



A 'made-in-China' crisis?

What happened, and why?

Global capital markets have experienced dramatic volatility over the past ten days. Even after the recovery that began yesterday, Chinese shares have fallen another 20% and are now 40% below their early-June peak. Other Asian equity markets have fallen about 9% in recent days and are nearly 20% down from their 2015 highs. Year-to-date, only Japan, New Zealand and Vietnam are in positive territory.

Credit markets were also badly affected, with Asian high-yield G3 currency bonds selling off 4-5 points on average and investment grade yield spreads rising 30-40bps. Much of these losses have been recouped in the last couple of days, but investors in both high yield and investment grade credits are under water for the year so far.

Big moves in foreign exchange markets have been seen as well, with EM and commodity currencies selling off strongly and the yen and euro rallying 4% in just a few days – reversing a little in the last two days.

No change in the fundamentals...

And yet we can find no fundamental reason for these developments. US and European data continue to show economies growing at moderate but healthy rates. US Q2 GDP was just revised up to 3.7% and the economy has now posted five straight quarters of 2.5% or better growth in YoY terms. The Fed is still on track, we think, to raise rates this year. The European Union has grown at a steady 1.7% rate for three quarters and YoY growth is at a three-year high. Around the world, monetary policy is almost everywhere still very supportive of growth and inflation is low. More to the point, the data in recent days have not suggested that growth has suddenly tailed off.

Even in China, we don't see any evidence of a sudden slowdown in activity that would explain the sharp decline in share prices. The weak flash PMI reading for manufacturing in August, which was released a couple of days after the Chinese equity market's big decline and therefore could not have been the catalyst for that market's selloff, was a little soft but reflects less than half the Chinese economy. As in the US, China is experiencing weak manufacturing but strong services sector activity – both the Markit and NBS composite PMIs have been stable in recent months and are consistent with the kind of gradual decline in GDP growth over the last few years that the government has been reporting.

...but in the 'technical' in China

Instead of changing fundamentals, we think what changed was in some sense technical. There was clear contagion from the selloff in the Chinese equity market at the middle of last week to other regional and to global equity markets. Asian equity markets had been in decline for most of this year already as concerns about growth dragged on sentiment. The inflating Chinese bubble offered little support – or to put it another way, regional markets largely ignored the Chinese bubble as it inflated – and the deflating bubble also didn't seem to have much impact outside China.

But that suddenly changed last week and as the Chinese market sold off regional markets moved in lockstep with the Chinese market. Further abroad, the same seems to have been true for the US and European markets. The