SkyView Investment Advisors:

China and the Global Market Meltdown

August 24, 2015

The Morning After – The Market Hangover

These comments are being written the morning after the Dow Jones index declined over 500 points or a loss of 3.1% for the day. At the same time, the Standard & Poor's 500 stock index fell 3.2%. Investment observers placed much of the blame on a potential economic slowdown in China and the Asian emerging markets. In addition, the decline in commodities and oil also influenced the outcome. So let's take a look at these influences.

China

In the past, we have written that the Chinese economy may face an inflection point. Very simply, from the end of the cold war when China entered into the global economy, it grew, in effect, by exporting cheap labor. It then used that income to build its economy. That source of growth, it appears, has run its course.

The leaders of China now face a period of restructuring the economy to give greater emphasis to consumer spending and exports of more value added products. To achieve this change should also require liberalizing trade and monetary policies. Without getting into the nuances of their options, we believe the Chinese leadership must ultimately let market forces reflect themselves in both financial and foreign currency markets. For a leadership that grew up in a command economy, they may either have to give up more command of their economy or face an even bumpier road to change. For an economy the size of China, this re-orientation will likely lead to many bumps and uncertain economic growth.

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Investors reacted quickly and negatively to one of these bumps. The Markit survey of Chinese industrial companies showed that industrial activity declined further in August. The Markit index showed its lowest level in six years at 47.1, compared to 47.8 in July.[1] A reading below 45 shows contraction. And as we saw on Friday, negative investor reactions to these numbers showed up in global markets.

How the Chinese economy will perform this year and next will depend, we believe, on the Chinese government's ability to restructure its economy and gradually move to a floating currency. Of course, what the government reports about the economic performance will likely be different than reality, adding further to investor skepticism. Despite the opaque nature of reporting on the Chinese economy, the sharp price decline in hard commodities provides a strong indicator of current Chinese economic performance. We believe the growth will likely be lower than their goal of 7%.

Emerging Markets

Competitive Currency Devaluations

The term emerging markets encompasses a broad swath of countries. Most of the recent investor focus has been on the countries in Asia (China for example). These countries in many cases face the secondary impact from the slowdown in China and the devaluation of the yuan. In some cases, they export raw materials or oil to China. For example, Kazakhstan exports oil to China. With the falling price of oil and the devaluation of the yuan, Kazakhstan devalued its currency (the tenge) over 20%.[2] Vietnam, a competitor with China for manufacturing of products, devalued its currency, the dong, for the third time this year.

Growing Importance of Intra-Asian Trade

An increasing proportion of trade for the emerging markets of Asia comes from within these emerging markets. A recent report from Goldman Sachs showed that exports from the Asian emerging markets to developed countries declined from 13% of their GDP in the late 90's to 8% at present.[3] At the same time trade among these emerging market countries jumped from 6% of their GDP in the late 90's to 15% currently.[4]

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Therefore, unlike the last 15 years, the future outlook for the Asian emerging markets may be more determined within Asia than from exports to developed countries. And within Asia, with China the largest economy, the outlook for the other Asian emerging markets may increasingly depend on the economic outlook for China. With the current concerns about China, this is not a positive for the other Asian emerging markets.

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Impact on US Investors

The easy monetary policies of the Fed enabled government and companies in Asian emerging markets to borrow dollars easily and at low rates. With the economic growth stimulated by this financial leverage, their equity markets responded favorably.

In reaction to stabilize their currencies against the stronger dollar, emerging market central banks raised their interest rates…

And now the trouble begins. First, the stronger dollar makes it more costly to repay these borrowings. In addition, in reaction to stabilize their currencies against the stronger dollar, emerging market central banks raised their interest rates. These higher rates cooled off their economies. Now a potential slowdown in China will likely reduce their exports and further depress their economies.

If the investor reaction to past problems in emerging markets repeats itself, then at first investors will likely sell their investments in the problem markets. Once those profits disappear, they may then look to other markets where they still have profits and reduce those positions. This is probably what we are seeing now in the selloff in the developed markets such as in U.S. This selloff occurred despite the cautiously optimistic outlook on the U.S.

Oil

The New Oil Production Technologies – Shorter Time from Investment to Production

The sharp decline in oil prices reflects the impact of increasing output from new oil production technologies. Using old technologies, it took roughly four years to achieve new oil production from initial investment. With the new technologies, it now takes 5-6 months to first production.

With the introduction of new technologies, the key to lowering production will be to reduce the capital flow to the industry.

So with these new technologies, we believe the key to lowering production will be to reduce the capital flow to the industry. Therefore, sustained lower prices may prove to be the only answer to remove capacity. The move to

$60/barrel oil earlier this year only prolonged the problem as we see it.

Interestingly, last Friday, the WTI futures curve showed a $59.83 per barrel price for oil delivered in December 2023.[5]

That future price demonstrates the sharp decline in the price outlook for oil since earlier this year when the price was

$60/barrel in the cash market. That future price will likely change many times between now and 2023.

What Could Reduce Domestic Oil Production

Bankers will significantly reduce credit lines available to drillers…will make it harder for many drillers to stay afloat.

At least twice a year, banks review their credit lines to oil drillers. This fall, if not already, banks will update their internal pricing models to value oil and gas reserves. These valuations will be used to adjust their credit lines to drillers. No doubt with those adjustments, bankers will significantly reduce credit lines available to drillers. The resulting reduced credit lines will likely make it harder for many drillers to stay afloat.

In addition, higher priced hedges used by drillers will be rolling off and no longer available to fund new production.

The net result will likely be declining new well activity by year end. If so, we may begin to see a bottoming in oil prices at that time. In our opinion, the key remains reducing the flow of capital into this industry and this will only occur if there remains a sustained period of low oil prices

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Sources:

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2 "Kazakhstan Tenge Stays At Record Low Versus U.S. Dollar." RTTNews. Accessed August 24, 2015.
http://www.rttnews.com/2543212/kazakhstan-tenge-stays-at-record-low-versus-u-s-dollar.aspx.

3 "Goldman: Don't Bet On An Emerging Markets "Pop" After This Drop." Asia Stocks to Watch RSS. Accessed August 24, 2015. http://blogs.barrons.com/asiastocks/2015/08/20/goldman-dont-bet-on-an-emerging-markets-pop-after-this- drop/.

4 Ibid.

5 "Crude Oil WTI Futures PricesMon, Aug 24th, 2015." Barchart.com. Accessed August 24, 2015. http://www.barchart.com/commodityfutures/Crude_Oil_WTI_Futures/CL.