

Weekly Market Flash

China In Trouble For the Right Reasons

June 29, 2018

It's been one of those weeks where a virtual hailstorm of headlines overwhelms the normal mechanics of cognitive functioning. So much so, that one could easily turn one's attention away from China for a brief second and turn it back to find that the currency has plummeted in a manner eerily similar to that of August 2015. The chart below shows the path of the renminbi over this time period, along with the concurrent trend of the Shanghai Composite stock index.



Source: MVM Research, FactSet

Remembrance of Shocks Past

In the chart above we highlight the two “China shocks” that rippled out into global markets in 2015 and 2016. The first was a sudden devaluation of the renminbi in August '15, a move that caught global investors by surprise. The domestic China stock market was already in freefall then, but the currency move heightened broader fears of an economic slowdown and eventually pushed the US stock market into correction territory.

The second China shock happened just months later, when a raft of negative macro headlines greeted investors at the very start of the new year. Another global risk asset correction ensued, though the drawdown was relatively brief.

Considering those past shocks, though, investors are reasonably concerned about the implications of this week's moves in both the renminbi and Chinese equities – which briefly entered bear market territory earlier this week. Pouring fuel on the flames, of course, is the addition of an X-factor that wasn't present for the previous shocks – the looming presence of a potential trade war. Coupled with renewed concerns about China's growth prospects – with or without a trade war – there is a strong sense in some camps that a third China shock may reverberate out into the global markets.

Less Is More

We understand the concerns, particularly as they are far from the only news items creating a general sense of uncertainty in the world. But our sense is that China's growth troubles are actually good – good for the country and ultimately good for the global economy. What has slowed down in China this year – well, ever since last autumn's Communist Party Congress, in fact – has been leveraged fixed asset investment. This is where state-owned enterprises raise copious amounts of debt and invest in infrastructure and property development projects for the primary (seemingly) purpose of beefing up the headline GDP number.

Beijing's economic authorities have been trying to rebalance the economy away from these repeated trips to the borrow-and-build trough since 2014, but the turbulent domestic financial market conditions of 2015-16 weakened their resolve. The deleveraging commitment got a new breath of life with President Xi Jinping's consolidation of power after last October's party congress. With little to worry about politically, Xi and the party formalized the model of "quality over quantity" in the growth equation. So while fixed asset investment and borrowing have slowed considerably, consumer spending has increased. The service economy is growing as a percentage of overall GDP. In the long term, this is a more sustainable model for the world's second largest economy than unwise lending for the construction of bridges to nowhere.

The Trade Factor

Yes, but what about the trade war? Well, it's true that uncertainty about the future of trade in general is a clear and present factor in the state of world markets. The unnerving headlines seem unlikely to go away any time soon – the latest today being Trump's apparent intention to take the US out of the World Trade Organization (without really understanding what that organization is or how, legally, the US would untangle itself from the organization that is the successor to the General Agreement on Tariffs and Trade framework the US itself architected at the Bretton Woods meetings of 1944).

We haven't had a global trade war since the 1920s, though, so while it is certainly possible to model alternative scenarios, there's not much in the way of actual data to support persuasive analysis of potential winners and losers. In the meantime, as regards China, the recent patterns in the stock and currency markets merit some concern, but the underlying story is not as negative as some of the present day commentary would suggest.

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