Flash

The “big picture” has not changed

Worries about growth are troubling the stock markets. They reflect problems in many emerging market economies and, in particular, developments in China. In fact the industrialized economies only have a limited dependence on exports to developing countries. US exports to developing countries for example account for just 2.1% of US GDP. Developments in China have seriously undermined investor assumptions as to the Chinese government’s ability to control events there. But, in our view, the Chinese government has by no means used up all its policy options. It continues to have a lot of room for maneuver in terms of fiscal and monetary policy and its approach to regulation and can thus keep the economy on a decent growth path. Sharp price falls in the commodity markets have more to do with an abundance of supply than with a shortfall in demand and reflect the massive investment between 2000 and 2010 in raw material production. This has exerted downward pressure on commodity prices in recent years, a trend which will continue. The fact that none of the economies of Europe, the US and Japan show signs of crumbling supports our assessment. The broad investment environment has not changed appreciably in recent months and recent stock market declines reflect an abrupt shift in investor sentiment which in our view is not justified by the facts. We have decided to buy equities to keep our overweight position in the asset class intact.

Growth fears are dominating the stock markets.

Since August 10th the German DAX index has fallen by 15%, while losses on the Swiss SMI and the US S&P 500 indices are of the order of 10%. Investor anxiety that the world economy is slowing sharply is cited as the main reason for these declines. The fact that commodity prices are at multi-year lows fuels this anxiety. So do the signs of slower growth in many emerging market economies and the weakness of their currencies. Developments in China are a particular concern. Not only has the stock market there fallen sharply, the yuan has been devalued while explosions in Tianjin encourage some in their belief that much investment in China is substandard and therefore wasteful. Media coverage is also fanning the flames. We note that the August 21st edition of the Financial Times carried a front page article under the heading “China’s devaluation triggers dramatic falls in emerging markets currencies“. But the only currency for which that headline was appropriate on that day was the Tenge of Kazakhstan, a country which accounts for less than 0.3% of global GDP.

Industrialized countries have a limited dependence on exports to developing countries.

Falling growth rates in emerging market countries and the weakness of their currencies are unlikely to cause the growth process in the industrialized world to fall apart. China accounts for barely 2% of Eurozone GDPs and only 0.7% of US GDP. Developing countries as a group account for 5% of Eurozone GDP but for only 2.1% of US GDP. Thus, should exports to developing countries fall by say 10%, the negative impact on GDP might be around 0.5% for the Eurozone and just 0.2% for the US. The impact on the US economy would be scarcely felt although emerging market country ties to the Eurozone cannot be quite so easily dismissed. That said, it seems unjustified to talk in terms of industrial economy growth crumbling away.

Investor confidence in the omnipotence of the Chinese government has taken a knock.

Bad news out of China has been making headlines in recent months. But, in our view, a cool assessment leads to the conclusion that the turbulence in the stock market there should not be particularly troubling for investors elsewhere and is unlikely to have much impact on the Chinese consumer. We view the Chinese government's decision to devalue the yuan not so much as a sign of a weak economy. The explosions in Tianjin, considered in isolation, do not represent a turning point in growth trends. Nor, also considered in isolation, do the other recent pieces of bad news. It is undeniable, however, that taken together events reported out of China have shifted investor sentiment powerfully. Specifically, an exaggerated confidence in the Chinese government's ability to control events has taken a knock. We point out, however, that the government has by no means yet exhausted all the policy measures at its disposal. Given its room for maneuver in terms of fiscal and monetary policy and regulation, the government should be able to keep the economy on a decent growth path. Admittedly, the third quarter will be negatively affected by lower revenues in the finance industry as well as by production cutbacks affecting some 12'000 firms around Peking. (This reflects an official desire to show clean skies as the world watches a massive parade to mark the seventieth anniversary of the end of World War II). Nevertheless, economic recovery should be apparent in the fourth quarter.

Commodity price declines reflect a general condition of excess supply.

The multi-year price lows in the commodity markets are being cited as a sign of an impending global recession. But in our view these price developments reflect a widespread condition of excess supply, rather than any general shortfall in demand. The massive investment in the capacity for raw material production between 2000 and 2010 has been affecting the commodity markets for some years now, a trend which will continue. It will be some time before capacity in the supply of many commodities matches demand. In the crude oil markets, for example, experts speak of an excess supply of the order of 2 to 3 million barrels a day. This is so substantial that it must impact prices negatively. Investors should remember, however, that much theory and analysis suggests that lower raw material costs are on balance positive for world growth.

There is no sign of a crumbling of the growth process in the industrialized countries.

The economies of Europe, Japan and the US are not showing any signs of crumbling which should not be a surprise given the analysis outlined above. It is important to us that the US is achieving a decent expansion and the indicators there for housing, the labor market and consumer sentiment are reassuring in this respect. Europe's economy is growing steadily, if unspectacularly and the latest PMI reading – at 54 – suggests that the pace of expansion might pick up in coming months. Also, recent data for Japan's PMI suggest that economy is already covering after a weak second quarter.

We think the abrupt shift in investor sentiment is unwarranted.

We believe that the "big picture", so far has investment is concerned, has not changed in any significant way. A sharp shift in investor sentiment is the main reason for the recent general fall in stock markets. Viewed analytically, this shift is not justified by the facts. We have decided to purchase equities so as to maintain our overweight position in the asset class.

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