

FROM THE CAPITAL

China a new source of market volatility

Once a miner's best friend, China becomes central factor in damaging global instability

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Are Chinese policymakers more skilled at economic management than their peers in other countries? That is one of the questions for investors confronting crisis-like ructions in financial markets.

The macroeconomic landscape has changed little over the past several months. Relatively slow global growth, little sign of incipient inflation, highly accommodating monetary policy settings and weak crude oil prices have set the tone.

In the USA, earnings have been struggling to validate equity prices but the market's upward impetus has long relied on low interest rates rather than strong sales. A growing consensus has tipped September for the first US Federal Reserve-initiated interest rate rise but no one of note has been expecting anything more than the most gradual pace of increases subsequently.

There has been little in this mix to hint at August's intense equity price volatility. Some market instability has been linked to news emanating from China including signs of further slowing in manufacturing output growth, but this was easily foreseeable and no change in direction.

The Caixin-Markit manufacturing purchasing managers index released on August 21 added to uneasiness about the pace of Chinese economic activity. The measure signalled a further contraction in output although the message in the most recent reading differed little from the implications for growth from survey outcomes in the previous three months.

China's central bank took markets by surprise when it announced modest yuan devaluations over successive days earlier in the month after altering the way in which foreign exchange rates are fixed.

The double-barrelled depreciation raised the spectre of competitive exchange rate adjustments and lost income among China's competitors. Some analysts inferred a worsening economic trend behind the bank's actions. The third possible interpretation – that Chinese output growth and emerging market economies generally would benefit from stronger manufactured exports – seemed to carry little weight.

The 3% net effect on the exchange rate was hardly enough to warrant subsequent market swings. Among other emerging economies, the ruble has fallen by as much as 16% against the US dollar during 2015. The Brazilian real is 36% lower. South Africa's rand has given up 14% and the Turkish lira has slumped 26%.

None of the news from China seemed enough to warrant a serious rethink about the trajectory of the Chinese economy. A commitment to place more emphasis on consumption spending and less on investment as sources of growth had long ago cast the die. Investment spending had already hit 50% of Chinese GDP. If that could go no higher, the burden on consumption to produce overall growth of even 7% would prove too heavy. Growth was more likely to edge toward 4-5%.

At the same time, China's policymakers had acquired reputations as highly deft practitioners of their art. Expectations about their skill, particularly among the foreign business community, have been high.

The reputations of the Beijing bureaucrats had been artificially enhanced as they surfed a tidal wave of economic reforms including, for the first time, private home ownership which allowed entrepreneurs to fund new business activities. The vestiges of a command economy combined with expanding reliance on market forces offered a unique transition in the pattern of growth. Even seemingly minor reforms helped build an economic avalanche that persisted for two decades.

As policymakers have had to rely more heavily on market forces and less on central direction, policies have taken longer to implement than those at the earliest stages of economic liberalisation. Also, policies benefiting growth no longer coincide neatly with the vested interests of those whose wealth and power had relied on the first round of market openings.

Like policy frameworks elsewhere, fresh initiatives have had to be tempered by the need to keep financial market risks within the bounds of prudence. In this way, China has become increasingly like other countries in which policy changes are less certain in their effect and timing.

In parallel with this evolving policymaking



Shanghai's Lujiazui Financial District in China

apparatus, global markets have become more prone to knee-jerk reactions. Technology has played an important role. Individuals as well as the largest global institutions can trade almost instantaneously in response to any event. Around the world, traders are being tempted to react to every fragment of news. The largest exchanges actively encourage high volumes to maximise their revenues.

Volume begets more volume. Leveraged positions requiring liquidation result in stocks being sold because they are the easiest to sell, not because they have the most compelling analytical cases for being dropped from a portfolio. Choosing to stay aloof from the pack, as some longer-term value-oriented investors still try to do, becomes tougher as market prices swing widely.

This typifies the modern market in which periodic bouts of volatility are becoming an ongoing likely feature. Historically, major corrections or bear markets were going to be initiated by policy changes designed to prevent financial market excess. Nowadays, the interplay of technology and market structures play an important role in setting reaction speeds and short-term market directions.

The Chinese overlay is an increasingly complicating factor. The country's global impact on growth outcomes and corporate profitability is rising. Several years may have to elapse before sufficient evidence accumulates to allow well-informed judgements about the ongoing effectiveness of day-to-day economic management in China. Until then, China will be a constant and possibly rising source of volatility for global markets.

These conditions have special relevance for the competitive positioning of mining equities. Stocks with the least volatile returns – typically large cap dividend paying industrial and financial companies with a spread of global income sources – will become the most highly prized investments.

The mining companies could find themselves increasingly stranded from the mainstream. Even more than they are now. They will be among the most vulnerable to the new volatility which will come as traders grapple with how well Chinese policymakers can manage a market-based economy. ▼