Weekly Update

C0 | EXTERNAL PUBLICATION

China's balancing act – deleveraging versus trade war


Alan Mudie
(41) 22 819 0255
alan.mudie@socgen.com


Xavier Denis
Head of investment Strategy
(33)1 5637 9817
xavier.denis@socgen.com


Antonio Bertone
Global strategist
(33)1 42 13 24 06
antonio.bertone@socgen.com


Sophie Fournier
Global strategist
(33)1 42 14 59 36
sophie.fournier@socgen.com


Paul Beecham
Editor in chief
(33) 1 56 37 39 61
paul.beecham@socgen.com

All data taken on 26/07/2018 from Bloomberg.

Since 2017, China has strived to curb excessive leverage of its economy. Policymakers have taken several measures to slow credit growth – letting interest rates rise, reintermediating shadow finance within the banking sector and trimming debt-fueled overseas acquisitions by conglomerates.

In the wake of the financial crisis, China opened wide the floodgates of credit to mitigate the impact of the Great Recession and avert hard landing. The results between 2008 and end 2017 are striking – corporate sector debt skyrocketed from 100% of GDP to 160%, taking China's overall debt burden from 165% of GDP to 265%. Household debt looks manageable (up from 18% of GDP to 48% over the period) but is rising fast.

Much of the borrowing was unwise and bad debt piled up, notably within local government firms and big state-owned enterprises. It was easy to extend and pretend with no imminent risk of default given the public backing. China had become addicted to credit growth, hence the crackdown on borrowing last year.

However, these concerns have had to take a back seat as the risk of trade war with the US has emerged, bringing with it significant downside risk to growth. According to some estimates, the impact of recently imposed tariffs on Chinese imports and those in pipeline (covering some USD250bn worth of goods) could shave 0.5pp off China's GDP growth in the first year.

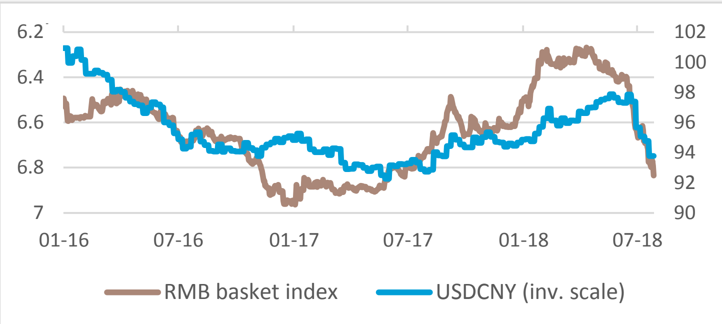
China has reacted on three fronts to mitigate these risks:

- Monetary policy: the reserve requirement ratio has been reduced by 150bps and 3-month interbank rates cut by 120bps since March in order to boost liquidity for mid-sized enterprises.
- Exchange rate policy: the RMB – a managed currency – has lost 8% versus the USD since April and over 4% against its trade-weighted basket.
- Fiscal policy: the Ministry of Finance has loosened the tighter fiscal stance decided last year, with tax cuts in March and specific measures targeting MSEs such as tax breaks for R&D.

China is walking a tightrope. Further deleveraging remains necessary to address financial risks and keep the country on a sustainable growth path. This is why policy initiatives are much less broad-based than in 2008, but rather primarily focused on the private sector.

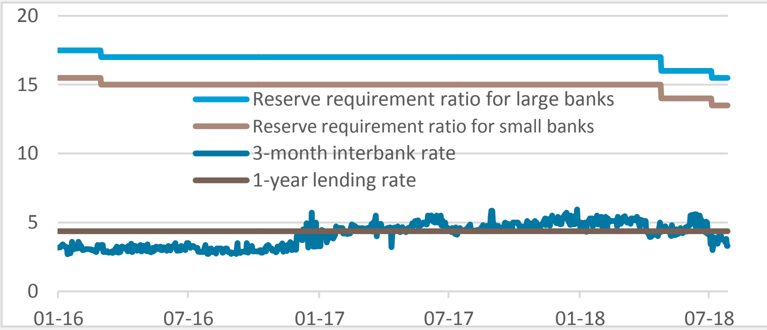
Bottom line. Deleveraging will remain a key priority to avert a debt-fueled hard landing and so we expect China to continue to roll back shadow banking but at a slower pace. We do not expect the yuan to weaken further. Devaluation is a double edged-sword: it creates incentives for capital outflows and can only exacerbate tensions with the US. There is probably additional room for fiscal easing should it be deemed necessary. All in all, this three-pronged policy should enable China to withstand the negative impact on growth of the ongoing trade frictions with the US.

USDCNY and RMB basket



Sources: SGPB, Bloomberg, 27/07/2018.

China money market



Sources: SGPB, Bloomberg, 27/07/2018.

This week and next

EUROZONE

- The flash composite PMI weakened to 54.3 in July from 54.9. Confidence in the service sector fell 0.8pts but manufacturing rose 0.2pts to 55.1, the first rise this year.
- The IFO measure of German business confidence in July hit 101.7, better than expected but marginally down from June. In France, July INSEE business confidence was unchanged.
- Eurozone consumer confidence was unchanged -0.6 in July, better than expected and still close to decade highs.

Next week's key events		Per.	Prev.	Cons.
30 Jul	Consumer confidence	Jul F	-0.6	-0.6
31 Jul	Unemployment	Jun	8.4%	8.3%
3 Aug	Market Composite PMI	Jul F	54.3	54.3

UNITED KINGDOM

- Mortgage approvals in May rose to 64.5k according to the Bank of England, but remain in a slowing trend since early 2016's highs.
- The Confederation of British Industry (CBI) index of the trend in total orders in July hit 11, down from June but well above forecasts of a decline to 8.
- The CBI also noted that average unit costs in the three months to July reached the fastest pace in a year.

Next week's key events		Per.	Prev.	Cons.
1 Aug	Nationwide house prices YoY	Jul	2.0%	1.9%
2 Aug	MPC	Aug	0.50%	0.75%

UNITED STATES

- The flash composite PMI eased lower in July to 55.9, mainly due to services down 0.3pts to 56.2. Manufacturing surprised on the upside at 55.5 versus 55.1 expected.
- Core capital goods orders (ex defence and aircraft) rose 0.6% MoM in June, above forecasts, after 2.0% in April and 0.7% in May, boding well for a strong capex contribution to Q2 GDP.
- Existing home sales in June hit 5.38m versus forecasts of 5.44m, but median prices remained in a rising trend at 5.2% YoY..

Next week's key events		Per.	Prev.	Cons.
1 Aug	FOMC	Aug	1.75-2	NC
3 Aug	Unemployment	Jul	4.0%	3.9%

ASIA & EMERGING COUNTRIES

- In Japan, Nikkei PMI manufacturing confidence hit 51.6 in July, the lowest level since late 2016. The Tokyo core CPI measure rose to 0.8% YoY, up 0.1pt over June.
- Chinese industrial total profits rose 20% YoY in June, the third consecutive month above 20%.
- Brazil's June current account balance shrank from $729m in May to $435m but net foreign direct investment bounced to $6.5bn in June.

Next week's key events		Per	Prev.	Cons.
30 Jul	Japan: Jobless rate	Jun	2.2%	2.3%
31 Jul	China: Caixin PMI manufacturing	Jul	50.9	51.0

Sources: DataStream, Bloomberg, 27 July 2018, Note: YoY = year-on-year; QoQ = quarter-on-quarter; MoM = month-on-month, P = preliminary figure, A = advanced figure, F = final figure, seasonally adjusted, ECB = European Central Bank

Our 6-month targets for currencies and commodities

	Thursday close	6mth target
EUR/USD	1.16	1.20
GBP/USD	1.31	1.35
EUR/CHF	1.16	1.18
USD/JPY	111	110
Brent	$74.6	$75
Gold	$1227	$1250

No change to our 6-month targets this week.

Forecast figures are not a reliable indicator of future performance

Question time

Past performance should not been seen as a guarantee of future returns.

NO QUESTIONS THIS WEEK

Market performance

Past performance should not been seen as a guarantee of future returns.

Interest rates

	Last	1wk		3mth	YTD	12mth
EONIA (EUR)	-37 bp	0 bp	→	0 bp	-2 bp	-1 bp
3mth Euribor (EUR)	-32 bp	0 bp	→	1 bp	1 bp	1 bp
3mth Libor (USD)	234 bp	-1 bp	→	-2 bp	64 bp	102 bp
3mth Libor (GBP)	80 bp	4 bp	↑	4 bp	28 bp	51 bp
10-year US Treasury bond	298 bp	13 bp	↑	-1 bp	57 bp	70 bp
10-year German bond	34 bp	7 bp	↑	-25 bp	-8 bp	-15 bp
10-year French bond	64 bp	7 bp	↑	-18 bp	-2 bp	-17 bp
10-year UK bond	133 bp	9 bp	↑	-21 bp	10 bp	4 bp

Credit

	1wk		3mth	YTD	12mth
BAML EURO Corp. IG	-0.1%	→	0.2 %	-0.2 %	0.9 %
BAML EURO Corp HY	0.1%	↑	-0.3 %	-0.3 %	1.5 %
BAML GBP Corp IG	-0.5%	↓	0.7 %	-1.3 %	0.3 %
BAML US IG	-0.4%	↓	0.7 %	-2.7 %	-0.9 %
BAML US HY	0.3%	↑	1.3 %	1.0 %	2.3 %
BAML Emerging External Sovereign	0.6%	↑	-1.0 %	-3.7 %	-0.4 %

Exchange rates

	Last	1wk		3mth	YTD	12mth
EUR/USD	1.16	0.0 %	→	-3.8 %	-3.1 %	-0.8%
EUR/CHF	1.16	-0.5 %	↓	-3.3 %	-1.1 %	3.7%
GBP/USD	1.31	0.7 %	↑	-5.8 %	-2.9 %	-0.1%
USD/JPY	111	-1.1 %	↓	1.8 %	-1.3 %	0.0%
USD/BRL	3.75	-2.2 %	↓	7.8 %	13.1 %	19.4%
USD/CNY	6.79	0.3 %	↑	7.2 %	4.4 %	0.6%
USD/RUB	63.0	-1.0 %	↓	0.2 %	9.2 %	6.0%

Government bonds*

	1wk		3mth	YTD	12mth
United States (3-7yr)	-0.4 %	↓	0.5 %	-1.3 %	-1.9 %
United Kingdom (3-7yr)	-0.3 %	↓	1.1 %	-0.3 %	-0.6 %
Germany (3-7yr)	-0.2 %	↓	0.9 %	0.5 %	0.6 %
Japan (3-7yr)	-0.1 %	→	0.0 %	-0.1 %	0.1 %

Equities*

	Last	1wk		3mth	YTD	12mth
MSCI AC World	522	1.5 %	↑	3.1 %	3.3 %	12.0 %
Eurostoxx 50	3'509	1.1 %	↑	2.1 %	3.2 %	4.1 %
DAX	12'809	1.0 %	↑	2.5 %	-0.8 %	4.1 %
CAC 40	5'481	1.2 %	↑	2.7 %	6.0 %	9.0 %
S&P 500	2'837	1.2 %	↑	6.9 %	7.3 %	16.8 %
FTSE 100	7'663	-0.2 %	↓	4.2 %	2.1 %	7.1 %
SMI	9'139	2.3 %	↑	4.0 %	0.7 %	5.2 %
Topix	1'766	0.9 %	↑	-0.2 %	-1.7 %	11.3 %
IBOV Brazil	79'405	2.5 %	↑	-8.1 %	3.9 %	22.1 %
MICEX Russia *	2'293	1.0 %	↑	0.3 %	8.7 %	18.6 %
MSCI EM	1'089	2.8 %	↑	-3.5 %	-4.2 %	5.3 %
SENSEX 30 India	36'985	1.8 %	↑	7.2 %	10.3 %	15.5 %
Hang Seng (H-K)	28'781	2.8 %	↑	-2.1 %	-1.4 %	10.9 %
Shanghaï Composite	2'882	4.0 %	↑	-6.3 %	-12.8 %	-11.3 %

Commodities

	Last	1wk		3mth	YTD	12mth
Brent	$75	1.8 %	↑	0.0 %	12.0 %	47.0 %
Gold	$1'227	0.8 %	↑	-6.9 %	-5.9 %	-1.7 %
Silver	$15.5	1.2 %	↑	-6.1 %	-9.0 %	-5.8 %

Source: DataStream, on 26 July 2018. 1wk = 1-week change, 3mth = 3-month change, 12mth = 12-month change, YTD = year-to-date change, YoY = year-on-year change, BAML = Bank of America Merrill Lynch, JPM = JP Morgan, IG = Investment Grade, EM = emerging markets.
* Price return for MICEX equity index. Equities; total return in local currency. Government bonds = 3-7 year returns. Figures are rounded.

Important information

Kleinwort Hambros is the brand name of SG Kleinwort Hambros Bank Limited, which is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. The firm reference number is 119250. The company is incorporated in England and Wales under number 964058 and its registered address is 5th Floor, 8 St James's Square, London SW1Y 4JU.

Societe Generale Private Banking is a division of the Societe Generale Group operating through its head office within Societe Generale S.A. and its network (subsidiaries, branches or departments of Societe Generale S.A.) located in the countries mentioned hereafter which use the "Societe Generale Private Banking" and "Kleinwort Hambros" brands, and which distribute this document.

Subject of the document

This document has been prepared by experts of the Group Societe Generale, and more particularly of Societe Generale Private Banking division, to provide you with information relating to certain financial and economic data. The names and functions of the people who prepared this document are indicated on the first pages of the document.

This document is non-independent research and is a marketing communication. It has not been prepared in accordance with legal requirements designed to promote the independence of investment research and the investment service provider is not subject to any prohibition on dealing ahead of the dissemination of investment research.

In order to read and understand the financial and economic information included in this document, you will need to have knowledge and experience of financial markets. If this is not the case, please contact your advisor so that you no longer receive the document. Unless you do this, we shall consider that you have the necessary skills to understand this document.

Please note that this document only aims to provide simple information to help you in your investment or disinvestment decisions, and that it does not constitute a personalised recommendation. You remain responsible for the management of your assets, and you take your investment decisions freely. Moreover, the document may mention asset classes that are not authorised/marketed in certain countries, and/or which might be reserved for certain categories of investors. Therefore, should you wish to make an investment, as the case may be and according to the applicable laws, your advisor within the Societe Generale Private Banking entity of which you are a client will check your eligibility for this investment and whether it corresponds to your investment profile.

Should you not wish to receive this document, please inform your private banker in writing, and he/she will take the appropriate measures.

Conflicts of interest

This document contains the views of Societe Generale Private Banking's experts. Societe Generale Private Banking trading desks may trade, or have traded, as principal on the basis of the expert(s) views and reports. In addition, Societe Generale Private Banking's experts receive compensation based, in part, on the quality and accuracy of their analysis, client feedback, revenues of their entity of the Societe Generale Group and competitive factors.

As a general matter, entities within the Societe Generale Group may make a market or act as a principal trader in securities referred to in this report, and can provide banking services to the companies mentioned in that document, and to their subsidiary. Entities within the Societe Generale Group may from time to time deal in, profit from trading on, hold on a principal basis, or act advisers or brokers or bankers in relation to securities, or derivatives thereof, or asset class(es) mentioned in this document.

Entities within the Societe Generale Group may be represented on the supervisory board or on the executive board of such persons, firms or entities.

Employees of the Societe Generale Group, or persons/entities connected to them, may from time to time have positions in or hold any of the investment products/ asset class(es) mentioned in this document.

Entities within the Societe Generale Group may acquire orliquidate from time to time positions in the securities and/or underlying assets (including derivatives thereof) referred to herein, if any, or in any other asset, and therefore any return to prospective investor(s) may directly or indirectly be affected.

Entities within the Societe Generale Group are under no obligation to disclose or take into account this document when advising or dealing with or on behalf of customers.

In addition, Societe Generale Private Banking may issue other reports that are inconsistent with, and reach different conclusions from the information presented in this report and are under no obligation to ensure that such other reports are brought to the attention of any recipient of this report.

Societe Generale Group maintains and operates effective organisational and administrative arrangements taking all reasonable steps to identify, monitor and manage conflicts of interest. To help the Societe Generale Private Banking Entities to do this, they have put in place a management of conflicts of interest policy designed to prevent conflicts of interest giving rise to a material risk of damage to the interests of Societe Generale Private Banking's clients. For further information, Societe Generale Private Banking's clients can refer to the management of conflicts of interests policy, which was provided to them by the Societe Generale Private Banking entity of which they are clients.

General Warning

This document, which is subject to modifications, is provided for information purposes only and has no legal value.

This material has been prepared for information purposes only and is not intended to provide investment advice nor any other investment service. The document does not constitute and under no circumstances should it be considered in whole or in part as an offer, a personal recommendation or advice from any of the Societe Generale Private Banking entities, regarding investment in the asset classes mentioned therein. The information in this document does not constitute legal, tax or accounting advice.

Some products and services might not be available in all Société Générale Private Banking entities. Their availability in your jurisdiction may be restricted depending on local laws and tax regulations. You should be aware that the investment to which this material relates may involve numerous risks. The amount of risk may vary but can expose you to a significant risk of losing all of your capital, including a potential unlimited loss. Accordingly these products or services may be reserved only for a certain category of eligible investors such as those who are sophisticated and familiar with these types of investment and who understand the risks involved. Also, they have to comply with the Société Générale Group Tax Code of Conduct. Furthermore, accessing some of these products, services and solutions might be subject to other eligibility conditions. Your private banker is available to discuss these products, services and solutions with you and to check if they can respond to your needs and are suitable for your investor profile.

Accordingly, before making an investment decision, a potential investor, as the case may be and according to the applicable laws, will be questioned by his or her advisor within the Societe Generale Private Banking entity, of which the investor is a client, regarding his eligibility for the envisaged investment, and the compatibility of this investment with his investment profile and objectives. Before any investment, the potential investor should also consult his own independent financial, legal and tax advisers in order to obtain all the financial, legal and tax information which will allow him to appraise the characteristics and the risks of the envisaged investment and the pertinence of the strategies discussed in this document, as well as the tax treatment of the investment, in the light of his own circumstances.

Prior to any investment, a potential investor must be aware of, understand and sign the related contractual and informative information, including documentation relating to risks. The potential investor has to remember that he should not base any investment decision and/or instructions solely on the basis of this document. Any investment may have tax consequences and it is important to bear in mind that the Societe Generale Private Banking entities, do not provide tax advice. A potential investor should seek independent tax advice (where appropriate).

Investment in some of the asset classes described in this document may not be authorised in certain countries, or may be restricted to certain categories of investors. It is the responsibility of any person in possession of this document to be aware of and to observe all applicable laws and regulations of relevant jurisdictions. This document is not intended to be distributed to people or in jurisdictions where such distribution is restricted or illegal. It is not to be published or distributed in the United States of America and cannot be made available directly or indirectly in the United States of America or to any U.S. person.

The price and value of investments and the income derived from them can go down as well as up. Changes in inflation, interest rates and exchange rates may have adverse effects on the value, price and income of investments issued in a different currency from that of the client. The simulations and examples included in this document are provided for informational and illustration purposes alone. The present information may change with market fluctuations, and the information and views reflected in this document may change. The Societe Generale Private Banking entities disclaim any responsibility for the updating or revising of this document. The document's only aim is to offer information to investors, who will take their investment decisions without relying solely on this document. The Societe Generale Private Banking entities disclaim all responsibility for direct or indirect losses related to any use of this document or its content. The Societe Generale Private Banking entities do not offer no implicit or explicit guarantees as to the accuracy or exhaustivity of the information or as to the profitability or performance of the asset classes, countries and markets concerned.

The historical data, information and opinions provided herein have been obtained from, or are based upon, external sources that the Societe Generale Private Banking entities believe to be reliable, but which have not been independently verified. The Societe Generale Private Banking entities shall not be liable for the accuracy, relevance or exhaustiveness of this information. Information about past performance is not a guide to future performance and may not be repeated. Investment value is not guaranteed and the value of investments may fluctuate. Estimates of future performance are based on assumptions that may not be realised.

This document is confidential. It is intended exclusively for the person to whom it is given, and may not be communicated or notified to any third party (with the exception of external advisors, on the condition they themselves respect this confidentiality undertaking). It may not be copied in whole or in part without the prior written consent of the relevant Societe Generale Private Banking entity.

Specific warnings per jurisdiction

France: Unless otherwise expressly indicated, this document has been issued and distributed by Societe Generale, a French bank authorised and supervised by the Autorité de Contrôle Prudentiel et de Résolution, located at 61, rue Taitbout, 75436 Paris Cedex 09 under the prudential supervision of the European Central Bank ("ECB"), and under the control of the Autorité des Marchés Financiers ("AMF"). Societe Generale is also registered at ORIAS as an insurance intermediary under the number 07 022 493 orias.fr. Societe generale is a French Société Anonyme with its registered address at 29 boulevard Haussmann, 75009 Paris, with a capital of EUR 1,009,897,173.75 on 11 December 2017 and unique identification number 552 120 222 R.C.S. Paris. Further details are available on request or can be found at www.privatebanking.societegenerale.fr/.

Belgium: This document has been distributed in Belgium by Société Générale Private Banking SA/NV, a Belgian credit institution according to Belgian law and authorized and supervised by the National Bank of Belgium ("NBB") and the Financial Services and Markets Authority ("FSMA"), and under the prudential supervision of the European Central Bank- ECB. Société Générale Private Banking SA/NV is registered as an insurance broker at the FSMA under the number 61033A. Société Générale Private Banking SA/NV has its registered address at 9000 Ghent, Kortrijksesteenweg 302, registered at the RPM Ghent, under the number VAT BE 0415.835.337. Further details are available on request or can be found at www.privatebanking.societegenerale.be.

Luxembourg: This document has been distributed in Luxembourg by Societe Generale Bank and Trust ("SGBT"), a credit institution which is authorised and regulated by the Commission de Surveillance du Secteur Financier ("CSSF") under the prudential supervision of the European Central Bank ("ECB"), and whose head office is located at 11 avenue Emile Reuter – L 2420 Luxembourg. Further details are available on request or can be found at www.sgbt.lu. No investment decision whatsoever may result from solely reading this document. SGBT accepts no responsibility for the accuracy or otherwise of information contained in this document. SGBT accepts no liability or otherwise in respect of actions taken by recipients on the basis of this document only and SGBT does not hold itself out as providing any advice, particularly in relation to investment services. The opinions, views and forecasts expressed in this document (including any attachments thereto) reflect the personal views of the author(s) and do not reflect the views of any other person or SGBT unless otherwise mentioned. SGBT has neither verified nor independently analysed the information contained in this document. The CSSF has neither verified nor analysed the information contained in this document.

Monaco: The present document has been distributed in Monaco by Société Générale Private Banking (Monaco) S.A.M ., located 13, 15 Bd des Moulins, 98000 Monaco, Principality of Monaco, governed by the Autorité de Contrôle Prudentiel et de Résolution and the Commission de Contrôle des Activités Financières. The Financial products marketed in Monaco can be reserved for qualified investors in accordance with Law No. 1339 of 07/09/2007 and Sovereign Ordinance No 1.285 of 10/09/2007. Further details are available upon request or on www.privatebanking.societegenerale.mc.

Switzerland: This document has been communicated in Switzerland by Société Générale Private Banking (Suisse) SA (« SGPBS »), whose head office is located at rue du Rhône 8, CP 5022, CH-1211 Geneva 11. SGPBS is a bank authorized by the Swiss Financial Market Supervisory Authority ("FINMA"). Further details are available on request or can be found at www.privatebanking.societegenerale.ch.

This document (i) does not provide any opinion or recommendation about a company or a security, or (ii) has been prepared outside of Switzerland for the « Private banking ». Therefore, the Directives of the Swiss Bankers Association (SBA) on the Independence of Financial Research do not apply to this document.

This document has not been prepared by SGPBS. SGPBS has neither verified nor independently analyzed the information contained in this document. SGPBS accepts no responsibility for the accuracy or otherwise of information contained in this document. The opinions, views and forecasts expressed in this document reflect the personal views of the relevant author(s) and shall not engage SGPB's liability.

This document is not a prospectus within the meaning of articles 652a and 1156 of the Swiss Code of Obligations.