

INVESTMENT PERSPECTIVES

OCTOBER 1, 2015

China's Shock

After years of steady, even quiet, market appreciation, investors were jolted awake by the late August swoon in stocks around the world. Those returning from vacations where they had no contact with the outside world (admittedly, hard to do these days) probably wondered, “What in the world is going on here?”

The answer can be made to sound simple—“China”—but it’s more complicated than that. While global markets had softened a bit in July and early August, it was the Chinese government’s decision to devalue the yuan that ignited a major sell-off on August 21. That action then led to fears that China’s economy was in serious trouble. Since it’s the second largest in the world, many investors quickly concluded that its contagion would spread to other countries in the form of competitive devaluations as well as further weakness in commodity prices.

Most indicators suggest that China’s economy is growing at a mid-single-digit rate. The government reported a 7% expansion in gross domestic product for the first half of the year, and wages are rising at about 10%—not exactly a picture of economic disaster. In fact, China continues to lead the developed world in terms of percentage growth.

Investors are worried about China for several reasons. Economic growth has appeared to slow, complicating government efforts to shift the economy away from reliance on heavy industry to more consumer- and service-oriented growth. Weaker demand from China has also intensified a decline in global commodity prices and possibly increased the burden of the country’s massive public- and private-sector debt. Finally, Beijing has seen confidence in its economic management erode following its failed efforts to arrest a tailspin in the country’s boom-and-bust stock markets.

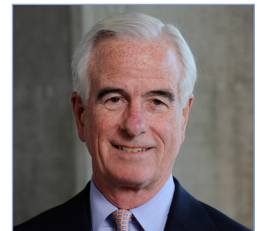
The global volatility triggered by the August plunge in Chinese equities is only the latest sign of what a central role the country now plays in the world economy. It is unclear

whether the China shock presages an extended economic downturn or is just a passing correction in a trajectory of resilient growth.

CHANGING COMPOSITION

Much has been written about the changing composition of the Chinese economy, from an industrially based engine to more of a consumer-led enterprise. This transition has led to increasingly intensive debates about its rate of sustainable growth. Skeptics point out that freight volumes have declined 12% year to year, and electrical consumption has increased by only 2% during the past nine months. Optimists underscore the growth of services and consumer spending. Apple, for example, reported 112% growth in “Greater China” (which includes Hong Kong and Taiwan) for the second quarter, and much of the country’s recent growth has been in entertainment and other services. As in most Western economies, services now account for a larger share of the economy than industry.

During this transition, deflation has set in as the demand for commodities has softened. Producer prices have been declining for four years, and the GDP deflator (the broadest measure of inflation) is in negative territory, although consumer prices remain positive. Similar trends are evident in other parts of the world, and of course central banks everywhere are attempting to stimulate demand in order to revive inflation, in part because today’s high debt loads are easier to pay down when currencies become cheaper. China is in the fortunate position of having far more room than most other governments to provide stimulus, both monetary and fiscal. Its one-year lending rate is around 4.5%, allowing room for easing, and its required reserve rate



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is among the highest in the world. Its budget is also running a surplus. Thus, there is ample ammunition to fight slowing demand, and there are signs that the government is beginning to use it.

At the same time, China's debt load has increased markedly since the financial crisis and now poses a significant risk. By some measures, it has reached about 250% of GDP, almost double its pre-crisis level but still lower than many developed nations. Within this figure, government debt is relatively low, but the Communist Party is responsible for the obligations of state-owned enterprises and would probably stand behind the debt of other Chinese companies as well. In recent periods, non-performing loans have increased as a percentage of total loans outstanding, leading some to worry that the debt build-up could lead to a financial crunch. But at slightly over 1% in 2014, bank non-performing loan exposure is low—about half the level of U.S. banks, according to the World Bank.

WORRIES IN SHANGHAI

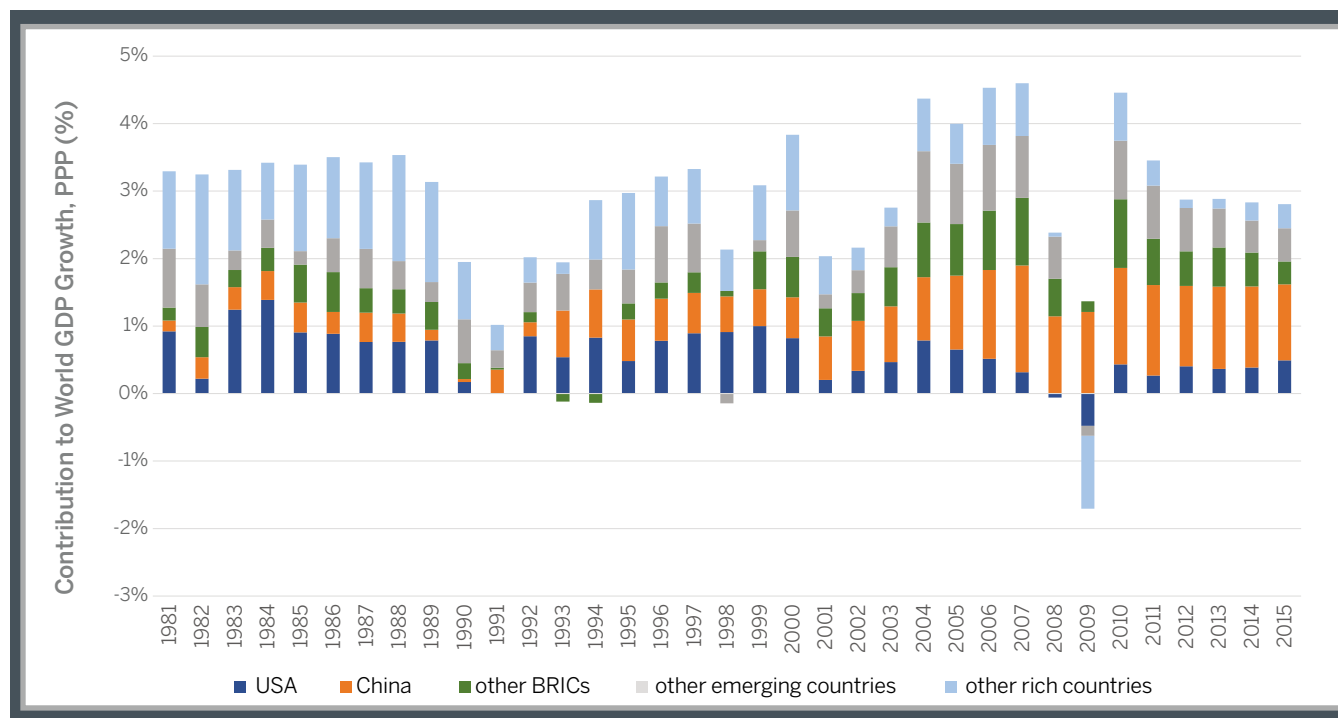
Second to the Dow Jones Industrial Average, the next most widely watched stock index today is probably the Shanghai Composite Index. Having peaked at 5166 in June, more than double its level of last October, the Composite has fallen about 40%, depending on the end date in the calculation. While many observers point to its decline as a sure sign that the economy is in trouble, we're not so sure. A correction was probably overdue. The Chinese market is, like those of many emerging nations, institutionally underdeveloped and subject to inflows and outflows of retail investors. Additionally, even allowing for the recent pull-back, the market is up 30% to 40% in the last year—far outstripping economic growth. Like

most stock markets, it reflects sentiment at least as much as the fundamentals. To those who believe that lower stock prices will lead to a decline in consumption (often called the “wealth effect”), we would point out that the value of tradeable Chinese equities is equivalent to only about a third of GDP, compared to over 100% for most developed nations. Further, less than a fifth of Chinese citizens participate in the markets.

If investors lack confidence in the Chinese economy, they seem to trust the country's authorities even less. In addition to questioning the credibility of published economic figures, many are beginning to doubt the government's ability to manage the economy effectively. The word “opaque” is often used to describe the country's corporate disclosure practices, but it could also be applied to economic figures. In a managed economy, the government can, at least in the short run, publish whatever it chooses regarding economic growth. (On the other hand, private surveys tend to corroborate much of what the government publishes.) Further, the Chinese economy is so sprawling as to be challenging to monitor. If initial GDP estimates in the U.S. are later revised by as much as two percentage points, imagine how inexact Chinese figures must be.

As Chinese GDP growth has slowed and debt has mounted, an increasing number of observers have wondered if the government can successfully navigate the transition to a more consumer-led economy. This undercurrent of doubt suddenly erupted when authorities decided to “devalue” the yuan on August 11. The 2% downward adjustment represented the largest one-day decline since 1994, but we put *devalue* in quotes because it was unconventional. In fact, it resulted partly from a technicality in how the value of the yuan is calculated against

EXHIBIT 1: China: The Big Driver of Global Growth (12/31/1981 - 4/14/2015)



Source: IMF World Economic Outlook (WEO) and World Bank Databank.

the dollar. Essentially, the yuan had been allowed to move 2% above or below the previous day's mid-point, but the authorities decided to start basing the 2% calculation on the previous day's closing price (which that day had been down 1.9%), thereby making it more market-based but, as it turned out, at a lower level. Since then, China has reportedly spent substantial sums to support the yuan. Part of the motivation for its change in practice was to curry favor with the International Monetary Fund, which is considering making the yuan a reserve currency. The IMF believes reserve currency values should be market-driven.

Before and after the "devaluation," the government took several measures, including buying shares and arresting a journalist and several traders for spreading negative rumors, in an effort to shore up the value of the Shanghai Composite Index, without much success. These efforts, which were well publicized (and widely ridiculed as misguided), only served to undermine confidence in the government's ability to manage the economy.

On the positive side, China has huge foreign currency reserves, estimated at \$3.5 trillion, built over many years of trade surpluses. Those reserves can be used to support the value of the yuan (in its quest to qualify it as a reserve currency), provide liquidity in the financial system, offset loan losses, etc. And, as we pointed out earlier, there is plenty of room for monetary easing and fiscal stimulus. Still, there are some analysts who see the recent devaluation and efforts to prop up the stock market as desperate precursors to a destructive round of competitive

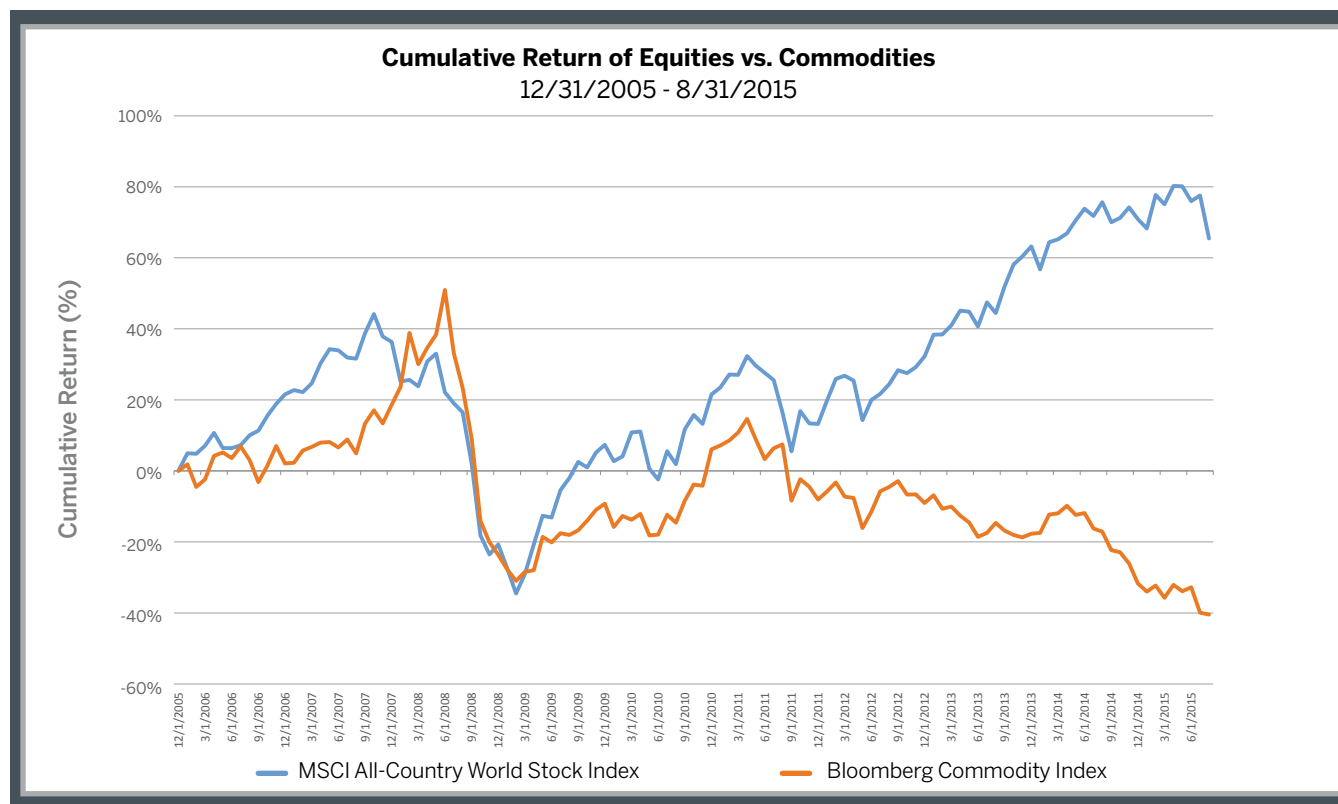
currency devaluations that could lead to a decline in trade, widespread deflation and ultimately a worldwide slump. While the authorities' action to support the yuan suggests that further devaluation is unlikely, it remains to be seen how other countries may react.

COMMODITIES FALLOUT

Weaker demand from China's industrial sector has led to lower commodity prices around the world. Copper, for example, hit a six-year low following the yuan's move in August. Oil, which has dropped by more than half in the last 12 months, is only the latest victim, and its decline is partly a function of over-supply. In any case, the weakness is a serious concern for many emerging markets (EM) countries, which are major suppliers of commodities. Not only are exports slumping in terms of volume, they are subject to lower prices. In some countries, such as Iraq, Venezuela and Russia, this combination could lead to social and political unrest, as well as competitive devaluations in an attempt to restore demand for exports.

Ironically, the resurgence of growth in the U.S. is exacerbating the situation in many developing markets. As the domestic economy strengthens, the Federal Reserve will inevitably raise interest rates in an effort to restore them to normal following the long period of quantitative easing. Higher rates here have the effect of drawing capital out of the EMs and into safer U.S. securities with increasingly competitive yields. In addition to raising the cost of capital in developing economies, such capital flows tend to strengthen the dollar,

EXHIBIT 2: Stocks Way Ahead of Commodities



making it more costly for EM borrowers to repay their loans if they've borrowed in dollars. Thus, EM countries are caught in the crossfire of a slowing Chinese economy and a recovering U.S. one. Particularly affected are Brazil, Russia, Mexico and South Korea—in addition to China itself.

PARALLELS TO THE '90S?

Some economists have suggested that the present situation is analogous to the late 1990s, when a sudden devaluation of the Thai baht in July 1997 caused a ripple effect among EM countries in East Asia. Attracted by Thailand's accommodative economic policies, stable exchange rate (the baht was tied to a basket of currencies), political stability and relatively modest inflation, capital flowed into the country and inflated asset values. Banks began lending recklessly and became overextended. Because much of the capital inflow was speculative, the actual trading of goods failed to keep pace with asset values, and as a result, the government lacked foreign currency to support the baht, necessitating a 15% to 20% devaluation. Capital markets reacted violently, and East Asian countries suffered a degree of economic and social instability. But the region began recovering in 1999, thanks in part to help from the IMF. At the time, the U.S. was recovering from an early-1990s recession, and the Fed was raising interest rates. Predictably, capital flowed into the dollar, the U.S. economy continued to expand, and the stock market moved on to new highs after 1998.

Today, EM countries make up a significantly greater percentage of world economic activity, so in a sense the risks are greater. At the same time, the economic underpinnings of many countries are far stronger than they were 20 years ago. Foreign exchange reserves are much larger, and current account balances are better—meaning that they are less reliant on foreign capital to finance the difference between their spending and what they earn from trade. Finally, most currencies are no longer “pegged” or fixed, so they are free to float up or down rather than being subject to a sudden and destabilizing decision to devalue.

The market turmoil caused by events in China is just another indication of its growing impact on the world economy. To date, we haven't witnessed the dark side of this impact, and it is still extremely difficult to gauge the extent to which developments in China signal a recession, a slowdown in growth or simply a transition—and even harder to predict the impact on the rest of the world. The only thing that's clear is that recent events have

rattled the markets and set off a period of renewed volatility. To maintain perspective, however, it's helpful to keep in mind that the markets often overreact to negative news. Our colleague Teddy Lamade reminds us, for example, that the S&P 500 Index has experienced corrections of roughly 10% or more on 15 occasions since 1987, yet its return over that period has been over 1300% with dividends reinvested. Trying to time the market has consistently proven to be an exercise in futility.

OUR POSTURE

With risks elevated and the outlook clouded, it's particularly important to stay diversified across asset classes. Market dislocations can sometimes cause allocations to shift away from one's strategic plan, so we are reviewing portfolios to be sure they remain in line. For example, the sharp sell-off in emerging markets may open the opportunity to add exposure to them in balanced portfolios, if only to restore strategic weightings. Moreover, diversification involves owning asset classes with low correlations to one another so that all holdings don't decline at once. Bonds, for instance, have held up well during the equity sell-off. Hedge funds, with both long and short exposure, can also help reduce portfolio risk and volatility.

For active managers like Brown Advisory, volatility provides a good chance to rearrange portfolios with a view to upgrading quality and positioning. Not all stocks move in a similar manner, so inevitably some of those that we consider most attractive on a fundamental basis will trade down into a buying range while other, less attractive ones may fare better in the short run and provide the opportunity to sell. Our portfolio managers see the sell-off as an opportunity to take advantage of these uneven price movements. As a result, portfolio turnover typically increases during times like these, but the end result tends to be favorable.

Most critical is to keep cash readily available to meet spending requirements. We have long advocated what we term our “three bucket” philosophy to impose discipline in this regard. Maintaining a cash cushion prevents clients from having to liquidate investments at depressed prices simply to meet the need for spending. The amount varies according to each client's need to draw cash from the portfolio, but typically we encourage clients to keep one or two years' worth of spending needs in cash or near-cash. The wisdom of this strategy is particularly borne out during periods like the present one. [B](#)

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An investor cannot invest directly in an index.

The **S&P 500 Index** represents the large-cap segment of the U.S. equity markets and consists of approximately 500 leading companies in leading industries of the U.S. economy. Criteria evaluated include market capitalization, financial viability, liquidity, public float, sector representation and corporate structure. An index constituent must also be considered a U.S. company. The **Dow Jones Industrial Average Index** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the Nasdaq. The **Shanghai Stock Exchange Composite Index** is a capitalization-weighted index. The index tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange. The **MSCI All Country World Index Ex-U.S.** is a market-capitalization-weighted index maintained by Morgan Stanley Capital International (MSCI) and designed to provide a broad measure of stock performance throughout the world, with the exception of U.S.-based companies. The **MSCI All Country World Index Ex-U.S.** includes both developed and emerging markets. The **NASDAQ Composite Index** measures all NASDAQ domestic and international-based common type stocks listed on The NASDAQ Stock Market. Launched in 1971, the **NASDAQ Composite Index** is a broad-based index. Today, the Index includes over 3,000 securities, more than most other stock market indices. The **NASDAQ Composite** is calculated under a market-capitalization-weighted methodology index.

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