Healing emerging markets banks key to global growth

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A headline in late March about a run on a rural Chinese bank in Jiangsu province was a fitting note on which to end the first quarter. For years, markets have doubted the health of the banking system and legitimately feared that the debt-funded excess capacity in the Chinese economy would end in a flaming pile of bad loans. In fact, the Hong Kong-listed mainland banks are priced for precisely this scenario. The long-term, low-grade fear of a financial bust escalated into fever in the first quarter of 2014, as China permitted its first defaults in the domestic debt market. More such defaults lie ahead as entire industries rationalize and consolidate. We stand at a critical juncture in Chinese economic/financial development – how things evolve over the next nine months will have important implications for global growth and risk asset prices. Ominously, I wrote the same words about the U.S. financial system in 2007, but with China I am betting on a different outcome.

Signature's central investment framework since the financial crisis of 2007-2008 has hinged on the health of capital channels, most notably banking systems and debt markets. Financial conditions in credit markets (which set pricing and availability of capital to the economy) have been the essential factor in pricing assets for the past eight years. This pricing mechanism is sound because when companies cannot rollover maturities, defaults and liquidation valuations replace going-concern valuations. Risk-on/risk-off market patterns have revolved around financial condition tightening/loosening sequences; hence, our fanatical surveillance of developments in this realm.

Lessons from the U.S. and EU

The onerous process of putting the world's financial system back on solid footing began in the U.S. after the mortgage crisis wiped out bank equity and froze bond markets. Dramatic policy interventions quelled the U.S. crisis by 2010, which then moved on to Europe, where banking stability was threatened by sovereign debt. Again, massive policy responses were met with success (to my dismay in the Eurozone case). The sequence of financial repair is entering its final stage in 2014/2015 with several emerging market countries, most notably China and India,now taking steps to inject public and private capital into their banking systems.

Chart 1: The state of the bailout

Money flows related to the Troubled Asset Relief Program

Outflows: $609 billion. This includes money that has actually been spent, invested, or loaned.

Inflows: $621 billion. Money returned and paid to Treasury as interest, dividends, fees or to repurchase their stock warrants.

Source: ProPublica

To me, this is a critically important development for markets, as it has been before. Tim Geithner and Ben Bernanke's actions to rescue the U.S. banking system through the Troubled Asset Relief Program, including equity injections, liquidity support and loan guarantees, proved to be a successful model for bailouts and an inflection point for markets that started the current bull market rally in 2009 (See Chart 1). Equally, Mario Draghi's famous 2012 pledge to do "whatever it takes" to backstop European sovereign debt markets and bank access to liquidity marked the turn for Europe. In both cases, the action removed the high probability tail risk of a deflationary debt spiral and economic collapse – and markets surged.

Subsequent annual U.S. bank tests of capital adequacy have limited dividend payouts, allowing retained earnings to accumulate inside the banks, resulting in a U.S. banking system that has been recapitalized to a level that is beyond reproach. Swiss and U.K. banks underwent harsh and appropriate recapitalizations involving state and private equity injections and now also receive clean bills of health. Europe's banks are less profitable, operate in weak economies and have more external capital to raise yet. A move to a new pan-European regulator in November and a standardized capital review are meant to once and for all expunge doubts about European bank balance sheets. Overall, continental European banks appear to have recaptured market confidence.

The same cannot be said about China and India. Publicly listed, state-owned banks dominate the financial landscape in both countries. In China, the first quarter saw these banks' share prices fall to price-to-earnings multiples of 3x and 4x, despite great profitability (ROE in the high teens), strong reported capital levels (10% plus tier one capital levels) and attractive dividend yields (6-8%). Clearly, market confidence in the reporting of non-performing loans (1-2% reported) and the true capital position is zero. Large-scale equity dilution is anticipated. The situation in India is similar.

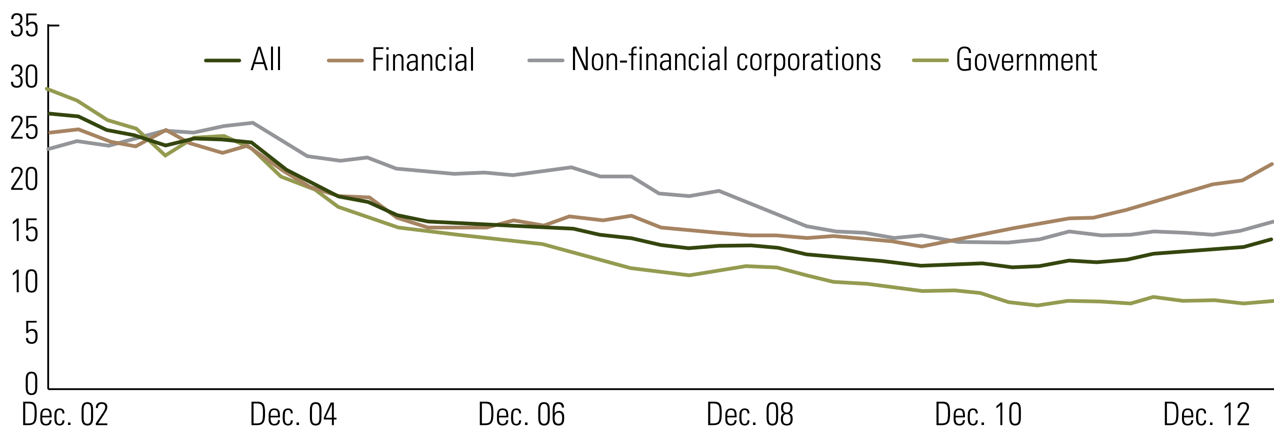
This lack of confidence was demonstrated in the first quarter with billion-dollar equity placements by State Bank of India and Harbin Bank in China. Global investor interest was non-existent and in both cases, underwriters were forced to fall back on friends and family (read government entities) to place the stock. These failed transactions put greater pressure on bank regulators and finance ministries to craft new solutions to either attract private capital or provide public capital. The capital needs are large but manageable, ranging from roughly US$30 billion to US$400 billion for India and China, respectively – assuming 10% of loans experience 50% losses.

The impact of Fed tapering

Additional pressure comes from the fact that economic growth has slowed in both countries and interest rates have risen substantially. Since the U.S. Federal Reserve began discussing its monetary policy normalization last spring, a reversal of global capital flows has struck emerging markets, forcing currencies lower and interest rates higher.

Weaker currencies in emerging markets and slow export demand from developed markets have left corporates with foreign currency liabilities in a difficult position across all emerging markets. Defaults are bound to increase in this environment; all the more so given the extended period of extraordinarily easy funding conditions that ran from 2009 to 2012 courtesy of U.S. monetary policy (See Chart 2).

Chart 2: Share of emerging market debt issued in international markets over total emerging market debt



Source: IMF

Credit markets in China are entering their first down cycle. Spreads on AA-rated five-year bonds have widened by 170 basis points over the past year. If you believe in markets, this is good news. The March bankruptcy of Shanghai Chaori Solar Energy Science and Technology Co. is a signal to creditors to do their homework or suffer the consequences. Local ratings agencies warn that the solar, steel and shipbuilding industries will see more defaults this year, and I would add property developers to that list. Local banks with concentrated exposures will surely be crushed, but Beijing will safely guard all depositors and avert contagion. Meanwhile, a Chinese bankruptcy process that includes debt conversions into equity, distressed company buyouts, outright liquidations and distressed credit trading will take shape. I expect Chinese financiers to excel at these pursuits in time (because they are going to get a lot of practice).

At last fall's Leadership Forum in Los Angeles, we argued that the new Chinese administration under Li Keqiang recognized the urgency to recapitalize its banking system and had sufficient resources and methods to successfully do so. With new people settled into new roles, the time for action has come.

What form will the emerging markets bank recapitalization take? Much of Europe took the wrong approach, reasoning that if you can't raise equity, then shrink loan books to get the loan-to-equity ratio back in line. But that route kills the economy. The U.S. got it right by forcing the banks to accept about $250 billion in capital, and China and India seem prepared to follow the U.S. lead. The only question is what the mix of government vs. private capital will be. In China, which has ample fiscal room and foreign exchange reserves, the answer is likely to be all state capital, while India will need the help of foreign investors given its weakened fiscal position. Preferred shares with warrants could provide an acceptable solution.

We believe these equity placements, as was the case in the U.S., will be viewed by the market as a both an inflection point and a liquidity event, presenting an opportunity for investors to rebuild their underweight emerging market positions. As financial conditions in emerging markets heal, the global growth tail risks will subside and we at Signature will become more positive.

Action expected

Already, a turn in emerging markets debt and currency markets is building. Strong appetite for peripheral European government bonds and high-yield debt reflects a bond community starved for yield. This will support emerging debt as investors seek out high-yielding assets elsewhere, in addition to the fact that emerging market economic fundamentals are bottoming and issuance volumes are low. A stabilized environment will draw equity capital back in, particularly if and when politicians turn more market-friendly and bank risks are lowered. The Indian election in April, alongside a dynamic new governor at the Reserve Bank of India, may provide a catalyst.

Why am I confident China is different? One, because the threshold to intervene is lower in a state-controlled and owned system; it took the risk of outright collapse to force U.S. President George W. Bush and Treasury Secretary Hank Paulson to discard their purist market ideology. Two, the progress made by the U.S. and European Union permits the Chinese to proceed with a greater degree of safety. Three, a financial catastrophe and property collapse in China that devastates citizens' wealth would have dire political consequences for the communist party. That lesson was earned in the 1940's when hyperinflation destroyed Chinese middle class wealth, opening the door for the communist revolution. It is not forgotten.

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