Chandler Asset Management

Slowing Growth In China And What It Means For The Global Economy

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Since 1988, Chandler Asset Management has specialized in the management of fixed income portfolios.

Chandler's mission is to provide fully customizable, client-centered portfolio management, which preserves principal, manages risk, and generates income in our clients' portfolios.

Concerns about China's economy have made headlines in recent weeks, as the country's interbank and money market interest rates soared to record highs last month. The spike in rates along with weakening economic data has fueled investors' anxiety about the safety of China's banking system and the sustainability of the country's economic growth.

A tightening in liquidity, along with an apparently deliberate move by the People's Bank of China to hold back on providing stimulus, drove overnight repo rates to surge as high as 30% in June, essentially freezing credit markets in China. The run-up in rates was driven by a number of factors, including fears that lending activities had become overstretched, speculation in the media that China could be facing a banking crisis, as well as actions by Chinese authorities to induce monetary tightening and discipline speculators in the country's shadow banking system. While China's central bank eventually injected liquidity into the system at the end of June and interbank lending rates have since eased, it has become evident to market participants that China's new leadership may be willing to tolerate higher interest rates and slower economic growth in pursuit of financial sector deleveraging and reform.

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Last November, Xi Jinping was named head of the Communist Party in China and subsequently became President in March. Since he has taken office, Mr. Xi has indicated that he wants to revamp China's economic structure and move toward greater interest rate liberalization (allowing market forces to have a greater influence on interest rates). Also in March, Li Keqiang was elected by the Chinese Congress as Premier (China's head of government and an influential driver of economic policy). Like Mr. Xi, Mr. Li has vowed to reduce the government's role in the economy and supports private enterprise and fiscal reform. These recent changes in leadership seem to be shifting the trajectory of the Chinese economy to some degree. Policymakers appear willing to accept short-term pain for longer-term gains.

Over the past decade, China's economic growth had been fueled by a number of factors including massive state spending, strong export growth (supported by low-cost labor), a burgeoning real estate market and easy access to credit. However, it appears that these factors are now decelerating.

In 2012, China's GDP grew by 7.8%. It was the first time growth had come in below 8% in more than a decade. For the second quarter of 2013, economists are forecasting GDP growth of roughly 7.6%, a deceleration from first quarter growth of 7.7% (which was below expectations of 8%). Growth is expected to decelerate further in the third quarter to 7.4%, according to Bloomberg. While GDP growth of more than 7% may seem strong when compared to GDP growth of roughly 2% in the U.S., it represents a slowdown for China.

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Meanwhile, Chinese exports declined 3.1% in June on a year-over-year basis compared to 1% year-over-year growth in May. In addition, Chinese imports fell 0.7% in June, reflecting weaker demand. Sluggish global economic growth, including an ongoing recession in Europe, has put pressure on China's exports, which has negatively impacted China's manufacturing sector and contributed to the country's overall slowdown.

We believe the most immediate risks related to China's slowdown are to commodity prices (where we have already seen significant volatility) and to second quarter corporate earnings (and second half 2013 forecasts) for companies that generate a significant portion of their revenues in China and/or companies that have been counting on China to be their growth-driver. We believe the slowdown in China also has the potential to spill over to other economies, especially in countries like Australia, South Korea, Taiwan, Indonesia, Japan, and Singapore. Europe, which is already struggling, is also likely to feel additional pain from China's slowdown. In terms of the U.S. economy, the fact that China's policymakers seem to be backing away from providing stimulus at the same time the U.S. Federal Reserve is mapping out its own exit from stimulus does, in our view, add risk to the sustainability of our economic recovery.

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We believe speculation in the media about a potential banking crisis in China may be overblown. The difference between what happened in the U.S. during the financial crisis and the trouble that appears to be brewing in China is that all big Chinese banks are owned, or are at least partially controlled, by the government. As such, we believe it is unlikely that Chinese authorities would allow a systemically important bank to fail. Nevertheless, Chinese policymakers have signaled less willingness to provide ongoing stimulus, and any risk to the financial stability of China's banks is a headwind for economic growth in our opinion.

This week, the International Monetary Fund lowered its growth forecast for the global economy to 3.1% in 2013 from its previous forecast of 3.3%. The IMF cited slower growth in developing economies such as China, as well as a deepening recession in the Eurozone, as reasons for the downward revision. The IMF cut its growth forecast for China to 7.7% in 2013 from its previous forecast of 8.3%. The downward revision to the IMF's growth forecast for the U.S. was less severe, down just 0.2 percentage points to 1.7%.

Overall, we believe the structural changes taking place in China will be a headwind to the global economy over the near term. However, we believe the country's new leadership regime is focused on putting China on a longer-term path to stability and consumer-led (rather than government-led) economic growth.

Shelly Henbest
VP, Credit Analyst

Shelly Henbest joined Chandler Asset Management as a credit analyst in 2009. She is actively involved in analyzing and assessing the credit suitability of debt issuers and assisting portfolio managers in the portfolio management process. Shelly is a member of the firm's Credit Committee, the Economic and Market Analysis Committee, and is responsible for monitoring developments in the financial markets and providing fundamental economic and investment research. Shelly has more than 12 years of experience in financial research and analysis.
