BLUE HORIZON
Wealth Partner AG

China sparks a global sell-off

- Concerns about Chinese growth and the health of its financial system led to major shock waves across global financial markets. The Shanghai Composite equity index fell despite major interventions from the Chinese authorities from 5,166 in mid-June to its low of only 2,927 on 26 August - a loss of almost 45%. This has led to major global contagion; emerging market equities were especially hard hit, falling 9.0% in August. The MSCI developed markets equity index declined 6.6% in the same period. The EuroStoxx50 index fell 9.1%, followed by the Nikkei index, which declined by 8.2%, and the S&P500 index, which lost 6.0%. We discuss below why we think that financial markets may have overreacted.
- Commodities also fell victim to Chinese growth concerns. The oil price dropped 5.7% in August and industrial metals declined by 2.7%. Gold, as a safe haven asset, recovered somewhat in August and rose 3.3%.
- Consistent with these developments, commodity currencies remained under selling pressure. On the back of weak economic data the Swiss franc continued to depreciate and fell 2% against the EUR. In this environment the EUR was remarkably strong and strengthened by 1.4% vis-à-vis the USD.
- While 10-year US treasury yields remained almost unchanged in August, the 10-year Bunds climbed 18 basis points. Credit markets overall were weaker.
- August growth data were mixed and confirm our weak growth scenario. While the US ISM index softened somewhat, the US unemployment rate fell to a level which the Fed regards as full employment. European growth data were by and large positive.
- The recent labor market data suggest to us that there is still a reasonable probability of a Fed rate hike in September. At the same time, however, the recent market turmoil will certainly make the Fed think about possible negative spill-overs onto the real economy and the additional market stress that would be caused by a hike. So we think it has become a close call, and continued market volatility could delay the rate-hike decision. In our view, markets may currently be overestimating the potential for negative economic spill-over effects from China. The macro picture for the US and Europe should not be impacted too greatly by the recent Chinese developments. As a result, we recommend holding on to equity positions, bearing in mind, however, that in our view the outlook for emerging markets equities has further worsened. We would even consider actually adding equity positions during the current market weakness. It seems to us that European equity still offers the best risk-return. We also stay positive for the USD based on monetary policy divergence, and we expect the Swiss franc to weaken further based on the negative economic outlook for Switzerland.

Macroeconomics and financial markets

The US ISM manufacturing index was again slightly lower at 51.1 after 52.7 in July. Also, non-farm payrolls rose by only 173,000 in August, which was clearly below expectations. However, the July figure was revised up from 215,000 to 245,000. The US unemployment rate fell further to 5.1% from 5.3% and reached, according to Fed estimates, the NAIRU level. The Fed believes that a non-accelerating inflation rate of unemployment (NAIRU) between 5.0% and 5.2% is consistent with the long-term equilibrium unemployment rate. An unemployment rate below 5.0% would imply that the labor market was creating wage pressure, which in turn would lead to an accelerating inflation rate. Reaching the NAIRU strongly suggests that we are getting closer to the first Fed rate hike as inflation risks rise.

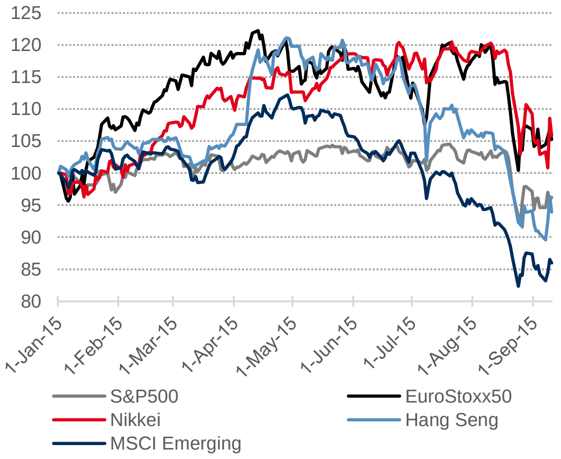
The Markit European composite PMI improved to 54.3 after 53.9 in July. Spain continued to show a very strong reading, confirming the vigorous growth dynamics in that country. France, in contrast, dipped back into the stagnation zone

Consistent with the dismal Chinese equity markets, the Chinese Caixin manufacturing PMI fell to 47.3 in August after 47.8 in July. A level below 50 indicates that the manufacturing sector is shrinking.

China

After decades of very strong growth and a government which seemed to be in full control and able to steer the economy so smoothly that market economists could only look on in amazement,

Fig. 1: Major equity indices in 2015



Source: Bloomberg / Blue Horizon Wealth Partner AG

Fig 2: 10Y bond yields

Source: Bloomberg / Blue Horizon Wealth Partner AG

Chinese macro-economic affairs seem to have spun out of control. On 11 August the drama started with what appeared to be a badly communicated move towards a more market-driven currency regime, resulting in a devaluing yuan. This already sent the first shock waves across global financial markets. In return, the Chinese had to accept large capital outflows and a plunging stock market. The interventionist Chinese government arranged to buy shares worth 1 trillion yuan – approximately USD 156 bn, and they also cut interest rates, banned short-selling and asked state-owned companies to buy back their own shares. All these measures were not enough to stop the Chinese equity market from selling-off very significantly. The Shanghai stock index lost 45% within a couple of days.

China constitutes a major risk to the world economy and financial markets. It has grown so big that every market participant follows Chinese developments. China's GDP is the third largest in the world after the European Union and the US. China imports about half the world's aluminum, nickel, steel and about a third of the cotton and rice.

The problems in China relate to the industrial sector, which is suffering from overcapacity. Furthermore, total debt has doubled in the last seven years and reached about 250% of GDP. There is evidence that banks carry significant amounts of bad loans. Large portions of the economy are still state-controlled, including the majority of the banking sector. The population is ageing rapidly. GDP growth has fallen and is now clearly below the forcefully communicated target of 7%. Current estimates are as low as 2-3%.

While a hard landing for the Chinese economy is a risk for global growth and financial markets, a number of considerations reduce the probability of such a hard landing. Firstly, while the industrial sector has been struggling, the services sector has grown as big and is continuing to grow. Also, retail sales have remained very stable. Secondly, the Chinese authorities are taking very active measures to stabilize the economy. Rates have been cut and further cuts are likely. The government has allowed for a fiscal deficit, which this year stands at 2.3%, a little larger than last year's deficit. Thirdly, the stock exchange is relatively small. Stock market capitalization accounts for 30% of GDP only, while in developed countries this value is more likely to be 100% of GDP. Less than a fifth of household wealth is invested in stocks. In addition, debt used to finance share purchases amounts to just 1% of total banking assets. Meanwhile, the property market is more stable and is by far the most important source of collateral in China. Fourthly, the impact of a struggling China is severe for emerging markets and especially commodity producers, but less severe for developed countries. In developed countries, exporters may suffer from lower Chinese demand, but dependencies are much less pronounced. In contrast, the developed world is benefiting from lower commodity prices.

To conclude we do think that China is a major risk for global financial markets. However, given the arguments stated above, we regard the recent market moves as probably excessive, and we tend to see the recent correction as a buying opportunity.

Outlook

The recent labor market data suggest to us that there is still a reasonable probability of a Fed rate hike in September. Furthermore, we think that the fixed-income markets will probably encourage the Fed to go ahead and raise the rate. Fixed-income markets currently regard a September hike as highly likely, while at the same time long-term rates have moved back to very low levels – the 10-year US treasury currently yields about 2.15%. This suggests that fixed-income markets are likely to stay calm after a potential September hike. At the same time, however, the recent market turmoil will certainly make the Fed think about possible negative spill-overs onto the real economy and about the additional market stress likely to be caused by an increase. Therefore, we think it has become a close call and continued market volatility could delay the rate-hike decision.

As discussed above, China has become an important factor for the global economy. However, markets may currently be overestimating the potential for negative economic spill-over effects. In addition, the Chinese financial markets are still somewhat shielded from global markets, which makes it less likely that large losses of Chinese financial assets will result in more severe contagion effects. The macro picture for the US and Europe should not be impacted too greatly by the recent developments in China, though the export industry may have to put up with a certain decline in Chinese demand. Lower commodity prices are , however, a clear benefit for developed Western economies.

As a result, we recommend holding on to equity positions, bearing in mind, however, that in our view the outlook for emerging markets equities has further worsened. We would even consider actually adding equity positions during the current market weakness. It seems to us that European equity still offers the best risk-return.

We also stay positive for the USD based on monetary policy divergence, and we expect the Swiss franc to weaken further based on the negative economic outlook for Switzerland.

Blue Horizon Wealth Partner AG
Sihlhaldenstrasse 10
CH-8803 Rüschlikon / Zürich
info@bluehorizon-wp.com
www.bluehorizon-wp.com

Important Legal Notice