Shades of grey show market gloom is overdone

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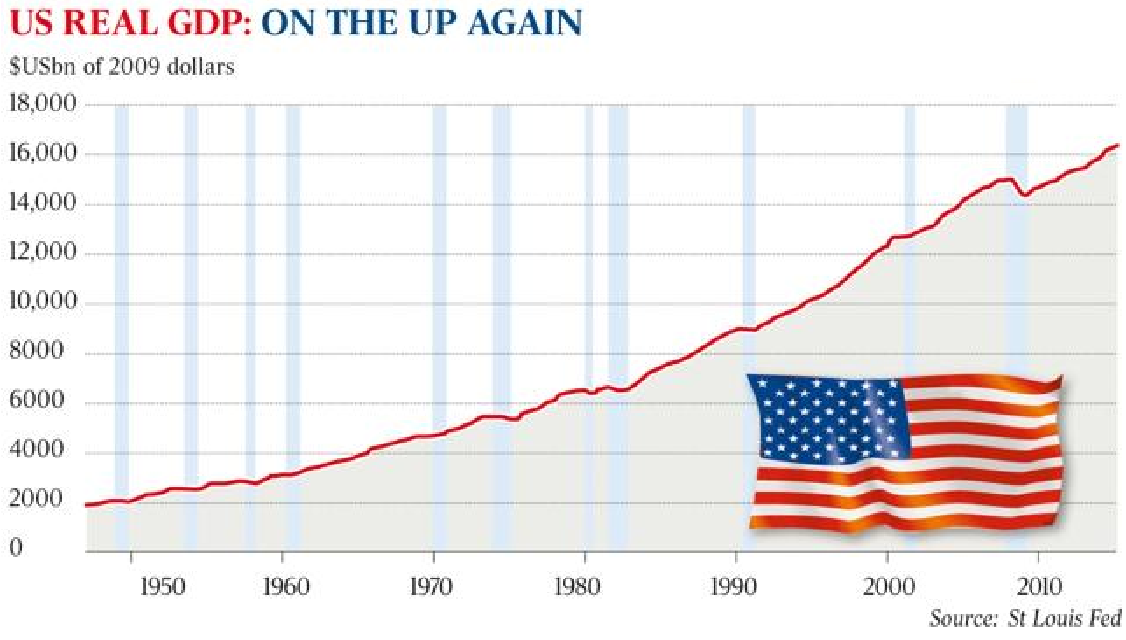

US on the up again. *Source:* TheAustralian

Since late July, share investors have focused mainly on the financial storm clouds building up. Their key concerns are the danger of recession in China and likely problems for investment markets around the world when the US cash rate is raised.

Only a small minority is looking for any shades of grey in the investment outlook.

Let’s list the top negatives and the main positives in the economic and financial outlooks for China and the US — to see if any investment opportunities are being created by the pervasive gloom that has enveloped sharemarkets and to prepare us for the happier days when sharemarkets start moving up again, as they surely will.

The negatives for China include: the recent slowing in the rate of growth in industrial production; the excess capacity in heavy industry and property construction; the inevitable lags before the new emphasis on consumption and services deliver big results; the painful unwinding of the sharemarket bubble; and the heavy debts and resistance to change of state-owned enterprises and regional governments.

The positives for China include: a high saving rate; abundant international reserves; the substantial easings of monetary policy; the spending power of the emerging middle class; the central government moves to restructure the economy and to liberalise financial markets; and the recent actions to expose corruption.

It’s clear that Chinese economic growth is slowing (and so is China’s trend rate of growth, but that’s inevitable given the gains in real incomes of the past 40 years).

However, concerns that China is heading for a hard landing — and that this is the main cause of the collapse in commodity prices including for oil — seem to be seriously overdone.

In particular, far too much emphasis is being put on monthly data on China’s manufacturing sector such as the Purchasing Managers’ Indexes of manufacturers — one for large companies and one for mid-sized and smaller businesses.

Whenever either index falls below a score of 50, we hear or read shrill reports of a “contraction” in Chinese manufacturing.

Recently, such claims were made in front-page reports of the *Financial Times* and the *Australian Financial Review*. In fact, industrial production has increased by 6.1 per cent in the 12 months through August.

As Mark Tinker, a Hong Kong-based strategist with Axa, points out: “The PMI is not a measure of output, it is a survey of future prospects and is constructed in the form of what is known as a diffusion index. This works on a ‘better or worse’ than last month format so that when things are growing a figure of below 50 means that on balance respondents believe things will not grow as fast as last month. This is not the same as saying they will shrink.”

The negatives for the US include: the cyclical recovery that began in 2009 is generally seen as having been stuck in second gear; the US energy industry is having to cope with the collapse in the oil price; the stronger US dollar is crimping growth in some sectors; despite negligible inflation, the Fed (correctly in my view) is about to increase short-term interest rates; even cashed-up companies have been reluctant to spend on new capital equipment; real wages have not grown in recent years; and US bond yields seem unreasonably low (last week, yields on 10-year US government bonds were a skinny 2 per cent).

The positives for the US economy and markets include: signs the rate of economic growth is picking up (real GDP grew at an annual rate of 3.9 per cent in the June quarter with business investment up by 4.1 per cent); consumer confidence has strengthened; and the US has global leadership in many fields of technology and the social media.

From time to time, investment markets overplay the gloom card. That happened in late 2011, when obsessive fears developed that the US economy might go into a double-dip recession, and in 2012 and 2013, when Europe was thought to be in a sovereign debt crisis. Maybe it’s happening now? At the least, it’s worth looking for shades of grey, if not for silver linings.

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