AQUILA

Flash

China is a fertile ground for those wanting to spread panic among investors

Just as investors said their farewells to the latest Greek crisis, market sentiment took a fresh dive. Those seeking explanations have found one in China. But a closer look suggests that the slump of the Chinese stock market since mid-June need not spell serious trouble for the development of the Chinese economy. Lower growth rates in China should not surprise investors as they are the inevitable consequence of a shift in China's growth model from an investment-led economy to one more based on consumer spending. We are suspicious of market commentary that sees developments in China as the cause of recent turbulence in stock markets elsewhere. Considering the world economy as a whole, we don't view the basic macroeconomic and monetary policy trends as having changed significantly from what they were a few months ago. Given this assessment, we are sticking with the investment strategy that we have previously communicated.

Some view China as the cause of recent weakness in stock markets elsewhere.

After global policy-makers had given the green light for negotiations on a third Greek bail-out package and a bridging loan to Greece of 7bn. euros, investors marked the latest Greek crisis as finished. Since then, however, investor sentiment has steadily deteriorated. Thus the German DAX index has lost over 5% since July 20th. Looking for explanations, we notice that problems in China – the slump in the Chinese stock market or weaker than expected trends in the Chinese economy – have been cited in recent comment on markets.

On consideration, China's stock market crash does not appear too threatening.

One should remember that the Shanghai stock market index rose by around 160% between the middle of last year and the middle of this. This gives some perspective to the 30% decline in recent weeks that has been making the headlines. The fact that the index is still up over 70% on year-ago levels is scarcely commented on. Relative to the start of this year investors can still book a gain of nearly 20%. Analysts suggest that the market is undergoing a classic technical correction in that it is testing its 200-day moving average. Viewed analytically like this, the behavior of the Chinese stock market does not appear so troubling.

The decline of Chinese stocks should not impact Chinese consumer spending.

It is frequently argued that the weak stock market in China will impact the broader economy by undermining consumer spending. But this is unlikely on several grounds. First, consumer spending did not seem to be particularly affected by the stock market's previous gains so it should not be much impacted by the more recent decline. Second, even at the peak of Chinese interest in their stock market, only around 50 million persons, or less than 4% of the population, were active in it. Third, China' stock investors are mainly well-to-do and therefore do not immediately need to cut back on spending if their wealth declines. Moreover, one should remember that over two thirds of total value of Chinese stocks is in the hands of the state, which further limits the impact of stock price movements on private investors. On these grounds, we believe that recent developments in the Chinese stock market will have little or no impact on Chinese consumer spending. Any negative economic impact is more likely to derive from the securities industry, at least temporarily. This sector had a very good second quarter which is unlikely to be repeated in the near term.

The opening of the Chinese stock market to the private investor has not gone to plan.

Despite the arguments presented so far it would still be “wide of the mark“ to suggest that everything is in order so far as the Chinese stock market is concerned. The government helped fuel the boom and has since reacted to the inevitable crash with panicky interventions. This sits poorly alongside the commitment of the last People’s Congress to allow market forces a freer rein. All in all, the government’s attempt to open up the stock market to private investors must be considered as not wholly satisfactory. Moreover, Chinese investors still have credit on margin to the extent of 1400bn. yuan, which amounts to around $230bn. and is thus roughly half the margin credit extended to investors in the US. With such market-related debts outstanding we don’t think the next Chinese stock market boom is imminent.

Lower growth numbers for China should not surprise anyone.

Alongside the turbulence of China’s stock market the weaker growth trends in China are also cited as a reason for recent stock market weakness. But such commentary normally ignores the argument that lower growth rates are an inevitable consequence of the resetting of China’s growth model from being heavily investment-based to becoming more based on consumer spending. The shift in the growth model has led to much reduced consumption rates for iron ore, copper and other industrial raw materials. This is to be expected and is in no way the precursor to an economic collapse. Data for the second quarter show that structural weakness in industry and construction was more than offset by the growth of the service sector. This good news was scarcely considered alongside the widespread suggestions that the reported 7% growth rate for the second quarter was too high and therefore suspect. In some ways it scarcely matters whether China grows at 7% or at 6%. With an annual GDP of over $10000bn., China is clearly a hugely important growth machine so far as the world economy is concerned. Moreover, many underestimate just how much room for maneuver the Chinese authorities possess when it comes to steering their economy. China’s position contrasts favorably with many other countries, not only in terms of fiscal and monetary policy, but also in the field of regulation. We have no doubt that the government will use these freedoms to put the economy more or less on the desired growth path and that, in the short-term at least, it will be successful in this respect.

The monetary and macroeconomic environment for markets has not changed.

On the whole we think comment, to the effect that China is the cause of recent stock market weakness in Europe, is wide of the mark. On the one hand, we don’t view the recent turbulence of the Shanghai bourse as conveying a negative message on the Chinese economy. On the other, we consider that China’s economy is developing within the bounds of reasonable expectations. On a world-wide basis, we don’t see much change in the monetary and macroeconomic environment for markets and on this basis we are sticking with the investment strategy that we have previously communicated.

Aquila & Co. AG, 28 July 2015