



Chinese market starts 2016 on an ominous note

by [Dexter Tan](#)

Chinese companies suffered steep losses as the CSI 300 Index lost 11.7% in the first four days of 2016, wiping out all the gains made in 2015. Beijing's attempts to support stock prices and its currency sent mixed signals to investors and raised grave concerns about the country's ability to manage an economic slowdown.

A few days after introducing the circuit breakers on Jan 4, regulators scrapped the circuit breaker system as it failed to stem panic selling among shareholders. China's state funds [reportedly](#) bought shares after China-listed firms lost more than USD 1tn in four days, resulting in a 2% gain for the CSI 300 index at the close on Friday. The topsy-turvy nature of market values increased the RMI-CRI aggregate 1-year Probability of Default (PD) for 2,119 China-listed firms, sending the aggregate PD past 166bps on Jan 8 (see Figure 1).

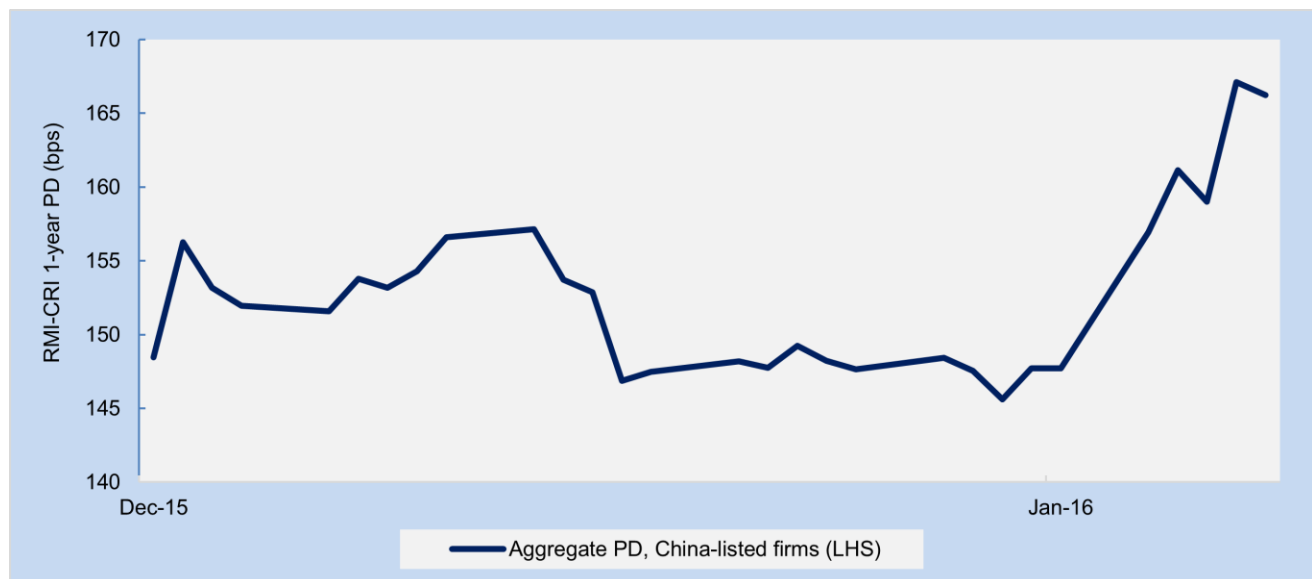


Figure 1: RMI-CRI 1-year aggregate PD for China listed companies. Source: RMI-CRI, Bloomberg

There were a number of reasons for the rushed selling and credit deterioration. In July last year, the China Securities Regulatory Commission (CSRC) placed a 6-month ban on shareholders with stakes of more than 5% from selling their shares. Investors might have sold off their holdings prior to the planned lifting of restrictions on share sales. One day before the ban's expiration on Friday, the CSRC implemented a new rule to replace the new ban, disallowing major shareholders from selling more than 1% of total shares outstanding within the following three months after Jan 9.

The perceived weakness of China's currency gave an incentive for capital to leave the country. [Last week](#), the PBOC fixed the CNY above 6.5 against the USD for the first time since 2011. The weaker than expected fixing triggered a selloff in the offshore CNH market, lifting the gap between the CNY and CNH to one of the widest on record. The wider gap reflects the offshore market's expectation that the central bank will allow a meaningful depreciation of the Chinese currency. Meanwhile, the overnight CNH-Hong Kong Interbank Offered Rate, a daily benchmark for offshore RMB lending, soared to a record high of 13.4% on Jan 11.

According to [Reuters](#), the PBOC considered letting the CNY depreciate by 10-15%, which they thought would improve the financial situation of Chinese companies that are heavily in debt. But allowing such a large currency fall would likely lead to more volatile equity markets as market participants have already become more skeptical of the government's capability to reassure markets. Recall what happened when the central bank last allowed the CNY to depreciate by 2% in August – Asian stocks were battered and many currencies dropped to fresh five year lows. Emerging economies dependent on China for their commodity needs also slid closer towards stagnation and deflation. Additionally, a depreciation of the CNY this time could instigate a currency war among nations to improve their exports at the expense of others.

So, are we witnessing a hard landing scenario for China? Yes, the likelihood for a hard landing consequence has increased but the odds of one happening soon remain unclear. On one hand, despite a stream of disappointing data and lack of confidence in regulators, Chinese authorities still have room to fight further flight to quality. For example, even though they have fallen, China's FX reserves remain large enough to defend its currency. FX reserves grew to a historic high of USD 3.99tn in Jun 2014 but have been declining since. In December, the level of reserves reached USD 3.33tn and the PBOC could use the funds to control the pace of depreciation of the CNY. Second, China's closed capital account prevents mass capital flight.

But on the other hand, the level of leverage in regional and local government (RLG) entities has increased. According to [Moody's](#), RLG debt exhibited a worsening credit metrics trend. Between Jun 2013 and Dec 2014, RLG debt grew by more than one third to USD 3.7tn, an equivalent of 38% of 2014's GDP.

Named the [rock star of China analysts](#), Charlene Chu, has a stark outlook for Chinese investors in 2016. She had forecast that the CNY would continue its slow and downward trend for the rest of the year, met with occasional bouts of volatility. The views of other China watchers, however, are for a soft landing scenario. Nonetheless, we should always prepare for the worst case scenario, as the financial crisis of 2008 has taught us.

<p>Credit News</p>
<p>Wall Street faces profit recession as earnings season begins</p> <p>Jan 11. Next week, Wall Street's fourth-quarter earnings season could confirm an earnings recession - two quarters of declining profits - led by the usual suspects, energy and materials companies. The severity of the recession may depend on consumer discretionary companies, which have been warning about profits at an unusual pace. Overall, S&P 500 earnings are forecast to drop by 4.2% in the fourth quarter. Major indexes lost about 6% last week, the worst start to a year since records were kept. (Straits Times)</p>
<p>China slowdown to hurt export-heavy Singapore the most in Southeast Asia</p> <p>Jan 10. China's economic slowdown is dragging down growth across the region. In Southeast Asia, Singapore could be the worst hit with exports accounting for a much larger percentage of its economy than peers. China will grow 6.7% this year, the World Bank forecast last week, down from an estimated 6.9% in 2015. Singapore's export-oriented economy is already feeling pain. Growth was 2.1% in 2015, the slowest pace in six years, mirroring the slowdown in China. (Bloomberg)</p>
<p>Big five US banks hurt by China and oil</p> <p>Jan 10. Wall Street banks are poised to unveil another batch of lackluster profits after the run-up to the Federal Reserve's historic interest rate rise failed to boost their crucial trading businesses. Results to be presented over the next week and a half are expected to show the big five US investment banks generated even less revenue from trading in the last three months of the year than in the troublesome third quarter. The Fed's rate increase came just two weeks before the end of the quarter, limiting its positive impact on the financial results. (FT)</p>
<p>UK economy faces 'dangerous cocktail' of risks</p> <p>Jan 7. Referring to a gloomy report by the British Chambers of Commerce (BCC) showing both manufacturing and services weakened at the end of 2015, George Osborne identified the slowing economies of China, Brazil and Russia, the slide in commodity prices and escalating political tensions in the Middle East as potential hazards for the UK. There are also signs that the UK is losing momentum, particularly in domestic demand. The BCC quarterly report states that while the UK's key measures of both services and manufacturing declined in the fourth quarter, the factory indexes fared worse. The cloudy outlook adds to reasons for the Bank of England to keep interest rates at a record low. (Bloomberg)</p>

HSBC downgraded by JPMorgan as bad loans in Asia set to surge

Jan 6. JPMorgan downgraded the HSBC stock to underweight from neutral on Jan 6, as waning growth in emerging markets more than doubles the bank's bad loans in Asia. HSBC's non-performing loans in Asia, which accounts for 39% of total lending, were estimated to jump to USD 5.4bn from USD 2.2bn over the past six months. If the NPL balance continues to grow in 2016, the bank needs to take more provisions against the headwind. With the rising probability of an emerging market credit cycle likely to be priced into bank valuations, JPMorgan expects HSBC to underperform relative to other European banks. ([Bloomberg](#))

Investors plan to cut hedge fund exposure ([FT](#))

Noble Group downgraded to junk status by Standard & Poor's ([FT](#))

Hanjin Heavy falls to record in Seoul on debt restructuring ([Bloomberg](#))

Regulatory Updates**Bank lenders dodge losses suggesting loopholes in new regulation**

Jan 11. With effect from Jan 1, creditors are supposed to take losses when European financial companies collapse, but regulators' actions late last year suggest that may not be the case. Bankers and supervisors in Italy and Greece found ways to shield investors in failing firms; in Portugal, regulators chose who should be impaired; in Germany, private-sector protection schemes mean bondholders may never suffer imposed losses. ([Bloomberg](#))

China flip-flops on stock crash rule and adds to chaos

Jan 8. After watching a stock-market collapse wiped out USD 5tn of wealth in less than three months last year, Chinese authorities hatched a plan to stem the pain: circuit breakers to halt exchanges for 15 minutes after a 5% drop in the benchmark and for the rest of the day after a 7% retreat. This new system went into effect on Jan 4 but lasted only for four days due to repeated circuit breaks. Critics say circuit breakers exacerbated the stock rout because investors expedite the selling for fears of being locked out. ([Bloomberg](#))

Banks get relief on accounting headache

Jan 5. Financial Accounting Standard Board (FASB) on Tuesday changed a provision which requires banks to record big, counterintuitive gains and losses known as "debt-valuation adjustments" (DVAs). Analysts and accounting experts criticized the rules for yanking earnings up and down regardless of how the banks' operations are performing and say the result of Tuesday's change will be a cleaner presentation of earnings. ([WSJ](#))

China financial regulator FCA denies 'going soft' on banks ([BBC](#))

Indonesia could impose extra capital surcharge on banks ([Business Times](#))