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- A Greek default is more likely than Grexit and may trigger hidden contagion, while the volatility in bond markets is making life very difficult for bond traders.
- Emerging markets continue to see outflows, particularly South Asia, as leveraged money exits in the manner of the taper tantrum of 2013, heightened by concerns over the nature of Chinese growth and adverse currency moves.
- New China is in a bull market, old China is in a bear market. Global investors can no longer rely on global companies with exposure to China as simple proxies for Chinese growth. The growth model has changed and so will the winners and losers.
- Energy companies, especially coal are facing not only regulation, but also economic and technological threats. Lending here, rather than the traditional problem area of property, may be where we need to worry most about bad debts.

When momentum stalls in a market, short term traders tend to become less greedy and more fearful and are thus vulnerable to profit taking – as well as to the stories the short sellers whisper in their ears to make them sell. Last week we discussed the slow-motion car crash in **Greece** and noted that the economic impact was likely to be limited now that the euro area breakup is not likely. However, this does not mean that there are no market risks. **As the deadline approaches at the end of the month, there is potentially a risk of a run on the Greek banks**, or even a collapse, which would carry clear contagion. Even if Tsipras blinks at the last moment, I think there **could well still be a ‘Lehman moment’** whereby some clever derivatives trader has stepped on a landmine of Greek debt and now that resolution is near, he will have to lift his foot and may wipe out his bank’s balance sheet. Very dangerous, those smart derivatives guys. Meanwhile, the **beleaguered bond traders have just seen a 20 basis point rally in Bunds and a 20 basis point sell off in Spanish bonds in the last week alone**. Somebody has to be hurting. 10 day volatility in Spanish 10 year bonds, while down from the eye-wateringly high levels of last month, is still at levels not seen since the euro crisis began in 2011. All while yields have basically doubled over the last three months. German 10 year volatility is dropping, but even after

the latest 20 basis point rally, yields have jumped from lows of 0.074% to 0.80% since April. Similar patterns emerge in France and Italy. This volatility partly reflects the lack of liquidity we were discussing last week, but will also doubtless further contribute to it, as market makers retreat to lick their wounds. **Ultimately, one might wish for a world where bonds are held to maturity and used for borrowing and saving rather than for trading**, but the transition to that state is not going to be pleasant for a lot of the financial sector. Not pleasant at all.

Meanwhile the **Shanghai Composite suffered another bout of volatility as margin requirements were tightened once again**. This is becoming a regular pattern as the authorities move to take leverage down. As noted previously, the two way pull on the Chinese markets reflects two steps forward based on fundamentals and one step back as day traders are steadily squeezed out. Just like the property market, the **authorities want the Chinese equity market to be firm rather than racing away, but they do not want to precipitate a crash**. Commentators are ramping up the rhetoric on a stock market bubble, just as they did in the US from 2009 onwards. I have often referred to the US bull market since 2009, as the most bad tempered bull market ever since so many 'clever' and vocal market timers sat on the side waiting for a correction only to see it move away from them in a series of spikes. Even worse were the ones who capitulated, usually at the top of a spike, and managed to catch the drawdown. In my view, trying to time a market is less valuable than recognising its trend. For example, **China along with most developed equity markets, remains in a bull trend**, while after the latest moves **US, UK and European bonds now look to be in a bear trend** with generic 10 year bond yields having broken above their long term moving averages over the last week. This is not to say that there won't be corrections along the way, but **the lesson is to buy the dips of bull trends and sell the rallies in bear trends**. Assuming your regulator allows you to of course.

Emerging market equities are not in a bull trend however. In fact they have been trapped in a sideways moving band for the last three years of around plus or minus 10%. Currently, the I-shares Emerging Markets ETF EEM is in the lower half of the band, albeit not at the bottom. Fundamentals, while okay, are not very positive and **funds flow**, which is very important in these markets, **continues to be negative**, particularly in South Asia, as leveraged money exits. This looks similar to the period around the so called taper tantrum of 2013, although this time it is heightened by concerns over the nature of Chinese growth and adverse currency moves. **From being +12% at the end of April, the I-shares Emerging Markets ETF (EEM US Equity) is now only +2% year to date**. And that is with a 20% exposure to China. Commodity exporters such as Malaysia, Indonesia and Brazil have all seen their markets weaken and their currencies fall heavily against the dollar as weak demand from China exposed over-capacity, excess inventories and high levels of debt. Meanwhile, while seen as the best of the rest for its domestic potential and its lack of exposure to China, **the bubble of enthusiasm for the Indian stock market has continued to deflate**, now at -5% to a dollar investor year to date, as the high frequency data driven traders abandon Modi and his five year plan after less than a year in an almost carbon copy of the way they gave up on Abenomics. **For 2015 India year to date, see 2014 Japan**. India can come back, as Japan did, but the fundamentals have to come through.

The Shanghai Composite is up 60%. This is not as much of a paradox as many are presenting it to be. The weak demand from China is a function of structural change. Less demand for commodities goes alongside much higher demand for goods and services – we’re witnessing real retail sales at +10% year on year. **If India is behaving like Japan in 2014, then China is behaving like the US equity market post the global financial crisis- moving steadily ahead despite ongoing predictions of imminent economic collapse.** This is neatly illustrated by Chart 1, which shows the correlation between China, the emerging markets index ETF (both shown relative to the S&P) and the price of Chinese steel – a favoured proxy for old style China growth. We can see that **the only emerging market not tracking the ‘old’ China is the Shanghai Composite!**

Chart 1: The only EM now tracking ‘old’ China is China



The story about **retail investors** is well known, but they are **much more focussed on ‘new’ China rather than ‘old’ China.** The Shenzhen index, mid-caps and healthcare stocks have all done even better than the benchmarked index. Meanwhile some of the biggest Chinese American Depositary Receipts (ADRs) such as Tencent, Baidoo and JD.com, which are used by many global investors as a way to ‘play’ China, are all ‘new’ China, not ‘old’. It’s interesting to note that search engine and internet security company **Qihoo 360, listed in the US, has just received a buyout offer from its top executive.** The idea that the company could relist at a much higher multiple in China may be part of the attraction, but it also highlights the wave of liquidity coming into ‘new’ China stocks to make them private.

Returning to Hong Kong and following up on my TED talk sourced quote that the **15 largest ships in the world produce more pollution than all the cars combined**, I was delighted to see that new regulation is being pushed through here to limit the use of bunker fuel when berthing in Hong Kong and should come in by the start of next month. When discussing pollution here, we are talking about nitrous oxide and sulphur dioxide as well as particulates. This is a health issue, we are not talking about carbon dioxide, which is an odourless, colourless gas. The **debate about** the extent to which carbon dioxide may affect **global temperatures** and climate change is obviously being ratcheted up ahead of the latest series of talks in Paris (the campaigners have even got the Pope involved) and **has tended to conflate carbon dioxide with the term pollution**. However, what is clear here **in Asia is that the health issues associated with particulates and toxins such as sulphur dioxide and nitrous oxide have a higher policy priority**.

In the west, the **campaign to disinvest from certain 'carbon' industries is gaining traction** (AXA Group has already signed up to divest EUR 0.5 billion from the companies most exposed to coal-related activities) partly, I suspect, because as well as politics, economics and technology are also operating 'against polluters'. The proposed US Clean Power plan would dramatically reduce coal production (especially in the Western States), but also **in China, economics and technology are likely to reduce coal demand significantly**. Indeed, it is already well underway. Chinese imports of coal have dropped dramatically, as have prices. For example, the chart below shows the price received for high grade metallurgical coal compared to the peak in early 2011, incidentally when Vale of Brazil commissioned a fleet of massive 400,000 tonne super-ships (doubtless burning bunker fuel) to ship iron ore from Brazil to meet the demand from Chinese steel plants.

China Metallurgical Coal Price



This primarily **reflects the sharp decline in Chinese steel production, as the post 2008 investment boom led to a dramatic increase in output and capacity.** Steel production is down, iron ore imports are down, as are prices and so, of course, is demand for the coal that fires up the steel mills. Thermal coal imports are down sharply too, with total coal imports down to 14.25 million tonnes last month from a peak of 36 million tonnes in January last year. This is mainly down to changes in the heating mix, with less localised coal burning and power generation and more centralised electricity from hydro, gas, nuclear etc. Because of these two factors- the moves to reduce pollution and the change in economic mix, China is becoming less energy intensive. According to China's National Development and Reform Commission, **energy consumption per unit of GDP fell by 5.6% in Q1 compared to a year earlier.** Meanwhile China is also becoming more focussed on 'green' energy, with greater focus on water, wind and solar as well as nuclear. Indeed by 2013, almost 60% of investment in energy is going to renewables.

Traditional proxies for Chinese demand such as electricity production, steel output, coal imports etc. are **pointing to very weak GDP growth in China** and fuelling a lot of bear stories, but they are **contradicted by data such as 10% real retail sales growth, higher wages and robust consumer credit growth.** In effect, companies, sectors and even countries exposed to the previous model of Chinese growth are suffering, while capital is flowing to those that are participating in the new, consumer focussed model of growth. **'New' China is in a bull market, 'old' china is in a bear market.** As I highlighted in my recent London presentations, the China growth story is about the composition more than the headline number.

Commodities are in a bear market and while **basic material companies,** be they Australian, Brazilian, Malaysian, Indonesian or even American, will still see demand from China, they will not see the growth they have previously enjoyed. This will tend to put a **premium on quality,** not only metallurgical and thermal coal, but also iron ore, which represents a big challenge for marginal producers. In this way, market forces are already taking capital out of the sector, although that is not to say there won't be any investment at all. In an interesting parallel to Japan 30 years earlier, China moved last month to strike an **extremely interesting deal with Brazilian iron ore giant Vale.** Having made life extremely difficult in recent years by refusing access to Chinese ports for the mega carriers mentioned earlier, China has now announced a deal with Vale to **invest in eight of the giant ships and to lend the company \$4 billion to fund an expansion in output that dwarfs anything planned by BHP Billiton and Rio Tinto.** With use of the mega carriers Vale becomes the third cheapest producer after these two. Tough times to be a higher cost commodity producer, such as Fortescue, especially if the boom has left you with too much debt. The likely solution for 'Twiggy' (Andrew) Forest of Fortescue Metals Group may be to strike a similar deal with the Chinese, which is probably why he was in Hong Kong this week saying Fortescue was "always open to commercial discussions with current and potential partners". As for ore, so for other commodities such as coal, Indonesia finds itself on the wrong end of this trade as well. Coal output in Indonesia quadrupled over the last decade, with China taking 30% of the total. This slowdown presents a real headache for the new government, but the reality is that China has become the Walmart of commodities.

Despite all the consolidation and talk of pricing power, China clearly has the upper hand. A rising concern has to be, how all of this commodity production has been funded? With excess capacity across the board, lower prices can mean higher production simply to meet debt covenants (as we saw with shale oil). **At some point, there are going to have to be some major write downs against commodity related loans**, something that the financial sector in commodity countries does not yet appear to be fully appreciating.

The lack of pricing power is perhaps even more evident **in the US**, where the supply side shock of the shale gas revolution has left gas cheaper than coal and a big shift in the energy mix has already taken place. **Coal has been, on average 60% less expensive than gas since 2001. It is now more expensive, not least because of increased regulation associated with clean air rules.** According to the US Energy Information Administration, coal fired power generation in March dropped to 36% of the total production, compared to 42% a year earlier, while gas fired has risen from 24% to 29%. Stocks are building up rapidly, which makes the **prospects for US coal companies even less attractive**, so that the disinvestment in coal is less of a political and ethical decision, and more of a simple economic one. The campaigners will claim the credit and that is fine, although I would be extremely careful of **the hidden price** they/we will pay. The various **vested interests continue to push for 'carbon pricing'**. This would undoubtedly leave consumers paying more and slow moving companies severely constrained on profitability, and subject to drastic market share loss against non-compliant competitors and a large wedge of economic rent accruing to the administrators and traders of the system (who naturally are the ones most in favour of it). **Cui Bono?** As we should always ask. Meanwhile, one can't help noticing the irony that **their biggest source of marginal demand for coal is now seen as Europe**, where the closure of the German nuclear grid post Fukushima has led to an upsurge in burning lignite, producing not only more carbon dioxide, but also the very pollutants that China is now clamping down on.

From the old economy to the new, and how exactly to play China? One of the phenomenon about China that I discussed with colleagues on my recent trip to London is that the **rapid change in shopping habits of Chinese consumers**, specifically buying from the internet, has left a number of the big global fast moving consumer goods (FMCG) companies stranded. This story hit the front pages this week, as **Unilever continued to see sales falling 20% year on year, Nestle was reported burning instant coffee it couldn't sell in its stores and both Colgate Palmolive and Beiersdorf reported problems with overstocking.** Many international investors have owned these FMCG companies as a proxy for China and have in many cases misinterpreted the slowdown in sales as a macro phenomenon. Closer inspection reveals that it is a market share story and a mix shift. One aspect of the **anti-corruption** campaign (aside from crushing the other great China proxy, Macau) that has been largely overlooked is that it was common practise to give out **gift cards** to officials, which **drove traffic into traditional stores.** Without gift cards, more of that spending has gone online, where the traditional 'shelf dominance' of large brands counts for relatively little. In effect, **the first mover advantage has eroded** and the '**moat**' (to use a Warren Buffet term) that had been built through control and dominance of the distribution chain **has been breached.** Last week we discussed the need for international investors to move up the knowledge curve about Chinese markets as index changes either

force them to participate or at least remove the lack of a penalty for ignoring China. This is the second stage of the process, **owning global FMCG companies as a proxy for the Chinese consumer is starting to unwind as a strategy**. Investors will have to start researching the rivals, most of them domestic Chinese, or partner with people who can do so.

Hong Kong has traditionally provided an outlet for 'old' China, not in resources, but in shopping and real estate. Here too we are having to adapt to the 'new' China. One obvious area is in our own business; **the beginning of July sees the official launch of the mutual recognition scheme for investment funds between Hong Kong and China**. This is part of the Rubik's cube, the long term structural reforms and opening up of China's capital markets. Just as we saw with other initiatives such as the quotas, or the stock connect, it is likely that in the first instance the flows north into China via eligible funds will outweigh the flows south from China into diversification and offshore funds. Nevertheless, international asset managers are getting ready to have qualifying funds for when the liquidity comes flowing south.

While the West continues to deal with the multi-year after shocks of the global financial crisis and the measures adopted to deal with it – of which both Greece and the bond market instability are the latest events, adapting to the changing demands from China is the dominant issue for all of us in Asia, not just this week, but for years to come.

Regards,

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