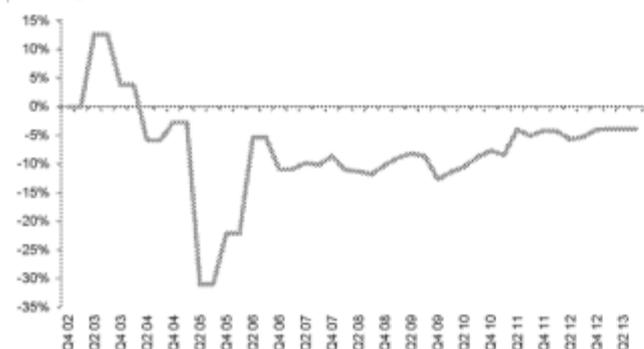


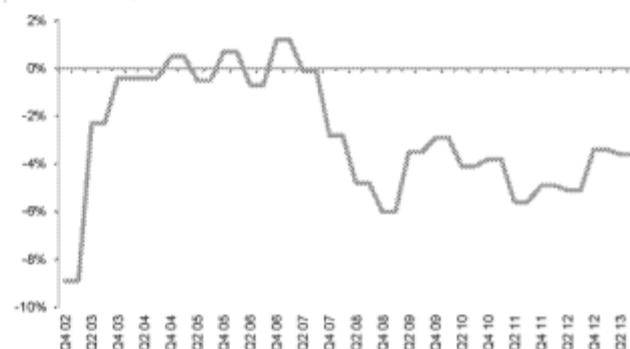


Figure 38: Chinese Materials – FCF/Sales (%), rolling 12m average



(1) Bottom-up aggregation of relevant stocks in MSCI EM index.
 Source: Deutsche Bank, Bloomberg Finance LP

Figure 39: Chinese Industrials – FCF/Sales (%), rolling 12m average



(1) Bottom-up aggregation of relevant stocks in MSCI EM index.
 Source: Deutsche Bank, Bloomberg Finance LP

No concrete measures in Plenum to deal with debt/fiscal issue

The authorities in Beijing need to completely re-engineer the fiscal system to address the issue of underfunding of local government in order to deal with the rapid build-up in debt at the corporate and local government level. Unfortunately, while the post-Plenum document devoted a lot of space to a discussion of fiscal issues, this appears to have been more a declaration of intent rather than a programme of specific measures for implementation. Michael Spencer who has a much more bullish view of the prospects for China than we do, believes that significant fiscal reforms will only take place on a ten-year time horizon; my own view is that this timescale will be far too long for borrowers and investors alike to keep pumping cash into sectors where the returns are visibly deteriorating.

Blurred boundaries between state and private sector impede financial reforms

The bulls argue that China can grow round the fiscal and debt problems by financial reforms which will help to promote the private sector at the expense of the state enterprises. Whilst this may appear a coherent strategy from a macro perspective, it breaks down at a micro level in our view because of the blurred boundaries between private and state-controlled companies, which are the main characteristic of the vast majority of privately-controlled listed Industrials and Materials companies above the SME level. Most firms which are nominally private have close links with central or local government and are in receipt of subsidised cost inputs which may include cheap loans or power, free or cheap land, and direct cash subsidies (usually booked as operating income). Moreover, the boundaries are even more blurred for many non-listed companies in many industries, as local government officials may derive personal benefit from their links with nominally private companies. The most pure private companies exist at the SME level and it is significant that many of these companies are currently struggling in operational and financial terms.

Risk of a debt trap increasing, which should eventually lead to devaluation

The post-Plenum rhetoric from the authorities in Beijing has been carefully calibrated to maintain the confidence among both corporate and financiers alike that structural reforms will enable China to grow at an acceptable level of 7% plus over the medium term without having to undergo a financial crisis. We believe that this is extremely unlikely given that there is an increasingly visible risk of a debt trap at the corporate level. Figure 36 and Figure 37 show listed Industrials and Materials companies cutting back on capex relative to