



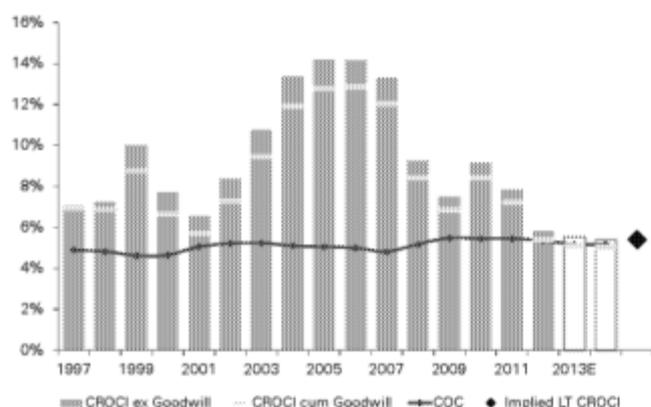
Still bearish on China

Positive sentiment overdone given risks of debt trap in corporate sector and local government

Ongoing deterioration in China real ROIC undermines growth prospects

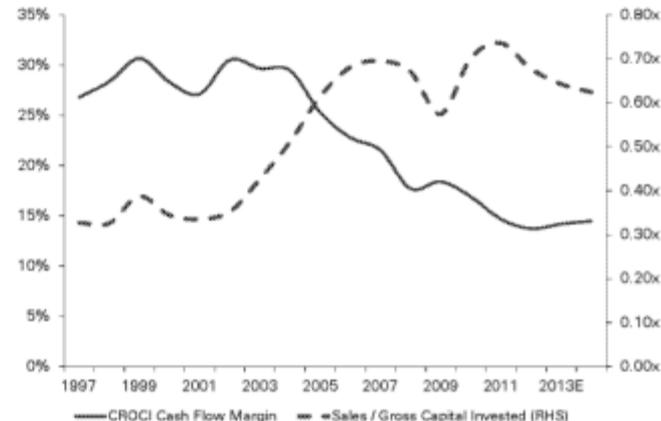
As regular readers will be only too aware, our negative view on both the Chinese economy and equity market derives from a micro-level perspective of the structure and returns of the corporate sector. For the past three years, we have been using the CROCI data provided by Francesco Curto and his team in which they analyse the real level of cash returns from about 68% of the MSCI non-financial universe as an advance warning of the extent to which productivity is deteriorating throughout the broader economy (Figure 32 and Figure 33). So far this appears to be working – most economists, including DB's own senior Asian economist, Michael Spencer, now acknowledge the extent to which the incremental capital to output ratio (ICOR) has deteriorated since the financial crisis, as the Chinese authorities have thrown capital at the economies in a so far successful attempt to maintain growth at what they deem to be an acceptable level. According to rating agency Fitch, the level of debt to GDP has risen by around eighty percentage points since the middle of 2008.

Figure 32: China ex-financials – CROCI



Source: Deutsche Bank CROCI team

Figure 33: China ex-financials – CROCI drivers



Source: Deutsche Bank CROCI team

Dysfunctional relationship between local government & corporate sector

The dysfunctional relationship between local government and the corporate sector is the underlying cause of much of the misallocation of resources in China in our view. As a result of the 1994 fiscal reforms, local government is chronically underfunded as tax revenues are inadequate to meet social and other expenditure obligations. At the same time, local government has been able to exert a relatively high degree of control over locally-based industrial enterprises and the local branches of state-controlled banks. One consequence is that wherever possible, local governments have subsidised costs for industry using household savings or what are nominally centrally controlled resources to maintain high levels of local employment and growth. This has had the effect of dragging down returns across almost all of the industrial and materials sector via overcapacity and diverting resources away from potentially more productive uses, thus undermining the potential growth rate for the entire economy.