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Better Than Nothing: S&P 500 Rebounds as China Supports Market

By Ben Levisohn - January 5, 2016

Stocks started the day in the red but found the strength to finish up on the day as China took steps to stabilize its markets.

The S&P 500 gained 0.2% to 2,016.71 today, while the Dow Jones Industrial Average finished up 0.1% at 17,158.66, and even the small-company Russell 2000 rose 0.2% to 1,110.45. Only the Nasdaq Composite finished lower today, dipping 0.2% to 4,891.43.

The **Economic Outlook Group's Bernard Baumohl** ties to see the bright side in China:

> "In particular, much attention will focus on China because it has served as a growth locomotive for so many other emerging economies. Its growth rate has steadily declined the last five years, and the economy will slow again this year to 6.5%, from 6.7% in 2015, as it works through high levels of debt and recessionary conditions in manufacturing and mining. But there are also some positive developments to consider. The country is making progress reducing its reliance on exports and heavy industry and giving a greater role for consumption and services. In addition, home sales are rebounding, and the IMF has granted the renminbi special reserve status now that it's part of the Special Drawing Rights basket.
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> In short, China's leaders seem determined to continue the delicate task of allowing market forces to have a greater say in the allocation of capital. The challenge is whether a fundamentalist communist country can do so without destabilizing its economy and generating social unrest in the process."

RBS's Alberto Gallo and team are less sanguine:

> "The "national team" is stepping in to help again. Government-controlled funds started to purchase stocks on Tuesday to support the market, reports *Bloomberg*. In addition, the securities regulator reportedly suggested that the sales ban on major stockholders will remain in place beyond 8 January. These measures are similar to the ones the Chinese authorities took amid the stock market crash last summer. The Shanghai Stock Composite Index was kept almost flat today, down -0.26% on the day
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> But China's problems are fundamental and go beyond the volatility in the stock market. These include heavy private debt burdens after eight years of rapid credit expansion, an imbalanced economy that's too dependent on investment, high industrial overcapacity and rising inefficiency in state-owned enterprises.
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> As we discussed in our 2016 Outlook, these problems are interlinked. To sustain strong economic growth, the Chinese government deployed a large fiscal stimulus and relaxed credit restrictions in 2008. These led to fast growth in private debt, which almost doubled to over 180% of GDP (see below), as well as huge resource misallocation and over-investment. Past crises have shown that such rapid pace of credit growth was almost never sustainable. Cracks have already started to appear in China: nonperforming ratios are rising, and were suggested by the banking regulator to be worse than 2008 (when NPL% was around 6%). There were several bond defaults last year, including by state-owned firm Sinosteel.
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> China's top priority is reforms, but the question is how much short-term pain the government is willing and able to take for long-term gains. The current government has shown greater determination to push through reforms. It abolished the one-child policy, published a detailed blueprint for reforming state-owned enterprises last year, introduced a debt-bond swap scheme to help local governments delever and made the foreign exchange system more flexible.
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> But the transition to a consumption-driven economy means a slowdown in growth rate is inevitable. And reforms and restructuring will mean a redistribution of income and wealth

> – there will be people losing out. These could stir up social dissatisfaction and slow down the reform process. The intervention in the stock market exactly shows that the government is afraid of volatility caused by a loosening of the State's grip on the economy. In our view, the real danger for China is a delay in the necessary reforms, if the government again uses investment and credit to prop up growth. This could further fuel the country's debt bubble, which will lead to bigger fallouts when it bursts and the government will have less policy dry powder to counter."

The upshot: Don't let anyone tell you what happens in China stays in China.

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