RBC Global Asset Management

Market Update

China's Issues and Their Reflection on the U.S. Economy
As of August 24, 2015

Sharp Performance Decline

Global markets plummeted last week driven by concerns over slowing growth in China. In the U.S., stocks reported their largest decline in four years as the week culminated with a 530.94 point or 3.1% drop, on Friday in the Dow Jones Industrial Average. This brought the U.S. Blue Chip Index total sell-off for the week to nearly 1,000 points, just the second weekly drop of at least 1,000 points in the index's history. This move also resulted in the index moving into correction territory having declined 10.1% from its May 2015 record high (declines of greater than 10% indicate a correction). Other U.S. indexes, though not in correction territory yet, also posted similar one-day declines, as the S&P 500 and NASDAQ suffered their largest one day losses since 2011. Much of the global sell-off is being attributed to the sharp slowdown in Chinese growth which is also wreaking havoc on their stock market as the Shanghai Composite Index, following another 8.5% drop in early Monday trading, has now erased all gains for the year after having been up by as much as 60%. In pre-market trading, the U.S., along with other European indexes, appears poised to continue their fall to start the day.

What Happened

In a word, China. Slowing growth in China is far from breaking news, but given recent actions by the Chinese government and recent reports, investors now fear that the second largest economy in the world is in far worse shape than once believed and has the potential to significantly impact growth across the rest of emerging markets and much of the developed world. Specifically, less than two weeks ago, the People's Bank of China (PBOC) allowed the yuan/renmidi to devalue, providing a rare glimpse into the black box Chinese economic policy, revealing Chinese growth may be in worse shape than initially feared. The widespread belief being that the PBOC allowed the currency to devalue in an effort to make exports more competitive as their peg to the U.S. dollar was causing their currency to become very expensive. While this action on its own was only marginally impactful to markets overall, when coupled with a recent report indicating that Chinese manufacturing activity had tumbled to its lowest level in 77 months, a picture of a Chinese economy potentially in crisis emerged, leading investors to fear how this will impact the global economy. These fears were initially confirmed to some degree, as China's position as the primary source of demand for commodities such as metals and oil, caused oil to dip below $40/barrel for the first time since 2009, severely influencing economies, currencies and markets in emerging countries which rely on such materials as exports. In the U.S., the sudden sell-off and global growth concerns also increased uncertainty as to whether the U.S. Federal Reserve (the Fed) will commence with the long awaited increase in its benchmark interest rate in September. This move will not only have direct implications in the U.S., but also across many emerging market countries, including China, which execute much, if not all, of their borrowing and lending activity in U.S. dollars.

What Happens From Here

Unsurprisingly, stocks across the globe plummeted at Monday's open as investor fear appears to be taking hold. As of this writing, U.S. indexes, including Dow Jones Industrial Average, S&P 500 and NASDAQ, were all down nearly 5%, European markets were down as much as 4% and China's Shanghai Composite Index had dropped as much as 8.5%, its largest one day drop since 2007. The question remains, however, is this the long anticipated end to the now six year bull market, or a near-term correction that will move market valuations to better reflect the current economic environment, one which is marked by steady, albeit slow growth? It is our belief that this move, despite its size, does in fact reflect the latter, particularly for the U.S. as the domestic economy continues to exhibit signs of relative stability. The economy continues to report tepid growth (initial second quarter gross domestic product growth of 2.6% for the quarter is expected to be revised upwards by many analysts), the country continues to move towards full employment defined as 5% unemployment rate or lower, and the ever important housing market is showing signs of renewed strength. That said, following this extended period of benign volatility, investors should expect significant increases in volatility potentially throughout the remainder of the year. Despite this challenging environment, we would encourage long-term investors, of which the vast majority of our strategies are, to remain patient and stay the course until additional information is made available. Investors should pay particular attention to any indication of what the PBOC plans to do to calm markets in China and support growth, as well as, where the Fed stands on the ever present interest rate increase debate. Both of these events will have significant reverberations throughout both domestic and global equity markets.

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