Heartwood Investment Management

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Investment Insight

Weekly Insight

Scratch beneath the surface of China's recent sell-off

The US tariffs target of $34bn on imports from China comes into effect today and the trade war has provided an easy explanation for the recent falls in China's stock market and currency. Scratch beneath the surface, however, and there's more to it than that. The stock market and currency charts may look similar, but there are different explanations for both.

Steepest decline since 2015

Chinese Yuan/US Dollar

Past performance is not a reliable indicator of future results. Source: FactSet

China local market now technically in bear territory

Shanghai Shenzhen CSI 300 Index and S&P 500

Past performance is not a reliable indicator of future results. Source: FactSet

The local, onshore China stock market – the Shanghai Shenzhen composite – is now technically in bear market territory, driven down primarily by nervous retail investors. Recent headlines around trade wars have had a negative effect on sentiment in the last month, but prior to this slowing economic activity was causing concern. Until recently, the Chinese authorities had been restricting financial leverage, with a view to slowing economic growth to more sustainable levels through measures including limiting the availability and raising the cost of state government and corporate loans. The effect of these measures – a slowdown in the growth rate of loans - has weakened economic activity, just when the economy is facing an escalating trade war with the US.

In response, the authorities are now implementing policies to be supportive of growth. One of the key moves has been to cut the RRR (reserve requirement ratio) by 50 basis points to inject liquidity into the system to relieve credit pressure from the earlier deleveraging policy. It has also cushioned the impact of a trade war by indirectly weakening the currency. ▶

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In addition, the authorities announced plans to raise the personal income tax levy threshold from RMB42,000 a year to RMB60,000, effectively benefitting over 80% or 340 million people and potentially generating RMB125bn in consumption, a boost to GDP of 15 basis points. Fiscal spending could also speed up with more budget for infrastructure projects.

China's currency, the renminbi, is more directly affected by the trade war. The country currently runs a trade surplus with the US, which would be reduced or even pushed into deficit by lower exports, a negative for the renminbi. It has been suggested that the cut in reserve requirements is also an indirect attempt to weaken the currency during the trade dispute, however this seems unlikely on the basis that such a move could lead to aggressive capital outflows by investors. Parallels could also be drawn with August 2015 when the deliberate devaluation of the renminbi by the authorities subsequently led to capital outflows and sharp falls in global stock markets. However, the global growth backdrop then was quite different with raised fears of a hard landing for Chinese growth and a sharp slowdown in emerging markets.

Overall, while further potential escalation in US-China trade tensions could drag the economy's momentum going into the second half of this year, macroeconomic policy will likely be supportive of the domestic economy. We believe the authorities are slowly but surely turning the 'China super tanker' around and are implementing more flexible policies to contain downside risk.

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