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China and its impact on equity markets and on the G3 economies

Summary	Investment Conclusions
The two "devaluations" of the CNY in August this year triggered,yet another,massive fall in global equities for reasons that lack support from facts.This is not about Ecognosis "knowing better" but it is about facts and not forecasts. The "devaluation" (note the inverted commas) caused the market to believe that China's economy was in far worse shape and, hence, would drag the global economy further down, since China is "the main locomotive of growth for the G20, let alone for Asia". None of these notions are fully based on facts, but what matter here is what equity investors believe to be the facts.	The Chinese equity market has a lot more to fall, possibly back to SHCOMP 2500 where it all started. China is a closed market whose fall will have little impact on global portfolios as foreign ownership of Chinese shares is a small percent of its market capitalization. The equity crash may have a modest macro impact in China.Investors should keep clear of Chinese and Hong Kong equities until 1Q.16 when China's cycle could have bottomed. The likely insanity of a Fed hike, although we do not expect one in 2015, would argue a move to cash for now in most markets.

The impact of China on the G3 , Part I

Item 1: China's economy has been continuously decelerating for the last 6 (SIX!) years, 2010-2015.During this time its equity market declined almost continuously and its explosive rise at the end of 2014, was completely unconnected to the GDP growth which had continued to fall.(Fig.1) Why did global investors notice only now that China's economy was slowing down? Why they decide that the Chinese equity crash was likely to detonate another global 2008-9?

Item 2 China's contribution via its imports to the growth of the US, EU and Japan is limited. China is not the growth driver of the G3 let alone of the G20 economies. Exports to China account for less than 10% of total exports from the US and the EU and the total net export contribution to GDP growth (which includes the exports to China), on average, subtracts from US' growth and adds nothing to EU's.(Factbox). For Japan, its exports to China account for nearly 20% of total but here, too, net exports make a negative contribution to GDP growth. Be noted that the analytics of the net export contribution to GDP growth can be misleading under certain circumstances. For example, imports can add to investment thus adding to growth. The deceleration of China's growth will have a modest impact on G3. However, it will continue to have a significant negative impact on the economies of commodities exporters such as Australia, Brazil,Argentina, Uruguay and Russia, but this is hardly the "global economy".Similar considerations hold for the economies of Hong Kong and Taiwan, but here, again, the impact is regional and not "global".

Chart 1:China, GDP growth(blue), SHCOMP (red)

Source: Bloomberg

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The impact of China on the G3 and other markets , Part II

Item 3 The 3.0 % devaluation of the CNY during August caused another major fall in global equity markets on the basis of the unfounded expecations that the economy of China was in dire straights and in need of a boost from exports. Be noted that since 2005, when the CNY was effectively unpegged from the USD, the CNY appreciated, on average, by 2.2% pa.China's growth is also not dependent on exports, as the data in Fig.2 show.The devaluation was an extremely poorly timed,further attempt at liberalisation of the forex market.

Item 4 The repeated crashes of the Chinese equities did nothing for sentiment, but consider the following. China's equity market is effectively closed to foreigners despite the repeated increases in the quotas of A shares available to foreign investors and the Hong Kong-Shanghai link. Estimates, taken with caution, put the holdings of foreigners at 5-7% of total market capitalization. The 40% drop of the SHCOMP is likely to have had a muted effect on the average G20 pension fund. The domestic macro impact in China is also likely to be modest, and most unlikely to trigger a financial crash. Chinese corporates had to postpone issuance and this could impact investment. The 90 ml retail punters represents less than 10% of the population and, hence, the wealth effect could be small. The authorities, however, have been left with a portion of the equity market in their hands, following the unwise price support intervention. Their holdings will remain as an overhang helping to tarnish a little the reputation of the communist party as a capable manager of the economy.

FACTBOX : The unimportance of exports to China

US (data for YTD July 2015 with 2015 forecasts)
Exports to China account for 7.4% of total exports or 0.37% of forecast 2015 GDP

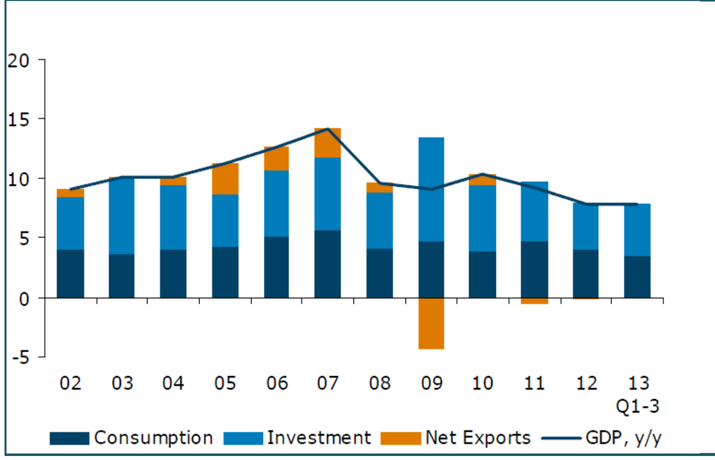
EU (data for 2014)
Exports to China account for 9.7% of total exports or 1.1% of GDP

Japan(data for 2014)
Exports to China account for19.0 % of total exports or 2.9% of 2014 GDP

Average contribution of net exports to GDP growth (bps) 2000-14,**US -4.5 EU 0.0, Japan -27.0**

Source :YCharts

Chart 2: China, contribution of net exports to GDP growth



Source : China statistics

Going forward-but slowly !

All post- war financial crashes, Greece,Argentina, Brazil,Russia,S.Korea,Thailand, and ,of course,US, had one or more of the following in common: Banks overexposed to the property sector, growing and externally financed fiscal and current account deficits, growing external debt, overvalued forex rates and falling forex reserves. China has virtually none of these. Its key banks are state-owned, so a domestic banking crisis becomes a fiscal issue. China has an external surplus, a small fiscal deficit financed domestically and a USD 3.5 tr reserves making it a global creditor. Creditors don't go bust. However, use of the forex reserves is not an obvious recourse for any further market support, as sales of USD for CNY will push the exchange rate up and reduce, temporarily,liquidity in the market. For investors, while the Fed makes up its mind, and we think that it will not commit the error of hiking in 2015, cash is a wise refuse. Sentiment will remain poor, and the invitable further falls in the SHCOMP will cause most Asians as well as G20 equities to sag.Chinese shares may find support in 1Q.16 when all the measures taken now help the economy to bottomThe gist of this reprt is **not** that all is well with China, but equally that the expecations of an impending crash and recession are unfounded. Watch out for an increased in "China bashing" as the US presidential campaign accelerates, not helped by the PLA flexing its considerable arms, figuratively and actually!

Andrew Freris (writing completed 7/9/2015)