The China Effect

- China’s evolving economic realities and its recent currency devaluation carries disinflationary and contractionary implications for the global economy while contributing to market volatility
- Global growth remains tepid, but a China hard landing or a repeat of 1997-1998 Asian Crisis is unlikely
- Nevertheless, investors should continue to de-emphasize emerging markets and avoid commodities

Global growth fears prompt recent market volatility with a direct focus on China

The kids may be back at school, but we are off to a volatile start this week. China, the world’s second-largest economy, seems to be the root cause of panic selling on Monday, which subsequently led to additional Chinese monetary stimulus measures. The initial market downturn was prompted by the People’s Bank of China’s (PBoC) small, yet significant, devaluation of the yuan last week. This change raised fears that China’s growth may be slowing faster than expected and could lead to a global recession. Of course, events in mainland China have also been accompanied by renewed uncertainty over the timing of the US Federal Reserve rate lift-off, a steady decline in commodities and economic deterioration across emerging markets (EM). Combined, these forces are undermining investor confidence, increasing deflationary pressures and weighing on global growth.

Beyond raising serious doubts over China’s near-term growth outlook, the yuan devaluation also sparked a flurry of policy responses in other countries—namely looser monetary, credit and exchange rate policies—aimed at addressing the current global growth conundrum. Importantly, the move has boosted expectations that further currency depreciation in the yuan will be necessary, thus raising the risk of more damaging currency volatility. Also, last week’s Chinese manufacturing data revealed an unexpected decline—which follows persistent weakness in electricity consumption rates, cement production, steel output and railroad freight traffic trends. These weak trends speak to ongoing industrial overcapacity concerns and generally weak global trade. Lastly, the sharp downturn in China’s stock market has raised concerns over the government’s ability to contain recent capital outflows, while remaining committed to financial market liberalization.
China is undergoing a complex adjustment, but the risks of a hard economic landing appear low

China finds itself in the midst of a complex macroeconomic adjustment as it attempts to rebalance toward a consumer-based economy at a time when it must still address excessive leverage, excess capacity, tighter liquidity, and reduced global demand for its exports. Further, the significance of these developments take on greater implications when one considers China’s role in the world economy. The country accounts for close to 18% of global GDP and accounts for over 50% of commodity imports.

While China’s slowdown is likely to persist, we do not believe that its economy is at risk of a hard landing. Importantly, Chinese housing, consumer and lending figures still look fairly solid and thus further support evidence of an economy pivoting towards a consumption-driven model. Secondly, the latest policy manifestations—such as devaluation of its currency and monetary policy easing—still speaks to a policy directive geared on reform and macroeconomic rebalancing. Moreover, even amid the ongoing capital outflow spree, China boasts over $3.6 trillion in foreign exchange reserves, or around 30% of the world’s total. That said, while a weaker exchange rate should aid export growth, it may also undermine consumer purchasing power given higher import prices. Ultimately, recent measures may alleviate some of the economy’s short-term growth pressures, but it also prolongs the country’s dependence on exports and investment.

Lastly, this is still China we are taking about, an economy with vast degrees of policy flexibility and maneuverability that can be easily deployed to address both external and domestic shocks, and further facilitate the reform implementation process. Fiscal, monetary and exchange rate policy tools are readily available, and already at work, in order to ensure against a hard landing, and even worst, a major social upheaval. The PBoC today not only cut the reserve requirement but also reduced lending and deposit rates. Ultimately, while we would not characterize Chinese growth risk as overdone, we also do not believe a material hard landing is in store for China any time soon.

We do not expect a repeat of the 1997-1998 Asian financial crises

Importantly, with the current global rout heavily concentrated in Asia, some commentators are drawing parallels with the Asian financial crisis of 1997-1998. We do not believe current global market dynamics are anywhere similar to the conditions that existed then. EM currencies at that time, especially in Asia, were either pegged or fixed to the dollar, creating constraints on policy response, while regional financial systems were lacking oversight and were generally less stable. Despite noted macroeconomic erosion across the EM universe in recent years, the region now boasts flexible exchange rates, an impressive chest of currency reserves, and visible improvements in fiscal and debt dynamics. Ultimately, these conditions have and should enable many developing bloc economies to successfully navigate the myriad of external and domestic shocks pressing the global economy.

Conclusions

A few weeks ago we detailed our growing concerns over the tepid state of global economic conditions. In particular, trends have been weighed down by the soft-patch in global manufacturing, reduced export momentum and still-fragile demand trends across the world economy. All in all, we noted that global growth was likely to remain lower for longer, but that the threat of an outright recession in the global economy seemed rather improbable.

While the global economy is indeed exhibiting limited upside potential in the second half of the year, the confluence of lower oil prices, still-low global interest rates, and more competitive currencies, should soften the blow. For China, a more competitive, market-friendly exchange rate is certainly welcomed, but it comes with rising volatility and deepening policy uncertainty. Such a backdrop is bound to fuel continued uncertainty and market volatility as investors digest the new realities of the Chinese economy and a transition in Fed policy. We therefore continue to favor developed market equities, mainly the US, amid a more constructive outlook, while maintaining that upside potential in global bond yields should remain limited. Importantly, such trends continue to drive our fundamental de-emphasis of EM and aversion to commodities.
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