MV Capital Management Weekly Market Flash

Is The "China Turn" At Hand?

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The world's second largest economy has influenced many asset markets beyond its own borders this year, from emerging markets equities to energy and industrial materials commodities. Much of that influence has been negative. The MSCI Emerging Markets index was down -8.4% for the year to date as of August 8, and continues to be the bane of any diversified equities portfolio manager. The Dow UBS Commodity index is off more than 10% for the same time period. But with record volumes of commodities imports by China in July, many investors are wondering if the turn is at hand.

Beware the False Turn

Those out of favor asset classes have come to life in the past week or so. The S&P Select Materials Sector has shifted from laggard to leader, and copper prices jumped nearly 3% yesterday as the July data points rolled in. Shares in emerging markets and China-correlated developed markets like Australia have also perked up. But a closer look at the latest data, while offering evidence that a major stall-out of the economy is likely not at hand, does not make for an open-and-shut case.

The 9.7% growth in industrial production, well in excess of expectations, comes at the same time that Chinese retail sales ticked down a notch. Long term China watchers focus on signs of economic rebalance, where domestic consumption gains ground over the traditional engine of export-focused investment in production and manufacturing. As a percentage of GDP, consumption in China is still about half what it is in the US. This month's production numbers don't do much to change that equation.

Commodities in Surplus

The record commodities purchases come at a time of overcapacity for many industrial inputs from iron ore to nickel and zinc. July's activity may well reflect decisions by large Chinese enterprises to stock their inventories while prices are favorable, which in turn could indicate weaker demand in the months ahead, particularly if overall growth proves to be modest. Much of the global overcapacity comes from years of extensive investment in industrial commodities. As China grew at breakneck speed during the 2000s international metals and mining companies invested heavily into production of the raw materials that power Chinese factories. It may be awhile yet before the resulting surpluses abate.

Plenty of Ground to Gain

From an asset allocation standpoint there may be more to lose than to gain by calling the China turn now. The out of favor asset classes in commodities and emerging markets lag the S&P 500 in many cases by more than 20%. That's a lot of ground to make up – and a lot of time to monitor successive data points to validate (or not) the directional trend. China will continue to be an important story over the remainder of 2013, and one that we will continue to monitor – carefully and prudently.

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