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China's policy dilemma may indicate the beginning of a negative cycle

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Foreign exchange, economic, stock market and other problems are emerging in China one after another. But the country now faces a dilemma because emergency actions to end these problems may make them even worse. The world had absolute faith in China because of the government's immense amount of control and ability to suppress potential sources of risk. Notwithstanding economic rationality and intrinsic value, the perceived power of the government to control everything eliminated worries about an economic downturn, market collapse, investment losses, non-performing assets and other events. There was a strong consensus that a crisis could not occur in China. Backing up this consensus were the infallibility of the Communist Party and members of the media that are under party control. However, the current crisis has created a dilemma that is exposing to the world the limits of the Chinese government's to control the country.

The contradiction created by devaluing the yuan

Foreign exchange is the ultimate dilemma for China. Actions taken from August 11 to 13 to devalue the yuan were a logical way to support the Chinese economy as it stands on the brink of a downturn. The People's Bank of China explained this action as part of its reforms. In accordance with an IMF recommendation, China is managing its currency with flexibility in order to reflect market conditions. But most market participants regard this statement as a lame excuse. People view the yuan's devaluation as a step that China was forced to take because of the economy. China's exports in the first seven months of 2015 are down 0.3% from the same period of 2014. In July, exports fell 8.3% from one year earlier. Unlike in prior years, exports are now pulling the economy down. China is clearly much less price competitive because wages in major cities are the highest among Asia's emerging countries. The yuan's strength was hindering China's ability to compete. Furthermore, China must allow the yuan to decline in order to ensure the effectiveness of ongoing monetary easing measures. China would have to buy the yuan and sell dollars to maintain the yuan's value in the face of downward pressure created by monetary easing. But foreign exchange market intervention like this would destroy any benefits of monetary easing. Therefore, a currency should obviously weaken along with a country's economy. If this is true, then the yuan's fall of less than 4% is far less than what is needed. China will very likely need to devalue the yuan even more.

Weakening the yuan also creates big problems. Ending the myth of a stronger yuan will make it much more difficult for Chinese companies to procure funds. A weaker yuan will also probably prompt investors to move funds out of China faster. Until now, China has relied on massive inflows of capital from overseas for financing. But outflows of funds will make credit even harder to obtain, which is certain to fuel expectations for the yuan to continue declining. Funds procured from overseas made a bigger contribution than the trade surplus to China's rapid economic growth in recent years. But a stronger yuan was the premise for these fund inflows. With the yuan declining, money is moving out of China at an increasing speed. In 2014, China's foreign currency reserves started to decrease even though the country still has a huge trade surplus. At the same time, China's net external assets, which had been climbing steadily, have been falling since reaching a peak of $1.99 trillion at the end of 2013. These reserves had plunged to $1.4 trillion by the end of March 2015. Clearly, a dramatic shift has occurred in how China manages foreign currencies. Now, the government's weak-yuan stance is very likely to accelerate the pace of this turmoil.

China's responses to the crisis are making matters worse

A dilemma exists regarding China's demand-stimulation economic policies, too. Excessive investments in real estate, industrial machinery and equipment, infrastructure, and other sectors is the fundamental cause of the rapid slowdown of China's economic growth. Shifting demand to consumption should be the only solution. However, raising wages and labor's share of income to boost consumer spending would directly impact the cash flows of companies as earning decline. This is why China has been making unnecessary infrastructure investments in order to prevent an economic downturn.

The financial sector has the same problem. China needs to stop the drop in stock prices, reduce outflows of capital and provide more financing to struggling government-owned companies and local governments. More discretionary financing is the only way to accomplish these goals. But this is contrary to the use of free markets to achieve the proper distribution of capital. For a long time now, the economic actions China needed have been clear: a switch to democracy to alter the structure for the allocation of capital and reforms of government-owned companies. But the government is pushing back these measures because they would weaken its control and produce more economic problems.

All these points indicate that the Chinese economy and its markets are finally about to reach a dead end. We cannot discount the possibility of a free fall of stock prices and the yuan. For the time being, China will probably remain relatively calm due to various stopgap measures. However, this situation will not allow China's downturn to bottom out.

Not all bad news for Japan, but risk-takers should be cautious

As China's exports fell, there has been a big upturn in Japan's exports, which do not rely on prices to compete because of their superior quality and technologies. In July, Japan's exports were 7.6% higher than one year earlier. Obviously, Japan is becoming more competitive in relation to other countries. Moreover, earnings growth rates in Japan are expected to be the highest among all major countries. At the same time, Japanese stocks are extremely undervalued, with the world's lowest PBR and other valuation metrics. Attractive investments have become much more difficult to find worldwide. As a result, investors will probably buy even more Japanese stocks in order to overweight Japan in their portfolios.

Supply and demand dynamics are good for Japanese stocks. All investor categories are believed to have an unprecedented amount of funds available to buy Japanese stocks. Overseas investors as well as public-sector funds in Japan, the Bank of Japan, the GPIF, Japan Post Bank, Japan Post Insurance, pension funds, insurance companies and other Japanese institutions are raising their Japanese stock holdings. Individual investors in Japan have substantial funds available for buying stocks, too. Consequently, there are still excellent prospects for Japanese stocks to continue moving up over the long term.

Despite this positive outlook, we have reached the point where investors need to be wary about the next phase of the effects of China's economic and financial problems. Investors should probably keep in mind the possibility of significant volatility of Japanese stocks from a short-term perspective. (Of course, investors should also realize that this volatility may create opportunities to buy stocks at low prices.)