Financial markets caught between too much and too little confidence

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Published
September 13, 2021

Length
3 minute(s) read

Investors show complacency regarding central banks and the decisions they may make in a complicated environment, yet at the same time they are excessively skittish about China, argues Gergely Majoros, a member of Carmignac's Investment Committee.

Now that everyone's back at work, how are things shaping up in financial markets?

Gergely Majoros : Equity markets are still going strong right now. But there are two issues worth focusing on. The first is China's recent shift to much tighter regulatory scrutiny. The second, which is equally important for equity markets the world over, is where interest rate will be heading.

China seems to condense a wide range of fears today. Why so in your opinion?

G.M. : The Chinese government has begun imposing tougher regulations on specific segments of what is known as the new economy, which is fuelled by consumer spending, new technology, healthcare and even the green revolution. But though the latest measures are far tougher than similar moves seen in 2015 and 2018, the rationale behind them is to provide a lasting fix for imbalances like market dominance, social inequality and insecure working conditions.

Does that explain why specific Chinese share prices have fallen?

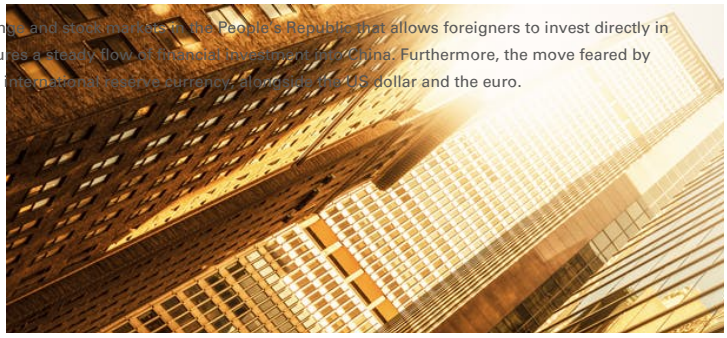
G.M. : The new policy has definitely affected Chinese equities. But the fears sparked by the regulatory crackdown raise a number of questions. Do investors have reasonable grounds to expect that, to ensure "common prosperity" or in the interest of the strategic rivalry in high tech between the US and China, the decision-makers in Beijing are willing to permanently weaken the country's top internet groups? Do they really imagine that the government will attack private property and the structures established to enable Chinese firms to offer shares abroad? Our answer to both questions is emphatically "no".

Why is that?

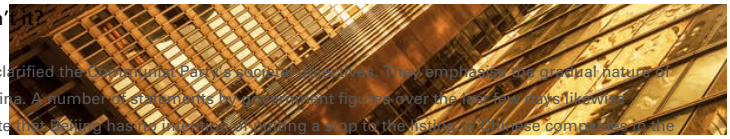
G.M. : Because those concerns are totally at odds with the government's strategic and necessary aim to gradually open up China's capital markets.

Could you be more specific?

G.M. : A few years ago, China put in place a link-up between the Hong Kong Stock Exchange and stock markets in the People's Republic that allows foreigners to invest directly in Chinese companies. This decisive step forward in the trend towards market opening ensures a steady flow of financial investment into mainland China. Furthermore, the move feared by investors would conflict with Beijing's long-term goal of boosting the yuan's status as an international reserve currency alongside the US dollar and the euro.



The Chinese government has since attempted to clarify its stance, hasn't it?



G.M. : Most definitely. The Central Financial and Economic Affairs Commission has just clarified the Communist Party's socialist objectives. They emphasised the gradual nature of the changes under way and the Party's eagerness to foster a healthy private sector in China. A number of statements by government figures over the past few days likewise underscore how important the Hong Kong Stock Exchange is to China and clearly indicate that Beijing has no intention of putting a stop to the listings of Chinese companies in the US.

But with regulatory scrutiny getting tighter, don't investors have legitimate grounds for expecting higher political risk in China?

G.M. : Not in our view. Most of the measures announced are still consistent with the Chinese Communist Party's long-range goals and ambitions like ensuring "common prosperity", and tackling market dominance, social inequality and precarious working conditions. The current skittish attitude towards China has driven down a lot of Chinese share prices, including for companies that weren't directly targeted by the new measures, for example, those operating cloud services and data centres. The result is that many companies are now attractively valued when compared with historic P/E ratios and their US peers.

So China is still an attractive market?

G.M. : We believe that China is still a market worth investing in – provided, of course, that you proceed selectively. And considering the pace and orientation of the latest government announcements, this new regulatory environment should gradually improve. That will enable investors to start factoring in all this new information and see for themselves that a number of Chinese companies are quite attractive indeed.

Could you say a few words about interest rates?

G.M. : Things may prove to be trickier than anticipated. With wages rising sharply, particularly for lower-skilled workers, and rents trending upwards in the United States, inflation could prove to have greater staying-power. In addition, GDP growth may weaken due to lingering uncertainty over where exactly the Biden administration's stimulus programme is heading. Though significant progress seems to have been made recently on the specifics in upcoming spending packages, the administration has truly gone out on a limb in submitting two huge spending plans in just a few months' time – especially with mid-term elections set for 2022.

Could that make the job tougher for the US central bank?

G.M. : Absolutely. The Federal Reserve (Fed) might find itself saddled with a kind of "stagflation 2.0" – meaning slower economic growth accompanied by rising inflation expectations. Stagflation could deprive the Fed of ammunition just when it seems to be on its way to normalising monetary policy, which is how the central bank acts to influence the pace of economic growth.

What about Europe?

G.M. : Europe currently offers a more benign environment than the US. Inflation expectations are too low in relation to the European Central Bank (ECB)'s target, so price levels will remain a key focus for the ECB's policymakers.

How exactly are you dealing with these two issues – China and interest rates?

G.M. : Interest rates call for a cautious but flexible approach. In our equity investing, we currently favour companies that have the resilience needed to weather possible disappointments regarding GDP growth. Returning now to China, we are holding onto the stocks that in our view offer major potential and have recently begun trading again at extremely attractive prices.

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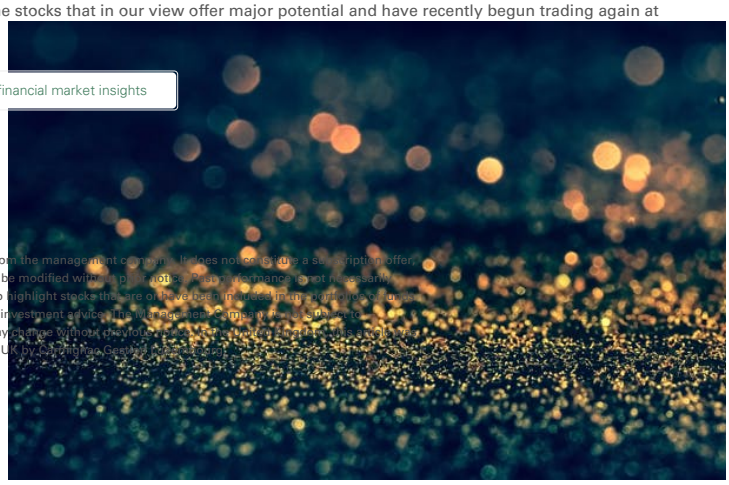

Source: Carmignac, Bloomberg, 31/8/2021

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