Volatility in China: Vanguard's view

By Peter Westaway, Chief Economist Europe

Markets around the world have been rattled by instability in China, where sharp declines in equity share prices have been an echo of the summer 2015 correction. Exchanges in Asia have borne the brunt of the volatility, but markets in Europe, the United States and Australia have been weighed down as well.

Investors are understandably apprehensive about this downturn. Some have wondered about the possibility of a recession in China – and what that might mean for the rest of the world.

What does Vanguard think? Our view is that the volatility in China is unsettling, but it is not surprising. It's consistent with the generally higher volatility of emerging markets and with the specific financial and economic transformations underway in the People's Republic of China.

An economic giant pivots

As we noted in Vanguard's economic and investment outlook for 2016
the high-growth era enjoyed by China and other emerging markets during the past two decades is over. From 1990 to 2007, China expanded at an astonishing average annual rate of 10%. In less than two decades, in other words, the value of Chinese economic output more than quintupled.

This rapid growth reflected China's heavy investment in manufacturing and real estate, which led ultimately to overinvestment and overcapacity. As policymakers in Beijing pivot their economic growth orientation away from investment and exports and toward domestic consumption and services, we expect GDP growth to decelerate to a more sustainable rate in the mid-single digits.

During this transitional period of rebalancing, China's investment slowdown, especially in the housing sector, represents the greatest risk to the global economy. Vanguard calculations show that China's housing market alone accounts for nearly a quarter of the world's demand for aluminium, steel, and zinc. Based on our analysis, a 10% decline in Chinese housing investment sheds more than 2% from the country's headline GDP growth.

However, while we expect oversupply in the real estate and manufacturing sectors to restrain domestic investment for the foreseeable future, we do not anticipate a Chinese recession. For the Chinese economy to contract, a housing crash much like the one experienced in the US and parts of peripheral Europe in the past decade would be required. We believe this type of event has a very low probability given the comparative lack of indebtedness in China's housing market.

Of course, this long-term transition may result in occasionally pronounced market reactions. For example, steep declines in Chinese A-share markets triggered trading halts twice in the first week of 2016, leading the Chinese government to suspend the "circuit breaker" system effective 8 January. A catalyst for this downturn was a decline in the government's monthly index of manufacturing activity. The data were consistent with consensus economic expectations, but they alarmed investors nevertheless.

Another source of apprehension has been pressure on the yuan, the Chinese currency, which has declined relative to the US dollar (while remaining steadier relative to a more meaningful trade-weighted basket of currencies). Does the yuan's decline reflect expectations of greater weakness in the Chinese economy? Does it indicate confusion about a new approach to exchange-rate management by the central bank? Or is it due to temporary, seasonal factors? These questions, and others, have contributed to an air of unease.

Implications for investors

For most investors around the world, the market tumult in China may mean relatively little. Vanguard investors – even those living in the Asia-Pacific region – generally have limited exposure to Chinese stocks.

For example, as at 30 November 2015 the Vanguard Global Stock Index Fund held just over 1% of its assets in either China or Hong Kong. This fund seeks to track the performance of a broad global equity index.

So, for an investor with a globally diversified asset mix, exposure to China is likely to be modest. But what if trouble in China sparks new turmoil in global equity markets?

Vanguard believes that equity market volatility is inevitable – but manageable for long-term investors who understand the importance of diversification and proper asset allocation. History teaches us that equity shares have the potential for higher long-term returns than bonds and cash precisely because they are riskier. Indeed, for the five years ended 31 December 2015, global stock markets produced an average annual return of 6.1%*, outperforming bonds and cash.

The New Year is off to an unsteady start, to be sure, but experienced investors know that patience and resilience during times of stress have historically been rewarded over the long run.

*Source: Bloomberg.