China meltdown commentary

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Avoid emerging markets but stick with developed world quality stocks

Global stockmarkets have fallen sharply in recent days, volatility has risen and traditional safe-haven investments such as gold and sovereign bonds have been in demand. Asia excluding Japan and the emerging markets are at the centre of the vortex but poor sentiment has now engulfed developed economy markets. Since the credit crisis, investors have become accustomed to "buying the dips" as stockmarket falls have provided good buying opportunities. Is this latest fall another buying opportunity or the start of a more extended reversal?

Asia ex-Japan and emerging market equities have been declining for weeks as investors have responded to falls in the prices of oil and other commodities and the prospect of renewed dollar strength as the Federal Reserve contemplates raising interest rates. For Brompton strategies that had Asia ex-Japan, emerging market and commodities holdings I reduced or sold outright their investments in these areas as appropriate early in the year. Capital has continued to flow out of these markets into developed economy assets, which have held up better.

Emerging economy currencies have tumbled this year, making it harder for borrowers to service their dollar-denominated debts but increasing competitiveness. By contrast, the Chinese renminbi, fixed by the People's Bank of China and effectively pegged to the dollar, was little changed. This had reduced Chinese export competiveness at a time when China's economy was slowing. Beijing has made no secret of its objective to persuade the International Monetary Fund to declare the renminbi an official reserve currency on a par with the dollar, euro, yen and sterling and a greater market influence on the currency may be a desirable pre-condition.

On 11 August, the People's Bank of China announced a new method of fixing the exchange rate, allowing market forces to play a greater role. This had led to a 1.64% fall in the renminbi against sterling by 24 August. Vietnam and Kazakhstan, although relatively small economies, responded to China's move by allowing their currencies to weaken. China could have started a "beggar thy neighbour" round of competitive devaluation. This policy change was unexpected and provided the catalyst for the recent acceleration in capital flight from the region and from risky assets generally.

It has been clear for some time from Chinese data that the economy has slowed and is probably underperforming the government's 7% target for gross domestic product (GDP) growth. China has stepped up support for its economy this year through interest rate cuts and an increase in bank borrowing. Currency depreciation was the last remaining measure in the central banker's tool box. China is the world's second largest economy and a slowdown there will dampen global growth.

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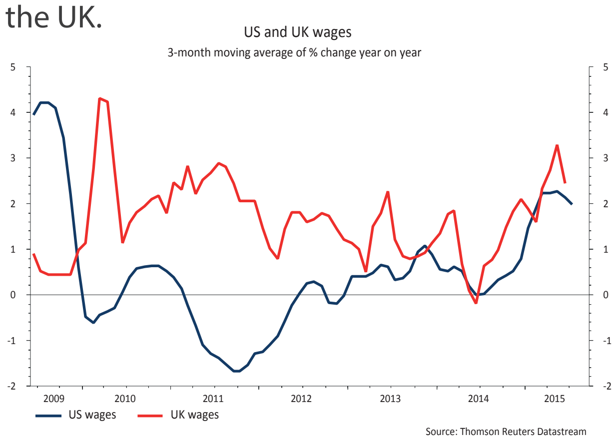
If, however, the renminbi's decline proves to be the start of a much greater currency devaluation then the greater concern would be the increased threat of global deflation.

Coincidentally, the US Federal Reserve published the latest minutes of its monetary policy setting committee last week. US jobs data is encouraging but the lack of inflation has the potential to stay the Fed's hand from raising interest rates. In July, US headline inflation increased by just 0.1% over the previous month although there are encouraging signs of wage inflation in the US and the UK.



The commodity price falls are largely to blame for low inflation. Energy costs are a key component of inflation data. Oil prices have fallen 15.83% so far in August, taking the annual decline to 60.01% in sterling.

So what should investors do? I do not yet see the recent falls as a buying opportunity for Asian and emerging economy equities generally.

The potential for negative surprises has risen with the change in China's monetary policy. Greater clarity on China's intentions may be forthcoming following the fallout from both the weakening of the currency and the ineffective handling of the bursting of the Chinese equity bubble. I am, however, looking for an opportunity to invest in some stronger developing economy markets such as India, where valuations have for some time been too high but the fundamentals are attractive. Narendra Modi, India's prime minister, is implementing reforms and the economy benefits from cheaper oil.

I remain confident in the prospects for funds such as Fundsmith Equity and Newton Global Higher Income, which are invested in consumer-orientated companies with strong business franchises and good earnings visibility. Such companies should benefit from weaker oil prices. Central bank policy is likely to remain supportive for some time; if US interest rates do go up in 2015, the pace of increase will be slow.

I have also increased investment in UK equity funds such as Man GLG Undervalued Assets and PFS Chelverton UK Equity Income, which focus on UK small and medium-sized companies. These businesses should benefit from the strength of the UK domestic economy. UK GDP is now 5.2% higher than the pre-crisis peak achieved in early 2008 and the UK could in 2015 be the fastest-growing Group of Seven economy for the second year running.

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