Pessimism about China’s economy, demand for commodities overdone

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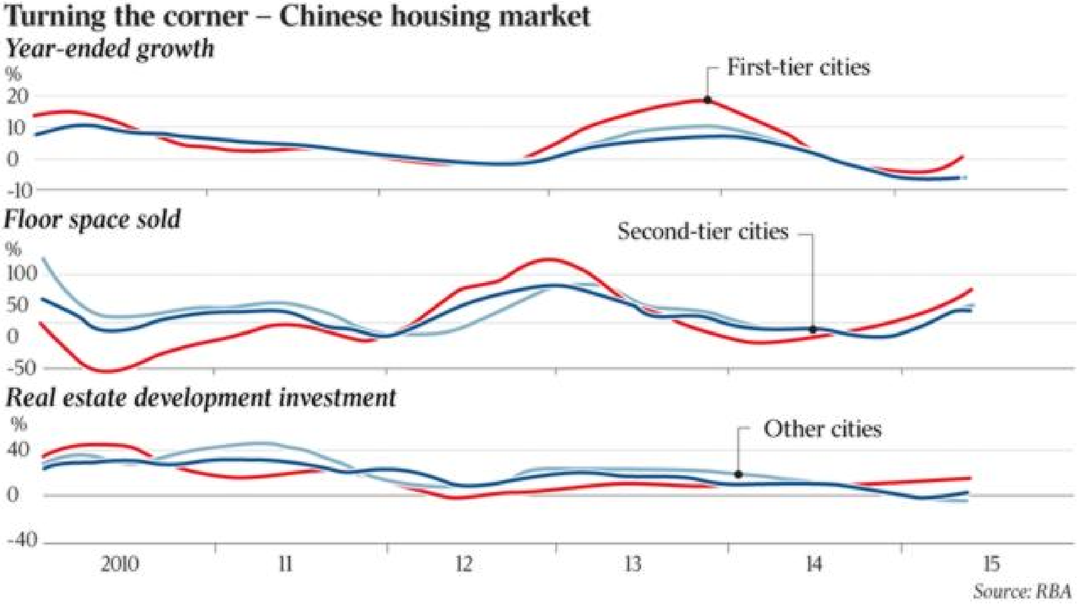

Turning the corner. *Source:* TheAustralian

There’s usually a dominant sentiment in investment markets — and at times it swings around widely. Recently, the mood among investors has changed a couple of times from positive to pessimistic and back again. Also, the issues that most investors are focusing on can vary at short notice: think of the shift of concern this year from an obsession with the Greek crisis to preoccupation with how the shake-out in Chinese shares will affect markets.

These are some key features of how market sentiment is shaped and how it affects investments:

1. There’s usually a clear majority-held sentiment in investment markets — and many investors are strongly influenced by it.

2. Globally, market sentiment is often influenced by the views of investors who’ve already taken positions. As fund manager Mark Tinker has pointed out in his blog for AXA: “Investors need to recognise that the received narrative on markets is usually created by short-term traders.”

3. From time to time, investors need to consider the extent to which the prevailing sentiment is already incorporated in market pricing — and the choices tend to be (a) excessively so, (b) hardly at all, or (c) just right.

4. At times, the prevailing view turns out to be seriously wrong — and investors would have been better placed with an approach that was strongly contrarian. Here are some recent examples.

In the first quarter of 2009, sentiment towards shares was dire. As things turned out, US shares have tripled in value since then and the accumulation index for Australian shares has more than recovered its losses endured during the global financial crisis.

In 2011, market sentiment favoured the idea of “peak oil”; instead, oil is (currently) unloved and its price has fallen by two-thirds. Early in 2015, German bond yields plunged because of the dominant narrative that Europe would experience a mild recession and deflation; it didn’t; and German bond yields surged.

In my view, there’s now too big a gap between what market sentiment suggests is the outlook for the Chinese economy and what’s likely to happen. To quote Mark Tinker again, “On China it (the received narrative) has swung from ‘uber bull’ to ‘uber bear’, while the reality has always been half way”.

For several years, the prevailing expectation has been that China will soon experience a sharp drop in growth — a hard landing — caused by the bursting of the speculative bubble in housing, and failures among the so-called shadow banks.

The worst days of stress in the Chinese housing market seem now to have passed. Also, monetary policy has been eased; financial reform has progressed; and funding for local government infrastructure has been stepped up. Nonetheless, concern about an imminent and deep recession in China has intensified: the prime concerns now are the sharp fall in share prices and last week’s devaluation of the yuan (and reform of the exchange rate mechanism).

In fact, linkages between the Chinese economy and sharemarket — both ways — are much looser than those in other countries. And China’s regulatory approach to the wide sharemarket swings will likely limit any further falls in share prices.

Most comments on last week’s announcement of changes to China’s currency mechanism have emphasised one component — the (opportunistic) competitive devaluation of the yuan — and claim it reflects a bleak outlook for the Chinese economy.

The changes are more significant than that. Clearly, China doesn’t want its currency to ride even higher with the strengthening US dollar. But the more flexible exchange rate mechanism will facilitate further easings of monetary policy in China, help in the liberalisation of capital flows, and strengthen the case for the yuan’s inclusion in the statutory drawing rights of the IMF.

In my view, China’s economy will slow further, but China is likely to avoid recession. This suggests the extreme gloom about China’s demand for commodities seems overdone. As and when excessive global supplies of commodities are cut back — and that’s not yet — their price trajectory could be a lot more favourable to producers than is currently expected. Contrarians, start getting ready.

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