China Matters More than Brexit

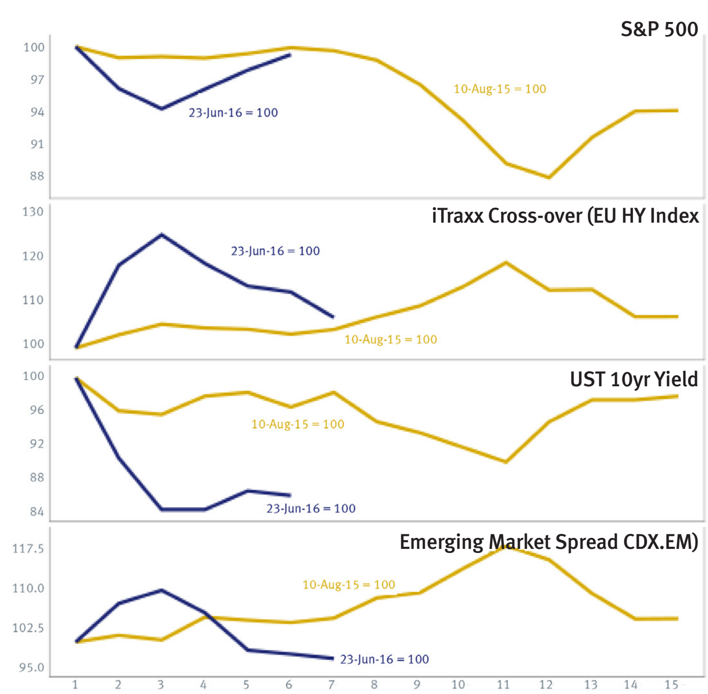
July 5, 2016

On August 12 last year, a less than two percent fall in the value of the Chinese currency (CNY) prompted turbulence in global financial markets. There was subsequently several days of calm until the final week of August when fears of a China-led global economic downturn roiled markets, including a 10% 'correction' in the S&P 500.

On 24 June, markets (and bookmakers) were shocked when the UK voted to leave the European Union. The following day the British pound lost 10% of its value against the US dollar. The German 10-year bund yield fell 27 basis points (bps) on the market open and European stocks were down more than 8% and the S&P 500 almost 4%.

The panels in the chart below show the evolution of the S&P500 in the top panel; European high yield (using as a proxy the iTraxx Cross-over credit derivative index); the yield on the US Treasury 10-year bond; and in the bottom panel, emerging market spreads (referencing the CDX.EM credit derivative index).

Exhibit 1
Market Reaction: Brexit Versus China Devaluation



Source: Bloomberg; data at 30 June 2016

The initial reaction of risk assets – global equity and credit - to the Brexit vote was more violent than to the CNY devaluation but within a week has been almost fully reversed. Emerging market assets have rallied strongly and end the week stronger than before the UK referendum vote to leave the EU. The relative out-performance of emerging market assets underscores that Brexit is essentially a local rather than global event.

However, it is also striking that the rally in risk assets has not been matched by a reversal in the decline in 'core' government bonds yields (US Treasury yields remain at all-time lows). In our view, this reflects investor expectations that risk-averse central banks fearful of global disinflation and fragile growth will deliver further policy relief. Nonetheless, a widening gap between government bonds and risk assets often ends with a correction in one or the other. It is only a week since the Brexit vote and a lesson from last August is that any after-shocks can also be severe.

China clearly matters much more for the global economy and markets than the United Kingdom. The drama of Brexit has distracted investors from worries of a more severe slowdown in China's growth as earlier policy easing is exhausted and the CNY's stealth depreciation. And while we share the view that Brexit is not a global systemic risk event, it is symptomatic of the rising pressure on the economic and political status quo especially in so-called developed countries.

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