CHINA SCARE

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China has replaced Greece as the main worry for financial markets – and it is fundamentally a much bigger deal. A depreciation of China's currency, a sell-off in the country's equity markets and declining confidence in Beijing policymakers are spooking global markets.

Overnight BlackRock investment specialists discussed the recent developments. The call was moderated by Richard Turnill - Chief Investment Strategist, Alpha Strategies Group. Speakers were:

- Nigel Bolton – Global Co-Head of Fundamental Equity and Head of European Equity
- Rick Rieder – Chief Investment Officer of Fundamental Fixed Income
- Helen Zhu – Head of China Equities, Fundamental Equity

Behind the Yuan depreciation

The yuan depreciation is motivated by two factors:

1) **Structural:** China wants to move toward a freely traded currency driven by supply and demand. Stamping out one-way bets on further appreciation means allowing more volatility.

2) **Cyclical:** The yuan had appreciated significantly for years – until authorities started guiding the currency lower last August. Policymakers want to mitigate the headwind of a strong currency at a time when the country is struggling to hit its growth targets.

We see three options for Chinese policymakers from here:

1) Indefinitely defend the currency through FX intervention (unlikely, we think);

2) A big, one-off devaluation (an unlikely but rising risk. This would shock global markets and raise trade tensions);

3) Gradually loosen the reins on the yuan (our base case; we expect further depreciation in the high single-digits this year).

The risk is that markets get ahead of policymakers. Capital outflows could intensify pressure on the currency, making a one-off devaluation more likely. Yet this would likely be a last resort. (Soft) capital controls to put the brakes on outflows and keeping up support for the ailing onshore stock market would likely come first. A worrying trend: Chinese capital outflows have broadened from short-term speculative swings to foreign direct investment and portfolio liquidations, JPMorgan argued in a note this weekend.

China has replaced Greece as the main worry for financial markets – and it is fundamentally a much bigger deal. The problem? Investors are losing faith in the ability of Chinese policymakers to control their markets. What could break the damaging spiral? Moving quickly and decisively to shutter excess capacity in state- owned steel and coal companies would be a game changer. Imagine the effect on commodities, for one. We see 1:5 odds for such bold action in the near term but do detect a greater appetite for tackling supply-side reforms.

Global equities have sold off, but U.S. Treasury yields are roughly unchanged since last May. We see U.S. Treasuries becoming less effective as portfolio stabilizers for three reasons:

1) The Fed is in hiking mode (albeit gently);

2) The low level of rates does not leave much upside;

3) Supply-demand dynamics have changed. There is heavy bond issuance as investment-grade companies lock in cheap financing, while price-insensitive buyers such as China and petro states have turned into sellers as their currency reserves shrink.

We see two other risks to the global economy today:

1) **Oil prices** and knock-on effects in the Middle East (political instability and more selling of risk assets by reserve managers);

2) **Cash flow** is getting much harder to come by. The global liquidity tide has crested with the Fed now raising rates and emerging markets selling FX reserves to defend currencies. Debt costs are going up – while the return on capital invested is heading down. This is a bad mix.

The good news?

Some markets have priced in the risks. We see opportunities in domestically focused companies with strong cash flow in the **eurozone** (where an accommodative central bank is your friend). Valuations are fair, so we do not count on market (beta) returns. In fixed income, **carry is the word**: We see some opportunities in the battered emerging markets, and like parts of the bifurcated high yield market (avoid energy!).

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