Orient Capital Research

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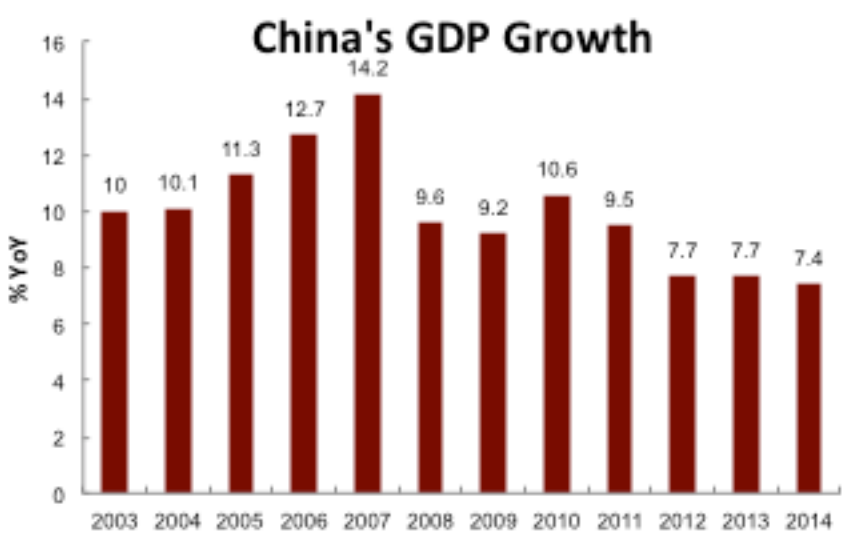
Why the World is Overreacting to China's Market Downturn

False Alarm Bells

The global markets are blaming China as the instigator for a global slowdown. As the New York Times noted, "The immediate trigger to the outburst of global volatility was China, where the sharp drop in stocks Monday continued a rout that has been underway — with periodic pauses thanks to government interventions — all summer." We are usually not one to praise Chinese economic sagacity. However, We believe there is a widespread misinterpretation of Chinese policy over the past few months that has created this global crisis in confidence. Apart from a few notable missteps, China has continued to administer its economy with the same tools as before and in some cases has even made modest progress in reform.

The downturn in the Chinese economy should come as no surprise. GDP growth has been ratcheting down steadily since 2010 and consensus forecasts continued declines. This is normal for an emerging market, particularly one that has relied so heavily on debt-fueled growth. Nothing recently has altered this equation.



The Stock Market Fiasco

The failed attempt to boost — and then halt the decline — in the equity markets was a surprise and did indicate a higher degree of governmental ineptitude that was expected for a leadership that prides itself on its ability to execute policy. But the impact on consumer confidence, capital raising and overall economic conditions is likely to be minimal. Exports did fall 8.3% in July, worse than people thought, but that is more a function of a struggling Europe than a struggling China.

There are other, far more important and systemic problems within the Chinese economy. These include local debt, the property bubble, inefficient capital allocation, financial repression of savings accounts, and continued support for the state sector. But we expect those to take some time to play out. There is no immediate crisis.

Surprising Reform Progress

More important, China continues to make progress, albeit at times haltingly, on economic reforms.

First, the devaluation of the currency was an unexpected and wise move. It will help to boost exports and was dressed up for internal political consumption as a pro-nationalist policy to make the currency a global currency, starting with the inclusion in the IMF's Special Drawing Rights. There are pros and cons to this policy change and there is some question of how far the PBOC can support the Renminbi. But it was a fairly determined policy change that is arguably in the right direction

Second, the program to swap 2 trillion yuan in local debt for bonds — a months-old policy now nearly forgotten — was a sharp turn to create a fungible market for local debt. Once again, it has run into various factions and quibbles over implementation that will hobble it to some degree. But it was also an attempt by Beijing to tackle one of the country's more intractable problems.

And there is the corruption campaign. It is now widely perceived as Xi Jinping's battle against the Jiang Zemin factions that oppose his rule. But internally, local Chinese quietly say that Xi is cracking down on corrupt groups within China while allowing modest liberalization in the economy. One Chinese fund manager I spoke with even said that Xi may be willing to move Premier Li Keqiang out of office and put someone else in who would be more effective on the economy. "A lot of Chinese think Xi would be pragmatic; he might just say, let's change the CEO," he noted.

Two Concerns

There should be concerns about two issues are paramount for China's growth and impact on the global economy: local revenues and capital flight. Local governments are running out of money. We were in Sichuan Province last week and were shocked at the overbuild of property and mortgage of future cashflows from land sales done by desperate local governments. In addition, the mobility of capital among China's elite could quickly drain liquidity from China's banking system, as we are already seeing with an estimated $225 billion leaving the country in just the past few months. But China is aware of these issues. The devaluation and bond swap are both aimed at addressing these problems.

There are serious problems within China's economy. But the alarm bells ringing on Bloomberg screens in New York are a bit out of whack with the reality on the ground.

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