Economic and Market Insights

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Is the Chinese economy the tail that wags the global markets?

Recent financial commentaries have generally focused on the economic slowdown in China as the main culprit behind the yo-yo volatility in the markets last week. Nick Fafoglia, CFA®, a Senior Investment Portfolio Manager at The Commerce Trust Company, takes a moment to address the underlying context peculiar to China's economic woes and the potential impact on U.S. stocks over the long term.

Q. Nick, the market continues to be volatile. Greece dominated the news until they reached an agreement and now it seems the focus has changed to China. What's going on over there?

A. The stock markets in mainland China, specifically the market in "A-shares," have recently dropped 25% from their June peak after a run-up of nearly 150% over the last 12 months. The market experienced a single-day drop of 8.5% earlier last week. Much of the original run-up was fueled by speculators borrowing to finance their stock purchases.

Q. Were there any warning signs?

A. Analysts feel that China's economic growth has been overstated due to the recent run-up in its stock market. Their investment and infrastructure economy will now likely give way to a consumer-driven economy. Thus, slower growth may be a fact of life for the foreseeable future. Another challenge to assessing warning signs is that the China market does not respond to fundamental economic and earnings information as do the developed markets. As early as last year there were indications that the Chinese economy was slowing and the real estate market was softening significantly. Stock valuations looked stretched and, in some cases, plainly absurd. Many investors borrowed money as a way to further buy into the market and get their piece of the "Chinese dream." Finally, many of those investors rushing into the market were novices with little understanding of what they were buying.

Q. What is the Chinese government doing to help avert a greater crisis?

A. China's government has been trying to limit the damage from the ongoing crash and help stabilize the situation. It has encouraged banks and other financial institutions to increase lending to investors, frozen initial public offerings, cut interest rates, forced state-owned companies and funds to buy shares, and threatened to prosecute short-sellers.

Q. Why is the decline in the Chinese market a worry?

A. A significant drop in any country's stock market is a concern, as it can weigh on future economic growth in the near term. China's market plays a relatively smaller role in their economy than stock markets in large, developed economies, such as ours. However, the loss of wealth can have spillover effect to the Chinese consumer, which may impact demand for good that we export to them.

Q. What does this mean for U.S. investors?

A. The good news for U.S. investors is that very few U.S. mutual funds invest in the volatile A-shares traded on the mainland. Instead, most funds invest in shares issued on the Hong Kong exchange. However, China A-shares are in the process of being added to many of the major international equity indexes. That may result in more volatility for U.S. investors in international equity funds down the road. The U.S. economy is too intertwined with China for there to be no impact. Chinese consumers often prefer foreign brands – including American – over local products, but that could change if China's economic troubles persist. Multinational companies with significant exposure to China could also be disproportionately affected by the crash if growth continues to decelerate. In the United States, 40% of the revenue generated by S&P 500 companies has come from overseas. Fears about a slowing China have already hurt earnings this season. However, it is important to remember that the movements in stock markets do not always correlate to the growth of their local economy. A diversified investment strategy tailored to your investment goals and objectives can help minimize risk.

Q. What's next?

A. The Chinese government has put a huge amount of money and energy into turning the market around and trying to stabilize and calm the situation. But as Scott Kennedy, a China expert at the Center for Strategic and International Studies, notes, Chinese leaders have difficulty reconciling the logic of the market – that "when the market goes up you win and when the market goes down you lose" with "the basic logic of Chinese regulatory style." It's a different situation than in the U.S. markets, so we'll just need to see where the Chinese government chooses to go next.