

The logo for BBVA Research, featuring the word "BBVA" in a bold, white, sans-serif font, followed by the word "Research" in a smaller, lighter weight of the same font. A small teal square is positioned to the right of the word "Research".

BBVA Research

Stable Sentiment towards Financial Vulnerabilities

3Q18

Sep 2018

Creating Opportunities

Main Takeaways

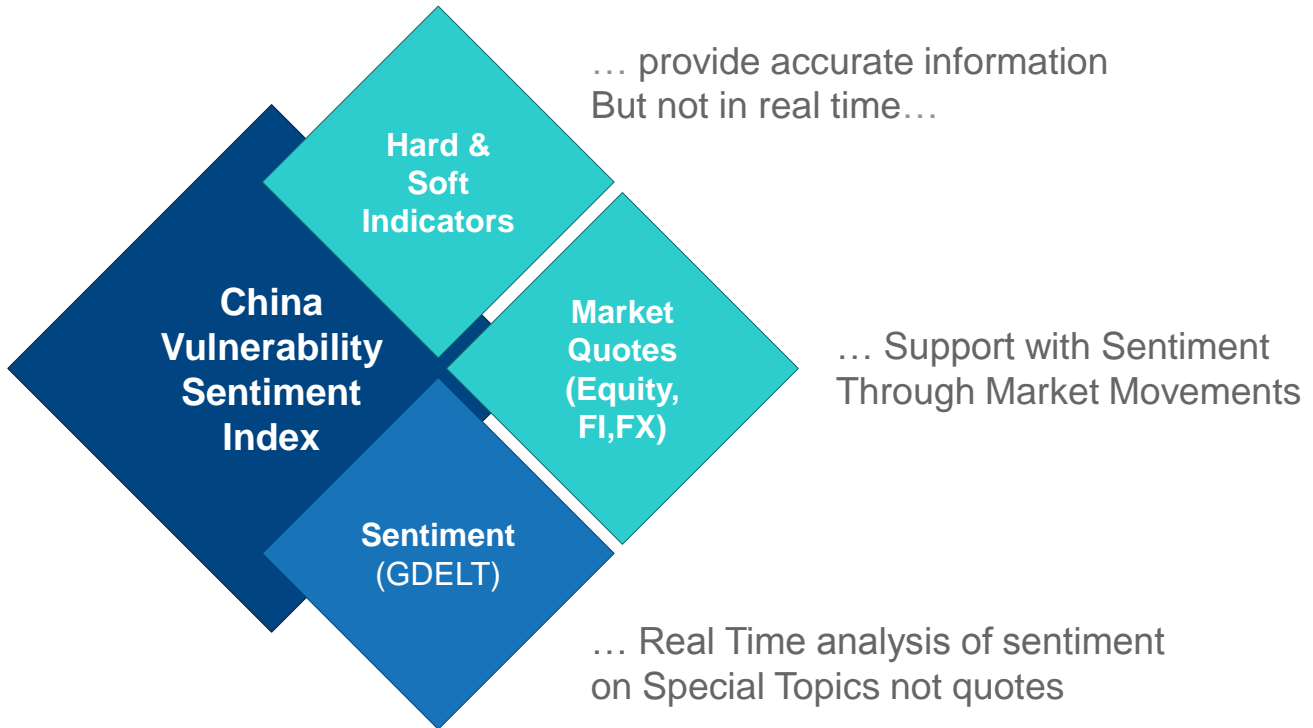
- The China Vulnerability Sentiment Index (CVSI) remained stable through Q3 despite the escalated trade disputes with the US and growth slowdown
- By component, the SOE Vulnerability index experienced a roller coaster trend, it remained vulnerable despite that SOEs still outperformed their POE peers amid tightening credit conditions
- Housing Bubble Vulnerability index remained healthy as property prices remained resilient in many cities. But the index was still in a positive territory
- Shadow banking Vulnerability index held well, driven by the government's persistent efforts to facilitate financial deleveraging and curb shadow banking activities
- Exchange Rate Vulnerability Index plummeted to the negative territory before it recovered on the central bank's revealed efforts to stabilize the exchange rate



01

The China Vulnerability Sentiment index

Tracking China Vulnerability in Real Time: Value Added through Big Data



A Balanced set of Information in the Database: Hard Data, Markets and Sentiment

Chinese Vulnerability Sentiment Index (CVSI): Components and evolution

China Vulnerability Sentiment Index (CVSI)

SOE Vulnerability Index (SOEI)	Housing Bubble Vulnerability Index (HBI)	Shadow banking Vulnerability Index (SBI)	FX Speculative Pressure Index (FXI)
---------------------------------------	---	---	--

Principal Components Analysis on each component Tone

Hard & Financial data

Total.profits (M) Liabilities (M) 25%	Mortgages.loan (M) GICS.Housing.Index (M) Housing.Price (M) New.Construction (M) RealEst.Invest (M) 45%	NPL.Ratio (M) TSF.Aggregate.New Increase (M) Entrusted.Loans (M) Wenzhou.Index (D) WMPs Acceptances (M) 35%	Foreign.Reserves (D) CNY Exchange Rate (D) CNH Exchange Rate (D) HICNHON.Index (D) 40%
--	---	---	---

Real time sentiment indicators

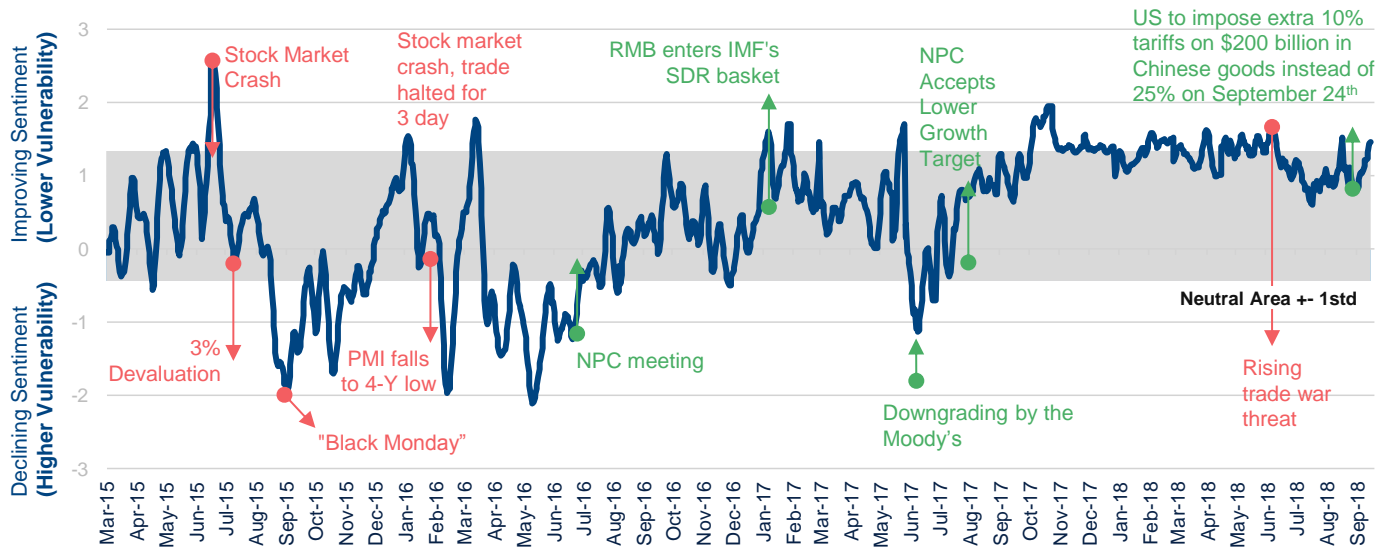
State owned enterprises (D) Resource misallocs & policy Failure (D) Resource misallocs&SOEs (D) Institutional reform & SOEs (D) Industry policy (D) Industry laws and regulations (D) Local government and SOEs (D) Debt and SOEs (D) 75%	Housing policy & institutions (D) Housing markets (D) Housing prices (D) Housing construction (D) Housing finance (D) Land reform (D) 55%	Non bank financial institutions (D) Asset management (D) Bank capital adequacy (D) Financial sector instability (D) Banking regulation (D) Infrastructure funds (D) Financial vulnerability & risks (D) Monetary & financial stability (D) State financial institutions (D) 65%	Currency exchange rate (D) Currency reserves (D) Capital account (D) Macroprudential policy (D) Exchange rate policy (D) Illicit financial flows (D) 60%
--	--	---	---

Vulnerability sentiment index has shown a greater volatility amid intensifying growth headwinds

Chinese Vulnerability Sentiment Index

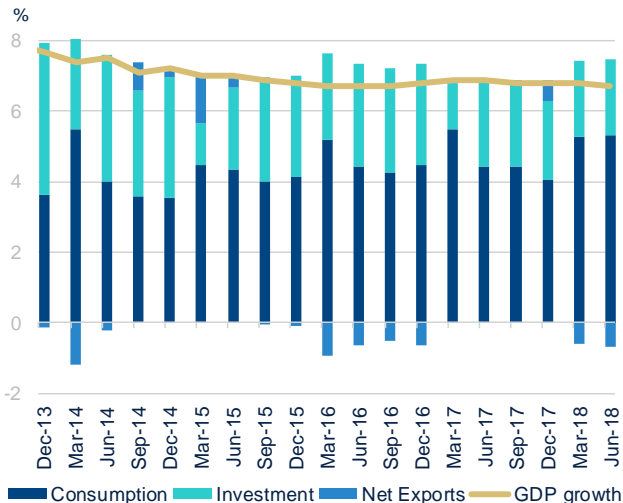
(CVSI) (Evolution of the “Tone” of main followed themes about vulnerability in China.

Lower values indicate a deterioration of sentiment and higher vulnerability)



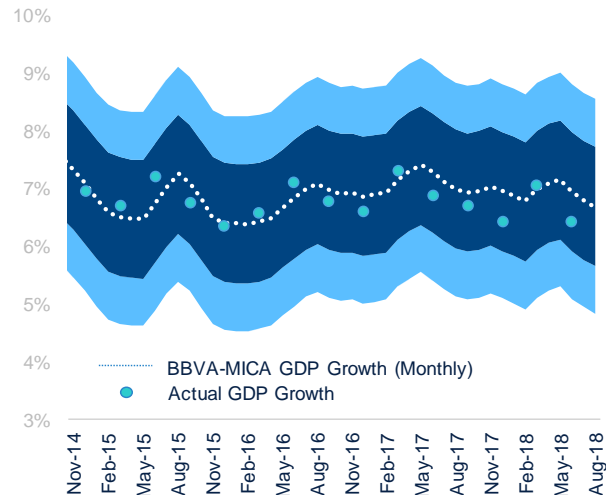
China's activity indicators confirmed growth slowdown

Growth moderated in Q2, with consumption contributed most



Source: CEIC & BBVA Research

BBVA MICA model for monthly GDP forecasting



Source: CEIC, Haver & BBVA Research

GDP growth slowed down slightly to 6.7 in Q2 compared with 6.8 previously, dragged mainly by slower business activity and domestic demand. Dual challenges from external trade war & internal de-leverage is expected to weigh further on growth going ahead

Escalating trade conflict with the US



23rd March, China is mulling tariffs on about \$3 billion of US exports of fruits and port etc. to China, imposing 25% tariff on US pork exports and 15% tariffs on US steel pipes, fruit and wine, effected from 2th April

4th April, China has announced a 25% tariff on \$50 billion worth of goods from the United States, including soybeans, cars, chemicals and aircrafts, with conditional implementation based on the next steps by the US

Solar panels and washing machines

January, new 30% tariffs on Chinese solar panels and washing machines

Aluminum foil

February, anti-dumping and anti-subsidy tariffs on China's aluminum foil

Steel and Aluminum

8th March, new tariffs on imports of steel (25%) and Aluminum (10%) from all other countries except for Canada, Australia and Mexico temporarily

301 Section result

4th April, the US released a detailed list of China's Section 301 Investigation related to aerospace, information and communication technology industries, involving a total amount of 500 billion USD, suggested 25% tax rate

The deterioration in US-China relations is driven by deep-seated concerns among American trade and national security officials that the US is at risk of losing its technological superiority because of China's unfair trade practices and massive subsidies for domestic firms

Escalating trade conflict with the US (2)



On 26th June, China lowered the import tariffs of some Asian countries, and cancelled the tariffs on soybeans

Anti-dumping subsidy investigation

On the 26th June, Trump said that he will strengthen the investment in technology of all countries through the Foreign Investment Committee

On 6th July, the Customs Tariff Commission imposed a same amount of tax to US imports. (34 billion goods at 25%)

Trade war started

On 6th July, the White House proposed a levy on 34 billion goods at 25%

On 9th Aug, the Chinese government unveiled the same amount of tariffs to retaliate against Washington's decision

More tariffs will be imposed

On 7th Aug, the White House unveiled fresh tariffs on \$16bn of American goods.

On 19th Sep, China retaliating by announcing tariffs on \$60 bn on US goods, also by filing a complaint to the WTO, as \$7 bn of US's anti-dumping measures are found illegal

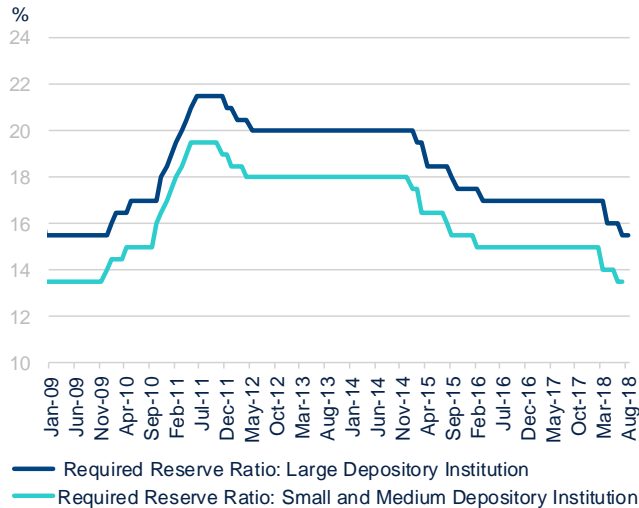
US ratchets up pressure on China

On 17th Sep, Trump announced to impose tariffs on \$200 bn Chinese exports at 10% on 24th Sep & also threatened tariffs on additional \$267bn Chinese goods.

Although the short-term impact of US punitive tariffs on China's growth is limited, the rising uncertainties have dampened economic confidence. We expect relevant uncertainties remain high before US mid-term election in November

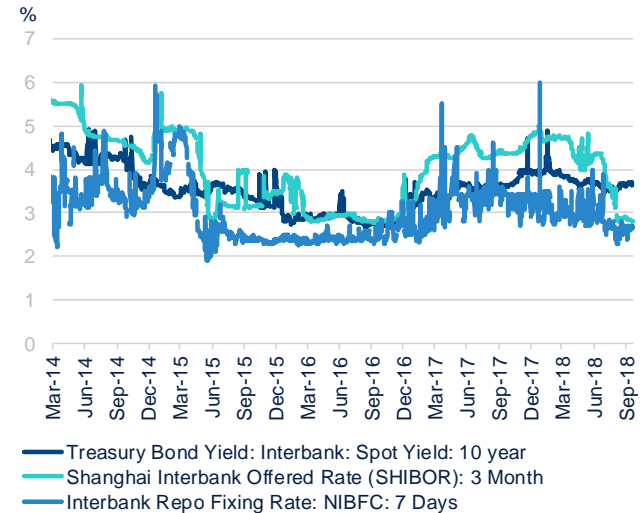
More supportive economic policies are expected to bolster the domestic economy

Further easing of monetary policy is expected...



Source: Haver & BBVA Research

Interest rates are falling as the central bank eases



Source: Haver & BBVA Research

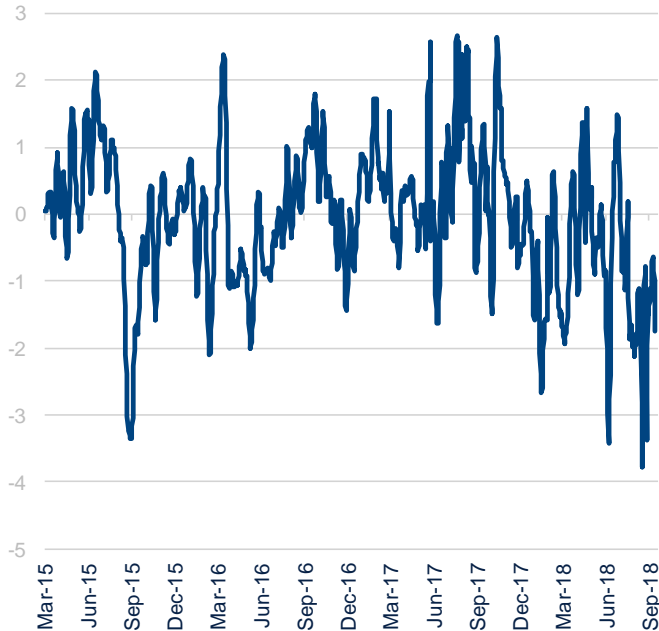
The authorities have shifted their monetary policy stance to pro-growth from the previously “neutral” at the conjuncture of an slowing credit growth, escalating trade war and worsening domestic indicators



02

The SOE Index

Chinese SOE Vulnerability Index recent development

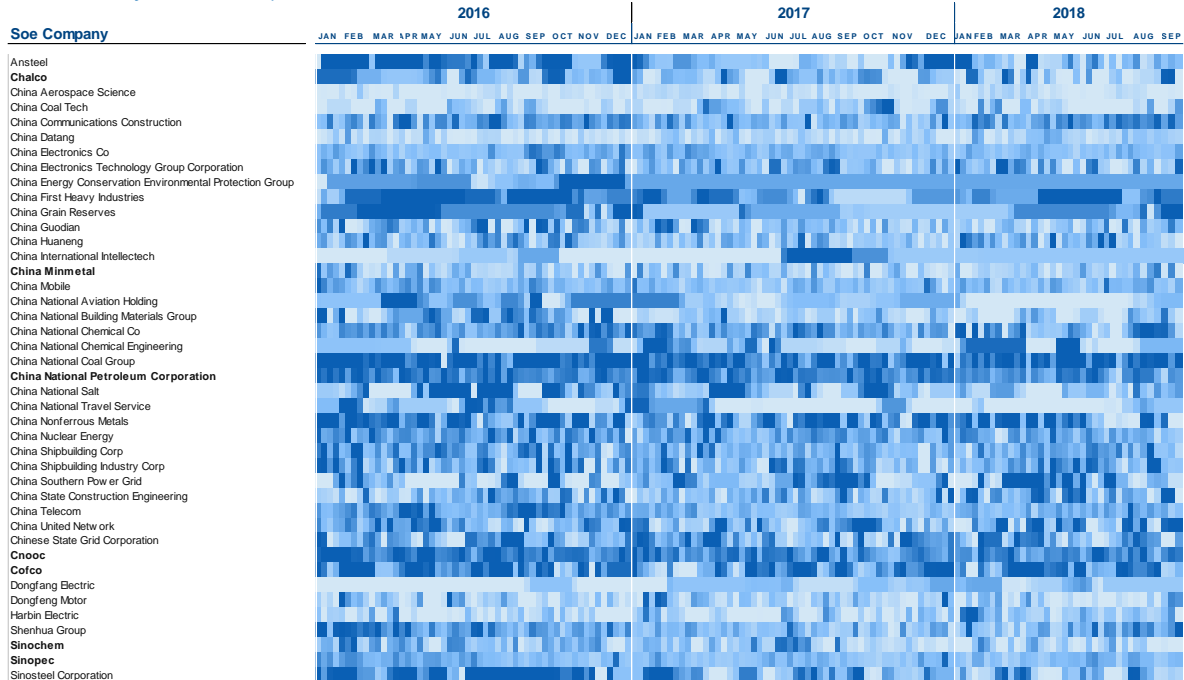


SOE Vulnerability index experienced a roller coaster trend, it remained vulnerable despite that SOEs still outperformed their POE peers amid tightening credit conditions

Risk sentiment improved in most SOEs in the 1H of 2018

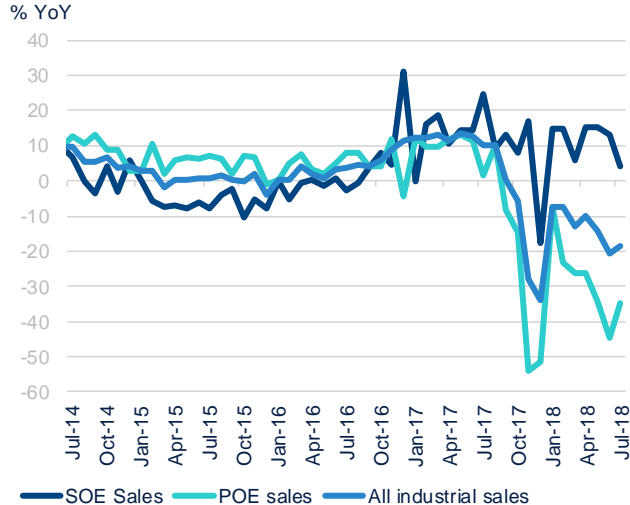
Chinese Vulnerability Sentiment Index Colour Map: Patterns and Comovements

(Standard values. Light Blue values indicate a improvement of sentiment while dark blue stands for higher vulnerability sentiment)



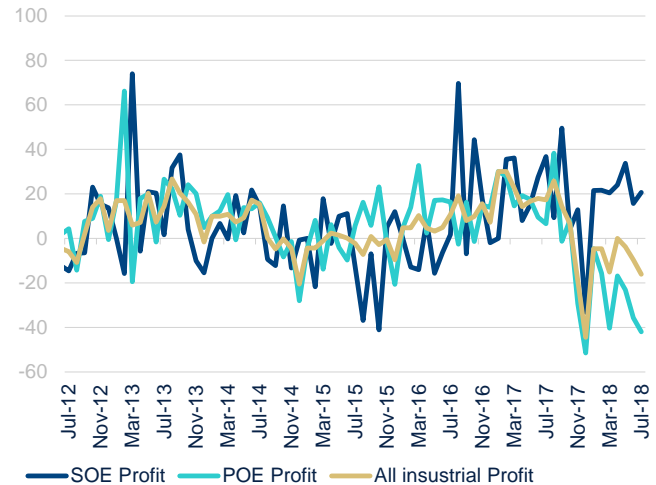
The profitability between SOEs and POEs are diverging

SOE sales rebounded from the year-end low in 2017



Source: NBS & BBVA Research

SOE profit also rebounded in recent months

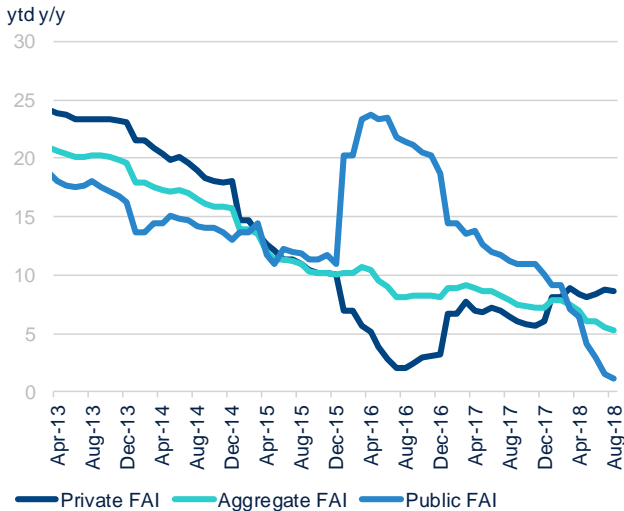


Source: NBS & BBVA Research

Both SOEs and POEs benefited from the rebound in industrial profits as a consequence of overcapacity reduction from the supply-side reform

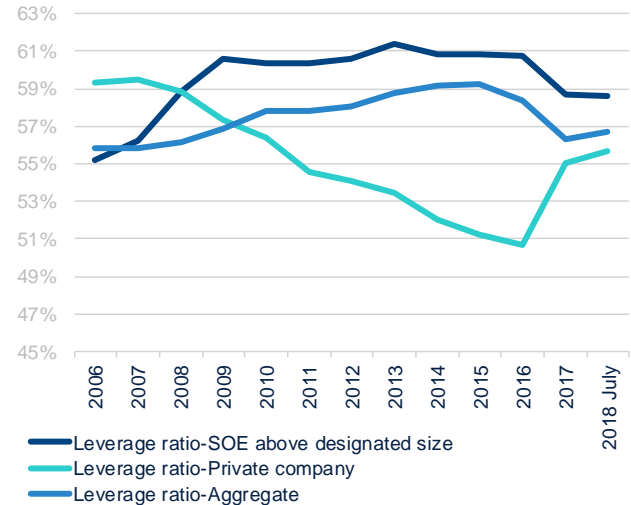
Fixed assets investment (FAI) of SOEs slump

SOEs' fixed asset investment continued to be sluggish



Source: CEIC & BBVA Research

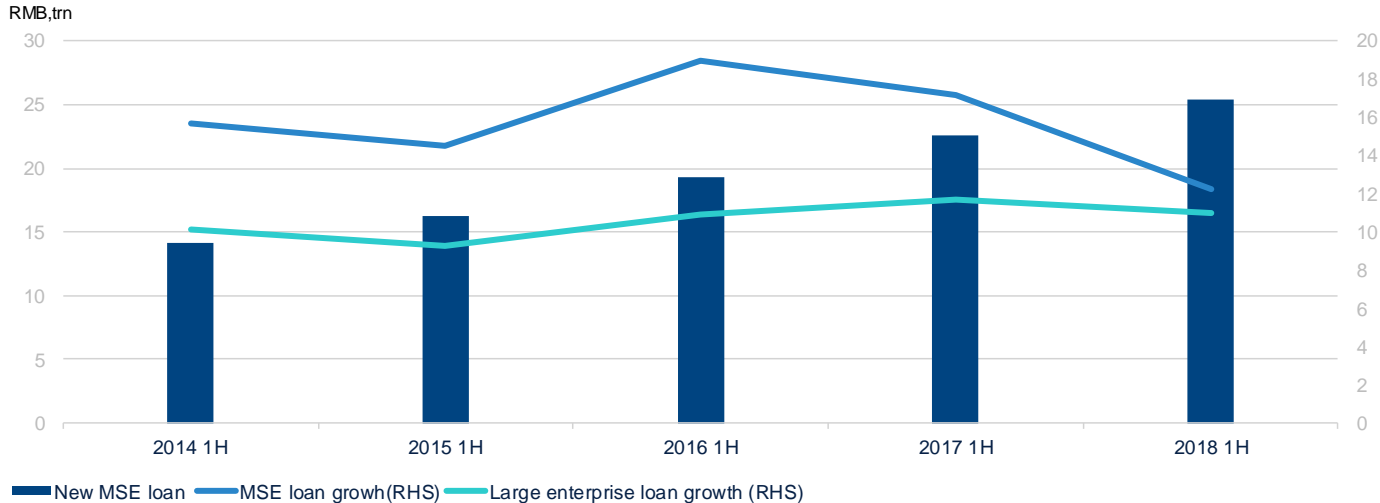
Leverage ratio in SOE rebounded



Source: NBS & BBVA Research

The sluggish FAI was dragged down by an outright decline in infrastructure investment undermined by increasing government checkups. Aiming to bolster flagging growth, China nearly quadrupled the value of FAI projects approved recently

China's de-leveraging effort has mainly squeezed smaller lenders rather than well capitalized SOEs

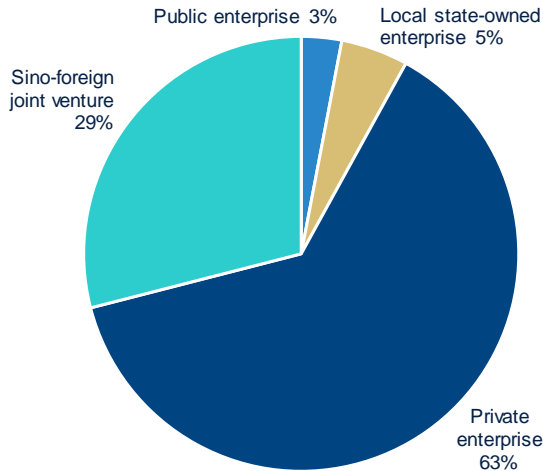


Source: PBoC & BBVA Research

Yearly growth of bank lending to micro and small enterprises (MSEs) moderated to 12.2% in June 2018 from 17.2% a year ago. As a result, share of new bank lending to MSEs declined to 20.9% of total new corporate loans, a five-year low. By contrast, bank lending to large enterprises remained stable

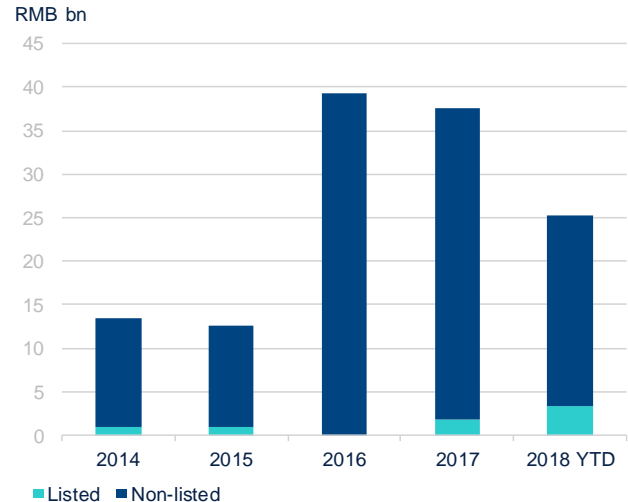
China's private companies are tested with default risks

Bond defaults mostly come from the private sector



Source: Wind & BBVA Research

More listed companies were involved in bond defaults



Source: Wind & BBVA Research

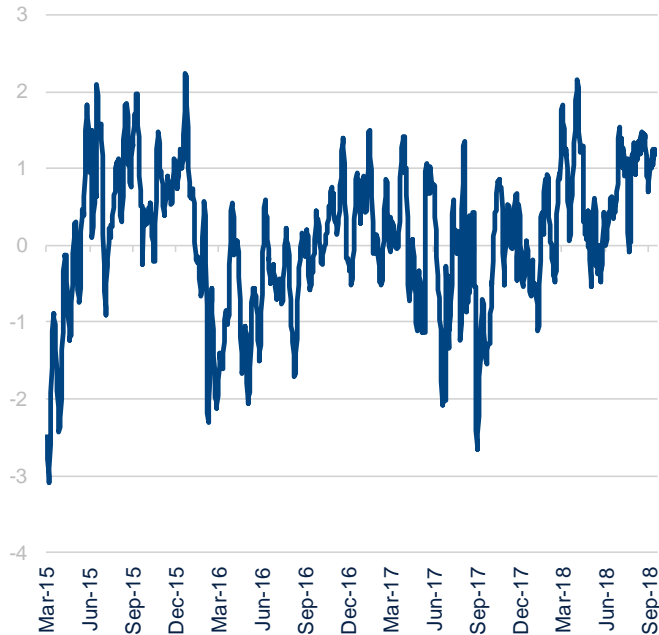
Amid the tight credit conditions, weaker corporate borrowers confront refinancing risk. Private firms dominated in this round of default, we expect that Chinese authorities will allow more defaults in the coming months. But the default risk seemed idiosyncratic rather than systematic



03

The Housing Index

Housing Bubble Vulnerability index



Source: www.gdelt.org & BBVA Research

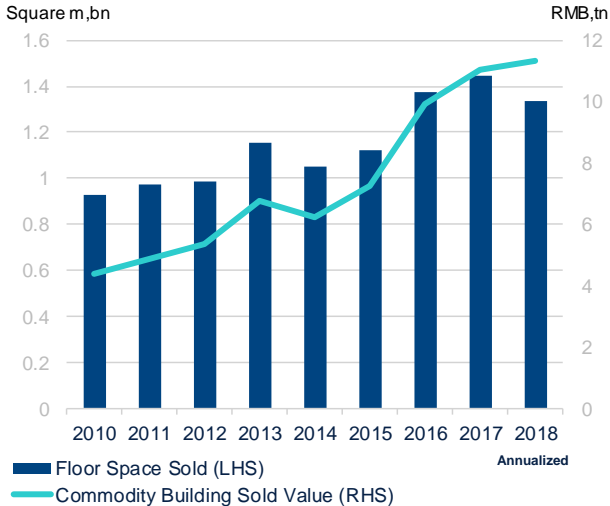


**Housing Bubble
Vulnerability index
continued its
momentum as
property sales remain
resilient**

**It is in a positive
territory**

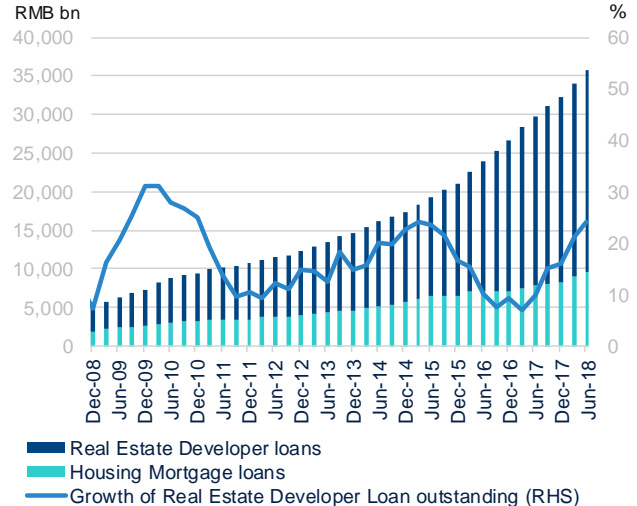
Property market delivered an upside surprise

The value of property sales is on the rise due to accelerating prices



Source: CEIC & BBVA Research

The amount of mortgage loans continue to grow

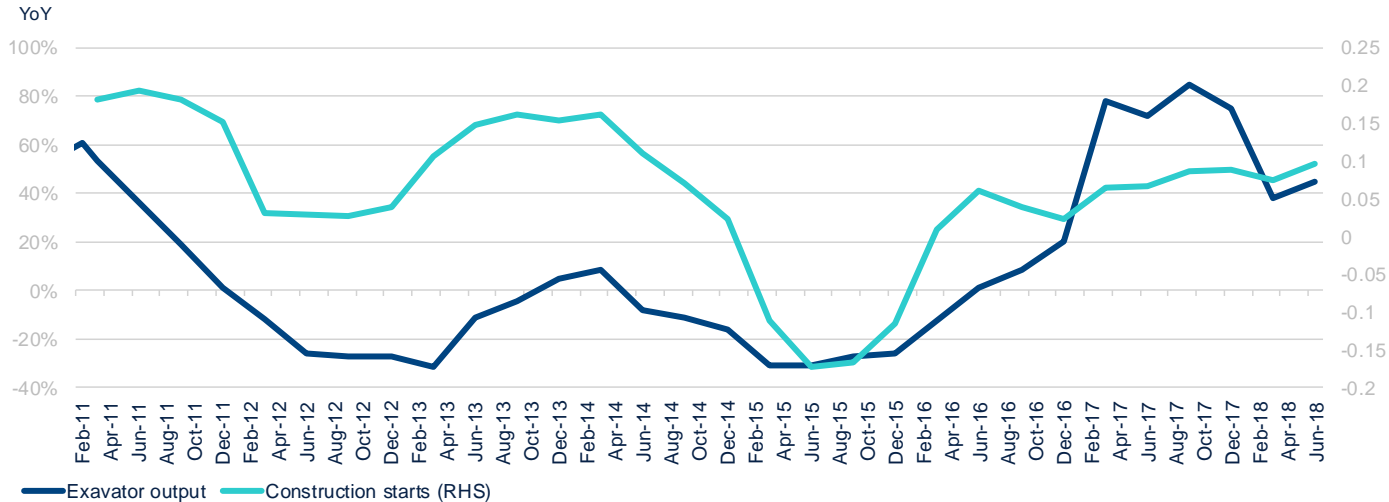


Source: CEIC & BBVA Research

The property market sales still resilient. Banking regulators are getting more cautious about mortgage lending

Construction activity has been quite strong in 2018

The rebound in construction activity in 2018 has been surprising



Source: Wind & BBVA Research

The recovery in construction starts is tightly linked to the recovery in sales. With housing sales surprising to the upside in recent months, this stimulates more construction activities. Other indicators confirm the strength: output of excavators, which historically correlates well with construction, is rising by more than 30% so far this year

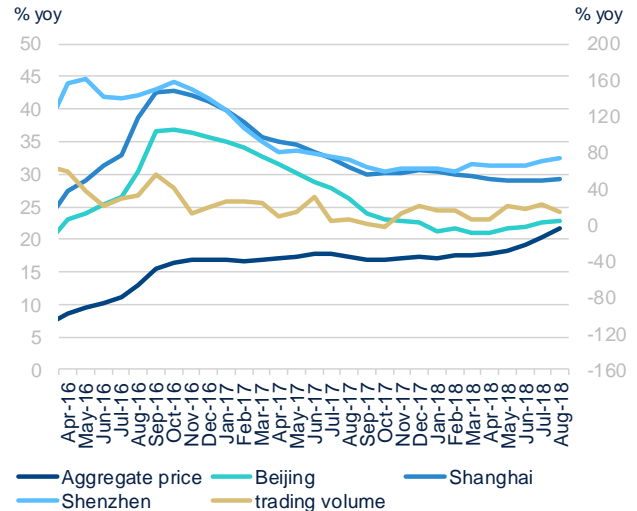
Housing prices rise but with a slower rate

Housing price MoM comparison among cities in Aug 2018



Source: NBS & BBVA Research

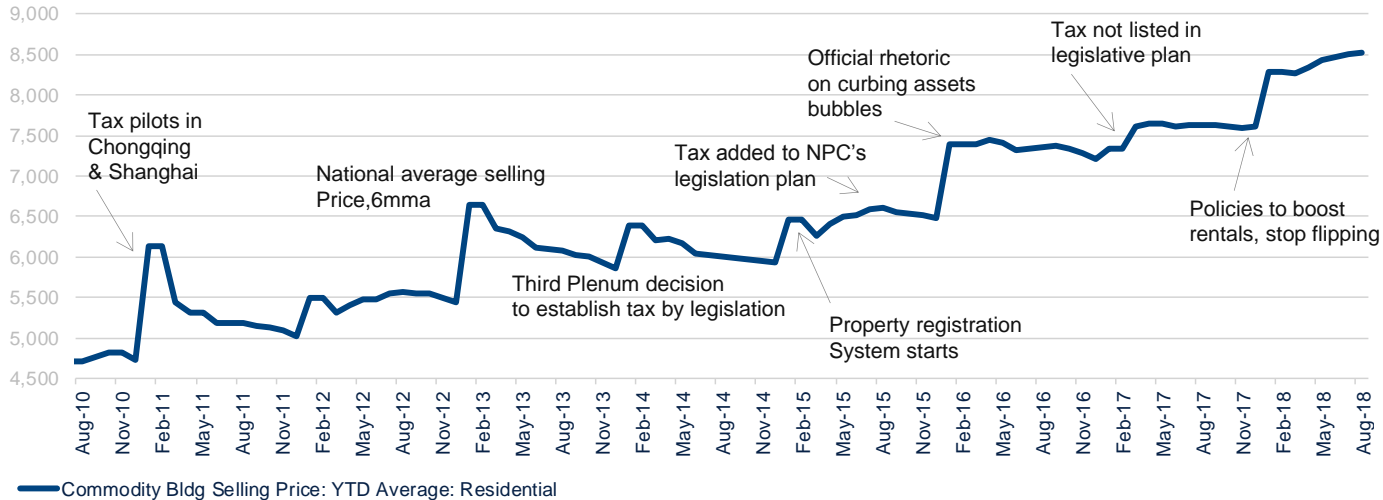
Housing price growth decelerated in first-tier cities since mid-2016



Source: CEIC & BBVA Research

Sales growth has been particularly strong in most cities, the property market will remain the main bulwark for domestic demand

A property tax has been discussed for years as yet there is no clear path to reality



Source: CEIC & BBVA Research

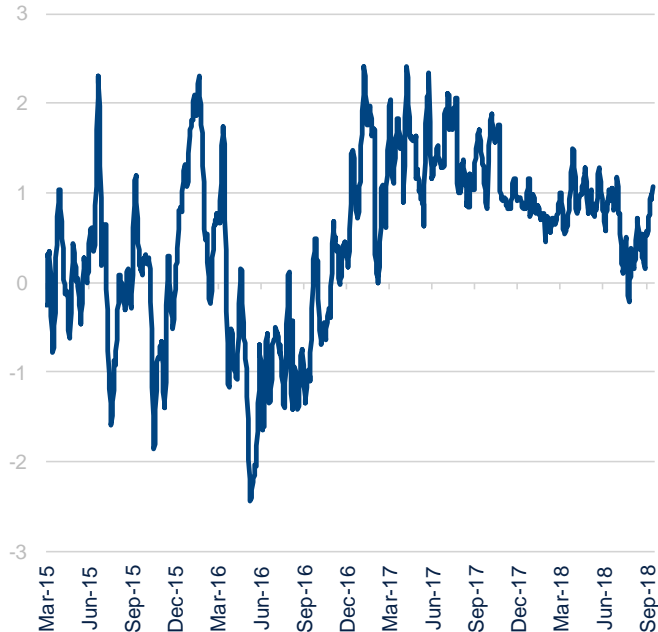
The authorities have brought up the idea of imposing property tax again. This time it seems that they really want to put it into practice rather than just paying lip service



04

The Shadow banking Index

Shadow banking Vulnerability Index



Source: www.gdelt.org & BBVA Research

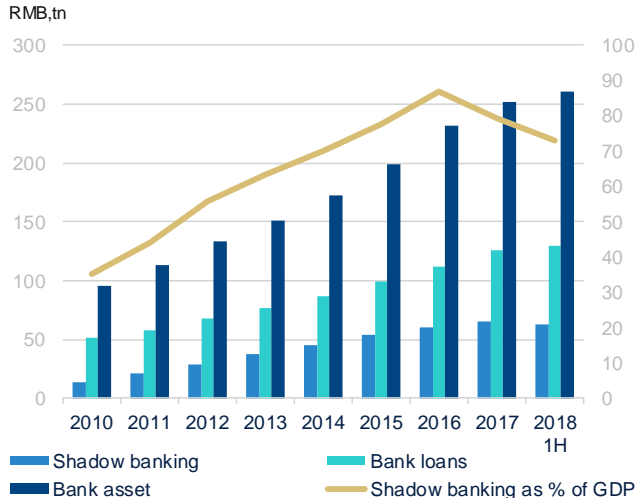


Shadow banking vulnerability index bounced as financial deleveraging continues to see progress due to government efforts to facilitate financial deleveraging

Financial regulatory campaign continues, limiting the room for financial arbitrage

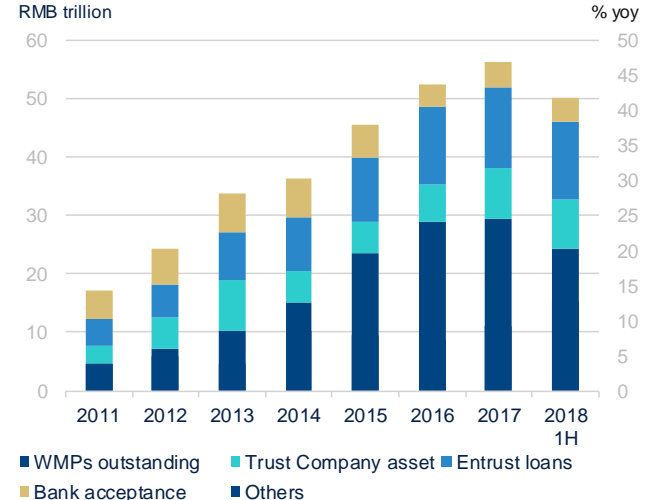
Financial deleveraging continue to see progress

Broad shadow banking assets continued to decline in the first half of 2018



Source: CIEC & BBVA Research

Intensified regulations have a growing impact across shadow banking sector

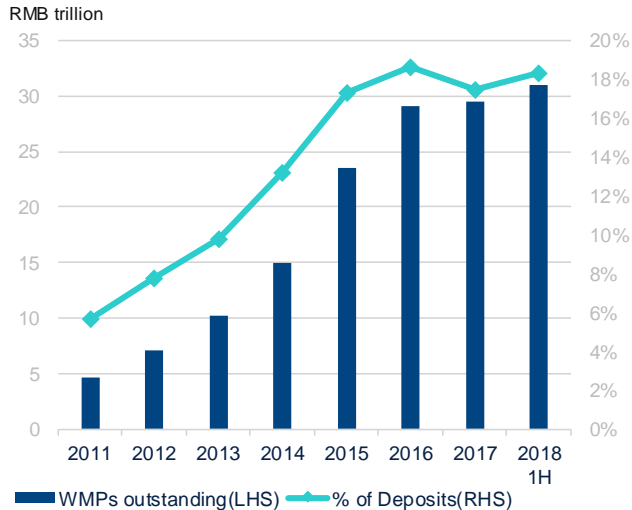


Source: CIEC & BBVA Research

The three core component of shadow banking including trust loan, entrusted loan and bank acceptance all dipped to their slowest pace in fifteen months. Besides, assets funded by bank's wealth management products (WMPs) and non bank financial institutions' (NBFIs) asset management schemes also declined

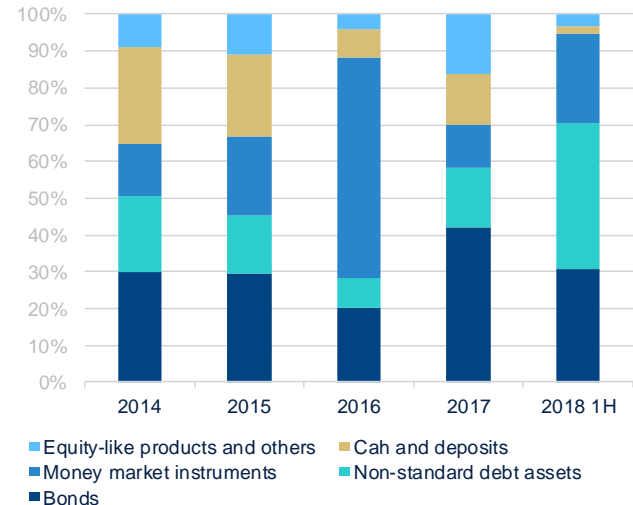
Coordinated regulatory actions help to curb WMPs growth

WMPs outstanding shrank in 2017



Source: CEIC & BBVA Research

WMPs shifted to equity-linked products

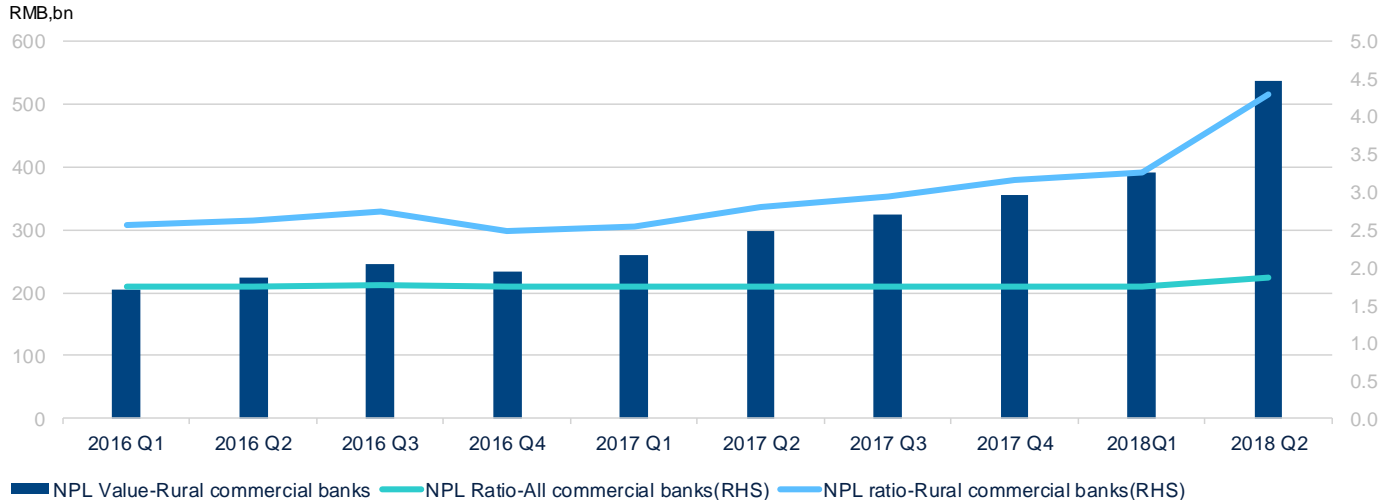


Source: CEIC & BBVA Research

WMPs distributed by banks has picked up to RMB31 trillion in May 2018. This translated to yearly growth of 6.0% compared with full year growth of 1.7% in 2017. The pickup was mainly from WMPs purchased by individual investors

Rural commercial banks' NPLs jump

Marked rise in rural commercial banks' NPLs ratio

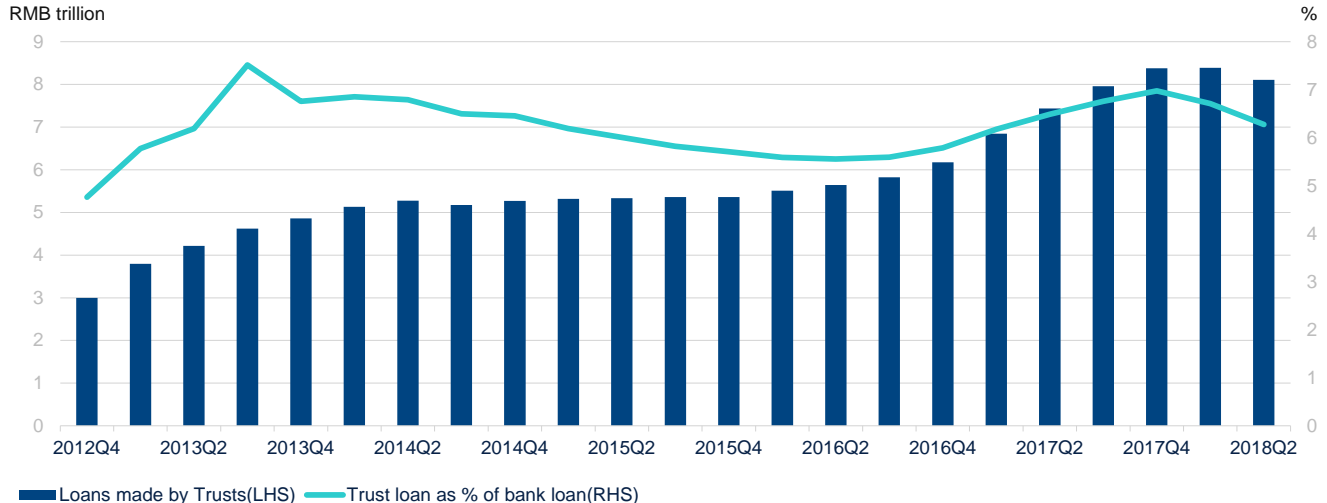


Source: PBoC & BBVA Research

Commercial banks' nonperforming loan (NPL) ratio increased by 11 bps in the second quarter of 2018, mainly driven by a 103 bps spike among rural commercial banks. This reflects impact from the regulators' enforcement of a stricter standard of NPL recognition policy

Trust loans were also hit by regulations

Growth in trust company loans

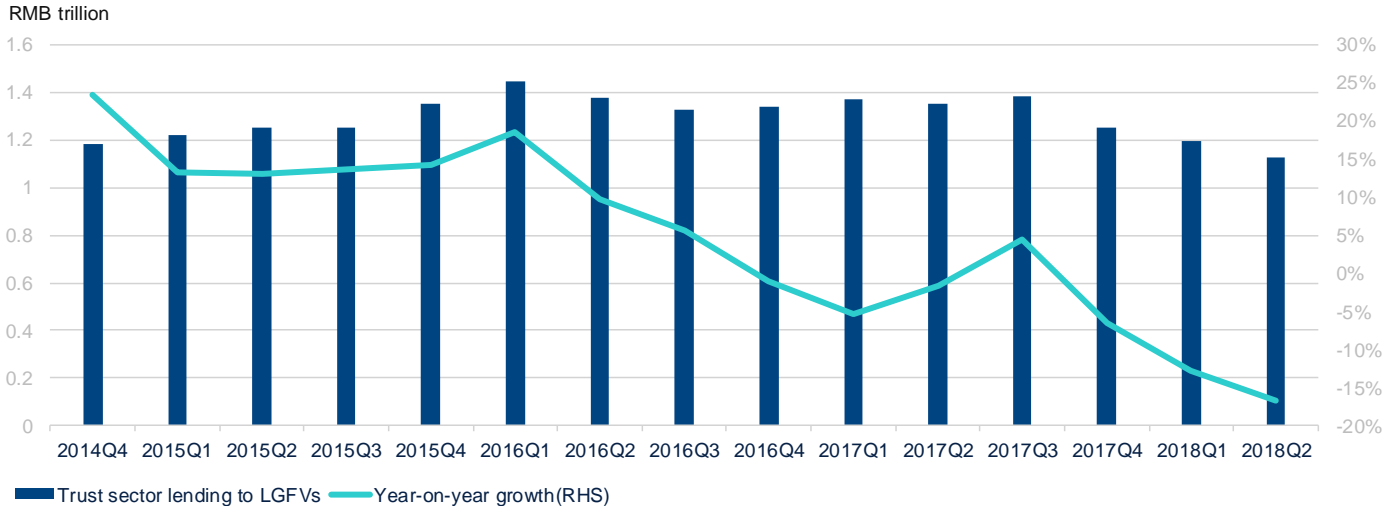


Source: China Trustee Association and BBVA Research

Growth of outstanding trusts loans remained strong in Q1 2018 but has begun to moderate. With the growth of other shadow bank components such as WMPs and asset management plans, trust loans have become the next focus for regulatory scrutiny.

Trust lending to LGFVs contracted on scrutiny restrictions

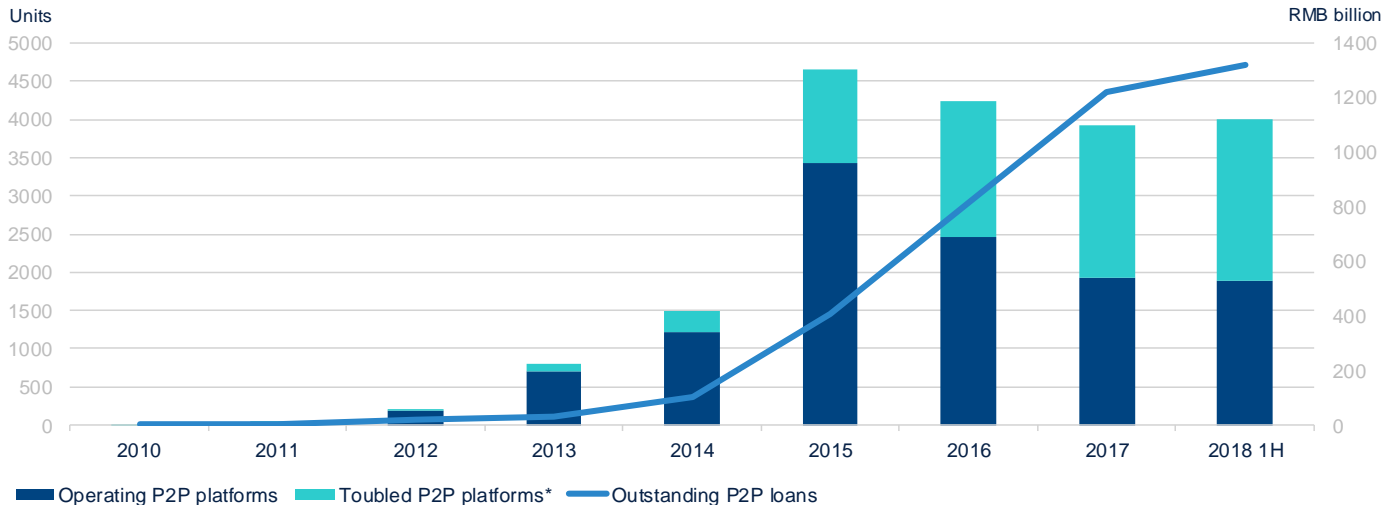
Growth in trust lending to LGFVs fell in 2018 Q2



Source: China Trustee Association and BBVA Research

LGFVs are facing more refinancing pressure followed by multiple policies introduced by the central government in the past twelve months to restrict new financing to LGFVs. China is pushing local Govt's to accelerate special bond sales to stabilize investment growth, which has slowed over recent months

P2P lending growth halved with declining number of operating platforms

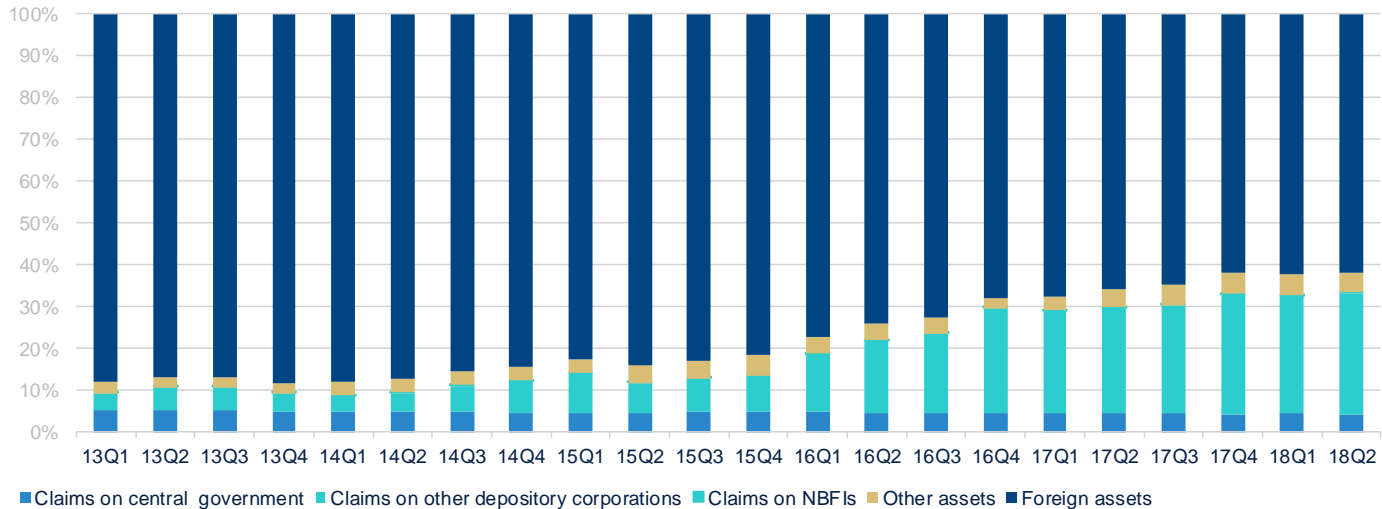


Source: Wind and BBVA Research

P2P lending has attracted more stringent regulatory oversight for its high default rates due to weak risk management and fraud. However, the continuous increase in “troubled” P2P platforms has not posed as a significant systemic risk given the industry’s relatively smaller size (around 2% of broad shadow banking assets).

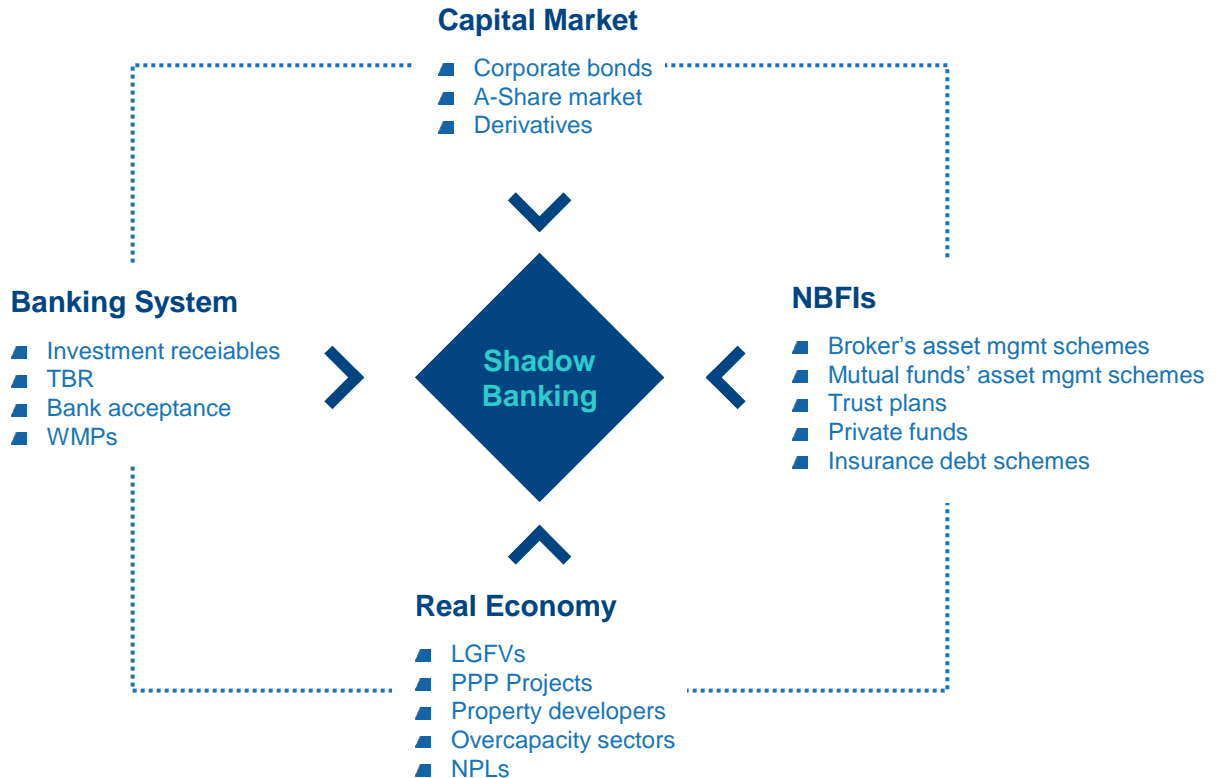
PBOC's direct lending to banks grows amid the financial deleveraging

The PBOC's claims on other depository corporations rose to RMB 10.3 trillion



The PBOC's claims on other depository corporations-mainly policy and commercial banks rose to RMB 10.3 trillion in the 2Q of 2018, with the share of such claims on the central bank's balance sheet inched up to 29% of its total assets

Shadow Banking connected with traditional banking was squeezed

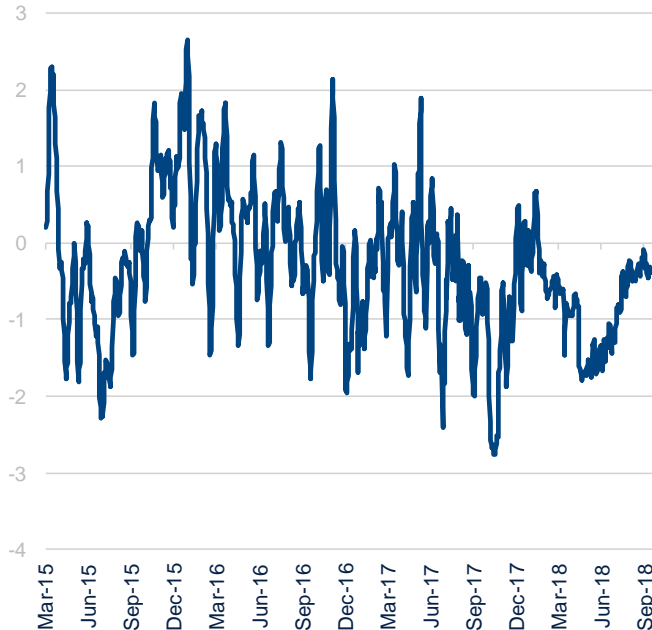




05

The exchange rate Index

Exchange Rate Vulnerability Index



Source: www.gdelt.org & BBVA Research

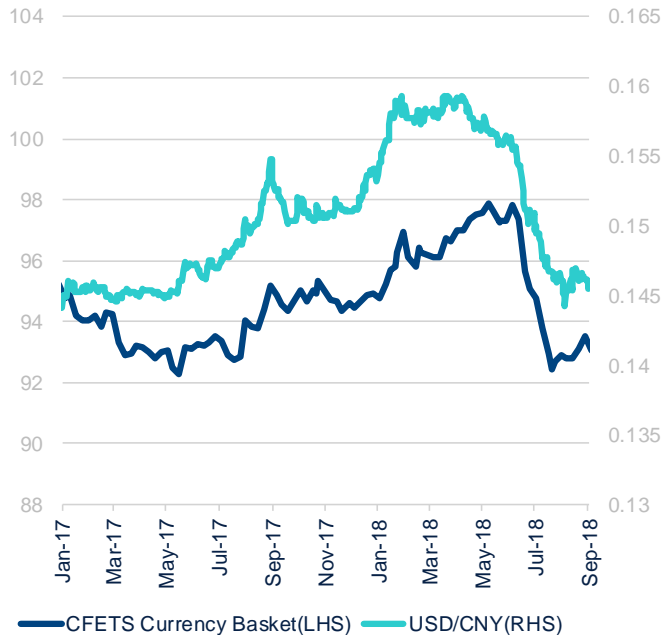


Exchange Rate Vulnerability Index bounced but still in the negative territory given that the recent RMB depreciation could partially offset the tax Trump administration levied

The authorities' recent efforts to stabilize the exchange rate helped to anchor market sentiment

The exchange rate got support from the central bank

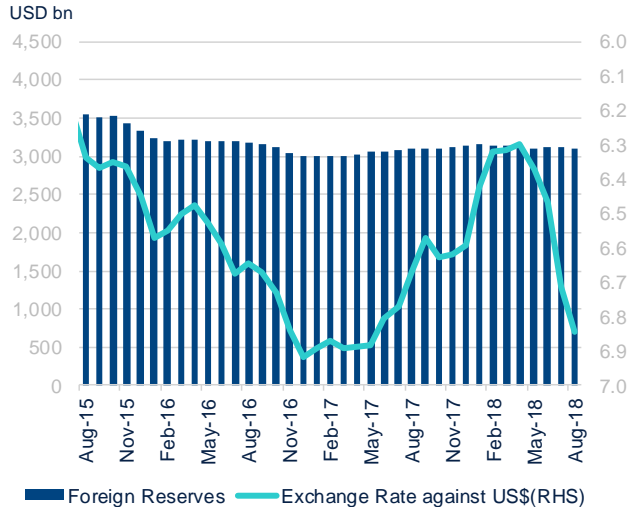
Recently depreciation significantly against USD as well as the CFETS basket



- The escalating trade conflict with US is likely further hurt the Yuan, which has hit a one year low against the US dollar
- Wary of excessive capital outflows, PBOC reapplied its model with a “countercyclical factor” for setting yuan’s daily official value to prevent Yuan from falling too sharply

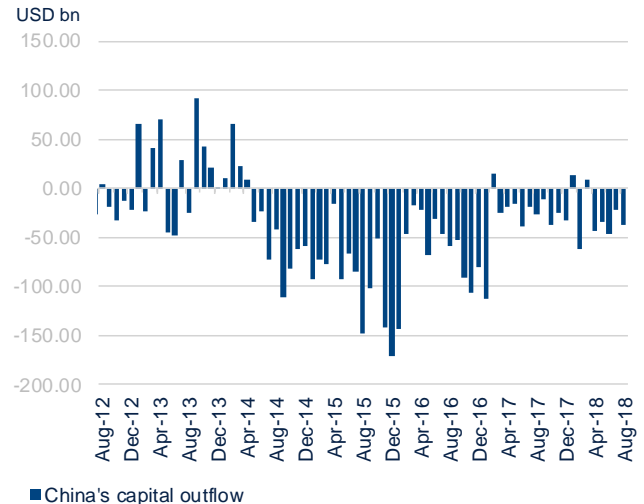
The level of FX reserves stabilized, but downward pressure remains

RMB to USD depreciated significantly in the recent months



Source: BBVA Research and CEIC

The depreciation added more uncertainties to capital outflows



Source: BBVA Research

The depreciating RMB exchange rates will add more risks for capital outflows. The authorities will interview the market to ensure that the RMB exchange rate and the foreign reserves are within the psychological level of 7 and \$ 3 trillion

This report has been produced by Asia, MENA & Geostrategy Team

Chief Economist

Álvaro Ortiz Vidal-Abarca
alvaro.ortiz@bbva.com

Betty Huang

betty.huang@bbva.com.hk

Tomaso Rodrigo López

Tomaso.rodrigo@bbva.com

Le Xia

le.xia@bbva.com

BBVA-Research

Chief Economist BBVA Group

Jorge Sicilia Serrano

Macroeconomic Analysis

Rafael Doménech

r.domenech@bbva.com

Digital Economy

Alejandro Neut

robertoalejandro.neut@bbva.com

Global Macroeconomic Scenarios

Miguel Jiménez

mjimenezg@bbva.com

Global Financial Markets

Sonsoles Castillo

s.castillo@bbva.com

Long-Term Global Modelling and Analysis

Julián Cubero

juan.cubero@bbva.com

Innovation and Processes

Oscar de las Peñas

oscar.delaspena@bbva.com

Financial Systems and Regulation

Santiago Fernández de Lis

sfernandezdelis@bbva.com

Digital Regulation and Trends

Álvaro Martín

alvaro.martin@bbva.com

Regulation

Ana Rubio

arubiog@bbva.com

Financial Systems

Olga Cerqueira

olga.gouveia@bbva.com

España and Portugal

Miguel Cardoso

miguel.cardoso@bbva.com

United States

Nathaniel Karp

Nathaniel.karp@bbva.com

Mexico

Carlos Serrano

carlos.serranoh@bbva.com

Turkey, China and Big Data

Álvaro Ortiz

alvaro.ortiz@bbva.com

Turkey

Álvaro Ortiz

alvaro.ortiz@bbva.com

Asia

Le Xia

Le.xia@bbva.com

South America

Juan Manuel Ruiz

juan.ruiz@bbva.com

Argentina

Gloria Sorensen

gsorensen@bbva.com

Colombia

Juana Téllez

juana.tellez@bbva.com

Peru

Francisco Grippa

fgrippa@bbva.com

Venezuela

Julio Pineda

juliocesar.pineda@bbva.com

Contact details:

BBVA Research

Ciudad BBVA

28046 Madrid (Spain)

Tel. +34 91 374 60 00 and +34 91 537 70 00

Fax. +34 91 374 30 25

bbvaresearch@bbva.com / www.bbvaresearch.com

BBVA Research Asia

43/F Two International Finance Centre

8 Finance Street Central

Hong Kong

Tel: +852 2582 3111

E-mail: research.emergingmarkets@bbva.com.hk

Disclaimer

This document has been prepared by BBVA Research Department, it is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

In regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions in the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

The content of this document is protected by intellectual property laws. It is forbidden its reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process, except in cases where it is legally permitted or expressly authorized by BBVA.