

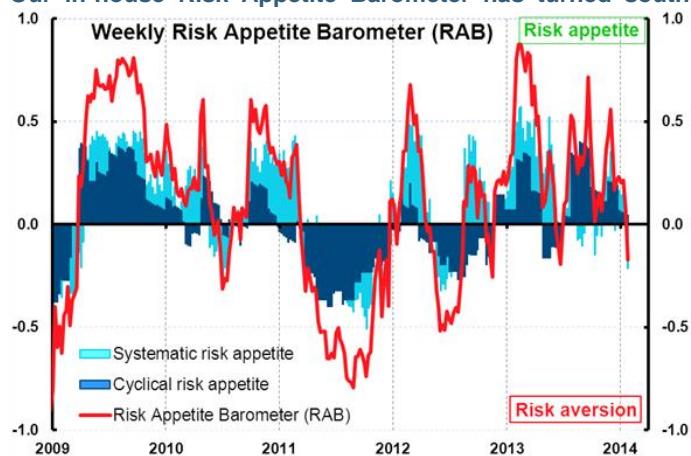
# Chinese jitters - no panic but a call for caution

- Markets are tentatively pricing a new global systemic risk, associated with China
- The Chinese risk is overstated, but caution is required when investing in risk assets

Equity markets suffered a sharp correction last week (global MSCI down 2.6%, MSCI euro area down 3.8%). At the same time, 'safe haven' bonds had a nice rally, with 10Y UST yields down 25bps from early January. Volatility prices have jumped. This market action mix is typical of a return of the bi-modal risk-on / risk-off behaviour, on the risk-off side. Our in-house Risk Appetite Barometer is confirming that this is not a pure random correction: not only the momentum component of the RAB has turned south (no surprise), but also the pair-wise correlation of equities (a gauge of herd behaviour) has risen to 60%, a clear sign of systemic anxiety.

## Exhibit 1

### Our in-house Risk Appetite Barometer has turned south



Source: Bloomberg, Datastream, & AXA IM Research

On a more positive note, panic has not reached the credit world: the low vs. high grade spread component of the RAB has been pretty stable over the month (Exhibit 1). The 'real component' of the RAB, based on monthly surveys such as the ISM or the Ifo tallies which was neutral in December, is likely to remain so in January, if the Ifo survey released yesterday is anyone's guide: German exporters, who know something about China, do not seem to be impressed by the China-doomsday mongers.

### Who pressed the risk-off button? It's China, stupid...

As I wrote last Friday, the dominant buzz in the markets is that a large scale financial accident might be imminent in China. The largely announced default of a high yield investment vehicle issued by Credit Trust –its name, 'Credit Equals Gold' sounds like a bad joke- since ICBC said it wouldn't shoulder it, is seen as the canary in the mine, even if a default is eventually avoided. Indeed, Chinese authorities are walking a fine line between bail-in and bail-out, in order to avoid a panic just as the New Year festivities are starting while sending a stronger than usual signal to both investors and trust funds. Yet, the scare in global markets is that Chinese authorities may have let the leverage genius out of the bottle when tightening the interbank lending market twice last year and that one default could ignite a chain reaction, a typical case of contagion and self-fulfilling prophecy. My colleague [Aidan Yao has argued](#) that Chinese authorities may not be in position of controlling each wealth product related specific risk (or maybe are not willing to) but have ample room for manoeuvre to prevent a systemic collapse of credit markets, as opaque as they might be. Even if markets do not share this cold assessment, one puzzle remains: since Chinese financial markets are largely insulated from the rest of the world (less so than ten years ago, for sure, but China's capital account is still under tight control), why are global markets so sensitive to an hypothetical Chinese financial accident?

## ... But only a sharp slowdown of Chinese growth amplified by a debacle in emerging markets could justify the correction

My assumption is that the hypothetical transmission channel to the rest of the world is real, not financial. Assume that we are wrong (needless to say I sit on Aidan's side) and that a financial meltdown happens in China, cutting the liquidity oxygen to a large number of private companies, even SOEs, and that the credit crunch results into a sharp slowdown, with Chinese GDP growth falling below 5%, for the sake of the analysis. Then, since China has become a major if not the main trade partner for many emerging economies as well as developed economies such as Germany, it's the global economy that could be harmed, via its weak link, emerging markets. Moreover, financial institutions in developed countries are to some extent exposed to emerging economies (10 to 20% of their foreign claims). Besides, the correction in stock markets has been sharper for financials than for other sectors.

### How serious is the risk?

For starters, it is hard to conceive how Chinese authorities may let a credit crunch occur at this stage. While excessive credit expansion most always ends in tears, China is very far from the edge of the abyss. According to [BIS statistics](#),

overall credit to the private non-financial sector reached 173% of GDP in China in June 2013, a worrying level, but still dwarfed by the levels reached in the UK or the Netherlands, respectively 184% and 221%. More importantly, Chinese authorities do not face the risk of sudden capital outflows, like many emerging markets with open capital accounts do, and would not hesitate to stem a crisis through liquidity injections (PBC may increase reverse repo operations on a discretionary basis). If top line growth was slowing below the political safe zone, they would not hesitate to increase government spending and/or reverse the appreciation of the RMB. All that said, bad things happen as we all know and even if China has the means to deal with a credit crisis, it might take time before policy reactions support the real economy. Therefore, if risk there is, it is of an unwelcome but temporary slowdown of China.

**Bottom line: it is difficult at this stage to assess the probability of a sharp but temporary slowdown of final demand growth in China. We are nevertheless working on it and will keep you posted. In the meantime, while I stick to the view that the markets most likely overestimate the risk, not of some sort of nasty credit event in China, but of a sharp growth slowdown, I would concede that the signal from the markets is strong enough to adopt a cautious behaviour when it comes to investing in risk assets, at this stage.**

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