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Time Out

China is fragile, but not broken

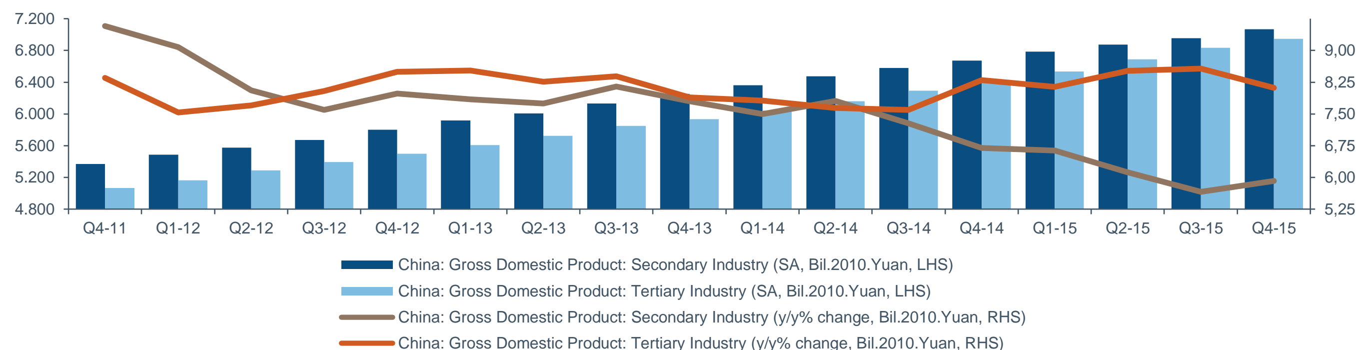
Markets have witnessed a volatile start to 2016, with negative sentiment on China being blamed as one of the key triggers. Yet with little change in the Chinese economy from December, there doesn't seem to be much justification for a sudden increase in concern from this perspective. A lot of the pessimism has been attributed to poor manufacturing PMI numbers, which came out at the start of January. Yet while manufacturing is one prism through which to view the Chinese economy, it is important to remember that this is no longer the sole focus for China. Difficulties in the manufacturing sector are often wrongly presented as a reason to worry about the whole economy, rather than being looked at in the context of a still strong services sector.

In China, the goalposts by which we measure the economy are continually shifting – not only in the rebalancing to services, but also in the management of China's capital and currency markets. Capital outflows on the scale of the past few months would have been catastrophic for the economy in the early 2000s, but can now be viewed as part of the volatility involved in opening up the capital account. Undoubtedly, this rebalancing process presents risks, but short-term volatility in itself is not a sign that China is coming in for a 'hard landing'. Fundamentally, China is attempting one of the biggest economic rebalancing acts ever undertaken, and it would be near impossible to achieve this without triggering at least some market volatility. When assessing China's progress, however, three fundamental mistakes are often made: an undue focus on manufacturing rather than services, conflating the strength of the equity market with the health of the economy, and mistaking trends in currency with policy direction. Once we examine each of these elements, the picture that emerges is more positive. It is still a picture with risks, but not one which justifies the pessimism we have seen across global markets in recent weeks.

Focus on services rather than manufacturing

It's clear that if the Chinese economy is to be successful in the future, then it will need to become less dependent on fixed asset investment to drive growth. There are encouraging signs here, with services now responsible for the majority of Chinese growth (Chart 11), as well as accounting for the biggest share of the economy in nominal terms. Indeed, while the wider economy has slowed over the past four years, services have maintained their momentum. Though there are concerns around the run-up in private debt, for the moment, services continue to contribute strongly to the economy.

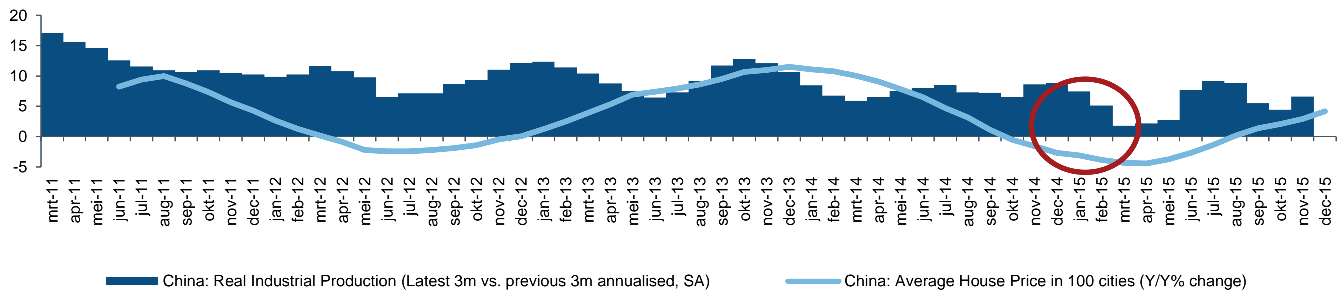
Chart 1: Served in China? Services are increasingly important to the Chinese economy



Source: CNBS/Haver, January 2016.

The picture in manufacturing is not unremittingly negative either, and we are likely to see mini-cycles within the sector. Poor manufacturing PMIs may have been blamed for sparking volatility at the beginning of January, but these were really just an extension of the previous trend. With signs of stabilisation in industrial production (Chart 12), there is the potential for better news out of China and for a more optimistic view to reassert itself.

Chart 2: Chinese industrial production and house prices are picking up



Source: CHIA/SF, CNBS/Haver, January 2016.

Of course, the move away from commodity intensive growth will have an impact on the global economy and will be negative for those countries which have relied on the commodity super cycle to drive growth. There could also be consequences for other sectors, such as financial companies with exposure to commodity prices. Given this, there is a danger that poor sentiment on commodities seeps into an overly negative view on China, when in fact, less commodity intensive growth would be a strong sign of the rebalancing that China needs.

Little correlation: Chinese stock markets and the wider economy

While sharp declines in Chinese stocks have raised concerns, there is little correlation between the performance of indices such as the Shanghai Composite and the wider state of China's economy. Indeed, the dramatic rise in the Shanghai Composite in the first half of 2015 occurred just as worries over the extent of the slowdown in China were intensifying. It is unclear why recent volatility should be cited in support of a bearish China view, when it was not seen as a counter balancing factor on the way up.

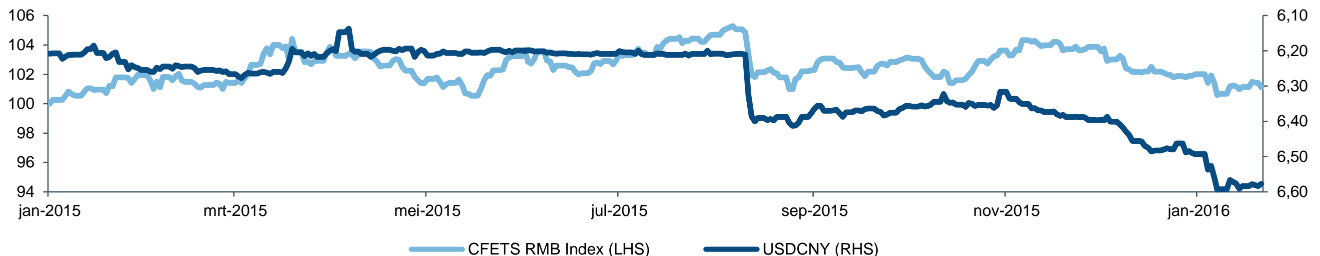
Some have cited the rising correlation between the Shanghai Composite and the S&P 500, with this having risen to levels last seen during the financial crisis. However, very little can be drawn from this, as the fundamental drivers of the two markets are entirely different. The dramatic moves in Chinese equities over January ultimately stem from fears over the expiry of the ban on short selling and the imposition of new trading rules, rather than any global factors or fears over the Chinese economy itself. While the introduction of the circuit breaker mechanism (which suspended trading if markets fell by 7%) was intended to pacify the index, it was poorly designed for such a volatile, retail-dominated market. This is particularly the case considering that Chinese equities frequently experienced the kind of intra-day moves which made trading suspensions almost certain. Indeed, this is one seven per cent target that the authorities will not have wanted to hit.

While recent volatility may not have direct consequences for the wider rebalancing process, the failure of policymakers to manage the situation – and for their interference to arguably have made matters worse – raises questions about the ability of the Chinese authorities to handle the task ahead. On the other hand, there are signs that policymakers are beginning to understand the importance of managing this transition more carefully, such as in their attempts at clearer communication over currency policy since August's surprise devaluation.

Currency moves should not be viewed as policy announcements

Central to a negative view on China is often an investor's interpretation of China's policy on its currency. For China pessimists, renminbi devaluation is sometimes seen as an implicit aim of Chinese policymakers who seek to export the problem of excess capacity in the manufacturing sector. In this narrative, the unexpected renminbi devaluation against the US dollar in August is the purest expression of Chinese policy. Yet renminbi depreciation has only partially reversed the US dollar strengthening trend of the past five years. Importantly, the August devaluation can be better seen as part of a wider policy to keep the renminbi stable against a basket of currencies, rather than just the dollar. Although this has been done at considerable expense, it is hardly the action of a central bank looking to boost exports through competitive devaluation. Where market volatility can be attributed to Chinese policymakers, it is through a much narrower criticism of having failed to communicate their policy clearly, rather than harbouring ulterior motives. With publication of the currency basket weights and heightened communication from the PBoC, there are signs that this criticism is being addressed.

Chart 3: The renminbi, a currency that belies an exciting reputation



Source: Fidelity International, January 2016. CFETS RMB Index: China Foreign Exchange Trade System Index. USDCNY: US dollar relative to Chinese yuan.

Indeed, China bears often confuse the difficulties the PBoC have had in keeping the renminbi stable with some secret plan to devalue the currency. Yet with a slowing economy, it is perhaps not surprising that the currency has faced continued pressure. Fears over the extent of the slowdown have led many to pull their money out – including Chinese as well as international investors. The end of renminbi appreciation against the US dollar also seems to have caught many financial companies off guard, who based many products on continued renminbi appreciation against the dollar which now have to be unwound. Finally as the central bank has reduced interest rates, the attraction of the renminbi as a currency trade has declined. All three factors have contributed to strong capital outflows, which the central bank has *countered* to ensure currency stability, rather than *exploiting* to achieve some kind of subtle devaluation.

Are there circumstances in which the central bank might abandon this policy? It seems unlikely for now – though not impossible. Further pressure on the manufacturing sector could tempt the authorities to devalue the currency, making Chinese exports cheaper and helping to boost foreign demand. This would represent a turn to a more mercantilist China, one set on exporting the problem of excess capacity to the rest of the

global economy. However, the success of such a policy would be uncertain, with any significant devaluation likely to be followed by retaliatory measures. If the central bank abandoned its defence of the renminbi, it would be more likely to do so because the costs of intervening had simply become too high. Continued outflows and consequent moves to prop up the renminbi could tighten liquidity in China, which would adversely hit the banking and property sectors, which have dramatically leveraged up in the past five years. The Chinese authorities would be keen to avoid a crisis here, but it remains a key risk for the outlook. Alternatively, China could decide that the absolute costs of intervening had become too high. But with considerable foreign exchange reserves, this is unlikely to come any time soon – even at the current rate of rundown. In the meantime, there is potential for a reversal in some of the trends driving capital outflows, or even for a reversal in broader challenges faced by the renminbi. For example, US dollar strengthening has partly been driven by interest rate policy differentials. Dollar strength could therefore fade if we were to see global monetary policy becoming more synchronised.

Investors should use the right lenses when looking at China

Falling markets are termed 'bear markets' supposedly on the basis that bears' claws strike downwards. In the case of China, however, perhaps a panda bear is a more appropriate metaphor. Pandas focus on eating bamboo – despite having the digestive system of a carnivore – just as bears on China can sometimes consume the wrong data in seeking to understand the Chinese economy. Instead of looking at services as the biggest contributor to growth, many still tend to focus on manufacturing. Instead of looking at equity markets separately to the country's overall economy, they see them as directly symptomatic. Instead of understanding the wide range of forces on currency movements, these are sometimes confused with deliberate government policy. While there are still risks around China, and we are likely to see continued volatility over the coming year, the current economic backdrop remains in line with expectations, given its significant transition.

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