

## China's stress signals: industrial metals at risk, precious metals to shine

### Summary

- China's commitment to curb lending and reform its banking system restrains fiscal stimulus. The Chinese corporate sector is at risk, burdened by overcapacity and indebtedness.
- Producers and exporters are forced to cut back. The process of unwinding operationally and financially levered businesses undermines industrial metals, thus exposing copper.
- With a broad-based slowdown, the toughened up Chinese policy agenda is fraught with risks. FX intervention to weaken the RMB and looser monetary policy are expected to become key policy tools to smoothen the rebalancing of the economy in 2014.
- The effects will revive inflation fears, for which China is readying its savers through its bank reform. Given the inflationary macro backdrop, potentially fed on geopolitical repercussions, a renewed boost is given to precious metals.
- Investors who share this sentiment may consider the following short products from the Boost ETPs product platform ([www.boostetp.com/products](http://www.boostetp.com/products)):

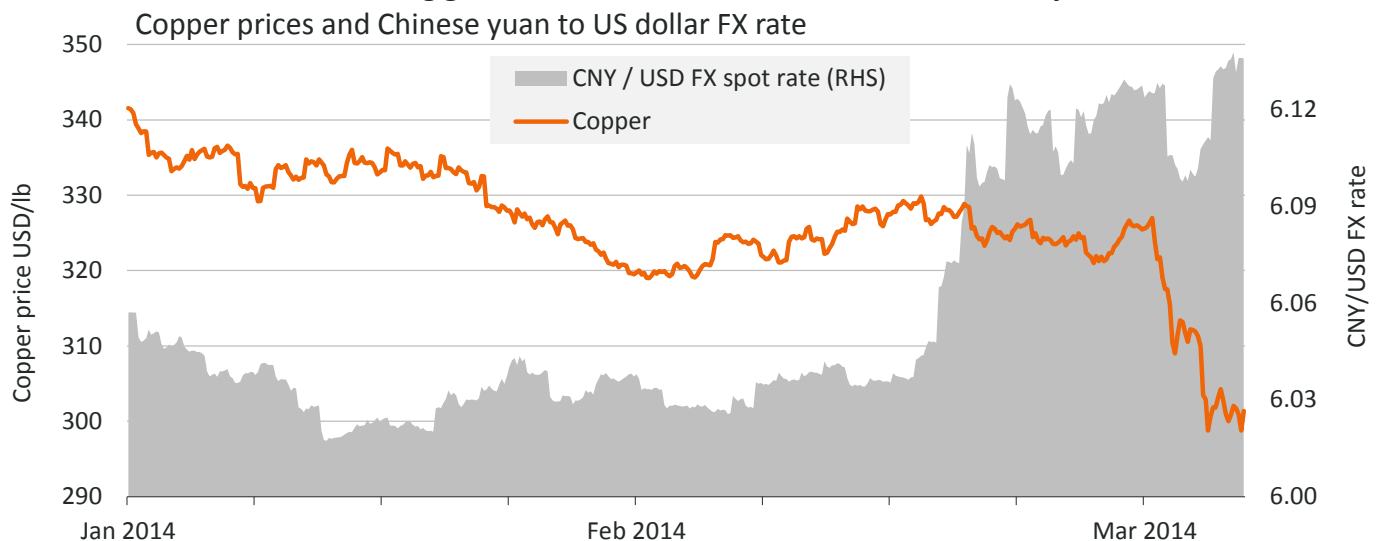
#### Shorts:

1. Boost Copper 3x Short Daily ETP (3HCS)

#### Longs:

1. Boost Gold 3x Leverage Daily ETP (3GOL)
2. Boost Gold 2x Leverage Daily ETP (2GOL)
3. Boost Silver 3x Leverage Daily ETP (3SIL)
4. Boost Silver 2x Leverage Daily ETP (2SIL)

### China in stress: stalling growth risks a more interventionist stance by China



Source: Boost ETP Research, Bloomberg. Data as at 13 March 2014

Slumping copper prices and the first set of major bond defaults this year signal stress within China's corporate sector. Amidst a broad-based slowdown taking hold over the economy, Chinese companies are suffering from policymakers' commitment to reign in credit as part of a bigger plan to reform the country's banking sector. Fraught with risks, the restrained fiscal stimulus agenda for 2014 will entice Chinese policymakers steering the rebalancing of the economy to more readily use FX intervention aimed at RMB devaluation as the main

tool to offer exporters relief. It may work to increase domestic consumption while absorbing potential sharper slowdowns in exports and investments. The looser monetary policy will imply a tolerance for higher inflation, for which China is readying its savers via its bank reform. In this environment, the outlook is bearish for industrial metals, while inflationary policy actions that risk a geopolitical backlash fuel bullish sentiment in precious metals. Investors who share this

**sentiment may consider the following short and long positions:**

**Shorts:**

1. Boost Copper 3x Short Daily ETP (3HCS)

**Longs:**

2. Boost Gold 3x Leverage Daily ETP (3GOL)
3. Boost Gold 2x Leverage Daily ETP (2GOL)
4. Boost Silver 3x Leverage Daily ETP (3SIL)
5. Boost Silver 2x Leverage Daily ETP (2SIL)

**Overcapacity and imprudent lending practises crunch copper**

Stress is building in China's corporate sector. This is evident not just in slowing industrial output, but also in the recent defaults by Shanghai Chaori Solar Energy Science and Technology Co Ltd on their 5 year debt issues. Allowing companies to default and depriving them of credit is a break from the past. The first hint of the PBOC tightening credit conditions was in June and December 2013 when it briefly deprived counterparties of short term funding and allowed interbank lending rates in Shanghai to spike as a warning shot to banks that fail to meet adequate reserve requirements. Now, with lending curtailed and growth slowing, Chinese companies are struggling to wind down the overcapacity and pay back debt. A good indicator for this is copper. Copper has been hit hard not only because investors see the metal as a good proxy for the excesses lurking inside China's construction boom, but also for the country's imprudent borrowing practices. With companies in China using copper inventories as collateral for financing risky investments, a fall in the copper price forces companies to post more collateral or sell copper. Increasingly shut off by banks from accessing funding, companies have been flooding the physical market with unwanted quantities of copper. As a result, copper has been hit hard, falling 7.7% in March and is down 12% this year.

**FX intervention underscores China's readiness for tolerating higher inflation**

China's fading growth momentum is coming at a bad time when policymakers are focused on reigning in credit growth and reforming the banking system. Given that constraints to credit growth by implication restrain fiscal stimulus, policymakers in China are looking increasingly towards FX intervention as a key tool to provide targeted relief to exporters.

While the devaluation of the RMB has started in February, clues to potentially weaken the RMB further are evident in the set of policy targets announced in China's annual National People's Congress (NPC). Chinese Premier Li Keqiang's warning on Thursday at the NPC that the economy faces severe challenges portends to China readying itself for slower growth in order to reform the banking system. With respect to reforms promoting more competition across China's established and smaller banks through its bank deposit insurance scheme, China's policymakers have started to lay the foundations for savers to absorb inflationary pressures in the future.

Inflation in China is a sensitive issue when banks offer savings account rates falling short of compensating for inflation but charge borrowing rates that are far above it. Social unrest briefly flared up in 2011 when prices of pork meat (a key staple in China) spiked following the droughts in the US (the droughts devastated corn crops on a large scale and raised the price of pork feed, of which corn is the main ingredient). Accelerating the intervention in FX markets to devalue the RMB would reignite inflation worries and risk reviving social unrest. By liberalising bank deposits, the combined effects of higher, potentially inflation-beating savings rates and lower borrowing costs will alleviate the potential higher costs inflicted on consumers as a result of loosening monetary policy. Given the relatively loose monetary targets announced in the National People's Congress, a 13% growth rate of money supply and inflation of 3.5%, enough scope for FX intervention and policy rate cuts are provided to become a key policy goal to help soften the blow on exporters as the process of economic rebalancing continues.

**Rebalancing act by China is fraught with risks**

A batch of disappointing data from China last week shows a slowdown in economic activity is broadening out. For instance, while investments (non-rural) growth decelerated to 17.9% (y-o-y), retail sales decelerated to 11.8%(y-o-y), well short of consensus (13.5% y-o-y) and well below the government target (14.5% y-o-y). It is also the lowest rate of growth since 2005. This reinforces the notion that China's attempt to transition growth away from investments towards consumption is fraught with risks and unlikely to go smoothly unless the RMB is weakened. Given industrial output is slowing to 8.6% y-o-y and showing the lowest reading since the aftermath of the 2008 credit crisis, RMB devaluation is going to be critical for exporters already

struggling to stay competitive amid double digit wage increases. The repercussions could trigger renewed geopolitical tensions between China and its trading partners. As the toughened up policy agenda is expected to further undermine sentiment in industrial metals, in particular copper, the geopolitical and inflationary risks create a unique breeding ground for precious metals to regain their appeal. The rally in gold and silver this year may continue to have legs.

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