Research

China: Vulnerability sentiment plateaus in November

Sumedh Deorukhkar / Alvaro Ortiz / Tomasa Rodrigo / Le Xia

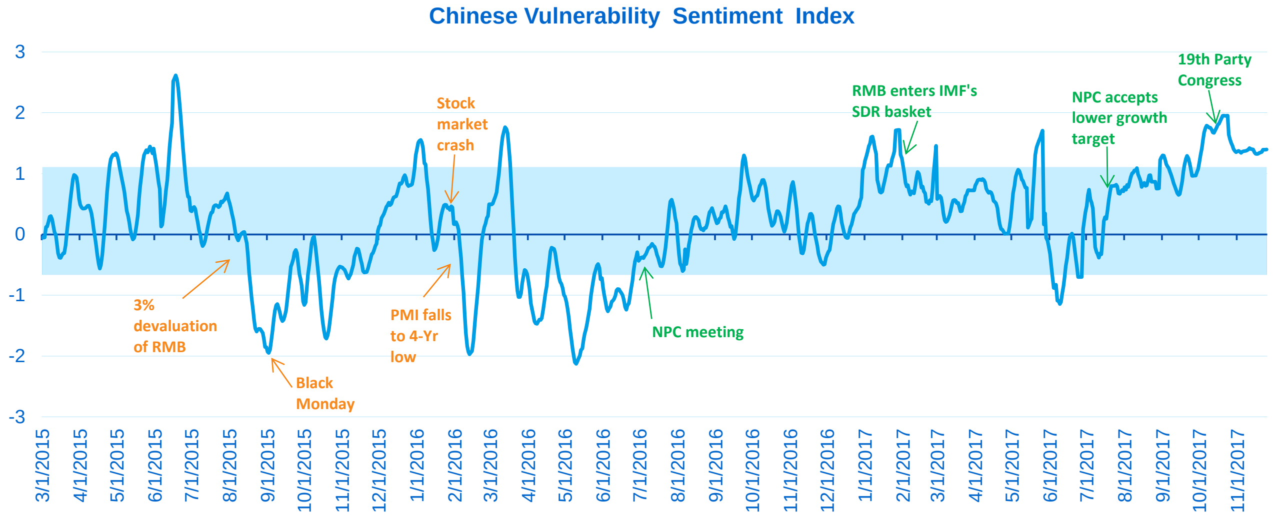
01 December 2017

Our China Vulnerability Sentiment Index (CVSI) held steady in November, remaining well within the positive territory although softer compared to its peak achieved during the 19th Chinese Party Congress. The past month saw authorities intensify efforts to curb risks to financial stability emanating from the shadow banking sector, high corporate leverage, speculative price gains in housing market and inefficiencies across SOEs. Looking closer, our SOE & Housing bubble vulnerability indices were marginally positive, Shadow banking vulnerability index extended recent robust gains while Exchange rate vulnerability index stayed under pressure.

A step up in efforts to curb financial stability risks post 19th CPC underpins CVSI

Our CVSI plateaued in November, well within the positive territory, athough softer when compared to its recent peak during the 19th Chinese Party Congress (Figure – 1). November marks the fifth straight month of positive CVSI print, reflecting policy commitment towards curbing financial fragilities and a shift in policy focus towards quality rather than the pace of growth. China's recent industrial, construction and housing sector data despitcted further activity slowdown in Q4 following several rounds of tightening measures, increased environmental protection and anti-pollution measures. On the flipside, consumption and services sectors remain stabilizing forces on growth. Looking closer at sub-components, our SOE & Housing bubble vulnerability indices were marginally positive (See Figures 2, 3 & Table 7). Ongoing capacity cuts coupled with robust external demand is underpinning SOE profitability although increased influence of communist party in operations of SOEs is a concern. Meanwhile, after surprising on the upside in 1H17, real estate activity appears to be easing as housing transacitons cooled and real estate FAI slowed. Meanwhile, concerted efforts to curb Shadow Banking risks reflect positively in our Shadow Banking index (See Figure 4). Of note is the recent tightening of asset management rules to curb risky lending aiming to close loopholes that allow regulatory arbitrage, reduce leverage levels and rein in shadow banking activity. Finally, our Exchange rate vulnerability index remains under pressure (Figures 5 & 6), which suggests capital outflows could pickup in a rising Fed rate environment even as PBOC's prudent policy stance and the recent financial sector liberalisation measures abet Yuan stability.

Figure 1. China Vulnerability Sentiment Index (CVSI)

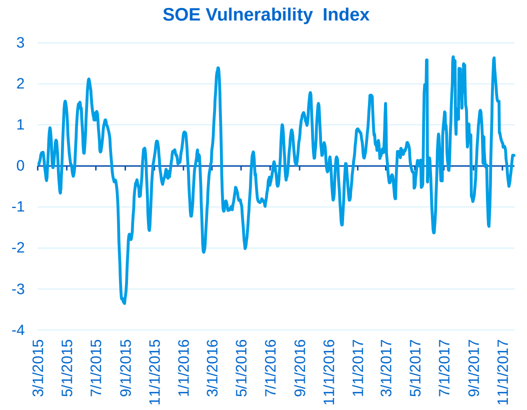


Source: BBVA Research based on figures by Gdelt, Bloomberg, CEIC and Wind

In sum…

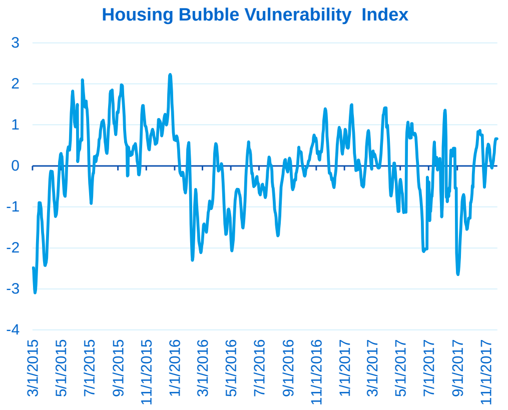
While Chinese policymakers have conditioned markets on expectations of deleveraging and financial tightening, the lack of clear detail is leading to excessive pessimism among market players, which in turn has raised domestic borrowing costs through a surge in Chinese government and corporate bond yields. Nevertheless, the acceleration of structural reforms since the 19th Party Congress, if sustained, should support China's potential GDP growth in the long run.

Figure 2. SOE Vulnerability Index



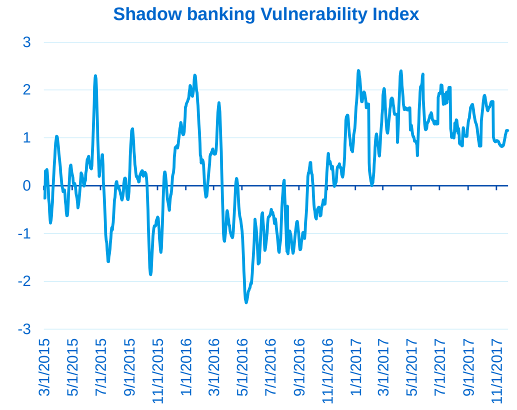
Source: BBVA Research based on figures by Gdelt, Bloomberg, CEIC, Wind

Figure 3. Housing Bubble Vulnerability Index



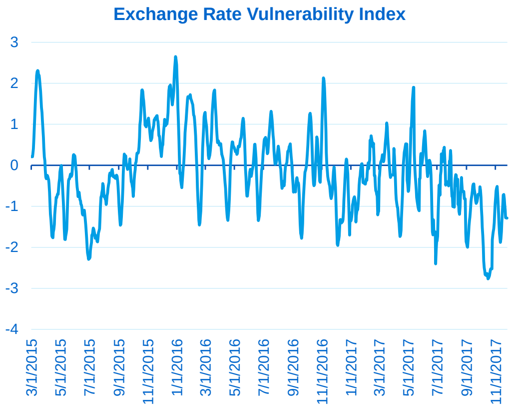
Source: BBVA Research based on figures by Gdelt, Bloomberg, CEIC, Wind

Figure 4. Shadow Banking Vulnerability Index



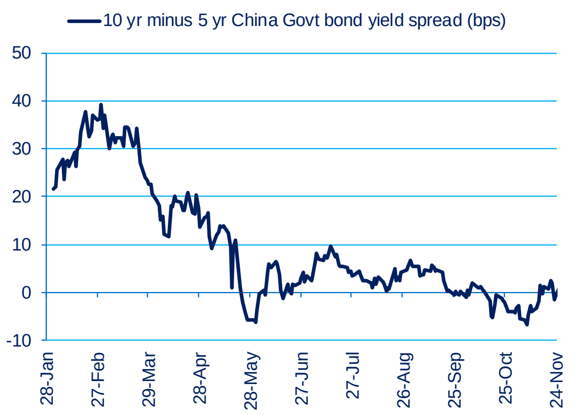
Source: BBVA Research based on figures by Gdelt, Bloomberg, CEIC, Wind

Figure 5. FX Speculative Pressure Vulnerability Index



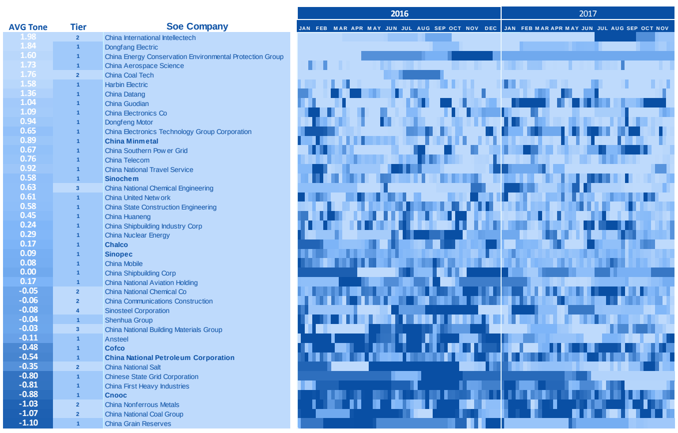
Source: BBVA Research based on figures by Gdelt, Bloomberg, CEIC, Wind

Figure 6. China bond yield spread



Source: BBVA Research, Bloomberg

Figure 7. SOE Sentiment softened vs. last month



Source: BBVA Research, Bloomberg

IMPORTANT DISCLOSURES

The BBVA Group companies that have participated in preparing or contributed information, opinions, estimates, forecasts or recommendations to this report are identified by the location(s) of the author(s) listed on the first page as follows: 1) Madrid, London or Europe = Banco Bilbao Vizcaya Argentaria, S.A., including its E.U. branches (hereinafter called 'BBVA'); 2) Mexico City = BBVA Bancomer, S.A. Institución de Banca Múltiple, Grupo Financiero BBVA Bancomer (hereinafter called 'BBVA Bancomer'); 3) New York = BBVA Securities, Inc. (hereinafter called "BBVA Securities"); 4.) New York Branch = BBVA, New York branch; 5.) Lima = BBVA Continental; 6.) Bogota = BBVA Colombia S.A.; 7.) Santiago = BBVA Chile S.A.; 8.) Hong Kong = BBVA, Hong Kong branch, 9.) Istanbul = Garanti Securities.

For recipients in the European Union, this document is distributed by BBVA, a bank supervised by the Bank of Spain and by Spain's Stock Exchange Commission (CNMV), and registered with the Bank of Spain with number 0182.

For recipients in Hong Kong, this document is distributed by BBVA, which Hong Kong branch is supervised by the Hong Kong Monetary Authority.

For recipients in Mexico, this document is distributed by BBVA Bancomer, a bank supervised by the Comisión Nacional Bancaria y de Valores de México.

For recipients in Peru, this document is distributed by BBVA Continental, a bank supervised by the Superintendencia de Banca, Seguros y Administradoras Privadas de Fondos de Pensiones.

For recipients in Singapore, this document is distributed by BBVA, which Singapore branch is supervised by the Monetary Authority of Singapore.

For recipients in USA, research on products other than swaps, or equity securities and equity derivatives prepared by BBVA, is being distributed by BBVA Securities, a subsidiary of BBVA registered with and supervised by the U.S. Securities and Exchange Commission and a member of the Financial Industry Regulatory Authority ("FINRA") and the Securities Investor Protection Corporation. U.S. persons wishing to execute any transactions should do so only by contacting a representative of BBVA Securities in the U.S. Unless local regulations provide otherwise, non-U.S. persons should contact and execute transactions through a BBVA branch or affiliate in their home jurisdiction.

Research on swaps is being distributed by BBVA, a swaps dealer registered with and supervised by the Commodity Futures Trading Commission ("CFTC"). U.S. persons wishing to execute any transactions should do so only by contacting a representative of BBVA. Unless local regulations provide otherwise, non-U.S. persons should contact and execute transactions through a BBVA branch or affiliate in their home jurisdiction.

Research prepared by BBVA on equity securities and equity derivatives is being distributed by BBVA to "major U.S. institutional investors" based on an exemption from registration provided by Rule 15a-6 of the U.S. Securities Exchange Act of 1934, as amended (the "Exchange Act"). BBVA is not a registered broker-dealer in the United States and is not subject to U.S. rules on preparing research or independence of research analysts.

BBVA and BBVA Group companies or affiliates (art. 42 of the Royal Decree of 22 August 1885 Code of Commerce), are subject to the BBVA Group Policy on Conduct for Security Market Operations which establishes common standards for activity in these entities' markets, but also specifically for analysis and analysts. This BBVA policy is available for reference at the following web site: www.bbva.com.

Analysts residing outside the U.S. who have contributed to this report may not be registered with or qualified as research analysts by FINRA or the New York Stock Exchange and may not be considered "associated persons" of BBVA Securities (as such term is construed by the rules of FINRA). As such, they may not be subject to FINRA Rule 2241 or 2242 restrictions on communications with subject companies, public appearances and trading of securities held in research analysts' accounts.

BBVA is subject to a Internal Standards of Conduct on the Security Markets, which details the standards of the above-mentioned overall policy for the EU. Among other regulations, it includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. This Internal Standards of Conduct on the Security Markets is available for reference in the 'Corporate Governance' section of the following web site: www.bbva.com.

BBVA Bancomer is subject to a Code of Conduct and to Internal Standards of Conduct for Security Market Operations, which details the standards of the above-mentioned overall policy for Mexico. Among other regulations, it includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. This Code and the Internal Standards are available for reference in the 'Grupo BBVA Bancomer' subsection of the 'Conócenos' menu of the following web site: www.bancomer.com.

BBVA Continental is subject to a Code of Conduct and to a Code of Ethics for Security Market Operations, which details the standards of the above-mentioned overall policy for Peru. Among other regulations, it includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. Both Codes are available for reference in the 'Nuestro Banco' menu of the following web site: https://www.bbvacontinental.pe/meta/conoce-bbva/.

BBVA Securities is subject to a Capital Markets Code of Conduct, which details the standards of the above-mentioned overall policy for USA. Among other regulations, it includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers.

Exclusively for Recipients Resident in Mexico

BBVA Bancomer acts as a market maker/specialist in: MexDer Future Contracts (US dollar [DEUA], 28-day TIIEs [TE28], TIIE Swaps, 91-day CETES [CE91]), Bonos M, Bonos M3, Bonos M10, BMV Price and Quotations Index (IPC), Options Contracts (IPC, shares in América Móvil, Cemex, CPO, Femsa UBD, Gcarso A1, Telmex L) and Udibonos.

BBVA Bancomer, and, as applicable, its affiliates within BBVA Bancomer Financial Group, may hold from time to time investments in the securities or derivative financial instruments with underlying securities covered in this report, which represent 10% or more of its securities or investment portfolio, or 10% or more of the issue or underlying of the securities covered.

BBVA | Research

DISCLAIMER

This document and the information, opinions, estimates, forecasts and recommendations expressed herein have been prepared to provide BBVA Group's customers with general information and are current as of the date hereof and subject to changes without prior notice. Neither BBVA nor any of its affiliates is responsible for giving notice of such changes or for updating the contents hereof.

This document and its contents do not constitute an offer, invitation or solicitation to purchase or subscribe to any securities or other instruments, to undertake or divest investments, or to participate in any trading strategy. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

Investors who have access to this document should be aware that the securities, instruments or investments to which it refers may not be appropriate for them due to their specific investment goals, financial positions or risk profiles, as these have not been taken into account to prepare this report. Therefore, investors should make their own investment decisions considering the said circumstances and obtaining such specialized advice as may be necessary. Other than the disclosures relating to BBVA Group, the contents of this document are based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA or any of its affiliates and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. To the extent permitted by law, BBVA and its affiliates accept no liability of any type for any direct or indirect losses or damages arising from the use of this document or its contents. Investors should note that the past performance of securities or instruments or the historical results of investments do not guarantee future performance.

The market prices of securities or instruments or the results of investments could fluctuate against the interests of investors. Investors should be aware that they could even face a loss of their investment. Transactions in futures, derivatives, options on securities or high-yield securities can involve high risks and are not appropriate for every investor. Indeed, in the case of some investments, the potential losses may exceed the amount of initial investment and, in such circumstances; investors may be required to pay more money to support those losses. Thus, before undertaking any transaction with these instruments, investors should be aware of their operation, as well as the rights, liabilities and risks implied by the same and the underlying securities. Investors should also be aware that secondary markets for the said instruments may not exist. Before entering into transactions in futures, derivatives, or options, investors should review all documents on disclosures for risks of investing in options and/or futures at the following websites:

Options - http://www.finra.org/Industry/Regulation/Notices/2013/P197741

Futures - http://www.finra.org/Investors/InvestmentChoices/P005912

BBVA or any of its affiliates' salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, BBVA or any of its affiliates' proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. No part of this document may be (i) copied, photocopied or duplicated by any other form or means (ii) redistributed or (iii) quoted, without the prior written consent of BBVA. No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. More specifically, this document is in no way intended for, or to be distributed or used by an entity or person resident or located in a jurisdiction in which the said distribution, publication, use of or access to the document contravenes the law which requires BBVA or any of its affiliates to obtain a licence or be registered. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

The remuneration system concerning the analysts responsible for the preparation of this report is based on multiple criteria, including the revenues obtained by BBVA and, indirectly, the results of BBVA Group in the fiscal year, which, in turn, include the results generated by the investment banking business; nevertheless, they do not receive any remuneration based on revenues from any specific transaction in investment banking.

In the United Kingdom, this document is directed only at persons who (i) have professional experience in matters relating to investments falling within article 19(5) of the financial services and markets act 2000 (financial promotion) order 2005 (as amended, the "financial promotion order"), (ii) are persons falling within article 49(2) (a) to (d) ("high net worth companies, unincorporated associations, etc.") of the financial promotion order, or (iii) are persons to whom an invitation or inducement to engage in investment activity (within the meaning of section 21 of the Financial Services and Markets Act 2000) may otherwise lawfully be communicated (all such persons together being referred to as "relevant persons"). This document is directed only at relevant persons and must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this document relates is available only to relevant persons and will be engaged in only with relevant persons.

BBVA Hong Kong Branch (CE number AFR194) is regulated by the Hong Kong Monetary Authority and the Securities and Futures Commission of Hong Kong. In Hong Kong this report is for distribution only to professional investors within the meaning of Schedule 1 to the Securities and Futures Ordinance (Cap 571) of Hong Kong. This document is distributed in Singapore by BBVA's office in this country for general information purposes and it is generally accessible. In this respect, this document does not take into account the specific investment goals, the financial situation or the need of any particular person and it is exempted from Regulation 34 of the Financial Advisors Regulation ("FAR") (as required in Section 27 of the Financial Advisors Act (Chapter 110) of Singapore ("FAA")).

Garanti Securities headquarters is in Istanbul, Turkey and is regulated by Capital Markets Board (Sermaye Piyasası Kurulu - SPK, www.spk.gov.tr). BBVA, BBVA Bancomer, BBVA Chile S.A., BBVA Colombia S.A., BBVA Continental, BBVA Securities and Garanti Securities are not authorised deposit institutions in accordance with the definition of the Australian Banking Act of 1959 nor are they regulated by the Australian Prudential Regulatory Authority (APRA).

General Disclaimer for Readers Accessing the Report through the Internet

Internet Access

In the event that this document has been accessed via the internet or via any other electronic means which allows its contents to be viewed, the following information should be read carefully: The information contained in this document should be taken only as a general guide on matters that may be of interest. The application and impact of laws may vary substantially depending on specific circumstances. BBVA does not guarantee that this report and/or its contents published on the Internet are appropriate for use in all geographic areas, or that the financial instruments, securities, products or services referred to in it are available or appropriate for sale or use in all jurisdictions or for all investors or counterparties. Recipients of this report who access it through the Internet do so on their own initiative and are responsible for compliance with local regulations applicable to them. Changes in regulations and the risks inherent in electronic communications may cause delays, omissions, or inaccuracy in the information contained in this site. Accordingly, the information contained in the site is supplied on the understanding that the authors and editors do not hereby intend to supply any form of consulting, legal, accounting or other advice. All images and texts are the property of BBVA and may not be downloaded from the Internet, copied, distributed, stored, re-used, re-transmitted, modified or used in any way, except as specified in this document, without the express written consent of BBVA. BBVA reserves all intellectual property rights to the fullest extent of the law.