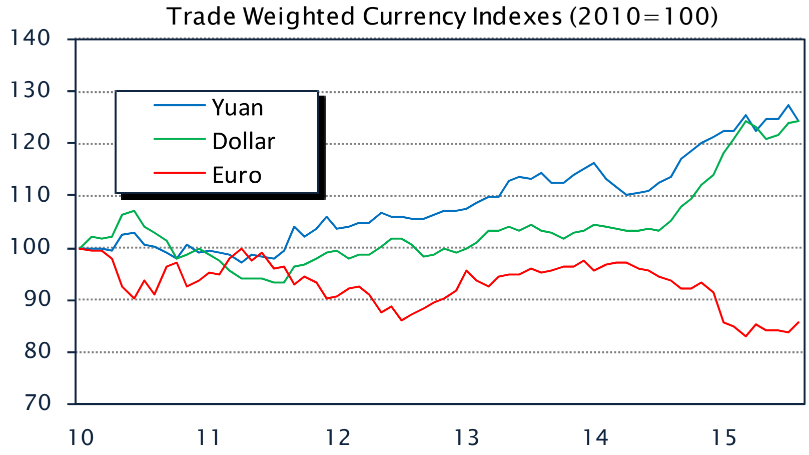
SEPTEMBER 2015

Agincourt
Capital Management, LLC

INVESTMENT UPDATE

It's been more than ten years since we last wrote about the relationship between the US and China (the "we buy stuff, they make stuff" *Investment Update* of May 2005). With all the turmoil that's been going on in China over the past few weeks, we thought it might be a good idea to revisit the topic of China, particularly as it impacts the US bond market.

First, some perspective (using data from *The Economist's* "World in Figures" publications). In 2005, China was on an economic hot streak, having generated an average annual growth rate in its GDP (gross domestic product, the total output of its economy) of approximately 9% over the previous decade, having slowed only slightly from the 10% annual growth of 1991-2001. This pace of growth was putting China on a trajectory to become the world's biggest economy in relatively short order. China's GDP was only 11.5% of US GDP in 2001, but had grown to 18% of that of the US by 2005, and was 60% of our GDP by 2014. When we wrote about China in 2005, we noted that it was the world's sixth largest economy; by 2012 it had climbed to #2. Perhaps more importantly, this has translated into a massive improvement in the life of the average Chinese citizen, whose per capita income has increased almost sevenfold since we last wrote about China.

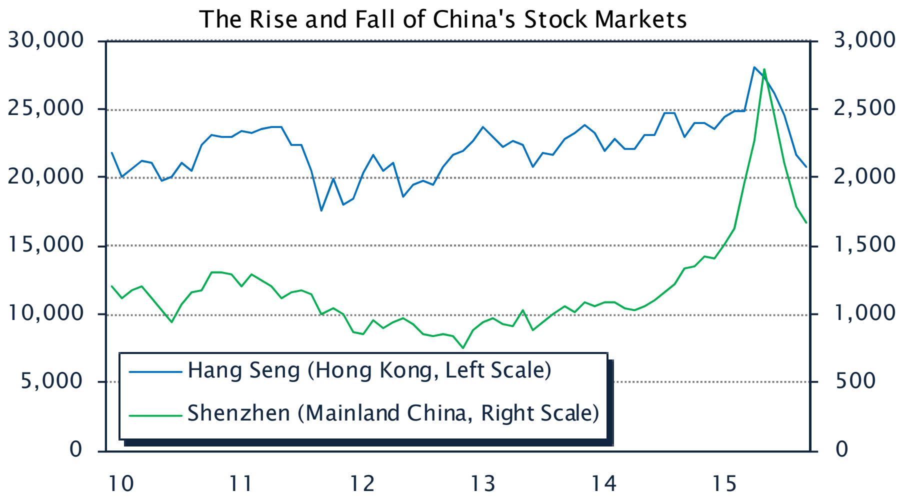

Trade Weighted Currency Indexes (2010=100)

Clearly, China has been an economic success story over the past couple of decades, transforming itself from an agrarian-heavy (37% urban population in 2001) , centrally-planned state with an oppressive central government to one that's embracing economic change while undergoing a modern approximation of the industrial revolution (55% urban in 2012). And therein lies the problem for countries like China. Having pulled itself out of the dark ages brought about by, first, dynastic isolation, and later, by communist totalitarianism, China finds itself at socio-economic crossroads: Continued economic growth will mean having to embrace true market and societal freedoms, something which its political overlords are loath to do. And of course, it becomes increasingly difficult to put up the same heady economic growth numbers once you've achieved a modicum of success; there is always someone with a lower wage base in the non-developed world. China is no longer the low-cost producer it once was.

China's economic growth over the past few decades has been mainly attributable to an emphasis on the manufacture of products for export. This has brought in trillions of dollars (as well as euros, yen and scores of other currencies) in capital, some of which has been funneled into massive construction projects for factories, roads, housing and other infrastructure. But that inflow of foreign money places upward pressure on the Chinese currency, the yuan (also known as the renminbi), which over time makes the exports on which its economy depends increasingly expensive to the outside world. In order to keep the yuan from appreciating too much over time, the Chinese government has "pegged" the yuan to the US dollar, while investing trillions (foreign reserves were $3.5 trillion at the end of August, to be exact) in foreign government bonds, effectively buying foreign currencies in exchange for its own. Nevertheless, as the chart on this page shows, over the past five years or so the yuan has been one of the strongest currencies around the globe, appreciating on a trade-weighted basis by roughly 25% since the start of 2010 (note, the dollar is up by a similar amount over the same period).

Which brings us to recent developments. As the chart on the next page shows, China's stock market, particularly as measured by the mainland Shenzen Index, has run up the proverbial flagpole in recent months, and by June was nearly double its level from year-end 2014. If it wasn't a bubble, the Chinese stock market was doing a damn fine impersonation of one, and there was growing speculation that the Chinese government was doing its part in keeping the bubble inflated. After all, this rapid rise was occurring against a backdrop of disappointing economic results (even the official, down-shifted, GDP growth target of 7% was looking dubious) and growing concern about overvalued Chinese commercial real estate.

What happened next was predictable, if unusual for China—investors began taking profits, pulling funds out of Chinese companies' stocks for greener pastures elsewhere, putting its stock market into free fall. The selling only accelerated in August when the Chinese central bank, the People's Bank of China (PBOC), concerned that exports were falling (down 8.9% year-over-year in July) because of a too-strong currency, depreciated the yuan by 2%—seemingly small, but the biggest currency "adjustment" in more than 20 years. Investors saw that as a sign of weakness and accelerated their selling; by the end of August the Chinese government had sold off more than $100 billion of its foreign reserves in order to prop up its stock market and defend the yuan from further depreciation. In addition, there were reports that government officials had been contacting some of the larger investment houses, inviting them to "have tea" in order to explain that while buying Chinese stocks was very welcome, the selling of stocks was not. The chart shows the degree to which the mainland stock market was inflated (and continues to remain elevated) compared to the far more stable Hang Seng index, which tracks Hong Kong's stock market; you'll notice that the lack of government intervention has meant that stocks traded on Hong Kong's exchange have fallen back to mid-2013 levels. For the mainland Shenzhen index to go back to its level from the summer of 2013, it would have to drop by more than 85% from its current level.


The Rise and Fall of China's Stock Markets

The global capital market fallout from the turmoil in China has been surprisingly severe over the past few weeks, with stock markets plummeting by multiple percentage points around the world, and volatility increasing to levels not seen since the financial crisis in many markets. We say "surprising" because, despite having grown to become the world's second-largest economy, the US and other developed countries have a relatively small economic relationship with China.

To this point, a recent Banque de France working paper modeled a "hard landing" in China (GDP growth falling to 3% by 2017) which showed that smaller emerging economies and those geographically close to China would be very hard hit, with cumulative multi-year losses in GDP of more than 10% in Russia, Singapore, Malaysia and Thailand. On the other hand, the impact was much smaller in developed economies; cumulative losses would be only around 3.5% in the Euro area and less than 2% in the US, Canada and Australia. Only 6.4% of the Euro area's exports go to China, and Deutsche Bank estimates that a 1% decline in China's GDP translates to the Euro economies' GDP falling by only 0.1%. The numbers are similar in the US—approximately 7% of US exports go to China (compared to 18% to both Canada and the Euro region and 16% to Mexico), and a 1% drop in China would translate to only a 0.1% decline in GDP here.

Of course these figures measure only the direct trading with China, and don't address the varied (and much more difficult to measure) indirect linkages between the countries, not to mention the psychological impact that a major decline in the Chinese economy might have on the global economy. Clearly, the world's stock markets have pulled back, as investors have become more uncertain about the knock-on effects of both a slowdown in Chinese growth and the potential for further currency devaluations. Many remember how economists, as a group, downplayed the effects of the US housing market meltdown, and are wondering if China might become the next subprime crisis.

More immediately, the question for this week will be whether the disruption and nervousness that has attended the past month's news flow will impact the Fed's decision of when to begin the much-anticipated liftoff of its overnight funds rate at the September meeting. In some ways, the reaction of the capital markets has already done some of the Fed's "dirty work" by throwing a bit of cold water on the over-exuberance that had cropped up in certain markets, where prices and valuations had become a little frothy. Certainly, credit spreads have widened significantly, even among US high grade bonds (where the connection to China is particularly tenuous), although we believe this has as much to do with heavy supply of new corporate bonds as the "risk off" attitude that pervades the capital markets at present. And even though the Fed values its independence and bristles at the notion that it can be swayed by outsiders, the Fed must be paying attention to their colleagues at the PBOC, who have cautioned the Fed against raising rates. A higher Fed funds rate will put further pressure on China to devalue the yuan again, lest exports fall even more.

The Fed’s move is a coin flip at this point.