MyStratWeekly

Market views and strategy

Ostrum ASSET MANAGEMENT

N° 109 // **April 17, 2023**

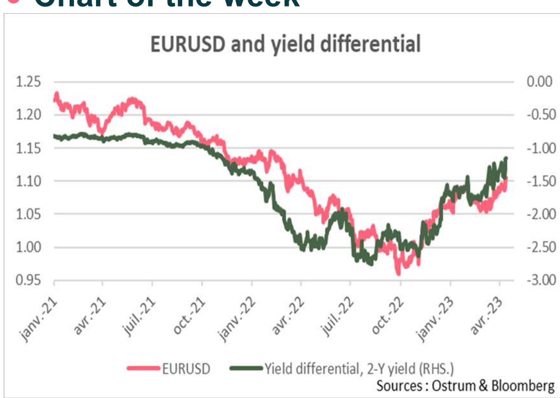
Topic of the week: China, lender of last resort of the “Belt and Road Initiative”

- **China has put in place a vast cross-border rescue plan for the BRI, to protect its own banks;**
- **The novelty is the use of PBoC swap lines for crisis management abroad;**
- **The main beneficiaries are the countries most indebted to China;**
- **However, the most opaque aspect is how its swap lines are used by beneficiaries;**
- **This system nevertheless remains nebulous and uncoordinated, which is worrying for the resolution of sovereign debt crises.**

Market review: Capitulation to the upside on equities?

- **Inflation prints at 5% but core measure still too high;**
- **Fed staff forecasts mild recession;**
- **Equities up post CPI amid weaker dollar;**
- **Tighter credit spreads in wake of strong stocks.**

Chart of the week



The euro exchange rate passed the symbolic bar of $1.10 for the first time in a year and the invasion of Ukraine by Russia. The ECB's belated response to rising prices and the dizzying terms-of-trade shock from soaring Russian gas prices had weighed heavily on the euro.

The ECB still looks like it has some ground to cover in its tightening cycle as the Fed nears its rate at 5.25%. By reducing the negative carry on the euro, the single currency should appreciate further.

Figure of the week

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Source : Ostrum AM

This represents total social financing (in CNY billions) in China in the first quarter. The scale of the financial stimulus is unprecedented.

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Topic of the week

China, lender of last resort of the Belt and Road Initiative

Between 2008 and 2021, China provided $240 billion in rescue loans to 22 countries that are part of the Belt and Road Initiative, nearly 80% of which were provided after 2016. The Covid-19 pandemic and the war in Ukraine have worsened their public finances. It is a large, rather unusual cross-border rescue plan that has been put in place by China to prevent its main debtors from defaulting and to protect its own banks.

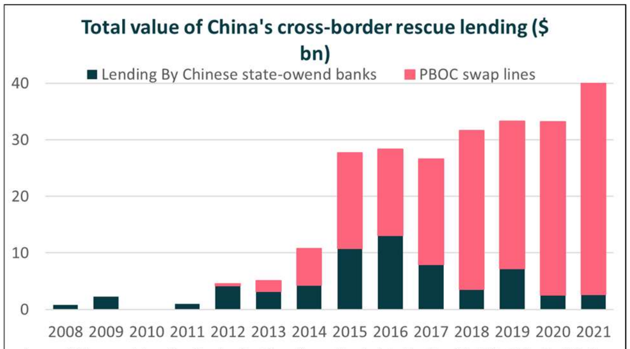
China's cross-border rescue plan

China has developed a rather unusual cross-border rescue plan for its Belt and Road Initiative, as recently revealed in the ***China as an International Lender of Last Resort*** study co-written by Sebastian Horn (World Bank), Bradley C. Parks (AidData), Carmen M. Reinhart (Harvard Kennedy School) and Christoph Trebesh (Kiel Institute for the World Economy).

For what purpose? To save its own banks.

This comprehensive rescue plan is based on two main crisis management tools:
- swap lines with PBoC;
- and loans from Chinese state banks.

The graph below shows the distribution of these two instruments in China's cross-border rescue loans between 2008 and 2021.



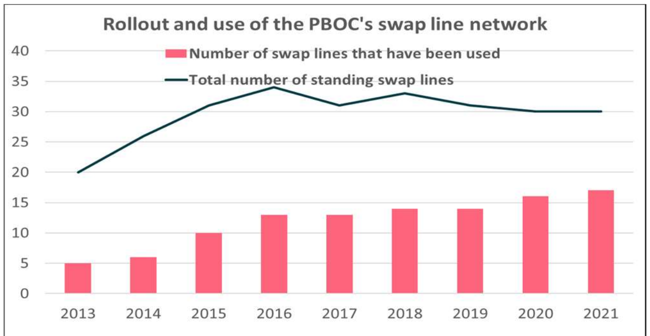
Sources: "China as an International Leader of Last Resort",co-written by Sebastian Horn (World Bank), Bradley C. Parks (AidData), Carmen M. Reinhart (Harvard Kennedy School) et Christoph Trebesh (Kiel Institute for the World Economy)

Overall, 22 countries received $240 billion in financial assistance in the form of rescue loans between 2008 and 2021. This amount rose rapidly after 2016, reaching $185 billion between 2016 and 2021, nearly 80% of the total amount! This goes hand in hand with the increase in countries in financial difficulties in China's cross-border loan portfolio. **They represented 5% of the portfolio in 2010, reaching 60% in 2022.** The Covid pandemic and the war in Ukraine have damaged the public finances of many countries, including poor countries.

PBoC's network of foreign exchange swap lines

The global network of swap lines, overseen by the Central Bank of China (PBoC), has become an increasingly important tool for crisis management abroad. More than $170 billion in foreign exchange swap lines were granted to countries in crisis.

The following chart shows the deployment and use of the PBoC swap line network.



Sources: "China as an International Leader of Last Resort",co-écrit par Sebastian Horn (World Bank), Bradley C. Parks (AidData), Carmen M. Reinhart (Harvard Kennedy School) et Christoph Trebesh (Kiel Institute for the World Economy)

PBoC had already established foreign exchange swap lines in 2009, with around 40 central banks and a combined capacity of nearly 4 billion yuan, or about $570 billion (according to the World Bank). The aim was to promote the use of the renminbi in trade and investment projects where the dollar reigns supreme.

The novelty is that they also serve as financial assistance to ensure repayment of loans when countries are in financial difficulties. Thus, as the authors show, of the 17 countries that have used bilateral swap lines, only 4 countries have done so without economic and financial difficulties.

Emergency loans from Chinese state banks

70 loans were granted by Chinese state banks to 13 developing countries, for a total of 70 billion dollars. These are loans denominated in dollars that allow to repay the loans, including, of course, those owed to Chinese financial institutions. Egypt benefited in 2016 and Belarus in 2019.

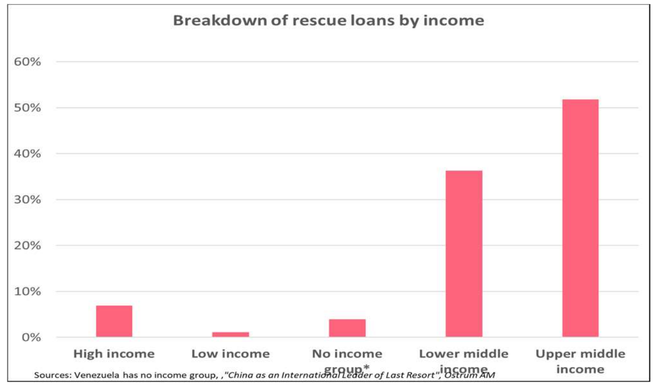
Facilities for prepayment of raw materials and participation in projects in difficulty

The facilities for the prepayment of raw materials are made with state-owned Chinese oil and gas companies such as China National Petroleum Corporation (CNPC) and China International United Petroleum and Chemical Co. Ltd. (UNIPEC). This financial aid consists in paying in advance to the exporting countries of raw materials in great financial difficulties. In 2009, Ecuador benefited from this facility for its oil. The country, which was not in financial difficulties, declared two of its international debts “illegitimate”, and then, when their prices had fallen, bought them through financial intermediaries. Ecuador had bought its own debt at 35 cents per dollar, which it declared “illegitimate”, with a possible participation rate of 90%!

Finally, the bailout may also take the form of equity investments in troubled projects (such as China’s investment in Laos’s electricity grid in 2020) or purchases of sovereign bonds on the secondary market.

Which countries have received a rescue plan from China?

China has targeted a limited number of potential beneficiaries, as almost all rescue loans have been granted to low-income or middle-income countries. The chart below shows the distribution of rescue loans by country income.



Middle-income countries (88% of China’s rescue loans) were the main beneficiaries. They also account for 80% of the $500 billion in total Chinese loans under the Belt and Road Initiative!

On the other hand, poor countries account for only 1.2% of Chinese rescue loans. These countries have generally been offered grace periods and extensions of maturity, instead of rescue loans. They represent 20% of China’s overseas loan portfolio.

China, a competitor to other lenders as a last resort?

Similarities to the American bailout during the 1980 Latin American debt crisis…

China’s bailout plan is like the one the United States put in place during the Latin American debt crisis of the 1980s, during which a significant number of countries could no longer repay their debt. Indeed, the United States had taken the initiative to organize an “international lender of last resort”, a cooperative rescue effort between commercial banks, Central Banks, and the IMF. Under the program, U.S. commercial banks had agreed to restructure countries' debt, and the IMF, along with other international organizations, had lent funds to repay debt interest, but not principal, on their loans. The plan also aimed to save American banks and exporting companies by targeting countries that were heavily indebted to the United States.

… But with notable differences

China’s rescue loans are still far from exceeding those of the International Monetary Fund (IMF). In comparison, China provided $40 billion in rescue loans in 2021, while the IMF provided $68.6 billion in loans in the same year. However, this amount could rise rapidly as poor countries face many headwinds, such as rising food prices and rising fertilizer prices.

On the other hand, the terms of the rescue loans granted by Chinese state banks are less advantageous than those of the IMF. For example, an IMF loan has an interest rate of 2%. The average rate associated with a Chinese rescue loan is 5%, more than double that of the IMF.

Finally, under the Fed's swap lines, the main beneficiaries are the Central Banks of rich countries, while the spectrum of Chinese swap line beneficiaries is wider, ranging from the ECB to poor countries.

Impact on investment strategy

Risk of sovereign risk distortion

The most opaque aspect of these swap transactions is exactly how funds are used.

The question is whether Central Banks are using PBoC's (undeclared) swap lines to artificially inflate their foreign exchange reserves or to repay their debt.

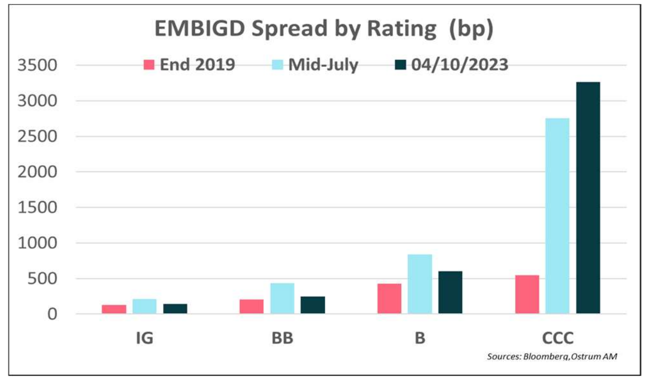
Indeed, if a borrower can use PBoC swap line draws to repay debts denominated in dollars and euros, then this is particularly useful during a balance of payments or debt crisis. For example, according to the authors' calculations, swap debt to PBoC represents half of Argentina's gross reserves. The country was able to use a portion of the funds drawn from its swap line to repay old debts, according to the study.

However, if a borrower can only use the RMB liquidity of its PBoC swap line as an artifice to strengthen its foreign exchange reserves, then its net reserve position and ability to service its debt remains unchanged. Turkey and Laos have indeed used swap lines to inflate their foreign exchange reserves, but do not appear to have spent the money, according to the authors of the study.

Nevertheless, there are signs that China could be more cautious to managing access to its swap lines. For example, a $1.4 billion swap line has been frozen for Sri Lanka until the country accumulates enough foreign exchange reserves, equivalent to three months of imports, according to the IMF report.

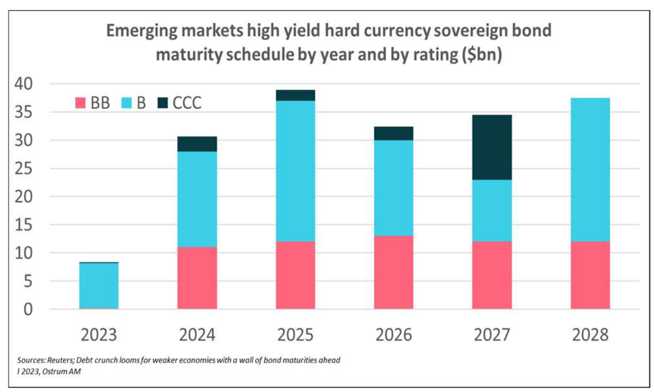
Investment opportunities at the mercy of China and the IMF

The chart below shows the risk premiums (spread) by rating categories of the JPM EMBIGD index.



Risk premiums for well-rated countries, "Investment grade" (IG, 52 % of the index) and countries rated "BB" have returned to their end-2019 levels. However, the risk premiums of countries rated "CCC" (nearly 7% of the index) have multiplied by 6 since the end of 2019!

These poor countries have been able to cope with the Covid-19 pandemic and the aftermath of the war in Ukraine, thanks to financial support from multilateral and bilateral creditors. However, their maturing international debt will increase by 2024, reaching $30.6 billion, almost four times the amount in 2023, as shown in the chart below.



It is therefore urgent to find a solution to mitigate the threat of severe debt distress in the most vulnerable countries.

Under the G-20 common framework for renegotiating the debt of poor countries created in 2021, the China guarantee is a prerequisite for the disbursement of IMF financial support. However, China did not want to participate in the negotiations, preferring to deal directly with its debtors and in an opaque manner. China recently announced a moratorium on Sri Lanka's debt, a prerequisite for unlocking the IMF's $2.9 billion bailout package. These are positive elements that should give these countries room to manoeuvre to regain economic growth. This should result in a reduction in risk premiums. These countries also need to accelerate structural reforms to achieve sustainable long-term growth. Improving country governance is a key element. For example, Sri Lanka is currently passing a law to fight corruption, which is causing social tensions in the country.

Conclusion

China has quickly played a role as a lender of last resort for countries in crisis by offering an alternative to traditional lenders such as the IMF or the World Bank. However, its new global rescue system for cross-border lending is opaque and uncoordinated. Indeed, its strictly bilateral approach has made coordination with other lenders of last resort more difficult, while sovereign debt crisis resolution usually requires some level of coordination among creditors. The spring meetings of the World Bank and the IMF, which bring together asset managers and policymakers, will hopefully pave the way for a solution to mitigate the threat of high indebtedness in the most vulnerable countries, which is the key issue. And will also pave the way for investment opportunities.

Zouhoure Bousbih

Market review

Capitulation to the upside on equities?

Falling inflation fuels rebound in risky assets as Fed staff see mild recession.

According to the minutes of the last FOMC meeting, Fed economists are forecasting a mild recession in the middle of the year… which the equity markets welcome with delight as this hypothesis reinforces the probability of cuts in the Fed funds rate. The market's reading of March inflation numbers also reflects this glass-half-full sentiment which both weighs on the US dollar and adds fuel to long positioning in equities. The Nasdaq continues to shoot higher, posting +20% gains in 2023 on the eve of the earnings season debut. The T-note is hovering around 3.50%. The expected interest rate cuts induce a steepening bias (+13 bp for one month on the 10-30 year spread). In the euro area, fixed income market participants once again focus on inflation, so that the yield on Schatz is up 26 bps to 2.82%. Unlike Treasuries, the curve continues to flatten. Both credit and sovereign debt benefit from the gradual reduction in interest rate volatility. Tensions are also easing on swap spreads. Inflation breakevens are widening in the rise in rates, taking note of the rebound in oil prices beyond $86 per barrel of Brent. The weakness of the US dollar is the flipside of the revaluation of all the G10 currencies, including the euro ($1.10) and sterling ($1.25). The Chinese yuan is also appreciating despite strong monetary stimulus. The foreign exchange market is coming alive after a surprisingly calm month of March given the wild movements in short-term interest rates.

The US economy is expected to grow by about 2% at annualized rates in the first quarter. Despite the decline in retail sales in March, household consumption remains the main driver of aggregate demand. The jury is still out on the inflation outlook. The decline in headline inflation (5%) now intersects with the underlying measure (5.6%). Corporate investment in equipment is moderating. This foreshadows a deceleration in GDP growth to 1% in the second quarter and flat growth in the second half. This GDP growth pattern appears consistent with the mild recession scenario advocated by Fed research. The rise in unemployment towards 4.5% at the end of the year requires, on the other hand, net destruction of jobs that is difficult to imagine at this stage.

In the euro area, inflation remains the main concern. Food prices are offsetting the easing in energy prices and wage demands leave little room for a rapid decline in underlying inflation. Final consumer price inflation in France was even rounded up to 6.7% in March (HICP). In China, the economic recovery is taking shape thanks to the service sector and the recovery of Chinese exports to Southeast Asian economies. The credit impulse, including household mortgages, is driving the rebound in aggregate demand. The trade surplus reached $88 billion in March.

The equity market is therefore banking on a slowdown strong enough to bring about a drop in inflation and consequently open the door for monetary easing. Under these economic conditions, firms would likely see their profits decline but equity valuations would be supported by lower interest rates. This fragile market equilibrium motivates speculative investors (including CTAs) that support the rise in equities. That being said, money market funds still attract strong inflows ($400 billion in the past month) from bank depositors or benefit recipients looking for a market entry point. An upward capitulation in equities cannot be ruled out given the amounts on the sidelines to be put to work, especially since the behavior of profit margins is atypical in this economic cycle. Fixed income markets are hesitating between potential monetary relief and a status quo that is harmful to future bond performance. However, the Fed seems determined to raise interest rates one last time by 25 bps in May. In the short term, the market will try to force the Fed’s hand. This requires breaking the 3.30% floor on the US 10-year note yield… but the latest speculative market positioning data rather attests to a resumption of short bets. Under the influence of the US leading market, the Bund yield is moving about 2.40% ignoring the latest activity or inflation indicators. The ECB's lag in its monetary cycle suggests that the T-note spread may continue to tighten. Sovereign spreads have been remarkably stable for several weeks. Italian BTPs, which enjoy the best sovereign bond performance in 2023, is moving at the bottom of the range around 185 bps on 10 years’ maturities. Fiscal issues are put aside and even the start of QT did not have a negative effect on credit spreads.

The euro area credit market has been undergoing outflows from investment grade bond funds since the end of the first quarter, but without any signifcant impact on spreads, which narrowed by 5bp over one week. The primary market slowed down despite the positive market sentiment due to the start of the earnings season in the United States. Nevertheless the financial sector managed to issue 12 billion euros, including around 6 billion in covered bonds. Big banks got the ball rolling with generally very good earnings. On high yield, spreads tightened by 21 bps over five sessions, falling within 500 bps in the wake of the powerful rebound in equities. European high yield funds also record outflows in the same vein as IG. These flows undoubtedly reflect profit taking.

In the foreign exchange market, the euro-dollar broke through the $1.10 ceiling. The US dollar, a barometer of risk appetite, is down against all G10 currencies. Note, however, the good performance of gold, which detonates in this risk-on environment.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	17-Apr-23	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	2.9%	+34	+51	+13
EUR Bunds 10y	2.44%	+26	+33	-13
EUR Bunds 2s10s	-46.6bp	-9	-18	-26
USD Treasuries 2y	4.12%	+11	+29	-30
USD Treasuries 10y	3.51%	+10	+9	-36
USD Treasuries 2s10s	-61.4bp	-1	-20	-6
GBP Gilt 10y	3.67%	+24	+18	-1
JPY JGB 10y	0.48%	+2	-3	+0
€ Sovereign Spreads (10y)	**17-Apr-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	56.42bp	+5	+6	+2
Italy	184.15bp	0	+4	-29
Spain	103.49bp	-1	+2	-5
Inflation Break-evens (10y)	**17-Apr-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2.52%	+10	+17	-3
USD 10y Inflation Swap	2.56%	+4	+4	+3
GBP 10y Inflation Swap	3.86%	+5	+2	-5
EUR Credit Indices	**17-Apr-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	161bp	-8	-8	-6
EUR Agencies OAS	76bp	+0	+2	-3
EUR Securitized - Covered OAS	83bp	-6	-1	-1
EUR Pan-European High Yield OAS	485bp	-31	+8	-27
EUR/USD CDS Indices 5y	**17-Apr-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	81bp	-7	-19	-9
iTraxx Crossover	429bp	-33	-64	-45
CDX IG	74bp	-4	-13	-8
CDX High Yield	458bp	-26	-69	-26
Emerging Markets	**17-Apr-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	478bp	-9	-2	+26
Currencies	**17-Apr-23**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.099	1.206	2.999	2.7
GBP/USD	$1.242	0.315	2.037	2.8
USD/JPY	JPY 134	-0.299	-1.612	-2.2
Commodity Futures	**17-Apr-23**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$86.3	$2.1	$13.5	1.81
Gold	$2 012.3	$20.8	$23.0	10.32
Equity Market Indices	**17-Apr-23**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	4 138	0.79	5.64	7.8
EuroStoxx 50	4 391	2.15	8.01	15.7
CAC 40	7 520	2.78	8.58	16.2
Nikkei 225	28 515	3.19	4.32	9.3
Shanghai Composite	3 379	1.91	3.94	9.4
VIX - Implied Volatility Index	17.07	-7.23	-33.09	-21.2

Source: Bloomberg, Ostrum AM

Additional notes

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