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A BEAR IN A CHINA SHOP?

BY MICHELLE M. BUCKLEY, RESEARCH ANALYST

Between August 17th and 25th, 2015, the S&P 500 Index fell 11.13% on a total return basis, breaking a multi-year upward trend that began in late 2011. The stock market had finally experienced its long-awaited "correction," defined as at least a 10% contraction from a previous high. Over the past two years, several of our newsletters addressed the potential of a correction, including an observation in March 2014 that the market had not corrected in 625 trading days, a phenomenon witnessed only six times in the last 85 years. Following that letter, the market held up for another sixteen and a half months before finally capitulating in August.

What was special about August? On August 8th, Chinese policymakers announced the devaluation of the tightly-controlled yuan, causing turbulence in currency markets that spilled over into U.S. equities. The magnitude of the devaluation, just 3-4%, was strange; emerging market economies had historically devalued currencies by 30% or more with one swift move. The small size of the yuan's devaluation immediately panicked investors into thinking more was to come. Devaluation also had psychological ramifications. According to economic theory, currency devaluation suggests an underlying economy that is no longer globally competitive. Did this devaluation signal a Chinese economy weaker than investors had already suspected? If so, would a significant Chinese slowdown spread throughout global economies?

To answer these questions, we need to consider the relevance of emerging markets to global growth and the role China plays in the global economy. For the first decade of the 21st century, emerging markets drove worldwide growth. Between 2000 and 2007, emerging market nominal GDP growth averaged 8% versus 5% for developed markets; emerging markets now account for 57% of world GDP versus 46% a decade ago. Such strength boosted multinational company earnings and investment; indeed, many developed market companies, particularly in the U.S., Eurozone and Japan, tied themselves to these geographical regions to bolster profits and enhance growth strategies.

Amidst the exuberance, investors and corporations may have overlooked a critical flaw: policymaker complacency. Key political thought has not materially changed since the last emerging market crisis and newer policies since 2008 have yet to be tested in times of strife. Several economists argue emerging countries are worse-governed and more corrupt than ever. Populist and protectionist rhetoric are on the rise; the spread of either could have dire consequences for global trade. Each "BRIC" country, so integral to growth a decade ago, now struggles with its own woes – Brazil faces political instability, a credit downgrade and negative growth; Russia devalued the ruble to combat plunging oil prices and trade sanctions; India, though still growing, now witnesses contracting earnings and rising real interest rates.

And finally, China. Of all emerging market turmoil, a recession in China would most dramatically impact the rest of the world. China is a driving force behind global production and trade, and its growth is commodity-intensive. Though Chinese policymakers argue a 7% growth rate is sustainable, GDP growth has decelerated each year since 2010, the last year China produced double-digit growth. In fact, many economists project less than 7% growth in 2016, slowing further in later years. Weakness in electricity consumption, goods carried by rail and financial institutions' balance sheets suggest the country is headed toward recession, as do over-inventoried consumer goods like autos, smartphones and even chocolate. Coupled with burdensome debt (a common problem across emerging markets) owed by local and provincial governments without suitable resources to fund and alarmist capital controls that include the arrests of the chairwoman of one of the world's largest hedge funds as well as other key media and finance executives for rumor mongering, China may be faltering.

A globalized world economy makes it difficult to avoid fallout from China; commodity-driven countries like Australia, Canada and the Pacific Rim are already facing challenges. While the U.S. can insulate itself to some extent, many formerly all-American corporations now strategically rely on China and other emerging markets for growth.

Time to head for the hills? Absolutely not. In fact, the team at F.L.Putnam has often discussed and subsequently positioned portfolios for an emerging market slowdown. Ten years ago, in part to capitalize on emerging market growth and China's export economy, international equities accounted for nearly 30% of client portfolios. Since the financial crisis, international equities have represented less than 10% on average. We were thus well prepared to weather this storm. The recent emerging market impact on U.S. equity prices also presents opportunities to buy high-quality, financially strong American companies that have insignificant exposure to afflicted regions.

Recession or not, China is not going away. The devaluation and subsequent loss of confidence in Chinese policymakers may force Beijing to move more quickly from a controlled to a market economy, which would ultimately make world trade more efficient. Emerging market growth will not languish forever; burgeoning middle classes are too large and evolving too quickly to stymie growth completely. A time will come again for these regions to contribute meaningfully to global growth and security selection. Until then, we remain focused on our high-quality, U.S.-centered strategy, taking advantage of opportunities any ensuing market volatility may provide.

2015 MARKET DIARY

	9/30/15	YTD Change*
Dow Jones Industrials	16,284.70	-6.95 %
NASDAQ	4,620.17	-1.52 %
S&P 500	1,920.03	-5.29 %
Russell 2000	1,100.69	-7.73 %
10-Year Treasury Bond Yield	2.04 %	-13 b.p.

Source: *Bloomberg Capital Markets*

* Includes dividends for equity indices

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