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2014 Global Credit Products Conference

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China: Putting the Formidable Risks in Perspective

The Forest & the China Syndrome

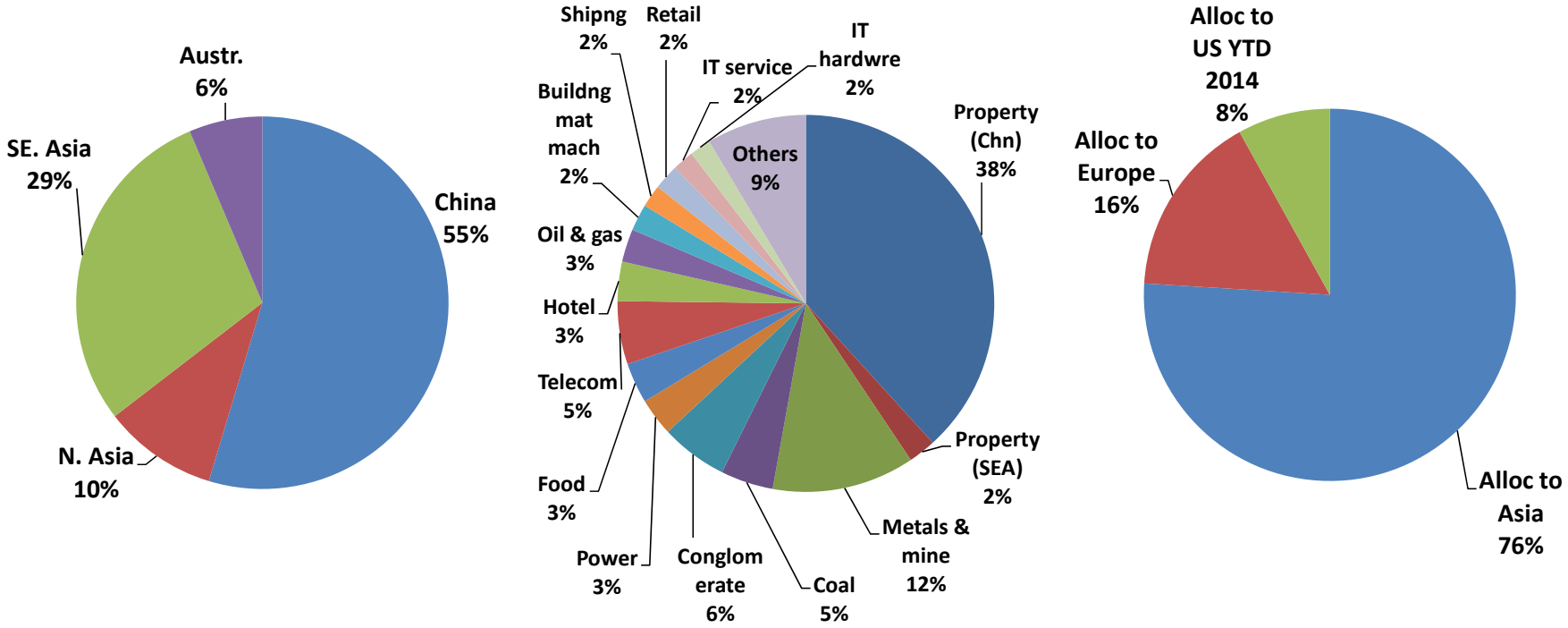
Charles Chang

Head of Asia Credit Strategy

Credit Suisse

Charles.c.chang@credit-suisse.com

Why China? – Asia HY

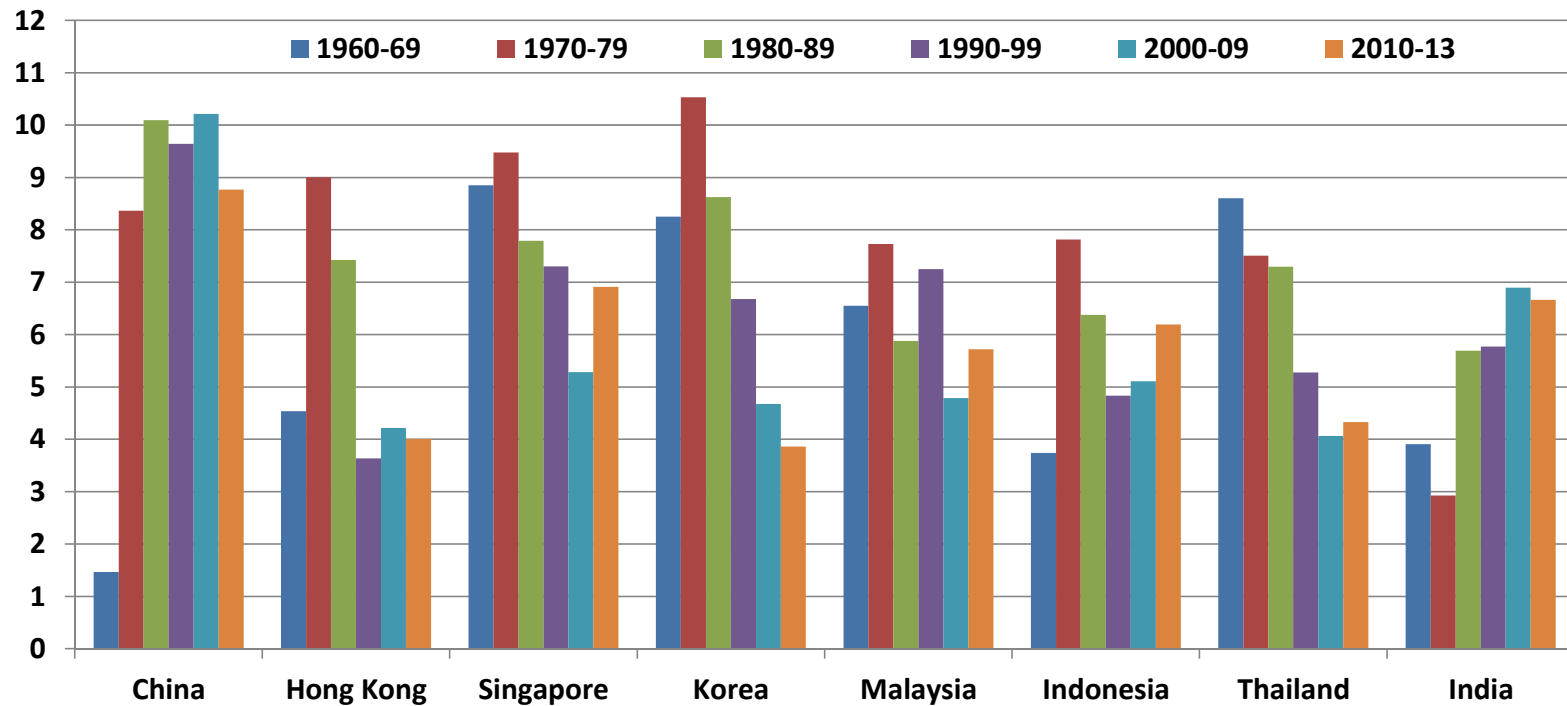


Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service. Alloc: allocation of all Asian HY deals YTD (including CNH).

Takeaway 1: See the forest, not just the trees

- **Dangers of seeing China's slow down as “cyclical”**
 - Misnomers bring false hopes
 - 10%+ growth not coming back, “cyclical” implies it could
 - This transition to slower growth observable throughout Asia post WWII
- **6% good, 8% bad**
 - Inevitable and desirable: 7.4% growth so bad if to be 6% in 3 years?
 - Key question: orderly and rational?
 - Key objective: pick winners and avoid losers in this consolidation process

Average Real GDP growth



Source: World Bank, Credit Suisse.

CCP and China – the forest

- **CCP – a history**
 - Inst. memory: conseq. of corruption/failure to gov., KMT to Cultural Rev.
 - Witnessed: Glasnost, Perestroika, dissolution of USSR
 - Lesson: chaos cannot be tolerated – to be stopped at all costs
 - Stability primary, growth secondary, latter serves former, not vice versa
- **What does CCP control & can use for its primary directive?**
 - Courts, regulators, banks, local gov., both sides of BS, careers of all
 - CCP to cut off left arm (local gov.) with right arm(banks)?
- **Financial crisis in China = existential crisis for CCP**
 - No Lehman, TARP, AIG moments. CCP to risk itself to protect capitalism?

Takeaway 2: Beware of the China syndrome

- **Symptom 1: invariable negativity**
 - Macro: fast growth is bad, slow growth is bad
 - Property sector: bubble bigger is bad, bubble smaller is bad
- **Symptom 2: short memory**
 - Market forgot: slowing partly due to gov. hitting the brakes in 2010 (6 RRR, 2 interest rate hikes) and 2011 (6 RRR, 3 interest rate hikes)
 - Result: GDP 2011 9.3%, 2012 7.8%, 2013 7.7%, 1Q14 7.4%, 2Q14 7.5%
- **Symptom 3: nearsightedness**
 - Failure to see big things from afar
 - Failure to see past up/down mind trap (up always good, down always bad)

Case 1: China's first bond & trust defaults

- **China's biggest problem**
 - Savings 50% GDP (>2x world) → bubbles, gov. debt, shadow fin., NPLs
 - A story: supposed to have some co. default and >1 bond/ABS default
- **What happens if the natural order is violated?**
 - Corp.: not so fit survives, lenders: eyes wide shut, banks: become giant...
 - Bond markets: blank default memory – regulators, rating agencies, investors
- **The forest: defaults are good**
 - “Defaults are good, defaults are right, defaults work, defaults clarify, cuts through, and captures the essence of the evolutionary spirit” – China needs more of this, not less

Case 2: China property 2014 – good or bad year?

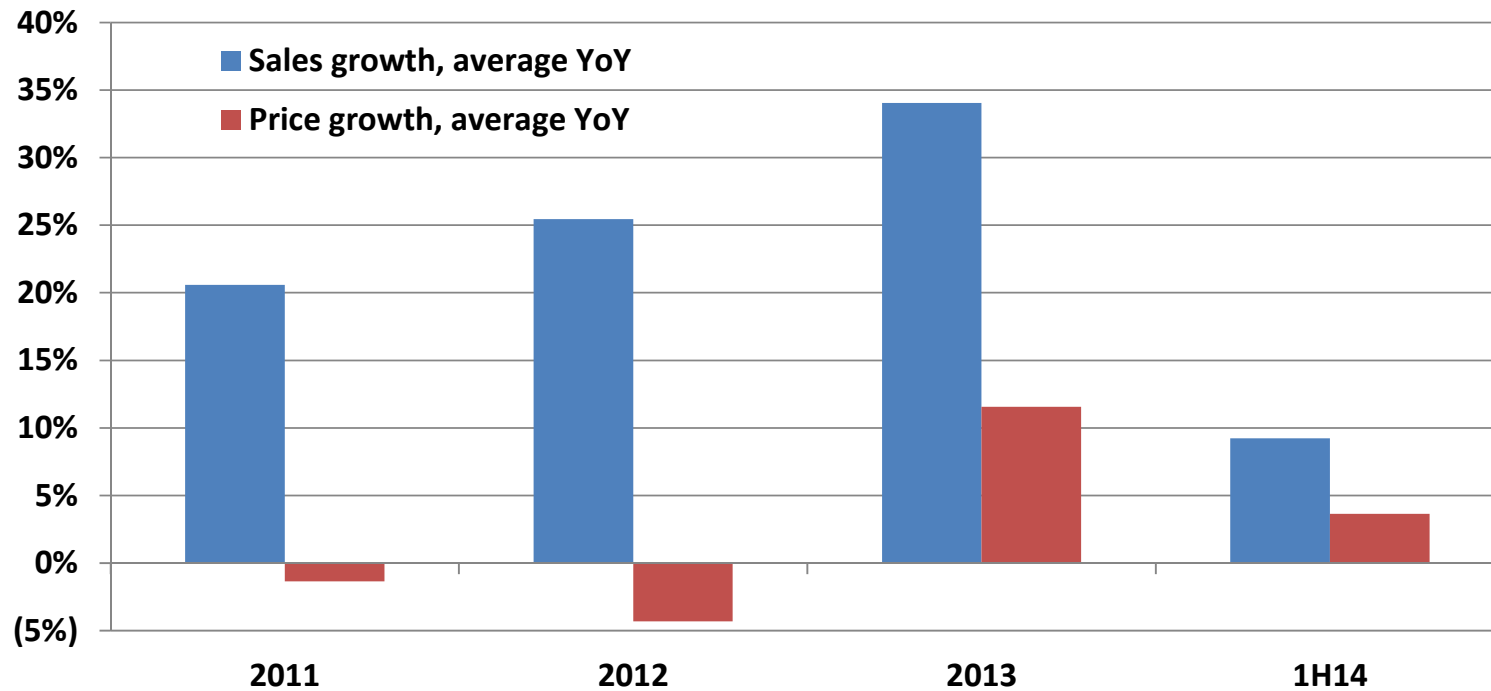
- **The China syndrome**

- Cause of failure to answer this simple question
- Invariable negativity: FY13 bubble bigger (sales/prices: +26%/+11% YoY), 1H14 bubble smaller (-9.2%/-1.5% YoY) – bad?
- Nearsightedness: failure to see Xi's two high-stakes policies and the listed developers' consolidation of the market
- Short memory: what happened to listed developers in weakest markets (2008, 2010-11)? got bigger or smaller? Easy to check, but missed by most

- **The Forest**

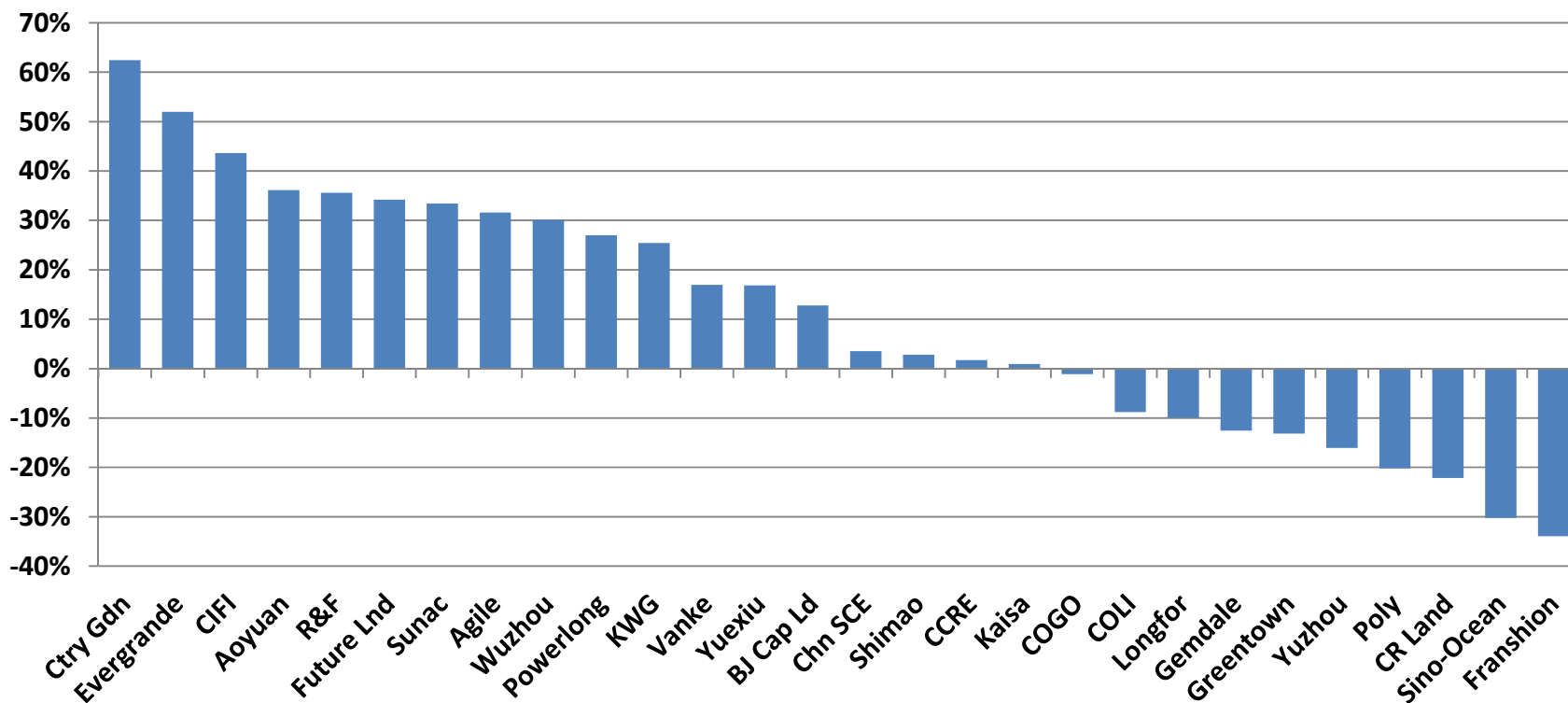
- China property and the Serengeti: natural selection accelerated by drought
- Market showing maturity and normalization, has been orderly and rational

So bad? Listed developers sales & prices



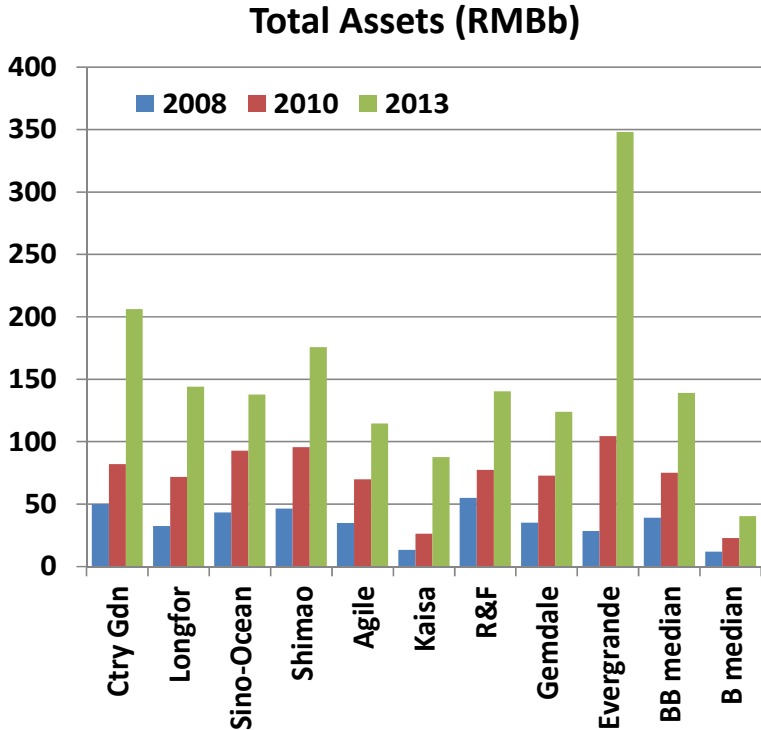
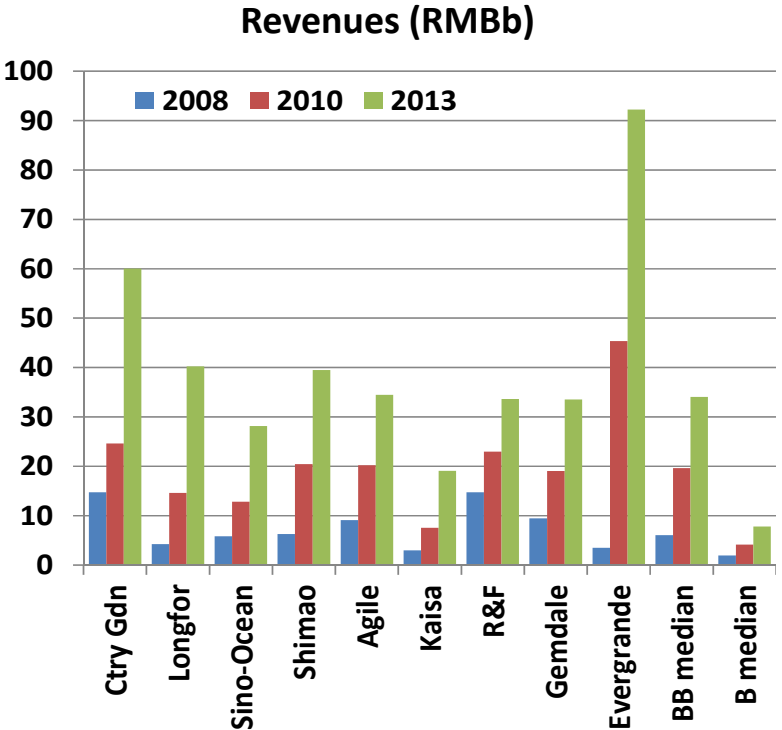
Source: Company reports, Credit Suisse.

So bad? Listed developers 7M14 sales (YoY)



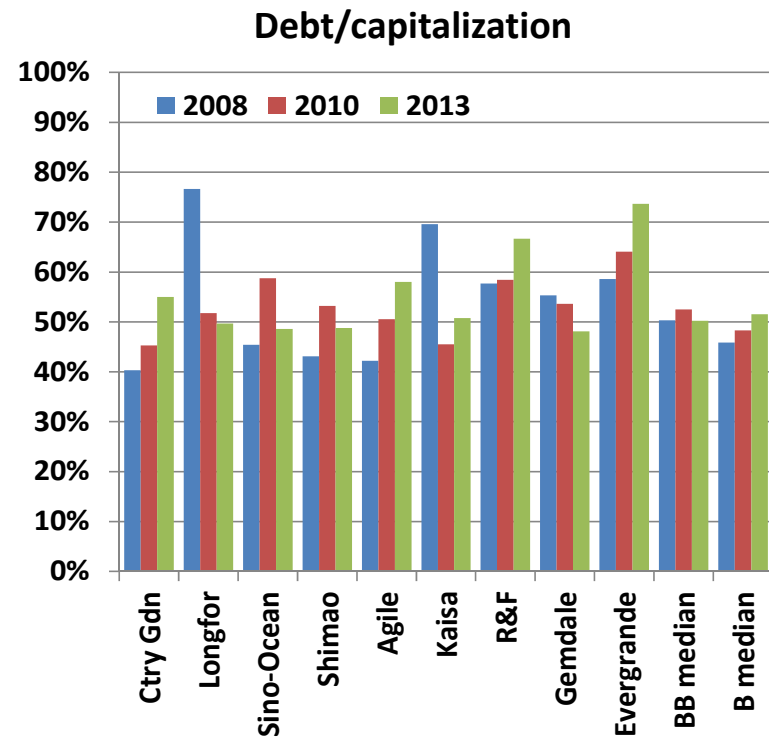
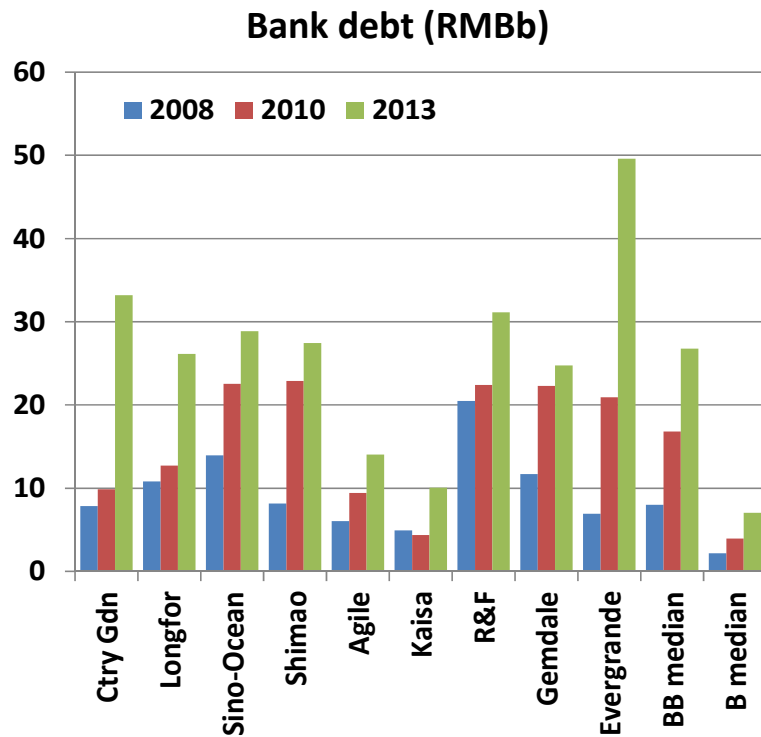
Source: Company reports, Credit Suisse.

Got bigger or smaller in weak markets?



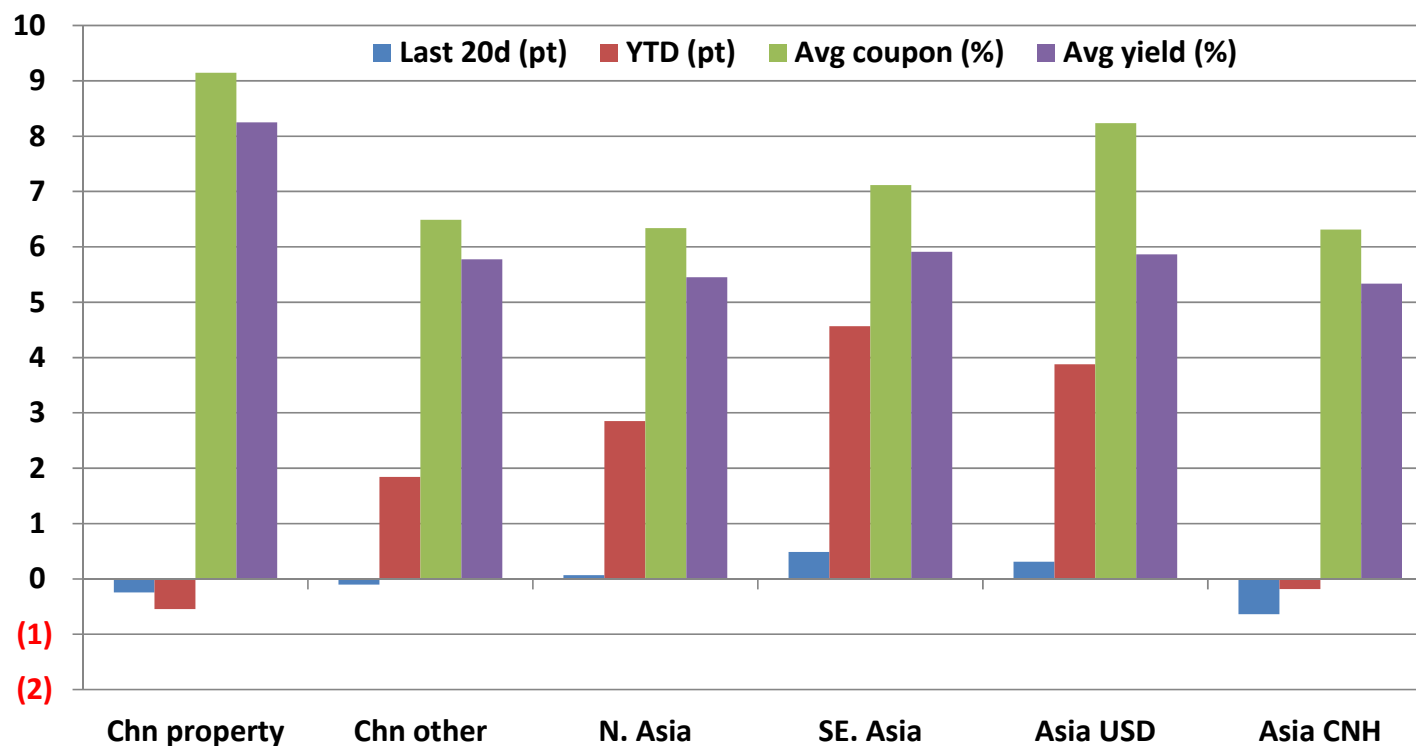
Source: Company reports, Credit Suisse.

Got bigger or smaller in weak markets?



Source: Company reports, Credit Suisse.

Asia HY year to date – overpaid for the risk?



Source: Credit Suisse, the BLOOMBERG PROFESSIONALTM service,.

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