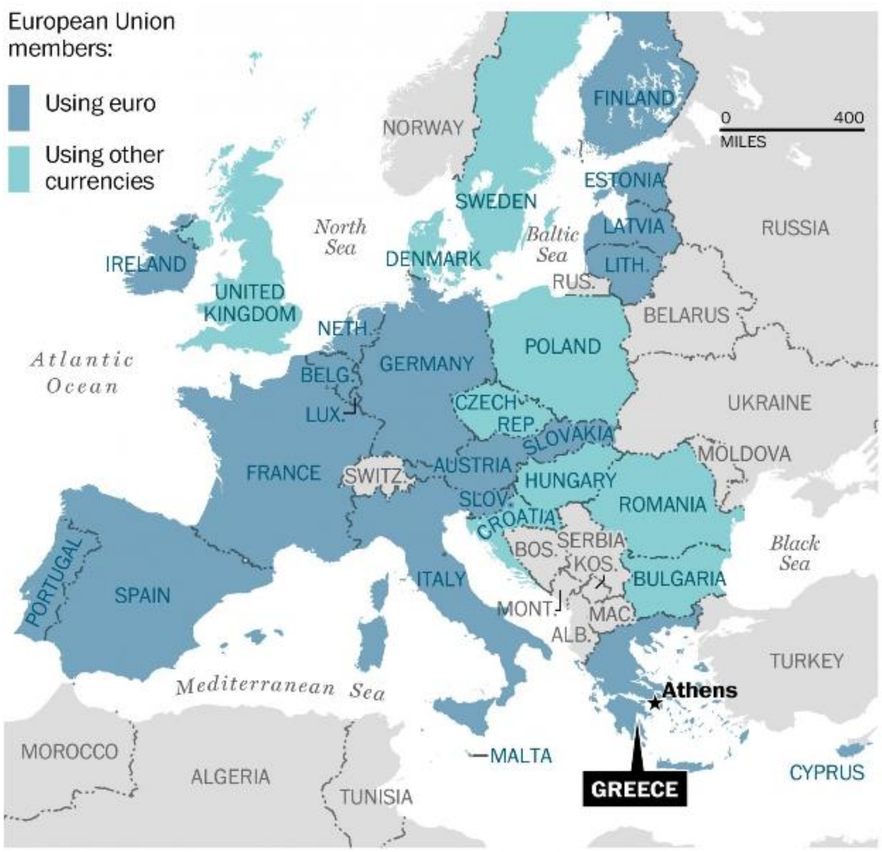
APW Partners: Insight

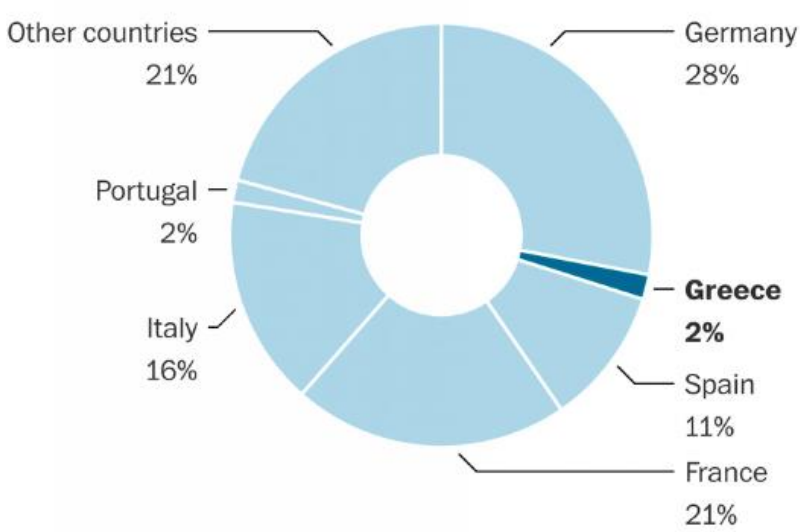
Greece & China: Investment Portfolio Implications

Lessons learned from Greece

The recent volatility in global financial markets sparked by the Greek debt negotiations is a reminder of the dangers investors' face of reacting to short term information. For example, the Australian stockmarket is now back at a similar level to early June, when Greece became the number one topic in the financial media. This is why APW Partners is reluctant to pounce on momentary issues and react.

Perspective and context is important. Greece is a relatively tiny economy of 11 million people, ranked 51st in the world based on GDP. On this measure, Greece is a smaller economy than Qatar, Peru or Kazakhstan. Its economy is about half the size of New South Wales and in Europe it represents only about 2% of the GDP of the 19-nation Eurozone.





As a proportion of global share markets, Greece is also a minnow, making up a very small portion of international portfolios. For example, as at 31 May 2015, Greek equities within the international shareholdings of client portfolios accounted for less than 0.2%.

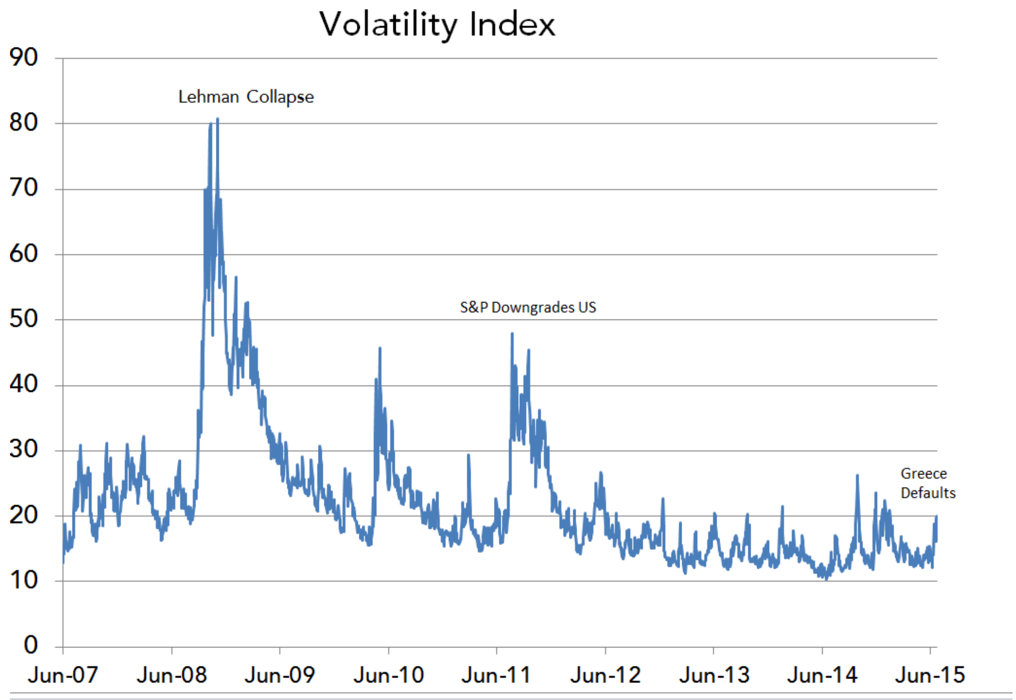
Greece is not regarded as an eligible country for global fixed interest investments and is therefore completely excluded from bond holdings within our client portfolios.

Although the total debt of Greece is large both in nominal terms and relative to its GDP (at around 180%), this still represents only about a quarter of 1% of world debt markets.

Of course, what worries investors is not so much Greece itself, but the wider ramifications of the debt crisis for its European bank lenders, for the future of the single European currency and for the global financial system.

Whilst no-one knows precisely what will happen next, we can look at measures of market volatility as a rough guide to collective expectations. A commonly cited measure is the Chicago Board Options Exchange's Volatility index (VIX), sometimes known as the "fear" index. This has recently spiked to around 18 from just 12 in mid-June. However, keep in mind this is still a long way off the index value of around 80 during the peak of the financial crisis in 2008.

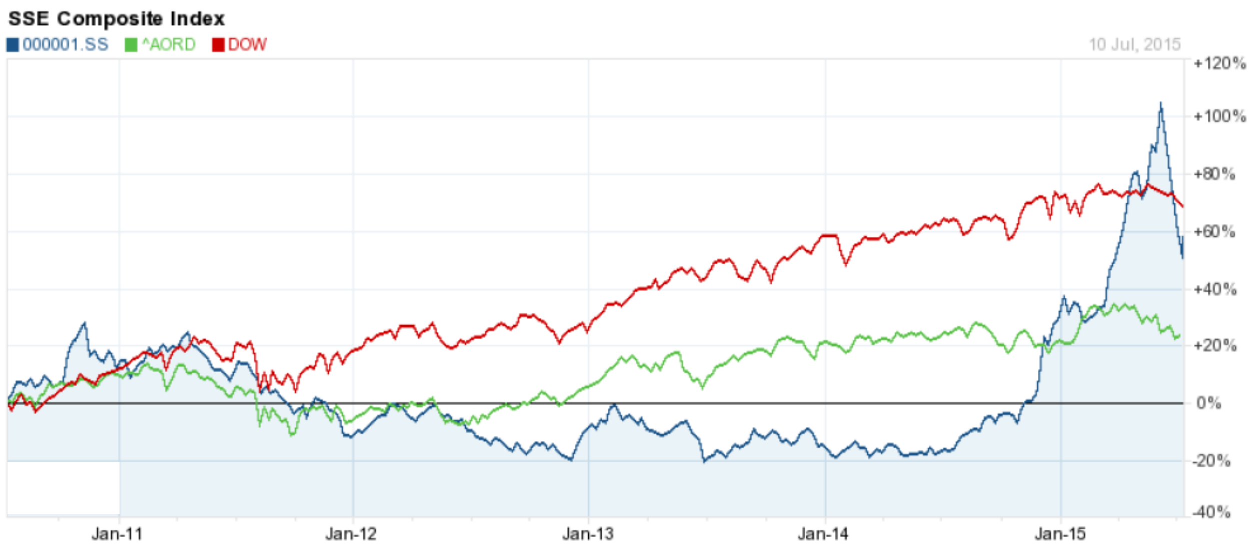
Whilst we recognise that the reaction of global markets is more significant than the direct exposure to Greek investment markets, it is important to highlight that the risk of permanent capital loss directly attributed to Greek assets is negligible in our clients' investment portfolios.



Update on China

The recent severe volatility in China's share markets has raised questions among many investors about the causes of the correction and about the wider implications for the global economy and markets generally.

The Shanghai Composite index (SSE – refer to table below), the mainland stock market barometer and one dominated overwhelmingly by domestic investors, had more than doubled in the year from mid-2014, only to lose more than 30% of its value in a month.



SSE = Shanghai Composite Index, AORD = S&P/ASX200 Price Index, DOW = Dow Jones Industrial Index (change in local currency)

The volatility was much less in Hong Kong, where foreign investors tend to get their exposure to China. The Hang Seng index fell about 17% from April's seven-year high, though it had a more modest run-up in the prior year of about 25%.

Nevertheless, the speed and scale of the fall on the Chinese mainland markets unsettled global markets, fuelling selling in equities, industrial commodities, and allied currencies like the Australian dollar and buoying perceived safe havens such as US Treasuries and the Japanese yen.

The decline in Chinese stocks triggered repeated interventions by China's government, which has been seeking to transition the economy from a long-held export-led boom toward more sustainable growth based on domestic demand.

Investors everywhere naturally are concerned about what the volatility in the Chinese market means for their own investments and what it might signify for the global economy.

HOW BIG IS CHINA'S ECONOMY AND STOCK MARKET?

Measured in terms of purchasing power parity (which takes into account the relative cost of local goods), the Chinese economy is the biggest in the world, ranking ahead of the USA, India, Japan, Germany and Russia.1

Yet, China's share market is still relatively small in global terms. It makes up just 2.4% of the MSCI All Country World Index, which takes into account the proportion of a company's shares that are available to be traded by the public.

[1] Source: IMF World Economic Outlook, April 2015

China is classified by index providers as an emerging market. These are markets that fall short of the definition of developed markets on a number of measures such as economic development, size, liquidity and property rights.

China's stock market is still relatively young. The two major national exchanges, in Shanghai and the other in the southern city of Shenzhen, were established only in 1990 and have grown rapidly since as China has industrialised. The Shanghai market is the larger of the two. Technology companies comprise a relatively large number of listings on the Shenzhen exchange.

During the past 25 years, Chinese authorities have slowly liberalised the country's capital markets, though foreign participation in the mainland markets has remained heavily restricted.

For this reason, many foreign investors have sought exposure to China through Hong Kong or through China shares listed on the New York Stock Exchange.

WHAT DROVE THE BOOM IN CHINESE SHARES?

The Chinese share market boom of the past year cannot be attributed to a single factor, but certainly two of the major influences have been the Chinese government's promotion of share ownership and increased use of debt / leverage.

Concerned about speculative activity in the property market, the government in Beijing sought to broaden and deepen the country's still relatively undeveloped capital markets, while encouraging greater foreign investment.

HOW HAS THE CHINESE GOVERNMENT RESPONDED?

Chinese regulators, mindful of the potential fallout from the stock market correction, have instituted a number of measures to curb the losses and cushion the impact on the real economy.

In the latest move, regulators banned holders of more than 5% of a company's stock from selling for six months. In the meantime, about half of the companies listed on the two major mainland exchanges were granted applications for their shares to be suspended.

While such interventionist measures may seem alien to developed market economies, they need to be seen in the context of China's status as an emerging market where governments typically play a more active role in the economy.

Whether the intervention works in the long term remains to be seen. But the important point is that this is a relatively immature and small market dominated by domestic investors and prone to official intervention.

WHAT DOES IT MEAN FOR THE ECONOMY?

While the Chinese stock market is about 30% off its June highs, it nevertheless is still about 80% higher than it was a year ago. As such, much of the pain will have been felt mainly by people who have entered the market in the past year.

While the Chinese economy has been slowing, it nevertheless is still expanding at around 7% per annum, which is more than twice the rate of most developed economies.

The IMF in April projected growth would slow to 6.8% this year and to 6.3% in 2016. Still, it expects structural reforms and lower oil and commodity prices to expand consumer-oriented activities, partly buffering the slowdown.

While economic forecasts are always subject to change, markets have priced in the risk of a further slowdown to what was previously expected, as seen in the renewed fall in the prices of commodities like copper and iron ore, which hit six-year lows.

With regards to the relevant strategies that Dimensional & Vanguard have been engaged to provide for client portfolios, investment in Chinese companies is restricted to those that trade on exchanges outside the mainland. This is via Hong Kong primarily.

The recent trading suspensions and government interventions have generally been for the Chinese “A-Shares” that trade on the mainland markets.

According to estimates, about 1,300 companies were suspended from trading across the Shanghai and Shenzhen exchanges as of July 9, with the larger number in the Shenzhen exchange. This represents close to 50% of the names of the combined Shanghai and Shenzhen exchanges. By comparison, suspensions in Hong Kong are fewer, and many appear to be for longer standing reasons of restructuring or new share placements.

In strategies that include emerging markets, Dimensional generally caps countries at approximately 15% to limit concentration risk and maximise diversification.. Vanguard maintains a market-like weight of closer to 25%. When combined, the 2 strategies result in an exposure of approximately 20% to China, within a total of 4-7% within any given client portfolio.

In simple terms, portfolios typically maintain approximately 0.8 – 1.4% to China overall.

Summary

The APW Investment Committee remains vigilant in assessing the impact of developments in Greece and China. As always we are committed to ensuring client portfolios remain very broadly diversified across countries and asset classes, so as to mitigate the potential impact of such events.

The direct exposure to investment markets in Greece and China through portfolio holdings is very minor for equities and non existent for global fixed interest.

Overall, we believe that our recommended model portfolios are well structured. Accordingly, we do not advocate the need to rebalance or alter the long term target asset allocation in response to current events in Greece or China, despite the 'knock on effect' in Australia that may result in a mid term weaker economy due to lower commodity prices.

Instead our focus remains on those factors that we can control and that have the greatest significance for clients in achieving their financial and lifestyle goals and objectives.

Should you have any queries in respect of the above, or any other matters, please do not hesitate to contact us.