Is China A House Of Cards? (written on Jan. 15th)

SYNOPSIS
- Concerns over China's economy, currency, and stock market have ignited another round of volatility across global financial markets.
- China is in the very early innings of an economic transition that will likely take a decade or longer to achieve, and there will be bumps along the way.
- Although the near-term future for China may be questionable, the impact of China on the U.S. economy will be inconsequential.

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What's Up With China?

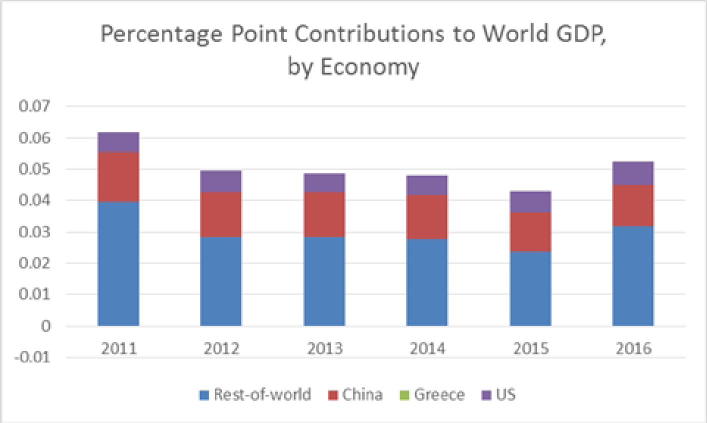
China's stock market turmoil has dominated trading in the New Year. Thanks to a seemingly limitless amount of headlines and commentary from the "experts" on TV, fear and panic has led many investors to believe that China is doomed and taking the U.S. down with it.

Three catalysts have fueled the volatility lately: (1) a slowing economy, (2) stock market mayhem, and (3) currency manipulation by their government. Let's discuss each and determine if the fear and panic are truly warranted.

A Slowing Economy

China's economy is absolutely slowing down, but that fact is not concerning on its own. When countries and companies grow past a certain point, their growth rate naturally falls. For example, Apple is the world's largest publicly traded company, but they can no longer double in size each year anymore, unless everyone bought six additional iPhones this year.

The question that should be asked is if China is still contributing to the global economy, and the answer is an unequivocal "yes." The chart below proves this point further.



Source: Econbrowser

The red bars in the chart represent China's contribution to world Gross Domestic Product (GDP), which is the de facto measure of economic growth. It does not take a PhD in economics to see that those red bars have not changed much over the past several years, so it's safe to conclude that China slowing down has had little effect on global GDP.

NOTE*: The green bar is Greece, which is not even visible. That's because Greece contributes less than 1% to global GDP, yet panic over Greece defaulting caused the U.S. equity market to get whacked last summer. Notice a pattern of fear-induced selling over inconsequential data?*

China has maintained its share because size matters. For example, according to the IMF, Mongolia grew around 12% in 2013, while the U.S. only saw 2% growth. Hence, Mongolia grew 6 times faster, but the U.S. contributed 150 times more to global growth. How could this be?

The answer also has to do with our size. Since we are so much larger than Mongolia, a small growth rate on a huge amount matters more than a large growth rate on a tiny amount.

China was about half the size a decade ago but growing twice as fast today, which actually comes out to around the same amount:

2006: $6 trillion economy X 12% growth rate = **$7.2 trillion** added to global GDP

2016: $12 trillion economy X 6% growth rate = **$7.2 trillion** added to global GDP

China is slowing but also transitioning. Much of their growth over the last several decades came from manufacturing, and the government desperately wants to convert the economy to a more consumer-driven one, much like the U.S.

These transitions take time because they require major structural and cultural shifts. Investors must expect a few bumps along this long road, and evidence of the Chinese government's efforts is already present for those who can read through the headlines.

Case in point: Apple doubled their sales in China last year to over $13 billion. They have opened 24 stores and expect to increase to 40 locations by mid-2016. Consumers are lining up to buy products that represent a far higher percentage of disposable income relative to here. People don't spend this type of money when an economy is crashing.

NOTE*: China is notorious for manipulating economic data, so I prefer to analyze the sales data from U.S. companies who sell to China. Publicly traded firms in the U.S. are audited, so their successes/failures in China tell me far more than what's reported by the Chinese government.*

Simply put, China is slowing, but they are doing what is needed to ensure a healthy future.

The World's Largest Casino

China's stock market is vastly different from ours due to (1) the composition of investors, and (2) the connection to the underlying economy.

The U.S. stock market is dominated by institutional investors, such as banks, insurance companies, and endowments, which consist of professional investors with long time horizons.

On the other hand, China's stock market is approximately 95% "retail" money. These are everyday consumers with little to no training in the mechanics of equity markets. Hence, periods of volatility are amplified because most participants there are gambling instead of investing.

The connection to the economy is also quite different than here. Institutions dominate our stock market, and they invest based on predictions of the impact of economic cycles on asset prices. Hence, the equity market here tends to anticipate and move with the economy over time.

China's stock market has soared and crashed in the face of economic data that has barely changed over the past two years. Hence, what goes on in their stock market cannot possibly be used as a barometer for economic health because the two act independent of each other.

Another problem with China's equity market is the constant involvement of regulators who feel they can maintain order. For example, last week's volatility was amplified unnecessarily due to their decision to install "circuit breakers" in the stock market.

The concept of a circuit breaker makes a lot of sense on paper. They are designed to reduce the effects of panic on a market by halting trading if an index falls past a predefined threshold. The pause in trading should then give everyone some time to take a deep breath and relax.

Circuit breakers are even used in the U.S. and are triggered after a fall of 20% during a trading session. Once activated, the market usually closes until the next trading day.

China quickly learned that these devices just don't work and made matters worse by setting the threshold at 7%, which is way too high. The law of unintended consequences spewed gasoline on a flame, as investors desperate to sell could not and subsequently amplified the panic.

Despite their stock market being a bit of a mess, Chinese consumers don't gamble too much of their net worth in stocks, so any losses should not hurt too much. They will probably just become disenchanted after learning the hard way that equities are to be left to professionals.

Simply put, China's equity market is the world's largest casino and bears no semblance to the underlying economy.

Currency Manipulation

Investors fear that China is intentionally weakening their currency to jumpstart their economy by making exports more attractive. Currency manipulation often fuels investor paranoia.

The issue with this argument is that China has manipulated their currency in some form or the other for decades, and they are also implementing positive changes alongside the weakening that will allow their currency to be more freely traded.

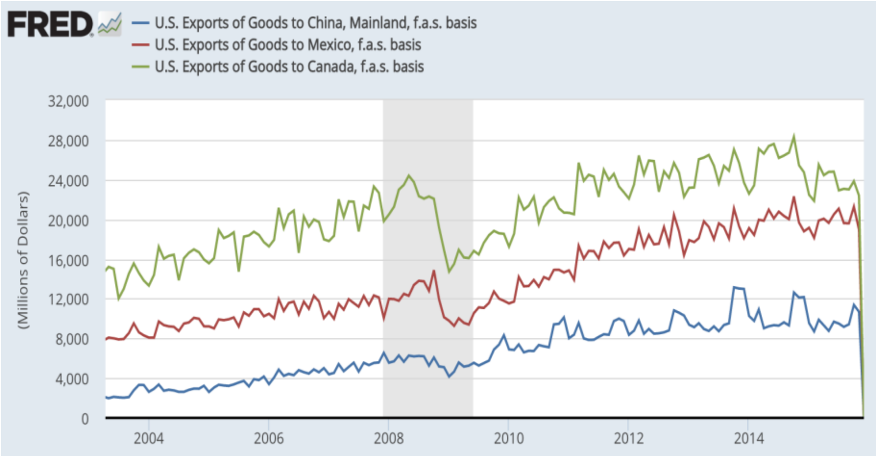
But china is not going to just give up full control overnight, so they are attempting to do so in an orderly manner. The problem is that they have not done a great job since August.

This road will also be bumpy, but the ends will justify the means when they arrive because a more freely traded currency is a net positive for most of the world.

Does China Even Matter?

I may not be as bearish on China as most pundits on TV, but it's still worth considering the possibility that my analysis is wrong and that China is in fact a house of cards. In this scenario, we need to assess the impact on (1) the U.S. economy, and (2) our stock market.

Our economy is rather self-contained, and we rely very little on China as a customer. Currently, less than 7% of our exports go to China, and the chart below shows that we actually export twice as much to Mexico ($20 billion/year) as we do to China ($11 billion/year). Add up Canada and Mexico together, and that total is 4.5 times more than China.



Source: St. Louis Fed

***NOTE**: Where a failed China would matter the most is in countries that rely heavily on China as a customer. Those who export a large amount of goods to China would feel pain.*

Furthermore, exports to China constitute less than 1% of our annual GDP, and we don't compete directly with China all that much. Meaning, if China were to weaken their currency by 10% to make their exports more attractive than ours, we would not feel much impact.

The effect on our stock market is another story and would likely evolve over time. In the short-term, I would expect to see elevated volatility due to the fear and panic of witnessing the world's second largest economy crumble.

However, over the long-run, our stock market is driven on fundamentals. If our economy continues to grow slowly in the face of a fallen China, at some point our stock market must reflect this growth (admittedly this could take more than a month or two).

Simply put, a failed China would not pull down the U.S. economy with it, but volatility could certainly infect markets for some time.

Implications for Investors

Rewind the clock back to August, and the causes of volatility look identical to the ones today (China, commodities, geopolitical scares, etc.). These issues still remain at large, and until they are resolved, global financial markets will continue to be exposed to periodic volatility.

The good news is that repeated volatility tends to wane over time, and this recent bout has been no different. Popular measures of volatility indicate that today's volatility is less than half of what we endured back then.

It's a lot like going to the gym after an extended period of rest. That first time back is going to be painful because it is such an unexpected shock to the system, but the second session should not hurt as bad as the first because the body is becoming conditioned to the pain.

The same applies to volatility. Investors become conditioned to repeated headlines over time, and they learn to ignore the pain. For example, Greece wreaked havoc last summer but it barely makes the news anymore, despite a situation which has deteriorated even further. It's become old news to investors because they now understand that Greece can't derail our economy.

That being said, although China bears little risk to the U.S., it is important to be mindful of the potential for volatility. Hence, the conservative DIAS portfolios have had next to no exposure to the broader Chinese market or entities that heavily rely upon China for quite some time.

The bottom line is that China's stock market will not impact your financial future unless you let it. Financial markets recovered from August's volatility spike in a matter of weeks, and although it's impossible to say if history will repeat itself, there is little evidence to support the notion that China can drag the U.S. down with them if they were to crumble.

Sincerely,

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