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China and The Silly Season (Again)!

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When I started preparing this article, neither China nor a global equity meltdown were on my radar. But several surprise Chinese yuan devaluations in early August battered domestic and foreign equity markets. Panic and volatility soared. Now China is on everyone's mind.

Much has been written about what transpired. Most writers blame China for the financial mess. Their economy slowed down and authorities felt stimulus was necessary. Unfortunately, how this was handled triggered the angst and global sell-off.

A Economist article titled "The Great Fall of China" had a disturbing three-part message. The Chinese economy is slowing, this harms emerging market countries as they are highly exposed to commodity shocks, and the long rally in equities is now over. The article acknowledges that these fears may be overblown or even misplaced.

Just one day earlier, David Rosenberg wrote "Why investors' fears about China are overblown." In my view, he is probably correct.

The question for me is why was everyone so shocked at how markets reacted?

In my 35 years of capital markets experience, every year at roughly the same time (Sept—Oct) fear spikes and prices gyrate wildly. The current episode seems strangely familiar. Industry professionals call this period "the silly season." Many fears dissipate and become irrelevant by December 31st.

Also, why was anyone surprised that China's economy slowed? Did anyone take China`s growth estimates at face value? There are many nations that provide superb informational transparency. China is not among them. State controlled outlets do the bidding of the Central Party and make pronouncements to please the leadership. Maybe China's current leadership is acknowledging this fact and is trying to improve transparency?

China's slowdown was to be expected. A few reasons include; (a) nations that host Olympic venues often experience a slowdown a few years afterwards (China hosted in 2008), and (b) China's sky-high growth simply had to be impacted by progressively slower global growth.

One disturbing wrinkle concerns China's investors, specifically the dominant retail investor. The Chinese have a gambling mentality versus a classic investment approach. Many use trend-following strategies. Behavioral finance theory predicts this will cause herding and set-up wild market swings. Recall that China's equity market rose over 120% in the 1-year period to June 2015.

Let's not forget weakness in the global economy. Europe's growth is almost zero. Emerging nations that rely on commodities for growth are getting crushed with low prices. For example, a year ago oil was $93 and today it is just $45.

One bright spot is the improved US economic outlook. The Fed might raise rates soon and this creates more fear. Then there is the 2016 US Presidential race. No doubt, this further adds to market concerns.

Conclusions:

I expect volatility to remain much higher in 2016 than it has been the past 3 years. China, Europe, war, oil and other headline news stories will be driving factors.

On a positive note, low commodity prices help the bigger industrialized nations. But these prices won't remain low forever. They are cyclical and very sensitive to even small shifts in demand.

Either way, for real long term investors, whenever a panic arises, they are the ones who accumulate assets. And ultimately, they are the ones who do well. ◻

Inside this issue:

ASI — What we do:

Alternativ Solution Inc. (ASI) offers consulting services on capital markets to institutional clients. We deal in topics ranging from investment strategy, risk management, asset allocation, manager selection and manager assessment.

Our recent engagements include development of investment policy (SIPP), searches for money managers, investment strategy (active vs. passive), and alternatives such as infrastructure, real estate and smart beta.

We also offer Trustees and/or Board members with training.

Mr. Klar is a faculty member in the Finance area at the Schulich School of Business and is a senior advisor to York University's $2.1 billion pension plan.

….Cheers, GMK

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