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China, US interest rate trends, "an end to the bull market" and how these might combine

China's economy is performing significantly better than had been expected thanks to continuing government stimulus. But China's massive debt burden is still increasing and we see a significant risk that a China bubble bursts within the next one to three years. With the US economy hitting its capacity limits and the process of US asset price inflation now well advanced, the Fed seems set to raise interest rates to 1.75% by the end of the year. Fed policy rates will cross the 2% mark some time in 2018. Thus interest rates are set to threaten China's credit-financed growth process, something that could spell serious trouble for the world's equity, bond and property markets.

Extremely stimulative policies have produced a marked pickup in China's economy. The extent of the stimulus is well illustrated by the fact that Chinese government spending has risen around 38% over the previous fiscal year. But the "economic surprise" is not limited to just the growth rate. Producer prices and the GDP deflator have also risen faster than consensus expectations. China's National Party Congress takes place every five years and the nineteenth in the series will take place in November 2017. Traditionally, China's leaders have sought to engineer a strong economic environment for their National Party Congress. The chances are therefore high that 2018 will see some slowdown for China. In the end, China's policy makers can do no more than boost growth today at the expense of growth tomorrow and China's explosion of gross debt is imposing an ever tighter straitjacket on their room for maneuver.

Bank loans have been growing at an annualized 13% rate, with "Total Social Financing" rising 12.8%. Both series are growing at a significantly faster pace than Chinese nominal GDP. But the Chinese authorities cannot allow the ratio of gross debt to gross GDP to continue rising in an unconstrained fashion. Underlying credit worthiness is so shaky that there is the real risk of private and quasi-public borrowers being cut off from the credit markets. (A particular concern relates to the indebtedness of non-financial public companies funded by state banks and local government financing vehicles.) It is hard to put a precise figure on China's gross debt to gross GDP ratio as, for example, the debts of publicly owned companies are not counted as part of public sector debt but allocated on an economic basis. Respected commentators, for example McKinsey, have suggested that China's gross debt to gross GDP ratio is well over 250%. The continuing swelling of China's credit bubble represents the biggest risk for the global economy and the world's capital markets over the next few years. And a bursting of the bubble would pose enormous challenges to policy-makers and investors. We forecast that the bubble won't burst this year, and on balance don't expect it to burst next year either. But we also recognize that the longer the bubble continues to grow, the more severe the fallout is likely to be when it eventually bursts. US interest rate trends, more particularly a rising real interest rate differential between the US and China, could well be the trigger factor.

America's headline rate of unemployment has already fallen to 4.7% and the more broadly-defined U6 unemployment rate (which includes those workers who are part time for purely economic reasons) stands at 9.2%. Latest figures show hourly wages rising at an annualized 2.8% and February saw a 235'000 rise in non-farm payrolls.

Meanwhile the net wealth of US households now stands at $92 trillion, an all-time high. Years of highly expansionary monetary policy have certainly boosted inflation – but for asset, rather than consumer, prices. And strongly rising asset prices have stimulated the global economy, with two transmission channels being particularly important.

First is the standard "wealth effect". Being wealthier and perhaps confusing wealth with income, consumers will feel they can afford to spend more. Second is the effect on corporate investment. With high asset prices, corporate expansion through the purchase of other firms has become more expensive. Rather than buy other companies, firms will opt to build out their own capital infrastructure, especially in the US. Investments and capital expenditures should increase.

The Fed is generally cautious when it comes to commenting on asset price trends. But a policy discussion on the likelihood that asset prices have risen too far too fast, and that this poses risks for financial stability, will certainly be held behind closed doors. Thus, in our view, there is not only a "Fed put" but also a "Fed call". Further gains in equity and property prices will be viewed as increasingly undesirable from a policy perspective, and would likely trigger a tightening of monetary policy.

Last but not least, we see signs the money multiplier is increasing in power due to a diminishing liquidity preference. The larger monetary aggregates respond with a lag to Fed policies and the transmission mechanism, or the link between the monetary base and inflation, is starting to make itself felt.

With a good economic environment, a low unemployment rate, wage growth, a more powerful money multiplier and asset prices which imply high levels of net wealth, we expect the Fed to announce another 25 basis point rise in policy rates next week, with a new target range for overnight funds of 0.75% to 1%.

By the end of 2017, the Fed funds rate (the Fed's key policy rate) is likely to be between 1.5% and 1.75%. Latest Fed forecasts for end-2017 put GDP growth over the prior twelve months at 2.1%, the unemployment rate at 4.5% and "core" inflation at 1.8%. Given recent data trends, we think these forecasts may well underestimate the implicit growth in US nominal GDP. Upcoming data are likely to embolden the Fed to move away from its still highly expansionary policy stance.

Higher interest rates don't only imply a rise in discount rates. They suggest the risks of deflation have diminished and that profits are growing more rapidly. They suggest the global financial system has become more stable and that, as a result, investors will demand lower risk premia. Moreover, higher rates increase the options for policy makers. When the next crisis occurs, central banks will want to offset its impact by cutting rates. But they can only do this in a meaningful way if interest rates have been allowed to rise significantly in the first place.

Given these considerations, higher rates ought to be taken positively, rather than negatively, by investors in risk assets such as property and equities.

A normalization of the US rate environment should allow the ECB and Bank of Japan to at least begin some discussion with the markets on cutting back on bond purchase programs ("tapering"), or even on raising interest rates.

But the chances are high in our view that within 12-24 months higher rates will pose a serious risk for China's debt-fueled growth process, and, as a result, they will threaten serious damage for the world's equity, bond and property markets. Coming quarters will probably see a shift in "investor traffic lights" from green to yellow. Investors will need to watch these signals carefully and react by putting on the brakes.

Contact: Thomas Härter, Investment Office
Tel.: +41 58 680 60 44