



## Market Viewpoints

Manish Singh

August 2015

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***“Traders who can both be right and sit tight are uncommon. I found it one of the hardest things to learn. But it is only after a stock operator has firmly grasped this that he can make the big money”***

**- Jessie Livermore**

When the Shanghai and Shenzhen stock exchanges opened for business in December 1990, there were eight listed stocks with a combined market capitalization of USD 500m. By 2015, the two bourses had 2,800 listed companies with a total market cap of over USD 10 trillion. Once purely a socialist command economy, China, the Middle Kingdom, is now partially socialist and partially capitalist. China represents 15% of world GDP and outweighs every country in the world except the United States. Therefore, what happens in China matters. Yet, it's worth remembering - Chinese equity markets are not the Chinese economy. Unlike in the Western world, where listed companies represent a large proportion of GDP, the free-float value of the Chinese markets is only about one third of GDP, compared with more than 100% in the US and the UK. Besides, less than 15% of Chinese household financial assets are invested in the stock market. US interest rates remaining at zero, at the margin, are now a net negative for the economy. The sooner we get the first rate hike this cycle, the sooner it would remove the uncertainty that a 25bp rise in short rates would spell doom for financial markets. I can't help but think that the real problem in the stock market is not now. It is for later, when inflation fears abound and the Fed starts hiking aggressively.

### What comes first? Thanksgiving or a US interest rate hike

On Monday, the Dow Jones Index (DJIA) gapped 1,000 points lower at the open and the S&P500 (SPX) index was just 34 points away from triggering a circuit breaker, which would have seen the Index shut down for 15 minutes. Some of opening bell moves seemed unprecedented, with the likes of General Motors and JP Morgan tumbling more than 20%. Europe finished down -5.5% for the day and the US was down -4%.

Despite the volatile few weeks we have witnessed in global equity markets, I still believe a September rate in the US hike is not off the table. The US Federal Reserve Bank (Fed) is “data dependent” not “market dependent,” and the data are good enough for rates to be off their zero level. The spread of US GDP growth to the Fed funds rate is at its highest since 2004 and the unemployment is rate low. I believe that the market news will have to remain bad from now until the September meeting for them not to raise rates. I would add that zero-rates, at the margin, are now a net negative for the economy. The sooner we get the first rate hike this cycle, the sooner it would remove the uncertainty that a 25bp rise in short rates would spell doom for financial markets. This is especially true since I believe the Fed will accompany any hike by significantly lowering the “dots” in the “dot plot” of forward rate projections and thus signalling that the terminal rate in this cycle will be in the low 2% and not 3%. If the August jobs report is strong again and equities recoup the recent sharp losses, then the Fed will probably pull the trigger at its next meeting in September.

Of course, this week we have also seen some talk of return of Quantitative Easing (QE). I am not sure that is a good idea. However if there is QE4, I would request the Fed print a trillion dollars and buy that much worth of crude oil and bury it in a secret location somewhere. That will do more for commodity prices and, in turn, for the economy than buying another round of US Treasuries and mortgage - backed securities!

### Bull in a China shop

When the Shanghai and Shenzhen stock exchanges opened for business in December 1990, they had eight listed stocks with a combined market cap of USD500m. By 2015, the two bourses had 2,800 listed companies with a total market cap of over USD10 trillion. China today represents 15% of world GDP and outweighs every country in the world except the United States. The five countries at the centre of the 1997 Asian crisis represented 4% of world GDP. Russia made up a

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mere 1% of world GDP in 1998 when it defaulted and caused a market panic. Therefore, what happens in China matters more than in any country during any of the economic crises of the past fifty years.

Once purely a socialist command economy, China, the Middle Kingdom, is now partially socialist and partially capitalist. When the Shanghai composite index (SHCOMP) reached a new pinnacle of 4,000 in April, a column in *People's Daily* effused that this "was only the start of a bull market." "What's a bubble?" it asked insouciantly. "Tulips and bitcoins are bubbles ... but if A-shares are seen as the bearer of the Chinese dream, then they contain massive investment opportunities." The Chinese people heeded and sent the SHCOMP flying high in pursuit of quick money.

In the 12 months since June 2014, the SHCOMP has risen +150%. It peaked on June 12, 2015 and then slid over -40% in three weeks. The Chinese policymakers, who like the stock market only so long as it's rising, promptly put the brakes on the slide and, at one point, only 3% of listed companies were freely tradable 51% took themselves off the market and an additional 46% were halted because of limit rules. Had the People's Bank of China (PBOC) stopped at cutting interest rates - justifiable support when inflation is so low - that would have been reasonable. Instead, we witnessed a slew of actions - a ban on short selling, a ban on new stock offerings and a ban on sales of any shares by large investors and around \$200bn worth of stock purchases by state-owned institutions. The short-lived rally that ensued persuaded many Chinese investors to jump back into the market, only to see it plummet again in recent weeks. China's benchmark index fell -17% this week before rallying back +5% Thursday.

China's intervention to help the equity markets has been like a Bull in a china shop. It has ended up unnerving the investors and left the index broken. Far from saving the markets, the succession of life buoys only pushed them further under water to the point of drowning. By acting so intrusively to initially encourage share purchase, and then haphazardly to save them from crashing, China's leaders have left themselves subject to what former US Secretary of State Colin Powell memorably called the "Pottery Barn rule" - if you break it, you own it. The Chinese equity markets have now become ward of the Chinese communist party.

China's Securities Regulatory Commission (CSRC), the market watchdog, has disclosed some interesting market statistics recently:

- The introduction of margin debt has been a big boost to SHCOMP's A-shares. Margin debt at one stage represented 9% of the total A-share tradable market cap. In comparison, margin trading on the New York Stock Exchange consistently equals 2% of the tradable market
- The number of new brokerage accounts created in the first five months of 2015 - nearly 18 million - exceeds the total created over the previous four years

It is doubtful that so many new investors understand the risks in the market that underpin equity prices in the long run. Not surprising then that doctors in China have reported a surge in what they are calling *gupiao jiaolü zheng*, or "stock market anxiety syndrome."

### What does the Shanghai market crash mean for the Chinese economy?

It's worth remembering - Chinese equity markets are not the Chinese economy. Unlike the Western world where listed companies represent a large proportion of national GDP, China's economy is still overwhelmingly dominated by the huge state owned enterprises (SOEs). Corporates are not reliant on the equity market as a source of financing and a very large part of the banking sector is not imminently linked to the equity market. The stock market plays a surprisingly small role in China. According to the World Bank, the free-float value of Chinese markets—the amount available for trading—is just about a third of GDP, compared with more than 100% in developed economies. Besides, less than 15% of the Chinese household financial assets are invested in the stock market, therefore, a soaring Shanghai Index didn't boost consumption, and a crashing one will do little to hurt it.

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In the short run, a bubble driven by uninformed investors buying on credit is bound to burst, and it did. On an economic front, China's foreign debt liabilities, measured at around \$1tn, still pale in comparison to foreign reserves of \$3.6tn. Unlike Asia in the 1990s, the Chinese Renminbi (RMB) shows few signs of overvaluation in its external balances. The current account surplus, although well down from its peak of 10% of GDP in 2007, is still 3% of GDP, and Chinese exports have continued to gain market share globally.

China's financial industry maintains a deep-rooted structure that is centred on the government and the state-owned sector. State-owned banks sit at its core, and loans are extended with priority given to state-owned enterprises, leaving small and midsize private enterprises cash-strapped. This has to change with capital allocated competitively. The best-case scenario for the government would be to align the stock market more with the actual economy. The country's national savings rate remains extremely high, protecting it from a U.S.-like debt crisis, and the government could still encourage more investment by lowering interest rates.

Earlier this week, China cut the required reserve ratio (RRR), a policy tool they will use more of in the future. In the long run, China's big equity market presents an excellent alternative to bank loans as a means of financing corporate investment. A thriving equity market, driven by profits rather than politics, will almost surely improve the efficiency of capital allocation, compared to central planning. As cross-border flows further liberalize, capital accounts open up and the RMB is inducted into the International Monetary Fund (IMF) basket of currencies, China's equity market will provide savers around the world with a chance to invest in the country that still contributes more to global economic growth than any other.

### Where to invest?

I can't help but think that the real problem in the stock market is not now. It is for later, only when inflation fears abound and the Fed starts hiking aggressively. Markets are preoccupied with macro factors, which presents an opportunity for investors to engage in selecting themes to trade a potential tactical bounce in Q4, when data improves. For me, some of the themes are US Housing, Japan, US Financials and beaten-down consumer and technology stocks.

Europe and the US are great buying opportunities. Sector-wise, it is best to wait a little before buying Industrials, Energy or Mining names. Japanese stocks are a buy too. The Earning per Share (EPS) surprise in Japan was +14% this earnings season, compare that to a +4% average earnings surprise we saw in the US. As for the Emerging Markets (EM), one can wait and watch and stay underweight. Best to hold off putting new money into EM until the "babies and bathwater" crowd has moved on.

In this selloff, the Indian market presents an interesting buying opportunity. India is a big oil importer, with a stable majority government and reforms being worked at slowly. Months of low oil prices will start translating into better a balance sheet at the national level. India also has a very credible central bank governor, Raghuram Rajan, who is determined to intervene to stabilise currency moves. The FX reserves stand at over USD 355bn.

This is not your 1997-98 EM crisis, back then EM currencies were pegged to the US Dollar and current account deficits were the norm. Now there are few USD pegs and FX reserves abound. Of course, reserves are not spread evenly. In EM, the investors will differentiate and India should be the beneficiary of a renewed rally and so should China, when things settle down.

The EUR/USD strength to 1.15 is not surprising given the unwinding of the long Eurozone stock positions in this selloff for USD investors. It's noteworthy that HEDJ the USD hedged ETF for Eurozone is the ETF with largest inflow this year. I believe this EUR rally is to sell not buy EUR/USD. Long European equities and short EURUSD is a good trade.

Some of the stocks I hold/recommend holding – Citi (C US), JP Morgan (JPM US), Bank of America (BAC US), Gilead Sciences (GILD US), Allergan (AGN), Apple (AAPL US), Google (GOOG US), Amazon (AMZN US), Facebook (FB US), Anheuser Busch (ABI BB), Pepsi (PEP US), UBS (UBSN VX), Richemont (CFR VX), Volkswagen (VOW GY), Airbus

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(AIR FP), United Technologies (UTX), Barclays (BARC), Societe Generale (GLE FP), Roche (ROG VX), Novartis (NOVN VX), Vinci (DG FP), Rio Tinto (RIO LN), Glencore (GLEN LN), Freeport-McMoran (FCX), Michael Kors (KORS US), Halliburton (HAL US), Nordstrom (JWN US), Caterpillar (CAT US), Intel (INTC US), Twitter (TWTR US), Walgreen Boots (WBA US), Union Pacific Corp (UNP US), Home Depot (HD UN), Intesa Sanpaolo (ISP), Inditex (ITX)

Best wishes,

Manish Singh, CFA