

Thoughts on China, Oil and the Dollar

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Last week, Professor Jeremy Siegel and I chatted with Marc Chandler, currency strategist at Brown Brothers Harriman, and Ruchir Sharma, head of macro and emerging markets at Morgan Stanley Investment Management. The conversation focused on the current state of affairs in emerging markets (EM), currencies and prospects in a rising rate environment—with a focus on China.

Oil, Inflation and the Fed There is much discussion about how emerging markets will react to a monetary policy interest rate hike by the U.S. Federal Reserve (Fed). One factor showing easing of inflation concerns—and that could potentially cause a slower or later hiking-cycle—is downward moves in commodity prices. Sharma firmly believes that low oil prices are a function of persistent weakness in China. While the Fed focuses on core inflation, it also looks for important signals from the labor markets, and we have yet to see any real signs of wage inflation there. This implies that the Fed may normalize policy slowly, and the pace could continue to be supportive for EM. Chandler does not believe a slowdown in China is causing oil to weaken. He believes oil prices are being suppressed due to the glut in oil supply—and the latest news showed U.S. rig counts increasing and OPEC persistently experiencing oversupply.

China's MSCI Equity Index and SDR Currency Inclusion Chandler believes that the recent sell-off in Chinese equities will have a limited impact on broader economic activity, and its adverse wealth effect is immaterial. This is in part due to the disproportionately small percentage of Chinese citizens who own equities—pegged at less than 10%. However, the government's heavy-handed actions aimed to counteract the fall in the stock markets will most likely delay its A-share inclusion in MSCI indexes. A key focus for the Chinese government this year has been the yuan's inclusion in the International Monetary Fund's Special Drawing Rights (SDR). The IMF makes this decision once every five years, and inclusion is a major status symbol for a currency. Despite meddling in the stock markets, [China has taken systematic steps](#) to ensure that its currency is more accessible to foreigners. It has also kept the yuan from weakening too significantly, and there has been remarkable stability in the currency despite the equity volatility.

Setting the Record Straight on Chinese Capital Outflows Many observers have cited three consecutive quarters of shrinking Chinese foreign exchange reserves as indication of severe capital outflows. Capital outflows tend to lead to a weaker local currency. The People's Bank of China (PBoC) has attempted to stem yuan depreciation by selling foreign reserves. This has manifested in much lower foreign reserves over the past three quarters. Chandler believes these concerns are overblown. He believes much of the outflow can be attributed to the fact that reserves are reported in U.S. dollars and the euro has fallen significantly. For example, if an estimated 25% of China's \$4 trillion of reserves were in euros, then because the euro alone has depreciated 20% last year, that would account for two-thirds of the shrinkage in its reserves.

Is China Close to a 2008-Like Crisis? Sharma believes that the Chinese outflows are systemic, even after accounting for valuation effects. He pegs real Chinese growth at 5% despite official numbers suggesting growth closer to 7%—considering

weak electricity consumption, low freight traffic, slower credit growth and flatlining manufacturing activity. Despite these concerns, Sharma believes that the very structure of China and its heavy state-owned influence will keep the country from falling into a 2008-style U.S. financial crisis. Instead, he believes that China may adopt a Japan-like model of extend and pretend to work out problem loans. This extended duration of bad debts could clog the banking system for a long time, forcing Chinese economic growth to remain lower for longer. **The USD in Perspective** Chandler focuses on currencies, so I was interested in his thoughts here. While some valuation measures show the euro and yen becoming undervalued, Chandler believes we are still in the middle of a longer-term move in the U.S. dollar. He notes the drivers of the major dollar rallies: • The Reagan dollar rally was a policy mix in which a fiscal accelerator was applied, leading to a tax cut and spending increases. Paul Volcker later put on the breaks through higher rates, which was ultimately bullish for the dollar. • The Clinton dollar rally was a function of the tech bubble and Americans showcasing increases in productivity—causing an influx of capital into the U.S. supporting the dollar. • The Obama dollar rally is a function of divergence in monetary policy, where the Fed is expected to raise rates in September of this year while the European Central bank (ECB) and Bank of Japan (BOJ) are stepping on the quantitative easing pedals well into 2016. This environment continues to be supportive for the U.S. dollar. Despite this being a fairly telegraphed cycle with surveys showing that a large majority of economists believe September will mark the first Fed rate hike, Chandler believes the hike is still not priced into the futures market. *Read the Conversations with Professor Siegel Series [here](#).*

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