CHINESE RATES: OPENING THE GATES
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"If only we could find a way of telling the truth without anyone knowing what actually happened." Quentin Collins, a character in "Dark Shadows", a popular American television show of several decades ago

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OVERVIEW AND CONCLUSION

Although China's economy of course differs from those of other major nations around the globe, it intertwines with them. However, China's huge debt securities marketplace receives relatively little attention from traders, analysts, and the media in comparison to those of the United States, the Euro Area, and Japan.

Debt, stock, currency, and commodity marketplace observers concentrating on matters such as Federal Reserve Board policy and the S+P 500's level and trend should extend their vision to include Chinese interest rates. China's 10 year government note, after establishing bottoms at 3.24 percent on 7/12/12 and 3.41pc on 5/10/13, has raced higher. After a brief stop at 4.02pc on 10/8/13, the note decisively crashed through 2011's 4.10pc barrier, recently breaking through 2007-08's wall around 4.60pc to reach its recent high of 4.70pc on 11/21/13. The one year government note yield likewise has ascended significantly. Chinese government interest rates probably will continue to climb higher.

Near-universal optimism reigns regarding China's economic situation and prospects. Even if the national economy is relatively robust, it may be less so than many believe. Some might argue that this Chinese government yield jump signals that the pace of economic growth will pick up. The Chinese government's increasing inclination to rely more on marketplace factors to determine yields (see its November 2013 party plenum) in part may express an inclination to tighten policy. However, the yield jump probably reflects other factors as well.

First, the trend of higher Chinese yields started nearly a year and a half ago, in July 2012 (and arguably sooner, in January 2009). Moreover, interest rate yields can jump due to significant credit (debt, borrowing) problems. Recall the European periphery troubles in Greece, Portugal, Spain, and so on in recent years; remember the experience of many emerging marketplaces as well. On Main Street, borrowers with less than stellar credit may have to bid up (pay through the nose) to get someone to loan them money. In any event, China has some noteworthy debt challenges. For example, many regional and local governments and perhaps other sectors (such as property and construction) apparently have significant debt (borrowing, financing) difficulties, which the path of higher yields probably reflects. Increasing inflation or widespread expectations that higher inflation will develop also can boost interest rates, right? China manifests signs of inflation. Keep in mind China's massive stimulus programs and substantial money supply growth in recent years.

Given China's obvious importance to the world economy, a greater than expected slowdown in the marvelous Chinese growth rate, in part due to sustained higher yields, probably would entangle with and undermine recovery prospects in other territories. Moreover, since the end of the joyous Goldilocks Era and during the dreadful international economic crisis and the subsequent recovery, many turning points in the 10 year Chinese government note have occurred around the same time as those in benchmark 10 year US Treasury and German government notes. Thus despite the yield repression policy tightly embraced by the Federal Reserve and its central

banking allies, the notable ascent in Chinese government interest rate yields underlines that the overall long run trend for yields in most key nations is probably higher.

LOOK OUT THE WINDOW: CHINA'S DEBT SECURITIES

China's "domestic debt securities" as of March 2013 were about $3.9 trillion. Of these, almost $1.3 trillion fall into the general government category. Non-financial corporations represented about $867 billion, with financial corporations over $1.74 trillion. See the Bank for International Settlements, "Quarterly Review" (9/15/13; Tables 16A and 16B). For China, domestic debt securities apparently make up most of its "total debt securities" (see Table 18). Goldman Sachs states: "China's bond market is now the fourth largest in the world" (Goldman Sachs Global Liquidity Management, "FAQ: China's Bond Market", First issue 2013, p1). "Aside from the U.S and Japanese government bond markets, the size of the Chinese market is on par with the largest government bond markets in the world." ("The Microstructure of China's Government Bond Market", Federal Reserve Bank of New York Staff Report No. 622, May 2013, p1).

CHINA'S OUTLOOK: THE OPTIMISTIC FRAMEWORK

According to the International Monetary Fund's "World Economic Outlook" ("WEO", October 2013), Chinese real GDP blossomed 10.4pc year-on-year in 2010 (and was 14.2pc in 2007; despite the worldwide financial crisis, it was 9.2pc in 2009). However, it dipped to 9.3pc in 2011 and 7.7pc in 2012. Yet China nevertheless continues to generate substantial real GDP growth. Economic output will expand 7.6pc in 2013, with 2014's edging slightly lower to just under 7.3pc. The IMF predicts real GDP will grow over the 2015-18 horizon at an enviable rate of around seven percent a year.

The IMF's WEO statistics suggest that China, unlike America and Europe, faces no big unemployment problem. Unemployment (percent of total labor force) was only 4.1 percent in 2012 and 2013. It stays there out to 2018. Looking back to 2002, the high was merely 4.3pc (2003 and 2009).

What about inflation history and prospects? According to the IMF watchdog, China's average consumer prices were 5.9 percent in 2008 (only 1.5pc in 2006). Consumer prices actually tumbled .7pc in 2009. However, they greatly leaped upward in 2011, by 5.4pc. In 2012, they climbed 2.7pc, and are estimated at 2.7pc in 2013 as well. Each year from 2014 through 2018 displays a modest 3.0pc boost.

Chinese policy makers have helped to encourage this widespread faith expressed by IMF and similar forecasts that growth will remain rather strong, that inflation will be controlled, and that unemployment (and social tension) will remain under control. The Chinese economic miracle probably generally will continue over the long run, right? Besides, the Chinese central bank declared at end September 2013 that its foreign exchange reserves were almost 3.7 trillion US dollars. Many devotees of the China growth story believe these reserves offer a safeguard to help fix any notable problems which may burst out in China.

CRACKS IN THE FAÇADE

See "Another Marketplace Tapering Tale: the China Story" (9/9/13) for an overview on the Chinese economy in general and an analysis of the Chinese debt problem in particular. Local

government financing vehicles, the real estate playground, and the shadow banking system may be particularly vulnerable on the debt front.

"Activity [in China] has been on a decelerating path. Activity has been supported by a huge expansion in credit-fueled investment—in 2012 investment reached close to 50 percent of GDP and credit reached almost 200 percent." (WEO, October 2013, Chapter 1, p21). According to the IMF, "Rapid credit growth in the shadow banking system in China remains a key vulnerability." (Global Financial Stability Report", "GFSR", October 2013, Chapter 1, p21). The GFSR points out that in early 2013, credit creation reaccelerated in China, with broad credit expanding by over 22 percent year-on-year. This extended the "sharp rise in China's credit-to-GDP ratio to almost 180 percent of GDP…It also heightens worries that the rapid credit expansion may foreshadow a marked worsening of asset quality." "Rapid disintermediation" ("surge in nonstandard instruments"; these seems to refer not only to "trust companies", but also to shadow banking in general) "carries considerable risks". The IMF says these include lack of oversight and lack of market disclosure; also, "Ties with the traditional banking system remain too close for comfort". Both local government financing vehicles and the property sector, though "important drivers of recent economic activity", "face serious questions about their financial sustainability."

In regard to the slowdown in Chinese economic growth, note also its still-weak stock marketplace (Shanghai Composite) and the bear marketplace trend in base metals (see the London Metal Exchange LMEX index). In recent months, China has fired up political disputes over territory with Japan (note the islands claimed by both countries) and other nations. In its squabble with Japan, China claims air rights in an "air defense identification zone" (NYTimes, 11/24/13, p12). China's growing willingness to expand its political (military) vociferousness abroad arguably reflects increased concerns about economic growth and political stability at home.

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To what extent may higher rates charged by the shadow banking system to local governments, corporations, and individuals be influencing upward moves in Chinese debt securities in general and government yields in particular?

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There are hints that Chinese inflation recently has been creeping higher. Review various tables in China's National Bureau of Statistics. In July 2013, the consumer price index for food was 105.0 relative to July 2012 (same month last year=100). However, other inflation categories grew less, from around flat to only up 2.8pc. Thus the national total for inflation for July 2013 was 102.7 (from another table on the NBS website), rather close to the IMF inflation estimate for 2013. However, in October 2013, national consumer prices were 103.2, with those in the food realm 106.5 (versus "corresponding period of preceding year=100").

Admittedly not all variables depict a notable inflation uptick. In fact, the producer price index for manufactured goods for October 2013 was 98.5, thus shifting down from the corresponding 2012 month. In July 2013, the retail price index was 101.7 (with food 105.1) relative to the same month last year.

What about China's labor costs? Some estimate that private sector wage growth in the China manufacturing domain was fourteen percent in 2012 (citing the National Bureau of Statistics). Even if 2013 labor costs have not spiked as they did in 2012 (the marketplace awaits statistics), they probably have increased somewhat given that inflation in general has moved higher.

The housing universe hints of inflation, at least in some important urban areas. Look at the Housing Sales Price Indices of Residential Buildings in 70 large and medium sized cities (National Bureau of Statistics). Even though Beijing and Shanghai produced property inflation on the high end of a continuum for various categories, they were not alone in having inflation.

In August 2013, the index for "newly constructed residential buildings" versus that month in the prior year (same month last year=100) in Beijing was 114.9, with Shanghai 115.4. For October 2013's year-on-year growth, Beijing saw 116.4, with Shanghai at 117.8. In August 2013, "newly constructed commercial residential buildings" in Beijing were 119.3 relative to August 2012, with Shanghai at 118.5. As for October 2013, these rose significantly, with Beijing at 121.2 and Shanghai 121.4. What about "second hand residential buildings"? In August 2013, Beijing was 116.4 relative to the August 2012, with Shanghai at 111.4. Other cities generally did not display an explosive rise in this category, most advancing around two or three pc. In October 2013, the index for second hand residential buildings in Beijing was 119.0 relative to October 2012, with Shanghai marching up to 113.2.

Surely there was very little to worry about in the US real estate marketplace in 2006-07 at the end of the Goldilocks Era, right? The same happy outlook must be true in regard to China's property playground nowadays, right? Sharp and sustained declines in housing (and commercial property) prices, real estate defaults, and drastic dives in mortgage-backed securities prices never occur, do they?

An extended period of easy money eventually may be reflected in inflation. In recent years, China's money supply growth has been rather significant, even relative to the substantial real GDP growth. According to the Chinese central bank, at end October 2013, broad money (M2) increased by 14.3 percent year-on-year. The low total for any month in year-on-year terms going back to end 2007 is 12.4pc (in January 2012), with the average gain for a given month since then nearly eighteen percent.

CHINESE POLITICS: OPENING THE GATES TO HIGHER RATES

China's political (economic) leadership surely wishes to maintain substantial control (or at least influence) over the nation's economy. However, in its increasing willingness to allow marketplaces to act more freely, the political establishment recently indicated a greater inclination to tolerate fluctuating (including higher) interest rates. Note China's third political plenum in November 2013. This November 2013 meeting advocates reforms, as evidenced by its issuing of a 60 point document titled "Decision on Major Issues Concerning Comprehensive and Far-Reaching Reforms". Reform goals include enabling marketplace forces to play a decisive role (not merely a basic) one in the allocation of resources. The plenum aims to make it easier for financial institutions to go bankrupt. Moreover, China's economic (political) guardians expect higher funding costs to arrive via liberalization of interest rates. (See the Financial Times, 11/19/13, p3; see also the Chinese Premier's FT editorial on 9/9/13, p9).

It will be interesting to see how high and how fast the Chinese leadership will permit various interest rates to rise. After all, despite the significant appreciation in recent years of the Chinese currency, the renminbi, that climb did not occur in a very brief time span. See "Currencies: the Waiting Game" (11/4/13).

Note that China's seven day bond repurchase rate, a key measure of short term liquidity in China, opened on 10/24/13 at five percent, a four month high and up 150 basis points from the end of

the prior week. In June 2013, the central bank drained money. Interbank rates spiked briefly into double digits, though the central bank then injected cash to lower them. (Financial Times, 10/25/13). These briefly soaring short term rate hikes look like a prelude to the reforms expressed by the third plenum.

Other actions indicate the authorities' concern regarding substantial credit creation, shadow banking, and related issues. Tightening of credit probably will force many borrowers to pay more to acquire financing.

Draft rules from China Banking Regulatory Commission aim to "curb interbank lending" via three "hard caps on the interbank market". (Financial Times, 11/27/13, p19). One regulation states that lending to any one financial institution should not exceed a bank's net capital. Also, lending to all financial institutions should not exceed 50 percent of a bank's total deposits. Finally, lending to non-bank financial institutions should not be more than 25pc of the bank's net capital. This draft proposal for tightening rules, as it was made only very recently, should make observers wonder how lax China has been in its "overall" credit policies in the time preceding that proposal.

Anyway, among other things, what was going on out there in the Chinese borrowing landscape? Citing Citigroup, there has been a 140pc increase in interbank assets at listed Chinese banks over the past three years. Citing Fitch, total credit in China likely will reach 218pc of GDP by end 2013, ballooning up from 2008's roughly 130pc. According to the Financial Times (11/27/13, p19), banks had exploited a loophole to boost financial system leverage. Their method: routing corporate loans through other banks and thus booking them as interbank products. Banks therefore could post less capital and thus avoid having to count the credit toward the loan-to-deposit ceiling. However, analysts believe banks under the new rules will still be able to conduct off-balance sheet lending, which will slow down but not halt the rapid credit expansion of recent years.

The IMF implied in its October 2013 WEO that "liberalizing interest rates to allow effective pricing of risks" would be good (Chapter 1, p21). Assuming the accuracy of the IMF viewpoint, China's interest rate pricing up to that time inadequately priced risks (rates were too low).

THE GREAT ESCAPE TO HIGHER RATES

The Chinese philosopher Chuang Tzu states: "External things cannot be counted on."

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In an interdependent world, the massive money printing by the US Federal Reserve Board and its yield repression policies entangle with the highly accommodative central banking policies of the European Central Bank, the Bank of England, and the Bank of Japan. The Fed seeks a sufficient amount of inflation (around two percent; also note its long run Federal Funds target), as does the ECB and the Bank of Japan. These easy money policies (and large deficit spending programs around the world since the worldwide economic crisis erupted) intertwine with similar Chinese ones.

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To what extent do Chinese, American, and German interest rate trends move together? Let's leave the starting gate and review the rate trends in recent years of China's 10 year government note in relation to the 10 year notes of the United States and Germany.

China's 10 year yield note pattern is not identical to that of America's 10 year US Treasury or the German Bund. The Fed's sustained vigorous yield repression, for example, propelled American yields lower until mid-summer 2012 (cracking its end-2008 floor); despite various twists and turns, China's interest rate low remained that of January 2009. Real GDP growth in the United States and Germany- and especially in the Eurozone as a whole- has been much less than that in China for many years, not just recent ones.

However, many key turns in the Chinese, American, and German 10 year government note marketplaces occurred around the same time. Since mid-summer 2012 (and mid-spring 2013), the rates in all three marketplaces have climbed higher together. Given the interconnected world economy, the similar movements of and recent boost in interest rates in these three key countries probably warns of a further long run rise in key yields not only in these countries, but also for the world in general.

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In the following table of 10 year government note history for China, the US, and Germany, yield highs and lows are in percentages, with dates achieved in parentheses. Sometimes several highs (or lows) occurring over a time span combine to create a significant marketplace peak (or floor). The 10 year government yields (and others discussed below) are from Bloomberg. Bloomberg wrote me that the members of its China 10 year government note index (GCNY10YR) are all China central government bonds, the index excludes local government bonds.

	China	United States	Germany
Yield High at End of Goldilocks Era	4.53pc (7/11/07) 4.59 (11/13/07) 4.61 (7/9/08)	5.32pc (6/13/07) 4.72 (10/15/07) 4.27 (6/13/08)	4.70pc (6/13/07) 4.70 (7/23/08)
Major Trough at End 2008 or Early 2009	2.70 (1/9/09)	2.04 (12/18/08)	2.85 (1/15/09)

[US yields collapsed from 10/5/08's 4.10pc final high. Recall China's massive stimulus package announced in early November 2008. In November 2008 and March 2009, the Federal Reserve announced quantitative easing (money printing) actions.]

	China	United States	Germany
2011 High in Rates	4.14 (2/14/11) 4.12 (8/31/11)	3.77 (2/9/11) 3.61 (4/8/11) 3.22 (7/1/11)	3.51 (4/11/11)
Summer 2012's Major (or Final) Low	3.24 (7/12/12)	1.38 (7/25/12)	1.13 (6/1/12 and 7/23/12)
Interim Low of Spring 2013	3.41pc (5/10/13)	1.61 (5/1/13)	1.15 (5/2/13)

[China's July 2012 bottom did not venture very close to its January 2009 major low. This July 2012 depth also did not pierce the important post- January 2009 lows of 3.21pc (7/14/10) and 3.06pc (5/15/09). The Chinese 10 year government note yield walked from its May 2013 low up to 4.15pc on 9/16/13 (compare the February and August 2011 tops). After briefly retreating to 10/8/13's 4.02pc low, Chinese yields were off to the races, reaching a new high in November 2013 (11/21/13 at 4.70pc) above the 2007-08 pinnacles. In late July 2013, China unveiled a mini-stimulus plan to boost its economy.

The yield high to date in the UST 10 year since its July 2012 trough was 9/6/03's 3.01pc. The high for the German Bund since its 2012 lows is 9/11/13's 2.09pc.The recent (10/23/13) low at 2.47pc in the UST 10 year occurred only about two weeks after China's 10 year low at 4.02pc (10/8/13). The low in calendar 2013 in Japan's 10 year government note (GJB) occurred 4/5/13 at .33pc.]

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Movements in the Chinese government one year note have moved roughly in line with those of the China 10 year government. Timing ties between Chinese short and long rates are not exact; one sector may lag the other by one or even several months. Nevertheless, underscore that the major trend in China short run (one year) yields since the 6/8/09 major low at .96 percent has been up. Noteworthy yield lows in the ongoing bear trend for the one year note include 2.15pc (6/8/12) and 2.63pc (4/16/13). China's one year note yield in late November 2013 soared to 4.29 percent (11/21/13). It thus smashed through major resistance built during the emerging worldwide disaster (yield highs at 3.89pc on 1/16/08 and 3.67pc on 9/2/08) and thereafter (9/19/11's 3.03pc top, which neighbors 2008's plateaus). At the short end of the government yield curve, the Chinese scene thus shows less yield repression by the central bank than does the American one. What happens to short and long US (and other worldwide) interest rates if US short rates begin to climb?

Also, recall the IMF statistics on Chinese consumer prices. The yield peaks in calendar 2008 and 2011 were years of significant Chinese inflation. Inflation arguably is emerging in China nowadays as well.

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Suppose US interest rates move upward significantly from current levels. Picture the 10 year US Treasury note sustaining a climb above the recent top around three percent. Will China be a significant net buyer of UST, or perhaps even become a net seller of them? What if the US dollar depreciates significantly?

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Monitor yield paths and the timing of trend changes in other key developing nations and emerging marketplaces. Of course countries differ in their policies and international situations. In any event, the Indian government bond marketplace is an important marketplace to watch. India's 10 year government note yield attained a major high during the worldwide financial crisis on 7/15/08. Compare this timing with that of Chinese, US, and German notes that year. Recently, 8/20/13's yield on the Indian government 10 year matched 2008's 9.47pc yield summit. The August 2013 high followed a spike from the 7.09pc low of 5/24/13. The major trough for the Indian 10 year note was 1/1/09's 5.24pc. Compare this time with the yield lows in Chinese, American, and German notes. The NYTimes reported (11/30/13, pB3) that India's October 2013 wholesale inflation (the most widely watched Indian price measure) rose to seven percent, with consumer inflation reaching ten pc.

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