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China Crisis – Global Contagion or a Correction?

> ***The Financial crisis that struck many Asian countries did so with an unexpected severity…The countries at the center of the crisis were for years admired as some of the most successful emerging economies, owing to their rapid growth and striking gains in living standards…No one could have foreseen that these countries could suddenly become embroiled in one of the worst financial crises of the postwar period.***

Though this could have been written today about the current economic slowdown and stock market bust in China, it was actually taken from an IMF report written about the Asian crisis which began in 1997.

The report cites several contributing factors to the crisis:

- large external deficits and inflated property and stock markets,
- prolonged maintenance of pegged exchange rates,
- lack of adequate supervision over financial systems, and
- government-directed lending practices.

All of the above-noted factors which led to the crisis in 1997 are again prevalent in China today. It is also worth noting that the Chinese last devalued their currency, the Renminbi, in the 1990s, and the threat of a US interest rate rise existed then as it does now.

Then, like now, investors fearing a global recession reacted by selling stocks. At its low on October 27, 1997, the Dow Jones Industrial Average had fallen 12.5% in only a few weeks. By February 1998, the Dow Jones hit a fresh new high. In hindsight, the Asian financial crisis of the late 90s proved to be just that: an Asian crisis, but not a US crisis.

If anything, the Asian crisis increased the amount of global capital being directed towards US stocks, fostering a US stock bubble which would peak in April 2000, long after the start of the Asian crisis.

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[1] *International Monetary Fund*. (June 1998, Volume 35, Number 2). "The Asian Crisis: Causes and Cures".

Readers of the LePoidevin Letter know that I have been warning about an unwinding of the China credit bubble since 2011; now it appears to be unravelling. However, given that the US exports very little to China, it should not have a lot of exposure to a Chinese contraction.

Until this month the US stock market had been 4 years without a 10% correction, only the third time in history to see such a long stretch of stability. The last correction of this magnitude was in the summer of 2011 when the Dow Jones fell 15.1% in reaction to fears about the European economy and whether a Greek default would spread to larger countries. The Dow Jones hit a new high in April of the following year.

Generally, 10% - 15% corrections are reactions to external factors which markets tend to recover quickly from. US “bear markets” (characterized by declines of over 20%) have historically been associated with only two events: a US recession, such as 2001 or 2008, or excessive US Federal Reserve tightening through a sharp rise in interest rates, as was the case in 1987. Unlike 2001/2008, the US is currently creating roughly 275,000 jobs per month, housing is picking up, lending is accelerating, and recent consumer confidence data just hit post-recession highs. While there was no recession in 1987, the US increased interest rates from 3% to 7% over a short period of time causing investors to flee stocks in favour of bonds or bank deposits.

Recently, we have seen 10% corrections in companies like Verizon (telecom) and Southern Company (electric utility), causing their yields to rise to over 5%, and neither company has exposure to China. This is a good indication that investor emotion is ruling the day.

While the US will continue to be largely insulated from a deterioration in China, it is important to recognize that the Chinese economic problems are real and are likely to have a material impact on the Canadian economy. A slowing China would prolong the commodity downturn and continue to keep oil at depressed levels for an extended period. Not only would this continue the current decline in home sales and prices in the Prairies, but the unwinding of the Chinese property and stock market bubbles may cause Chinese real estate investors to lose confidence or have the means to continue bidding up real estate prices in Vancouver or Toronto.

While the US is experiencing modest growth, the current recessionary climate in Canada could continue for some time. Long-time clients know that the yield curve, which plots interest rates from short-to long-term, is the best indicator of future growth. The positive slope of the US yield curve suggests continued growth, while the Canadian yield curve has remained inverted all year. Each time the Bank of Canada has cut rates this year, the 2-year yield has fallen below the Bank of Canada overnight rate. As long as the overnight rate (currently 0.5%) exceeds the 2-year yield (currently 0.33%), a Canadian recession is likely to continue.

Historically, when the CAD has weakened against the USD, the Bank of Canada has attempted to counteract the devaluation by offering investors a higher interest rate than is being offered in the US. Curiously, the Bank of Canada seems content to allow the CAD to move lower, with 5-year interest rates in Canada currently sitting at 0.73% versus 1.43% in the US.

I would suggest the current sell-off in US stocks represents a good entry point for new investors in US equities. For investors who had the foresight to buy 4 years ago, just ride this period out, especially while the Canadian stock market's heavy exposure to oil and banks continues to keep it vulnerable to both domestic and global forces.

Sincerely,

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