Market Update: 1/7/2016
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Good evening. Stock markets around the world have had a challenging first week of the New Year……and today is only Thursday.

Today's newspaper and website headlines are fixated on the government, economy and stock markets (there are several) in China. And given our flattened and inextricably-linked world of global finance, the containment of issues to their source country is comical and the exportation of anxiety is common.

China is certainly this week's sneezer but the rest of the world has caught a cold.

The latest bout of contagion kicked off last night (China's markets open @ 7:30pm in the Midwest), and here's a synopsis of what took place in the Chinese stock market:

- China's primary stock market traded for less than 30 minutes and dropped approximately 7% before triggering a circuit breaker mechanism;
- Circuit breakers halt all trading in an attempt to provide orderly price discovery between buyers and sellers of shares;
- Circuit breakers are invoked when markets drop quickly and there is a heightened risk of unfair pricing;
- Circuit breakers are designed to calm markets…to allow trader's (or computer programs) to take a breather and generally encourage less feverish behavior;
- The circuit breaker's influence on participants was not perceived as intended and it actually escalated the panic rather than assuaged its fears;
- The circuit breaker has been used in 2 out of the 4 trading days it has been available. It was just implemented this year - 4 days ago;
- In addition, China's regulators issued new rules Thursday to prolong restrictions on sales by some major shareholders….forbidding a certain amount of shares from even being allowed to be sold.

The supposition as to why China is taking what seem to be such extreme interventionist steps to shore up their markets is their concern about falling economic growth and its impact, and their standing, on global markets. To explore a little more:

- China's economy and financial markets are notoriously hard to read due to the government's opacity but that didn't matter, or wasn't questioned, when the growth was exploding;
- The Chinese government currently pegs growth at +7% annually;
- China's economy still has a major manufacturing component and looks to be contracting based on some data that we discussed on Monday;
- The Keqiang Index (railway cargo volume, electricity consumptions, and loans disbursed by banks, http://www.economist.com/node/17681868), mainly tracks the manufacturing sector of the economy and showed an annual growth rate of 2.4% at the end of November;

- The service sector doesn't have a reliable indicator like that – it's hard to know much about the Chinese service economy without living there and how much does an internal service based economy's growth matter to other countries growth?

In addition to messing with their stock markets, China is also in the process of actively devaluing its currency to stimulate exports. By doing so, they actually transfer their economic problems to the rest of the world as other countries are tempted to follow suit with their own currencies. This can set off what is known as a currency war, that tends to deflate prices and undermine global growth – again……the opposite of the intended effect!

In many respects, what we've witnessed in the first week of this year is a repeat of what took place in the summer of last year – calling into question the capability of Chinese bureaucrats to manage sophisticated financial markets.

The interesting, and frustrating, thing is that the histrionics of the Chinese stock and currency markets may be obscuring the stabilization of a transitioning economy that is currently underway. I listened to a great interview on Bloomberg.com last night featured Stephen Roach, formerly of Morgan Stanley, currently on the faculty at Yale, and unequivocally a lauded scholar in all things China.

The link to the interview is here: http://www.bloomberg.com/news/articles/2016-01-06/china-may-have-hard-landing-amid-credit-bubble-faber-says but the Cliff Notes are here:

- The "Hard-Landing School" has it wrong on China;
- Investors need to look beyond top-line GDP, and the parts within the sum are far more constructive than you'd otherwise think;
- Growth of debt in China is concentrated in state owned enterprises and that is the responsibility of management within those organizations;
- Growth is strong in private China (which is relatively unlevered);
- China can grow itself out of debt challenges;
- China is growing rapidly within services sector (+8.5% growth annually);
- China is Shifting from an export to an import economy.

We'll keep in close touch as it relates to the global market instability we're experiencing and look for some interesting data points tomorrow morning about the state of our domestic economy. Certainly the stiffer the economic spine of the US, the better we can withstand the inevitable importation of problems.

Have a great night. dc

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