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8/F, 2 Exchange Square, 8 Connaught Place, Central, Hong Kong. Tel: 852 3167 4591, Mob 852 9738 0944
Email: afreris@ecognosisadvisory.com Website: www.ecognosisadvisory.com

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Why China does not matter and why we should not worry about it.

Summary	Investment Conclusions
The abysmal performance of capital markets from the start of 2016 has been partially blamed on China, as well as to the Fed hike, the negative rates in the EU and Japan and the collapse of oil prices. The role of China has been exaggerated beyond any reasonable interpretation of data. Hence our deliberately provocative title. Some of the material in this Econote appeared in Econote No.40 on 7/9/2015.All of it has been revised extensively and a lot more added. None of this distracts from the fact that the global fixation with China (and incidentally its attendant wish that China's economic hubris will meet its nemesis) is basically wrong, as it is not supported by facts.	The inability of the EU and of Japan to enter firm recoveries, the failure of QE to stimulate inflation, negative rates in both economies and the vacillation over further hikes in the US, cannot be blamed on China as China's macro impact on the three economies is too small to matter. Oil prices did not collapse because of China and China's capital markets remain closed to global investors and, hence, their collapse cannot have triggered the falls in other markets. Focusing on China's recovery as a signal to re-enter equity markets will, therefore, give misleading signals.

Measuring the global impact of China

Item 1: Concerns over China's GDP deceleration China's economy has been continuously decelerating for the last 6 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 worry about China's falling growth now, when it still leaves it with one of the highest absolute growth rates in the world? **Item 2: Concern is justified, as China's external trade contraction will impact the G3.** 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 10.0% of total exports from the US and the EU and the total net export contribution to GDP growth (which includes exports to China), on average, subtracts from US' growth and adds nothing to EU's. (Factbox). For Japan, its exports to China account for 18.0% 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 fall in China's growth will have a modest impact on the G3 but it will have a significant impact on commodities exporters such as Australia, Brazil, and Russia, but this is hardly the "global economy",Similar considerations hold for Hong Kong and Taiwan,but the impact is regional and not "global".As for oil prices, blame the US shale oil boom and the Saudis, not China.

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

Source: Bloomberg

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Yet more arguments why China does not matter

Item 3: The CNY will have to devalue. China's growth is not dependent on exports, and hence a sharp drop in the CNY will not be a cure for poor growth. (See Fig.2). However, the poorly timed and managed CNY gyrations since August 2015 did not help. The expectation that a banking crisis in China will cause a devaluation and vice versa is too naïve, to say the least. Devaluations are caused by, primarily,overvalued and pegged currencies unsupported by forex reserves and not by poor bank credit decisions. China still has a large external surplus which may argue for an **undervalued** CNY and still has USD 3.2 trillion reserves. Of a banking crisis in China see below. **Item 4: The crash in Chinese equities will add to the GDP deceleration and will pull down global markets.** China's equity market is effectively closed to foreigners unless they receive quotas. Officially there are

FACTBOX : The unimportance of exports to China

US (data for 2015) Exports in the US account for 13.0% of GDP while exports from the US to China account for 7.0 % of total exports or 0.9% of GDP

EU (data for 2014-15) Exports to China account for 9.7% of total exports while exports account for 19.0% of GDP, thus exports to China account for 1.8% of GDP

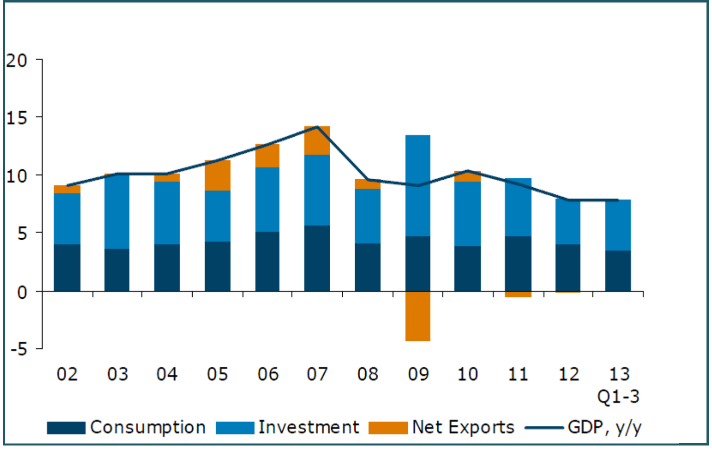
Japan (data for 2015) Exports account for 12.9% of GDP while exports to China account for 18.0 % of total exports or 2.3 % of GDP.

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

Source: US, EU and WTO statistics

USD 80.8 bl in QFII quotas and USD 72.2 bl in RQFII, a total of USD 153.0 bl or about 4.5% of the market capitalization of SHCOPM in Feb 2016, too small to make any difference, assuming that all quotas were invested! The Hong Kong- Shanghai connect in its first year of operation in 2015 saw only 40% of the two-way quota utilized with its turnover at about 1.0% of the market. Bottom line is that Chinese markets are still effectively closed to global flows and ,hence ,cannot directly affect the S&P or Nikkei, except through (uniformed!) negative sentiment. As to the impact of the crash in Chinese equities on China's GDP, past history is clear. There is very little systematic connection between the real economy and the performance of the stock market.

Chart 2: China, contribution of net exports to GDP



Source : China statistics

Aha..they still can't get away, they are bound to fail

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 triggered by NPLs will become a fiscal issue. China has an external surplus, a small fiscal deficit financed domestically and a USD 3.2 tr reserves making it a global creditor. Creditors don't go bust. China can multiply its fiscal deficit in order to rescue banks without incurring Japanese type debt burdens.

So why this incessant insistence that China will crash in one way or another and that it will take all of us with it? Answers: (1) Ignorance of basic facts about China's growth and repetition of received but stale wisdom. (2) Political desire in the US for China to fail and to weaken as China is now flexing its military and political muscles in Asia and elsewhere. (3) Wrong generalisations based on the 2008-9 crisis which was as American as apple pie and, hence, unrelared to China. Not one bank in Asia, except a minor one in indonesia, failed or had to be rescued by the state in 2008-9, and that includes Japanese banks, which is saying something ! The gist of this report is **not** that all is well with China, but that the expectations of an impending crash are unfounded. A.F.Freris (Completed on 22/2/2016)