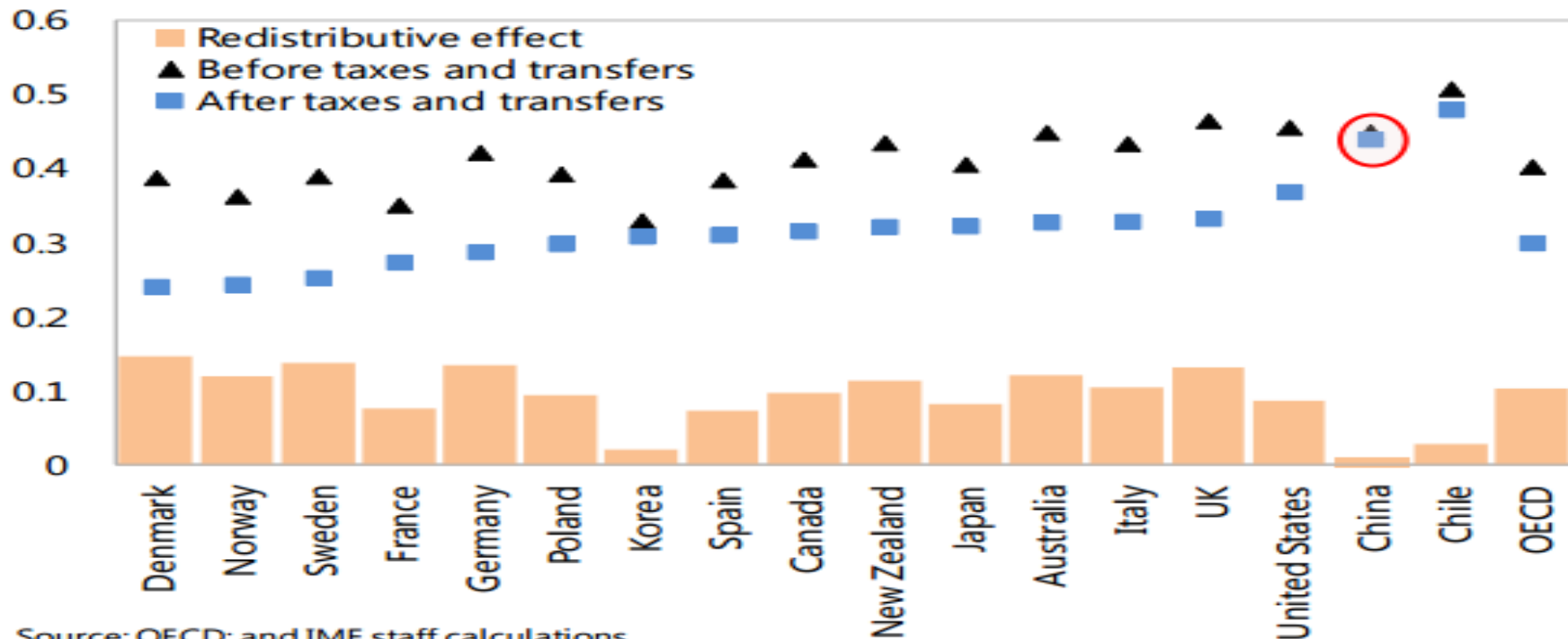


BUELLER?... BUELLER?... BUELLER?

THE CHINESE GOVERNMENT IS DOING VERY LITTLE WITH FISCAL POLICY TO OFFSET THE AFOREMENTIONED DEMOGRAPHIC HEADWIND TO END-CONSUMPTION DEMAND GROWTH.

Redistributive Effect of Taxes across OECD relative to China

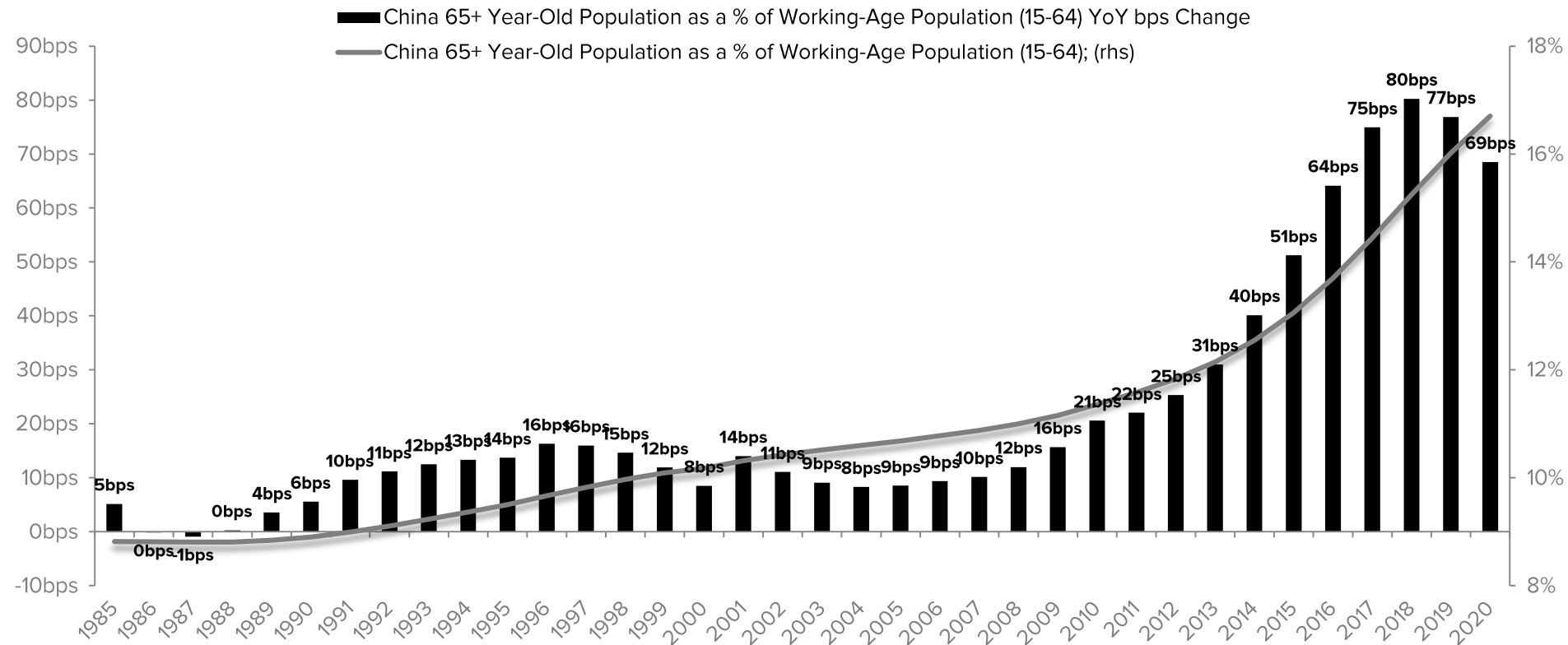
(Gini coefficient between 0 and 1)



Source: OECD; and IMF staff calculations.

GETTING REALLY OLD, REALLY FAST

MUCH AKIN TO THE DEVELOPED WORLD, THE CHINESE POPULOUS IS AGING AT ITS FASTEST RATE EVER OVER THE NEXT 3-5 YEARS.

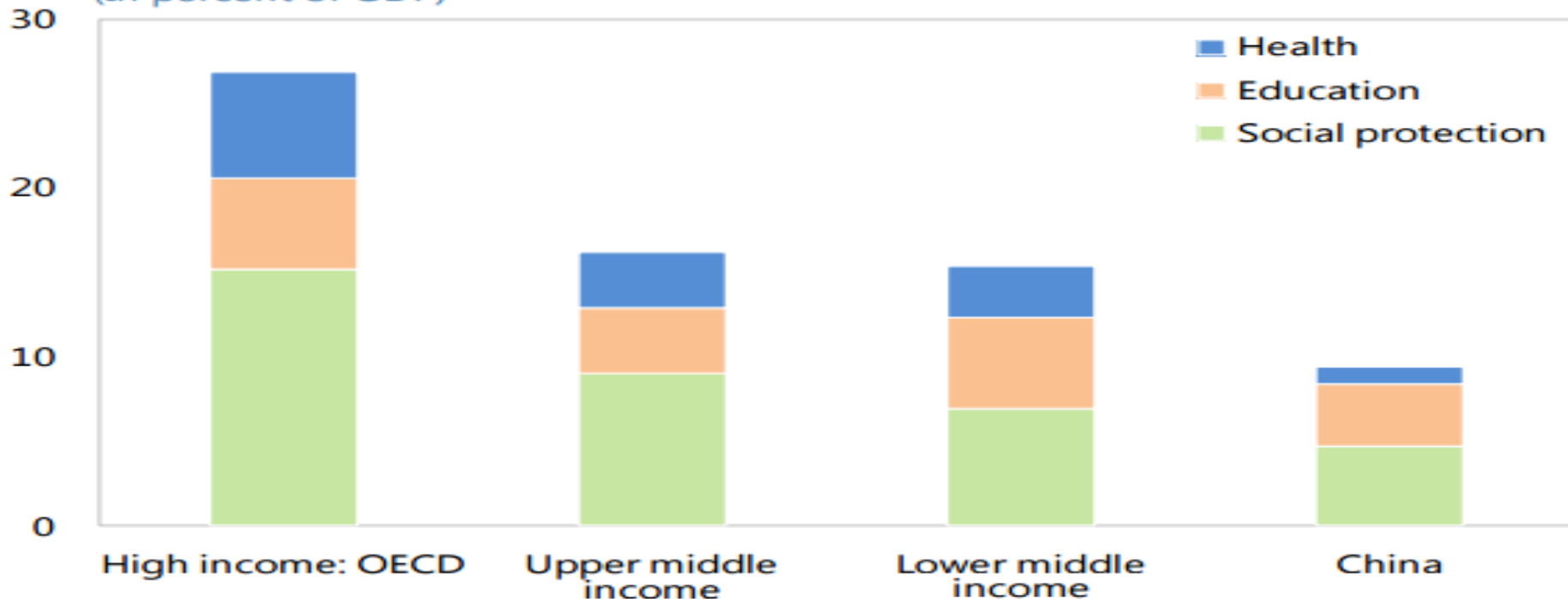


WITH NO SOCIAL SAFETY NET

MUCH ADO HAS BEEN MADE ABOUT CHINA'S IMPRESSIVE HOUSEHOLD SAVINGS (~25% OF GDP), BUT WITHOUT AN ADEQUATE SOCIAL SAFETY NET (THAT WILL TAKE YEARS TO DESIGN AND IMPLEMENT), SUCH "PENNEED UP DEMAND" FOR CONSUMPTION WILL REMAIN JUST THAT.

Social Spending by Country Group

(In percent of GDP)

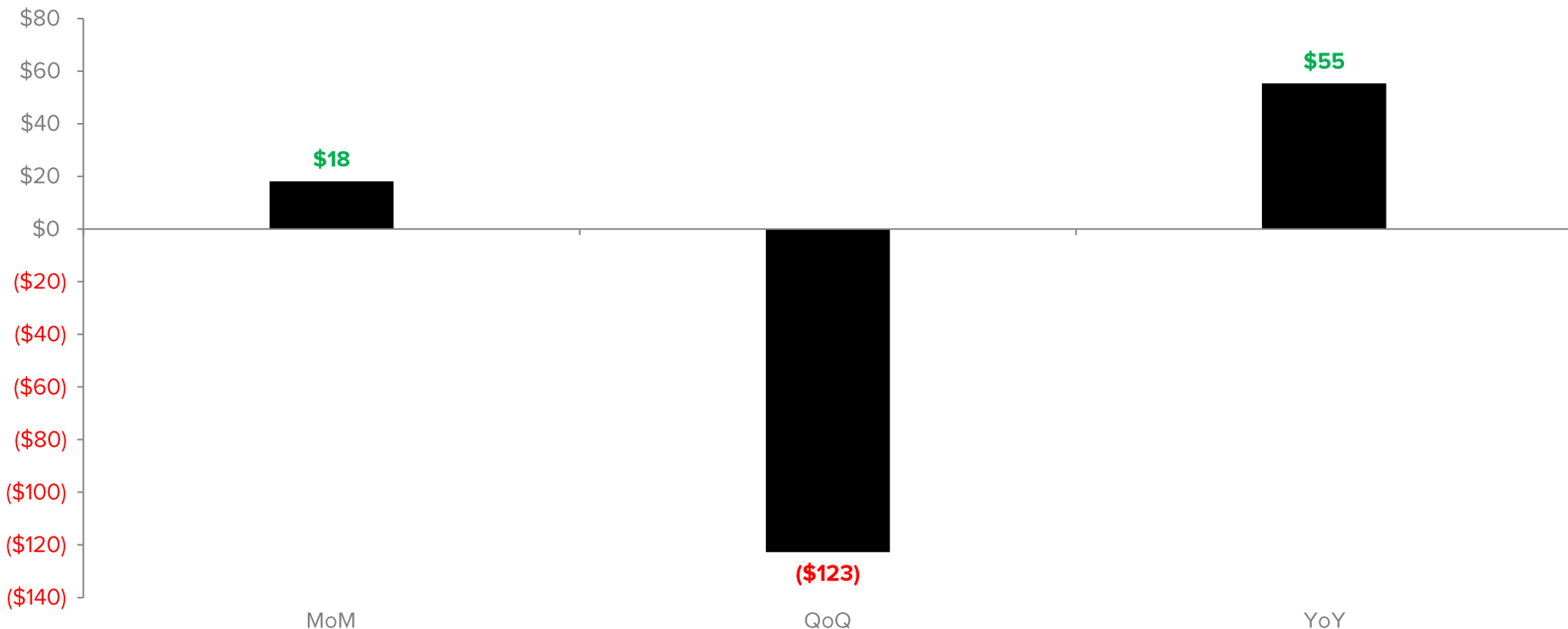


Sources: China 2030, World Bank; and IMF staff calculations.

CAN BEIJING MAINTAIN FX STABILITY? YES.

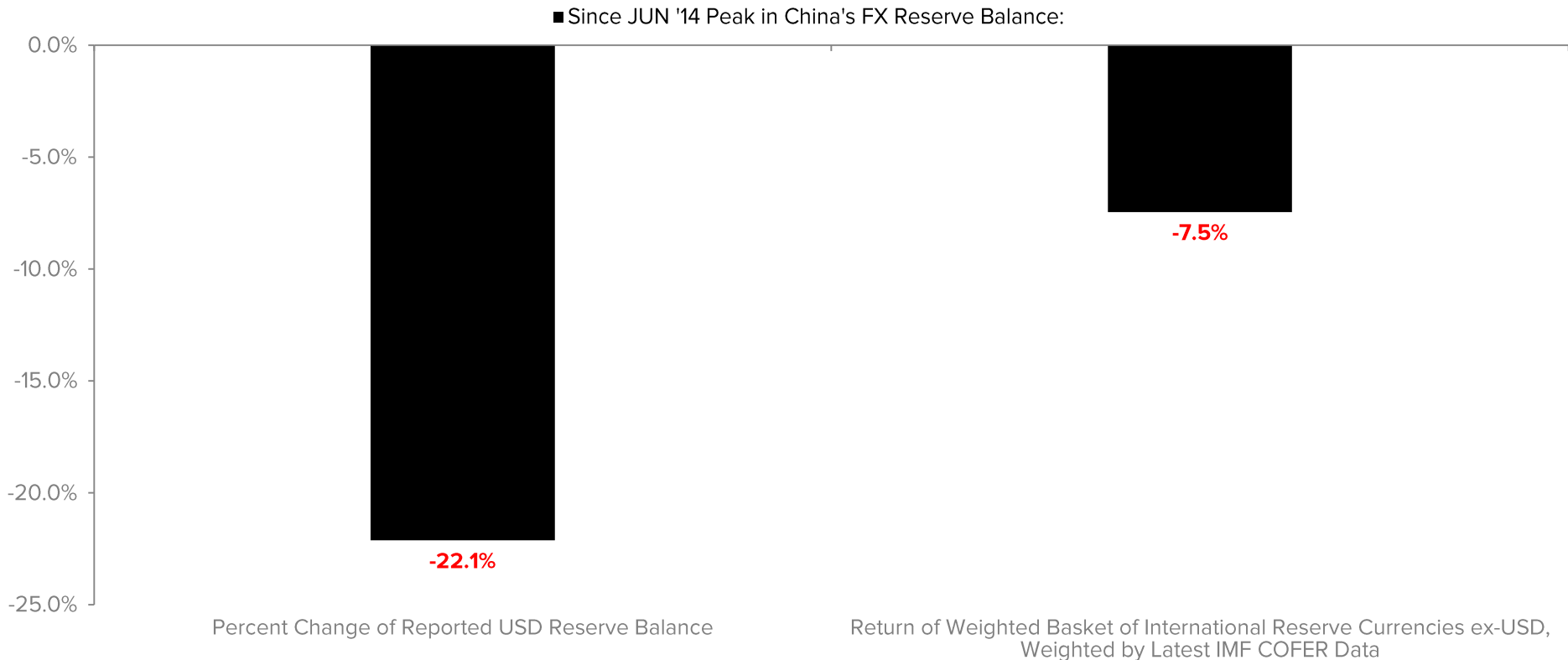
CHINA IS NO LONGER BURNING THROUGH ITS FX RESERVES AT AN ALARMING PACE. MOREOVER, THE RESIDUAL LEVEL OF RESERVES THAT WOULD TRIGGER A BROAD-BASED LOSS OF CONFIDENCE IN THE RMB REMAINS UP FOR [INTENSE] DEBATE.

■ China Foreign Exchange Reserves - Annualized Nominal Change (\$B)



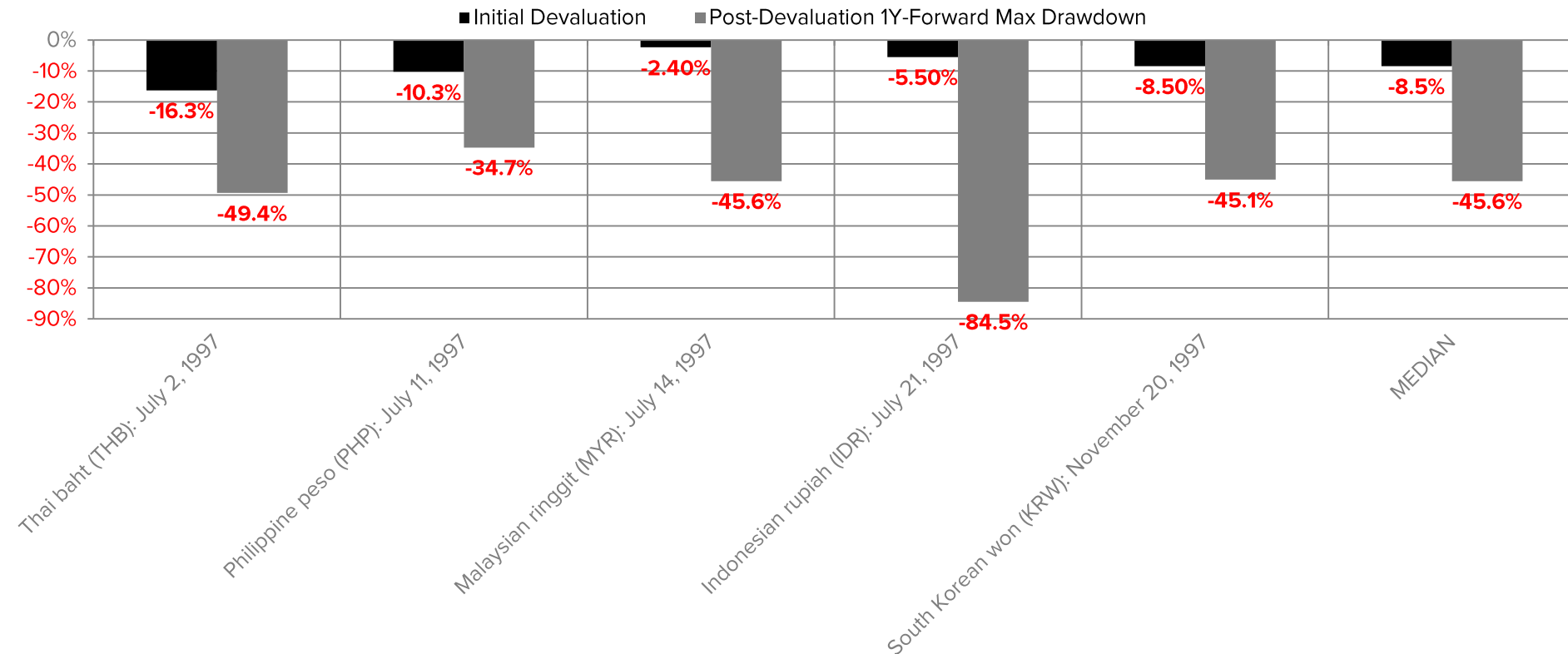
ANOTHER SILVER LINING

ROUGHLY A THIRD OF CHINA'S REPORTED PEAK-TO-PRESENT RESERVE BALANCE DECLINE CAN BE ATTRIBUTED TO MERE ASSET REVALUATION AMID USD APPRECIATION VS. OTHER KEY RESERVE CURRENCIES.



CHINA HAS NO INCENTIVE TO DEVALUE

BEIJING HAS LONG FAVORED POLITICAL, ECONOMIC AND FINANCIAL MARKET STABILITY. AND WHILE ITS SUCCESS PROMOTING THE LATTER HAS BEEN DICEY OF LATE, THERE IS ONE THING WE CAN ALL AGREE ON WITH RESPECT TO THE YUAN: THERE'S NO SUCH THING AS A "ONE-OFF" DEVALUATION.



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