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BNY MELLON

WHAT'S CHURNING UP CHINA'S MARKETS?

The first few trading days of 2016 proved to be choppy for investors with China enacting a market circuit breaker[1] and suspending trading twice in four days and global markets subsequently responding negatively. Here BNY Mellon Investment Management looks at what has happened and why.

Simon Cox, investment strategist APAC, BNY Mellon Investment Management[2], comments that in the opening week of the New Year, China's markets echoed their worst three months of 2015. "Now as then, clumsy stock market intervention interacted badly with an embryonic, poorly understood currency policy. Global investors reacted to the week's events, just as they did in August 2015, when Beijing unexpectedly devalued the yuan. On both occasions, outsiders interpreted the currency moves as a sign China's officials knew something about the true state of the economy the rest of us did not. I believe that was a misinterpretation of the August devaluation and I think it is an over interpretation of the week's currency depreciation also. China's economy is weak, but no weaker than we already knew. Just as global markets staged a relief rally in October 2015, they may recover their composure after this week's sell-off."

Cox says in order to understand this week's market drama it helps to walk through the sequence of events backwards. The abrupt equity sell-off on Thursday, 7 January was prompted by the unexpectedly large depreciation of the yuan's central-parity rate earlier that morning, he comments. "But the interaction between the stock and currency markets extends back further than that. Beijing presumably weakened the parity on the 7th in response to selling pressure in the currency markets earlier in the week. That downward pressure on the yuan was itself was partly a response to the stock market turmoil on Monday (4 January), when shares fell by the daily limit of 7%. Why, then, did equity investors sell on Monday? They may have been acting in anticipation of the imminent easing of selling restrictions imposed on large shareholders during the equity debacle of last summer. There is then a long causal chain extending all the way back to last July."

Beijing's various stock market interventions (including what may have been a renewed effort to buy shares on 5 January by its proxies, known as the "national team") appear, in Cox's opinion: "clumsy and counterproductive." He believes its currency policy, however, is more justifiable. "To defend it, one only has to examine the alternatives. Preventing any depreciation of the yuan against a strong dollar—either by raising interest rates or selling reserves in even greater amounts—could tighten monetary conditions, undoing Beijing's much-needed efforts to revive demand. Conversely, allowing an abrupt, unbroken fall in the yuan would probably harm confidence more than it would help exporters. So a muddy Chinese middle-way—involving some depreciation, some currency intervention, and some tightening of capital controls—is a defensible policy mix."

Still Cox believes there is something missing from what he terms a "ad hoc policy framework": it provides no medium-term anchor for currency expectations akin to Singapore's "basket, band and crawl" system, he says. "That lacuna could leave investors free to assume Beijing "secretly" wants a big devaluation. Moreover, since

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[1] A stock circuit breaker is a mechanism by which trading in a market is suspended after a certain percentage fall occurs. In China's case the threshold was a 7% fall. China suspended this rule on 7 January, after it had been enacted twice in four days.

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China’s official statistics command little faith around the world, global investors are also free to assume the worst about China’s economy. Both assumptions—that Beijing wants a big devaluation and that China’s economy sorely needs one—drive greater capital outflows, forcing Beijing to intervene more heavily to keep the depreciation within respectable limits. Managing expectations is a big part of macroeconomic management. But it is a part that Beijing has left strangely unattended.”

Paul Markham, global equity portfolio manager, Newton Investment Management, says with respect to an equity outlook, it’s too early to tell whether the volatility in global markets emanating from the suspension of China’s markets – twice - is a sign 2016 will be problematic. That said, he does think it could be a difficult one for markets. “There is general concern the global economy could be slowing down and China is both leading and reacting to this.”

With respect to fixed income Sarah Percy-Dove, head of credit strategy, Asian Fixed Income, Standish Mellon Asset Management Company, LLC[3], says: “We remain quite constructive on China, even though we currently expect below consensus economic performance in 2016, based on valuations.

“The stock market gyrations don’t really impact the Asian USD bond market directly. It’s quite a small part of the Chinese economy and is (currently) heavily impacted by government decrees. The ripple effect into the broader economy is not direct and not of huge import. It does get a lot of air play offshore though and gives global markets a good reason to “act up” when it suits.

According to members of Newton’s Emerging Markets and Asian equity team, policies such as market circuit-breakers do not allow markets to clear naturally and they believe further attempts to prop up the market with similar policies will ultimately fail. Portfolio managers Caroline Keen and Sophia Whitbread say that although economic growth as a whole in China is decelerating, slowing headline GDP growth does not preclude some compelling investment opportunities in areas of structural growth which they assert as less reliant upon economic growth.

“The reform agenda being pursued by the Chinese leadership has also focused upon cracking down on corruption and improving the profitability of State-owned enterprises, with a greater role assigned to the private sector. Ultimately such measures should translate into a higher quality of growth, even at a slower pace.”

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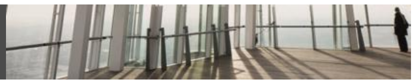

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