Global update: Time to hit the panic button?

***"The year has turned, and, in my view, the decision proved straightforward – now is not yet the time to raise interest rates"*[1], Mark Carney, Governor of the Bank of England, 19 January 2016**

New Year sees sharp increase in risk aversion

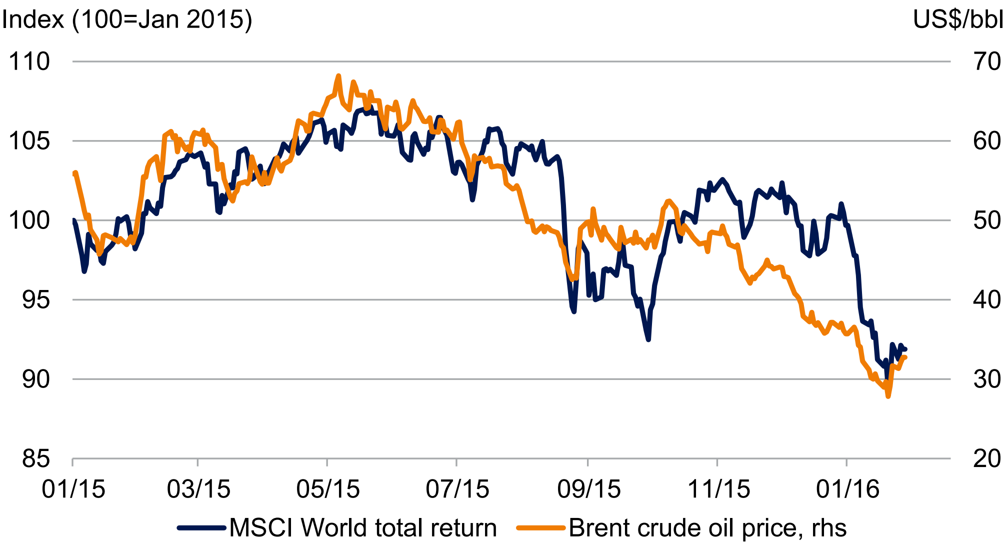
It has not been the best start to the year. Equity markets have fallen sharply with several entering bear market territory, whilst credit spreads have widened sharply. Risk aversion has risen significantly and the Credit Suisse risk appetite index is now well into "panic" mode (chart front page). The comment from the Governor of the Bank of England sums up the view of markets, which have pushed out rate rises in the UK and US, and eased expectations globally since the start of the year.

Two factors have been blamed for the rout in markets.

Lower oil prices seen as a negative for markets…

The first is the further fall in the oil price, which appears to have led global equity markets down over the past year (chart 1). Lower oil prices directly undermine the energy sector, which has a significant weight in equity and credit indices. The complex has responded to weaker prices by cutting back on capital spending (capex) and employment, adding to the gloom surrounding global activity.

Chart 1: Oil and equity markets



Source: Thomson Datastream, Schroder Economics Group. 27 January 2016.

…despite the long run benefit of lower energy costs to global growth

Investors are also concerned that bank exposure to the energy sector will lead to a systemic crisis in the banking sector, thus cutting off credit to the real economy. There are also fears that sovereign wealth funds, half of which source their funds from hydrocarbons, are selling assets to help shore up their finances in the wake of the fall in energy prices.

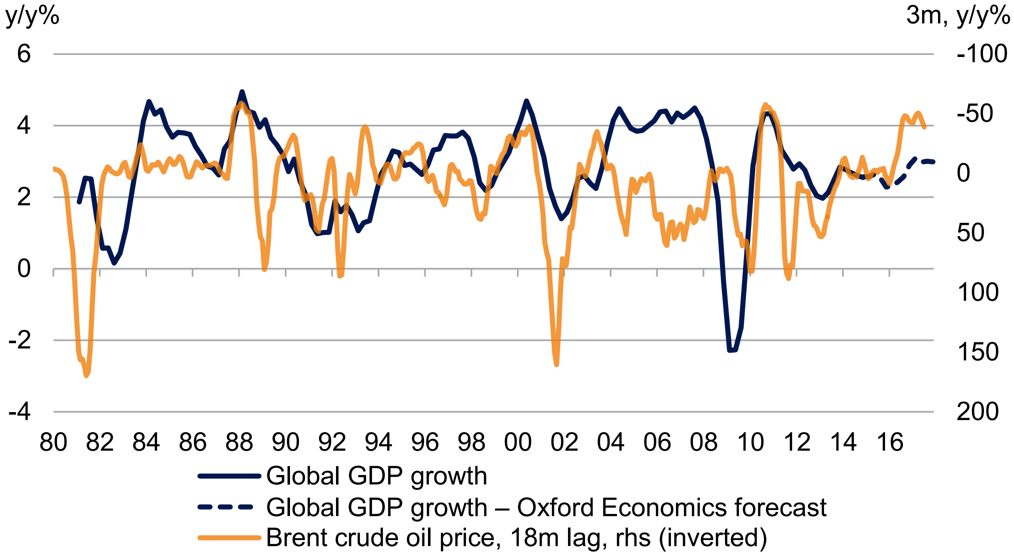
All these arguments have some merit, although we would be shocked if we experienced another systemic banking crisis so soon after the last one! Moreover, bank exposure to energy is between 1% and 6% of assets for the US – considerably less than sub-prime mortgages in 2007. This time around though, the asset management industry may face a greater proportion of the losses as holders of energy debt through the credit markets.

However, such arguments only look at one side of the oil price fall and fail to take account of the boost to global growth from cutting the price of a key good. Lower oil prices generally lead to stronger growth, especially if they have been driven by increased supply, as is the case today. The lags are long though, with global

[1] http://www.bankofengland.co.uk/publications/Documents/speeches/2016/speech873.pdf.

activity taking around 18 months to respond as people take time to recognise and adjust their expenditure patterns. On this basis, the world economy and equity markets are yet to see the full benefit of lower oil prices (chart 2).

Chart 2: Oil and growth



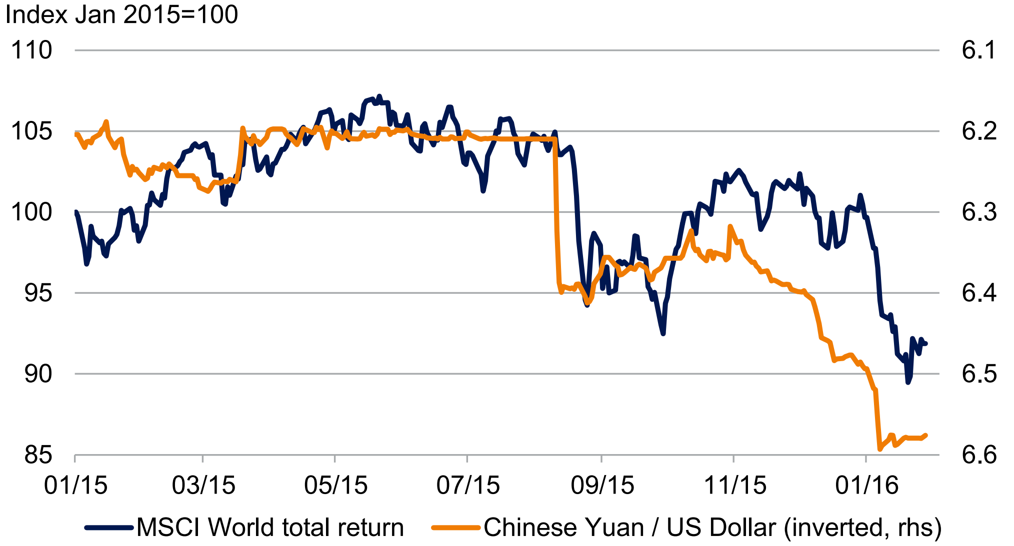
Source: Thomson Datastream, Schroder Economics Group. 27 January 2016.

Weaker yuan, weaker equities

The second factor blamed for the rout in markets is China. As with the oil price, there has been a strong correlation between the Chinese yuan against the dollar (CNY) and global equity prices over the past year. Markets fell sharply in August following the first devaluation in the CNY and then suffered again in the New Year (see chart 3).

China does not gain much from a weaker CNY

Chart 3: Global equity and CNY



Source: Thomson Reuters Datastream, Schroder Economics Group, 27 January 2016.

Although many commentators take this relationship for granted, the link between the weaker CNY and weaker equity markets is not obvious. Arguably, China is simply following on from Japan and the Eurozone, both of which have devalued their exchange rates over the past two years. Markets did not react as badly to these moves. China has said that it is now targeting the trade-weighted exchange rate and so is merely trying to offset dollar strength, which makes sense from a macro perspective.

China does not gain much from a weaker CNY

Furthermore, the economy does not gain much from a devaluation of the CNY. For example, a 10% depreciation of the CNY boosts China's GDP by just 0.3% in 2016 according to Oxford Economics ("How the CNY can shake the world" 18 January 2016). The impact on the rest of the world is correspondingly modest with global GDP 0.1% lower.

The effects on the rest of the world are more significant if exchange rates behave in line with recent experience. For example, falls in the CNY have been accompanied by depreciations in many emerging economies with the Korean won and Taiwanese dollar devaluing sharply whilst the Japanese yen and US dollar have risen significantly. Building in these moves, the Oxford Economics model finds a greater range of effects on the rest of the world, adding to pressure on policymakers in Japan in particular. However, the benefits to China are even less than in the simple devaluation scenario.

Do China's policy moves signal that there are deeper problems in the economy?

So why the link from CNY to equities? Two reasons seem plausible. The first is that due to the opacity of Chinese data and policy intentions, a change in policy of this type is seen as a signal that all is not well, and that the authorities are looking for new ways to stimulate the economy. If growth really is substantially weaker than the official figures, it is bad news for commodities and the rest of the emerging markets who depend on Chinese demand.

Furthermore, if the CNY is now a tool to boost growth, devaluation could be seen as a means of exporting the problems of excess capacity to the rest of the world. That would be bad news for those who compete directly with China, such as the steel industry in the Europe, which is already suffering. However, there are benefits to those who consume Chinese exports.

We look at the growth picture in China in more detail below and conclude that growth has not significantly deteriorated and there are actually signs of improvement at the margin with our own activity indicator picking up. This combined with the model evidence that China does not benefit significantly from a lower CNY, would support the authorities' contention that they do not intend to devalue the currency in trade-weighted terms.

Losing control?

Or are the authorities losing control of the currency?

However, the second worry is that China does not have control of its currency and as capital pours out of the economy, they will be forced to give up on the managed basket and allow a significant devaluation. The CNY has been stable since 7 January, indicating that the authorities have a better grip on capital outflows, although the effect of this on foreign exchange reserves, which have fallen significantly over the past year, remains to be seen.

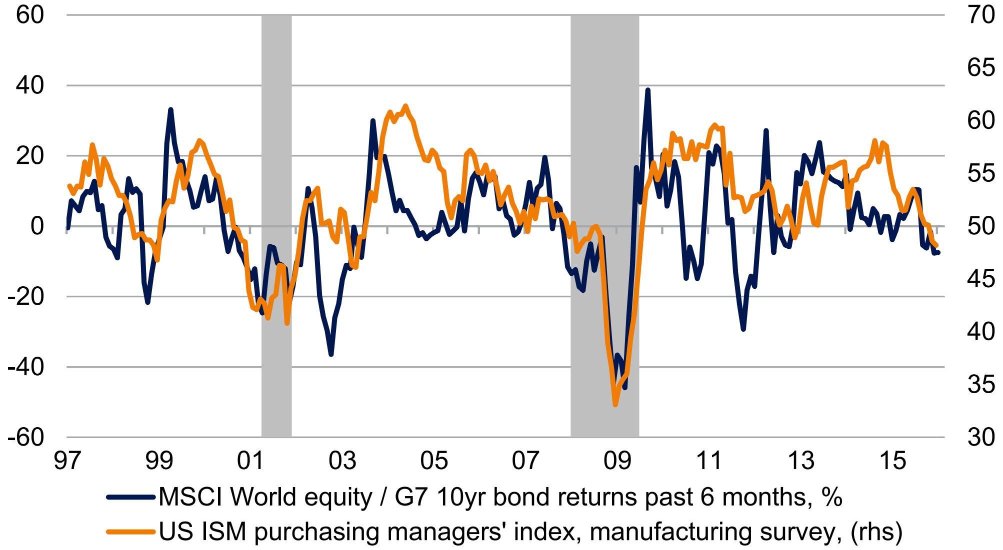
This is encouraging for now, but it will be some time before China can resolve the problem of trying to keep the economy on track and the exchange rate stable in a world where the US dollar remains firm. In our view, it is likely that the authorities will have to reintroduce some capital controls to square the circle as domestic rate rises are out of the question, even if this might conflict with future membership of the IMF's Special Drawing Rights[2] basket. Against this backdrop, we see our exchange rate wars scenario (where China devalues by 20% triggering a reaction from others), as increasingly likely. The move by the Bank of Japan to cut interest rates into negative territory at their January meeting can be seen as a response to the sharp appreciation of the trade-weighted yen since the beginning of the year.

[2] An international reserve asset, created by the IMF, which member countries can use to supplement their official reserves.

US recession risk?

Although the oil price and China have dominated markets concerns, the US economy deserves a quick word. Arguably, fears about US growth have also been driving risk assets lower, a view supported by the close relationship between the Institute of Supply Management (ISM) manufacturing index and the relative performance of equity and bond markets (chart 4).

Chart 4: ISM signals underperformance of equity markets



Source: Thomson Datastream, Schroder Economics Group. 27 January 2016.

US recession fears are overdone

Clearly, a US recession as some are predicting, would result in this trend extending further. We will review our forecasts next month, but at this stage do not wish to join the gloom mongers for three reasons.

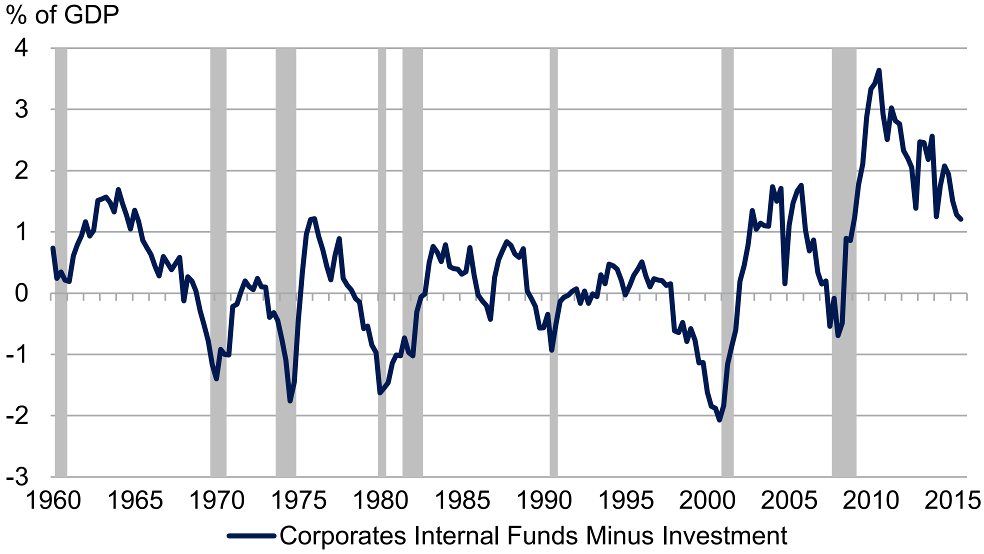
The first is the oil price effect referred to above, which will boost consumer spending. Furthermore, the drag from spending and employment cuts in the energy sector will ebb as the fall experienced so far makes it less significant in overall GDP.

Second, fiscal policy will add 0.5% to US GDP this year through increased government expenditure (not including the longer run multiplier effects).

Third, the corporate sector is not unduly extended. Most recessions are preceded by a sharp deterioration in corporate cashflow relative to capex, such that a shock forces the sector to retrench and cut jobs and capex (chart 5). In this cycle, capex has been disappointingly weak, but as a result company cash flow remains positive and hence the sector should prove resilient. Meanwhile, household balance sheets have been significantly improved.

Much of the recent weakness in the US has been due to the inventory cycle and, as long as final sales hold up as we expect through the consumer, growth should firm in the current quarter. Nonetheless, the likelihood of the Fed raising rates in March has been considerably diminished.

Chart 5: US corporate cashflow not signalling recession



Source: Thomson Datastream, Schroder Economics Group. 27 January 2016.

Conclusions

Our analysis suggests that some of the gloom on the world economy has been overdone, particularly in respect to the oil price. Does this mean markets have become too bearish? The biggest unknown is what will happen to the CNY and whether we will see a more significant devaluation. We do not see a strong case for devaluation, but the reserve figures will probably be the best guide. If we now see some stability in the CNY, soothing comments from the US Federal Reserve and better growth figures in coming months, the backdrop for markets would brighten considerably. If so then the current “panic” reading on the risk index would enhance its reputation as a contrarian indicator.