Fixed Income Compass.

Quarterly outlook and positioning from LGIM's Fixed Income Team

Looking through the noise

Our three themes for 2016 are devaluation, default and a vulnerable Europe. These are a natural consequence of the structural problems that have dominated recent years, centred on our four Ds of debt, deficits, demographics and deflation. As always, markets have not followed a consistent trajectory, but through the noise our themes are playing out.

Devaluation

Currency devaluation has been grabbing headlines all year. The Chinese renminbi weakened at the start of the year, but this was quickly arrested as outflows threatened economic stability. Policymakers have since backpedalled on policies of rebalancing and liberalisation – restricting capital flow, extending bad loans and boosting the housing market. As we discuss later, this is compounding the country's structural problems.

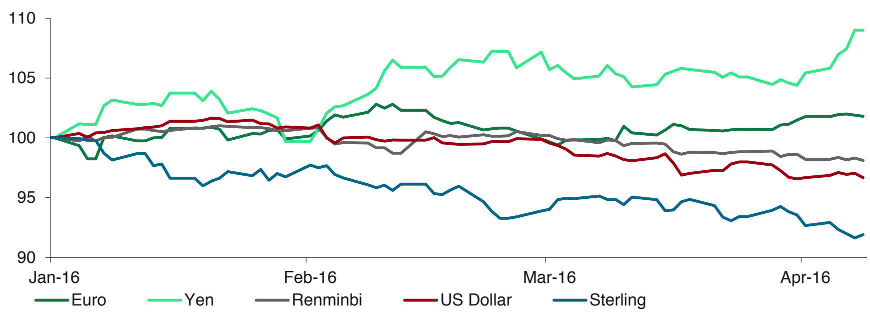
Meanwhile, having benefited from currency devaluation in recent years, the Bank of Japan and the European Central Bank must be unnerved that their latest unconventional monetary policy measures not only failed to accelerate currency weakness, but have actually led to appreciation.

This is partly because Janet Yellen at the US Federal Reserve has admitted that her interest rate hiking plan was too aggressive, with not even one rate hike now being priced into the futures market for 2016. This has temporarily stalled the dollar's strength. But yen and euro appreciation also reflects a growing realisation that central bank policy is impotent in the face of the global debt mountain. It seems the more central banks battle to boost growth and inflation, the tighter the noose becomes, as negative interest rates bite into bank profitability and asset purchases undermine the productive allocation of capital. As our Asset Allocation team discussed in their April Macro Matters, central bankers may be about to double down, turning attention towards a helicopter drop of money. This is basically printing money and handing it out to governments, corporates and households. Not only would this further undermine the capitalist system, but it would also represent a blatant attempt to devalue currencies with a nod to the Weimar Republic's policies in 1923. No wonder gold has had such a good start to the year.

Default

Yellen's inaction has at least eased pressure on commodity producers and emerging economies that were struggling under tighter US dollar borrowing conditions and collapsing oil prices. But the reason she hasn't hiked rates in 2016 is because of weak global growth, which weighs on the outlook for such borrowers. The Fed probably wants to conserve as many bullets as possible, and is therefore unlikely to plan another round of quantitative easing or even pre-emptively cut rates while the US domestic economy remains out of recession. Without this monetary support, and without oil reversing last year's fall, a severe default cycle for commodity producers is very likely.

Figure 1: Trade-weighted currencies, rebased to 100



Source: Bloomberg L.P., Morgan Stanley

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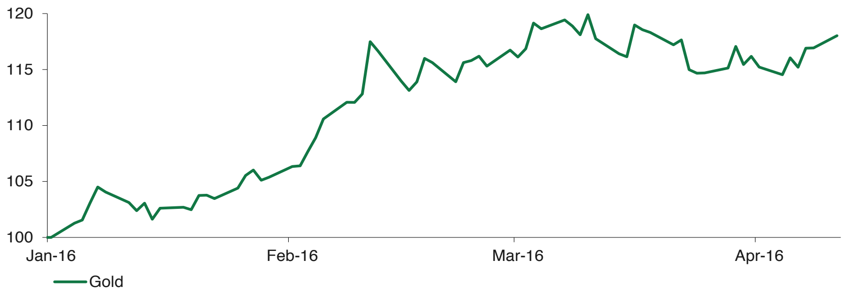
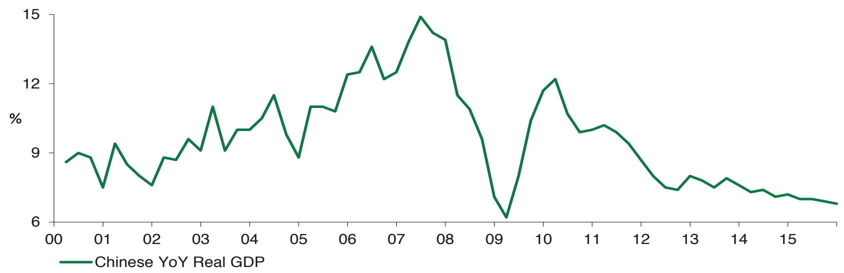
Figure 2: Gold price, rebased to 100



Source: Bloomberg L.P.

Figure 3: Chinese growth has been slowing



Source: Bloomberg L.P.

Vulnerable Europe

Another predictable development has been the return of European stress. We've long held the view that the euro is an unstable construct without unconditional fiscal transfers, a true banking union and euro area wide government bonds. Politics has the potential to bring focus on such vulnerabilities, with 2016 already witnessing problems in forming a Spanish government, the refugee crisis pressurising Angela Merkel and Greece's inability to stick to its bailout programme. In addition, the undercapitalised Italian banking system has come under the spotlight, as retail depositors face losses given new rules restricting government bailouts. Finally, the UK's EU referendum is now just weeks away. Whatever the result, just like last year when Greece was nearly ejected from the euro area, the fact that a country can leave the European Union underlines its vulnerability. We do not believe investors are sufficiently compensated for this weakness.

Assuming that Janet Yellen continues to delay policy easing until it is too late for the global economy, our three themes of devaluation, default and a vulnerable Europe should remain key drivers for 2016.

China: from engine of growth to systemic risk

So far we have only mentioned China in the context of currency volatility at the start of the year. But, for some, China also represents a positive scenario of structural reforms returning the country to its position as the engine of world growth. Such a development would go some distance to balance problems elsewhere. But not only do we think this is unlikely, we actually believe China poses a systemic risk of historic proportions.

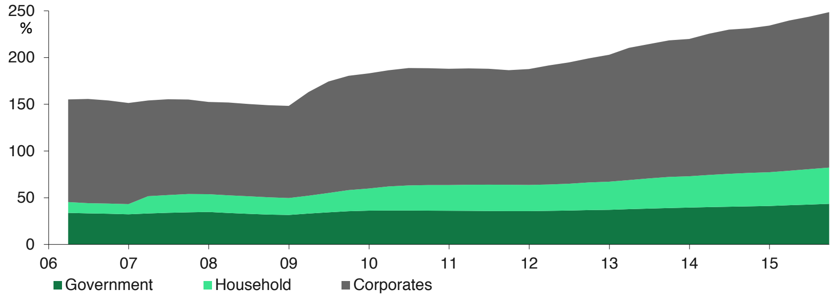
It is now clear that China is not smoothly passing its growth baton from exports and investment to the service sector. Indeed, viewed from the perspective of demand for foreign goods, China might as well be in a recession. Official GDP data still shows growth, but this has decelerated significantly despite numerous interest rate cuts and massive fiscal support.

Debt is key

The reason for such weakness is debt. It is hard to exaggerate the magnitude of the Chinese debt bubble. According to the BIS, debt to GDP has increased by around 100% since 2008, which compares to about 40% in the US leading up to the subprime meltdown, 60% in Japan prior to its collapse in 1997 and is even more than the credit booms of Greece, Portugal, Spain and Italy in the run up to the euro crisis. The only similar credit bubble in recent history was Thailand before the Asia crisis. And if an economy the size of China's goes through what Thailand did in 1997, the world will be a very ugly place indeed.

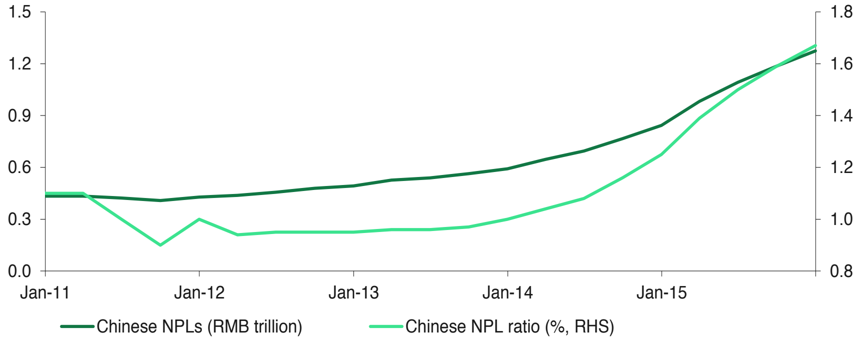
Chinese debt is concentrated in the corporate sector, but this distinction is blurred given the use of state owned enterprises and local authority lending vehicles by the Chinese government during their investment binge. According to Autonomous Research estimates, corporate sector debt will rise to above 8x income in 2016, double its level in 2008. There are many zombie companies that simply have to borrow just to service their current debt. Gavekal Dragonomics estimates that 28% of Shanghai Composite companies are loss-making when subsidies are stripped out. And debt is still growing rapidly

Figure 4: Chinese non-financial debt/GDP



Source: Bank for International Settlements

Figure 5: Chinese NPLs are rising, but significantly understate the problem



Source: Bloomberg L.P.

with credit growth running at twice the rate of nominal GDP expansion.

One positive aspect is that the vast majority of the debt is funded domestically, so China's external vulnerability is nothing like Thailand in 1997. However, this still means Chinese savers are on the hook. As with all debt bubbles, there has been a great deal of financial engineering to hide the debt and who guarantees it. In China, banks have created vast off-balance sheet structures named Wealth Management Products (WMP) that are stuffed full of bank loans, funded by short-maturity deposits. The US and Europe had their own off-balance sheet vehicles in 2008, SIVs and conduits, which subsequently blew up when the mortgage debt bubble collapsed. Autonomous estimates that by the end of this year Chinese WMPs will be more than double the size of the $1.7trn SIV/conduit market in 2008.

Even more worrying has been the rise of peer-to-peer (P2P) lending which has all the hallmarks of a ponzi scheme. In January, authorities closed down P2P lender Ezubao, with 900,000 investors facing losses of $7.6bn between them. Total P2P loans quadrupled in 2015 to around $150bn and the Chinese regulator thinks that about a third of P2P lenders are problematic.

Estimating the amount of debt that needs to be written off by China is not an exact science. It boils down to how much excess capacity has been built with little chance of making an economic return. Julien Garran at MacroStrategy estimates that there has been around $8trn of excess fixed capital formation in China since 2008, which assuming that 60% turn into non-performing loans and a 40% recovery rate, suggests losses of $3trn. This is about 30% of Chinese GDP. Autonomous get to a similarly large number by looking at losses realised by other countries following their own credit bubbles. This far outstrips the loss-absorbing capacity of the financial system, and would therefore require significant state support to resolve.

There seems to be very little public recognition of the problem among Chinese policymakers. Banks' non-performing loans (NPLs) are increasing, but they remain very low. Even including 'special mention loans' brings the total to a fraction of the true problem. Without facing up to the problem, and with credit growth continuing to outstrip economic development, future losses will continue to mount.

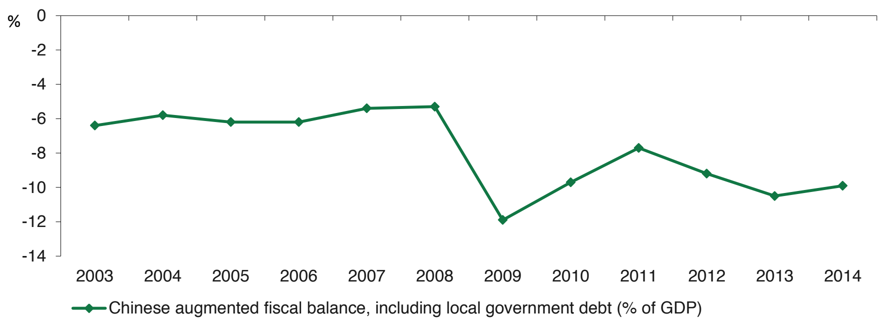
The potential for a crisis

The key to a crisis is domestic confidence. If households lose faith in the banking system and withdraw cash, or if capital outflows suddenly accelerate to the point where Chinese foreign currency reserves are unable to cope, then a crisis becomes more likely. If this happens, Chinese policymakers would most likely respond with a massive state-funded recapitalisation of the banking system, central bank money printing to plug the liquidity gap and a reduction of excess capacity by withdrawing state support from zombie companies, leading to their closure. There are all sorts of problems associated with this, not least the destabilisation linked to a spike in unemployment. Falling growth and a flood of domestic liquidity could also exacerbate the downward pressure on the Chinese currency. The combination of a large drop in Chinese demand and a depreciating renminbi would of course be catastrophic for a weak global economy.

It's therefore easy to see why Chinese policymakers are trying very hard to avoid this scenario. Instead, they are attempting to take the Japanese route of delaying the final judgment day. However, this is a double-edged sword. Volatility remains subdued for now, but the future crisis is getting larger.

This year has already witnessed a number of Chinese policies that help paper over the cracks. The housing market has been in focus, with purchase restrictions being lifted leading to a rapid increase in house prices across a handful of major cities. However, there is still a huge nationwide housing inventory

Figure 6: China is already running a 10% fiscal deficit



Source: IMF

backlog that needs to be worked through. It now seems as though restrictions are being tightened once again to try to avoid this localised housing bubble.

There have also been headlines of fiscal loosening, with Beijing lifting the official central budget deficit to 3% of GDP for 2016. However, the true government deficit is already around 10% accounting for local authority budgets, funded via a surging government bond market. It will be difficult to accelerate this already breakneck speed.

Not recognising NPLs is also part of a broader policy of 'extend and pretend'. However, not crystallising losses does not make their impact go away. Even if the Chinese debt mountain and excess capacity does not collapse overnight, it will continue to weigh on domestic economic activity and inflation. Moreover, as Chinese growth slows and liquidity conditions are gradually loosened, capital will continue to leave the country, placing downward pressure on the currency. Capital controls are being tightened, but a country that trades as much as China will find it very difficult to stem a determined flow.

Chinese debt might be a domestic matter, but the global economy is still very exposed to its impact. This is mainly felt through trade and capital flow. As debt weighs on Chinese growth, demand for foreign goods should remain subdued, while Chinese exporters are likely to be supported by state subsidies and a weakening renminbi. In addition, as capital leaves China, policymakers will probably elect to reduce foreign currency reserves to partially offset the impact. By selling foreign currency assets, China is compounding the tightening of global liquidity conditions.

Therefore, even by taking this Japanese extend and pretend route, the combination of weakening Chinese growth, tightening global liquidity and a new wave of deflation from a weakening renminbi is a significant drag for the global economy. And to reiterate, this policy does not solve the structural problems in China, it simply delays and worsens the final resolution.

Bottom line

Markets have been very volatile in 2016, but through the noise, our themes of devaluation, default and a vulnerable Europe are playing out. The Fed's initial rate hike plan has been rescheduled, but this is in response to the deteriorating global macro backdrop. Of particular importance, China is countering its structural problems with a policy of extend and pretend. But even if they manage to delay the resolution, the implication for credit markets is still negative.

Legal & General Investment Management Ltd, One Coleman Street, London, EC2R 5AA

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