The Impact Of China's Slower Growth On Global Financial Assets
Connecting The Dots

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Introduction

Many current market pundits claim that the present reaction to slower Chinese Growth is overblown because there are minimal direct connections between the Chinese Financial System and the Triad [North America, Europe, and Japan] since Chinese banks lend almost exclusively to Chinese firms. Further there is minimal exposure by US firms or banks with the at-risk State-owned Chinese enterprises. Therefore as long as US growth remains steady US markets will be OK.

From their perspective the dramatic recent drops in the US, Japanese and European stock markets in concert with the sharp drop in Chinese markets as well as in oil prices is empathetic and not substantive except in the rare situation such as Yahoo due to their large ownership in Alibaba, the Chinese Amazon. If one accepts this viewpoint US, European and Japanese investors should look at the recent drops as only market corrections and not as something systemic that could impact the global financial system and portfolio values longer-term.

However, accepting this facile explanation at face value would be a mistake similar to accepting Wall Street's view that the sub-prime market crisis was manageable because over the long-term US housing prices tended to rise.

Leveraging The Real Goods Sector

Modern investment analysis and portfolio theory is fundamentally based on some discounted value of expected earnings, dividends or cash flow streams. If one changes the discount rate, the expected growth in earnings and cash flow, or the volatility of these income streams or how they are correlated with other portfolio elements, it will impact the price investment managers will pay for a financial asset. One often used metric in this regard is the P/E or Price/Earnings ratio for a stock where firms with higher expected growth rates can generally command a higher P/E and thus stock price for any level of earnings. However if earnings and earnings expectations fall then even given the same P/E stock prices will drop. In reality the justifiable P/E, though, may also drop, accelerating the downward price movement as the hot tech stock GoPro has recently demonstrated in dropping from over $96 a share in August 2015 to just over on $11 January 15, 2016.

In this way the financial sector acts as discounting mechanism for future expected economic performance effectively leveraging the expected results in growth for the economy's goods and services sector [GDP]. In teaching macro-economics we separate the two sectors [real goods and services from financial] for analytical purposes and only bring them together to achieve an IS-LM equilibrium. Yet in the real world the two are closely related through the impact of changing real economic results on the value of financial assets and thus on market performance and personal wealth. This includes bonds or bundled loans in addition to stocks since when the projected cash coverage drops so do their ratings and market price.

As presented in some earlier postings on this website it is the view of the author and others that attended the 5th Leir Conference on Bubbles and Financial Crises that China is in the final stages of the export-led growth model when growth slows significantly. In the process there is less demand for energy and raw materials. Further if workers become under-employed due to the reduction in export and infrastructure demand they will not have the wages to support a shift to a consumer and services based economy. China has the added problem that the wage gap between what a factory worker might earn and the kinds of goods China produces for export is too large to jump start this process. In addition because economies are circular in that one needs to earn a wage in order to consume and then create jobs for others, once the production, reduced employment, reduced consumption interaction begins it becomes difficult to reverse.

Connecting The Dots

China during its high growth period has been a voracious consumer of imported energy, food, and raw materials. This demand has slipped dramatically over the last year and a half and as noted above is not likely to recover given that China has hit the economic technological frontier and has entered the export led growth model's slower growth phase as indicated by weaker industrial production figures. Also purchases of existing businesses such as Haier's recently announced purchase of GE's appliance division for over $5 billion is typical of this phase because it indicates that opportunities in the local Chinese market for its existing product segment have become limited.

Therefore if you are an existing supplier of products such as iron ore, soybeans, bauxite, oil, or coking coal the demand for your products is falling along with their price. Since this slowdown is systemic, analysts will revise their earnings expectations and your stock price will fall along with the P/E growth premium. On top of this if you borrowed heavily to expand your long-term capacity, those borrowings in the form of bonds, loans or loans bundled and securitized are going to be downgraded due to a lower cash flow coverage of the debt service. This situation could be particularly unfortunate if you borrowed in US dollars or Swiss Francs but have earnings in a devalued currency such as Canadian dollars or Brazilian Reals.

So it is not surprising S&P is reporting the largest increase in bond and loan defaults since 2009 with most related to energy, raw materials and emerging markets. Even major companies such as Exxon [down over 20% from its 2014 high despite GDP growth] and BHP [down over 70% in the same period] cannot escape these market forces given revised demand expectations for oil and raw materials combined with increased supplies since their revenues and markets are global.

Nor are the banks exempt since they have loaned money to those raw material producers or to the farmers producing corn and soybeans who now will cut back as well on their purchases of new Caterpillar mining equipment or John Deere tractors. Those that are highly leveraged may have trouble servicing loans used for high cost oil leases or farmland purchases even though they will keep producing as long as they can cover anything above their variable costs. The banks may also have derivative exposure to mutual and hedge funds with large concentrations of high yield debt.

Therefore stock and bond values have fallen for logical economic and asset valuation reasons combined with continued uncertainty and not because of any “market empathy”. They will likely keep falling until there is a match of market prices with greater understanding of expected earnings and cash flows that reflect the reality of the slowdown in China’s growth engine and its impact on the earnings and cash flows of those firms and countries that had expected to continue supplying the fuel for that engine for the long term.