Neil Dwane on...
China

The perspective from the Global Strategist

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China's Year of the Goat goes out with a Bang! Will the Year of the Monkey Swing Better?

In the first full week back at work, the Chinese A share market has now been twice suspended using new "circuit breakers" which have now been withdrawn. The apparent causes for these suspensions have focused on the small devaluation which we have seen this week in the Renminbi, akin to the turmoil last summer, which has unnerved domestic and international investors; or to the poor economic data which has been revealed this week, and which simply shows that China's rebalancing is actually slowing aggregate GDP growth; or lastly, to the impending sale of stakes in Chinese companies by insiders, who have been banned from reducing their holdings since last summer's market turbulence.

However, it is perhaps more important to assess why there is such nervousness both within and without China.

From within

It has been clear for some time that the Chinese economy has been both slowing as global growth slows and as the strength of the Renminbi impairs export growth, as China and the USA have allowed others, especially Japan and Europe to retain exports with their weaker currencies and has been affected by the continuing and pervasive yet popular "anti-corruption" campaign which has resulted now in a near freezing of any Central or Local Government decisions for investment and planning. This has increasingly affected both the large State Owned Enterprises and the private sector suppliers, frustrating all. We, however, anticipate that the next 5 Year Plan will be agreed and start to be implemented in Q2 2016, producing a stronger H2 2016 into prospect. The scale of ideas in the next five years include the well-known "One Belt, One Road" as well as huge investment into pollution and waste control, agricultural efficiency and c 500bn USD of railway infrastructure.

As China has now seen 52% of its population move into urban areas, we continue to expect to see reforms to the "hukou" system which will grant rights of residence to many which should in time stabilise property and consumption markets. We also anticipate that the emerging middle class, all 300mn of them, will experience rising income levels which will be spent on better food, travel and other services which will foster the rebalancing away from exports and manufacturing. Importantly, we therefore conclude that it is not in the interests of the Chinese consumer to devalue the Renminbi substantially as that would impair their spending power.

Understand. Act.

From without

China has been "the source" of global economic growth over the last five years and we have already experienced in global commodity markets how sensitive the world is to changes (downwards) in China's appetite for oil, iron ore and related materials. Thus international investors, and local Asian ones especially, are extremely sensitive to the pulse from China's economy as well as to the diligent economic management shown from Beijing. This longer term economic track record though can be juxtaposed poorly in the last year with their inability to manage their Equity markets, which has undermined confidence in China's financial provenance especially as there is now extraordinary levels of debt being consumed by the economy, especially the old parts of the economy. Thus fears over a credit collapse have been growing with all the related consequences for Singaporean and Hong Kong banking systems and which have been sustained by the monthly updates on China's Official Reserves, as evidence of whether they are selling down their reserves.

We have seen inventory levels across Asia become very elevated as many economies and industries have maintained production and fought for market share by cutting prices which has led to significant traded goods price deflation. This is clearly unnerving investors as leverage around the region has increased substantially in the last five years and is often funded in US Dollars which has seen continuing strength as the Federal reserve starts to raise US interest rates, albeit tentatively.

China has recently gained acceptance into the IMF's Strategic Drawing Rights bestowing serious global credibility to the Renminbi which will in time allow c 500bn USD to be re-allocated into their currency. Over the medium term, we therefore expect the capital outflows from China, much derived from the fears over the anti-corruption campaign, to be matched by Sovereign and Central bank reserve inflows.

It seems clear that the real global investor fear around China relates not to its slowing economy, which has been widely documented, but to the fear of a serious devaluation of the Renminbi akin to that of the Yen in 2013-2014 and the Euro in 2014, both experiencing falls of over 30% in value. Such a fall in the world's largest exporter's currency could herald a collapse in traded goods prices that would generate global inflation levels of minus 5% or worse, and would undermine all Central Bank Quantitative Easing policies at a stroke. We remain sanguine about this disaster scenario and believe that Chinese Monetary Policy is allowing the Renminbi to be "more volatile and less predictable" than the managed peg of the past, and it is Mr Market's "Spiderman senses" which need to be recalibrated!

The rebalancing of China was already a key theme for 2016 for all industries and especially all economies in Asia who have prospered from the Chinese rising tide for the last 25 years. Just as Europe has been restructuring through austerity for the last 3-4 years, so Asia itself must respond by generating more internal demand and services to cope with the Chinese rebalancing as well as hoping that Prime Minister Modi can bring India online soon.

After all the volatility of the last year or so, Chinese equities in many cases look attractively valued and offer good dividend yields and, as we highlighted in our 2016 Global Outlook, we expected all asset classes to become more volatile in 2016 as global monetary policy diverges. Thus such "down days" could be seen as opportunities to invest, provided that specific research and insight as well as risk awareness has been duly done—once again active investment is key.

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We welcome your comments, thoughts and opinions. Follow us for the latest market updates!

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