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China must stop the spread of the "poison" and impose restrictions on capital

– The first faint signs of the end of this stock market downturn are emerging

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Niizeki: Today's theme is about the critical importance of stopping the spread of China's "poison" and enacting capital controls. We will also talk about the first faint signs of the end of the stock market downturn. The Economist and The Financial Times are respected opinion leaders concerning global economic and financial issues. In both of these publications there were articles stating that China should impose restrictions on capital. Please explain this point and the importance of these restrictions.

Musha: Many people are worried because of the worldwide drop of 15% to almost 20% in stock prices in January. In a few words, my view is that actions have started that are aimed at eliminating the root causes of these worries. These actions will take time. But the main point is that China has started to block the numerous poisonous elements that can cause deflation. If China is successful, the global bear market may quickly reverse direction and become a powerful bull market.

The primary channel for the expansion of China's problems to other countries is the fear of global deflation caused by the outflow of capital from China and resulting plunge of the yuan. To end these worries, China must stop the outflow of capital and eliminate worries about a free fall of the yuan. If this happens, the situation will improve immediately.

With respect to this point, the strong recommendation of the Economist and Financial Times, global economic and financial opinion leaders, for capital controls in China is of particular interest. Especially significant is the January 26 Financial Times editorial titled "Capital control may be China's only real option." It is a peculiar position for this publication. Until now, the Economist and Financial Times have wanted China to ease regulations and allow unrestricted capital transactions. The aim is to use a market economy to enact economic reforms. But now these two publications have adopted precisely the opposite stance of urging tighter capital controls. This is very strange. However, these controls are now the key to dealing with the current situation in China.

A cover story with the same position appeared in the January16 issue of the Economist. On the cover is an illustration showing Chinese President Xi Jinping riding a bucking dragon, desperately holding on but not falling off. The story urges China to enact restrictions on capital. The article says that China should take "one step back, two forwards." In other words, the country needs to take one step back in order to advance. A Japanese translation of the entire article appeared in the Nihon Keizai Shimbun on January 19. China needs to use tighter capital controls to be prepared for a crisis. The Economist, Financial Times and Nihon Keizai Shimbun all want China to establish rigorous capital controls in order to avoid a crisis.

I made a similar statement in my January 8 bulletin (No. 154) titled "The beginning of the end of the Chinese economy's free lunch." I said that capital controls are the key to resolving China's problems. I am surprised that prominent global media like these publications have adopted the same opinions. At the same time, I think this demonstrates that the opinions of people worldwide may very quickly converge on this position.
http://www.musha.co.jp/attachment/5694241d-6df0-4120-82a7-0c0985f2cfe7/bulletin_e_20160108.pdf

Why are capital controls critical to solving China's problems? The biggest cause of the current global crisis is a surplus on the supply side in China on a scale never seen before.

This surplus supply capacity is rapidly weakening China's economy. There is no doubt that the entire world will be affected by China's economic decline. Falling oil prices are making people around the world worried. A dramatic decline in China's economic growth rate is a major cause of the drop in oil prices. A weaker economy is reducing demand for oil, resulting in a growing imbalance between supply and demand. As a result, we can say that China's problems are at the core of a variety of worries. Keeping this crisis within China is one way to prevent the country's problems from growing into a source of concern for the entire world. Deflationary pressure in China could start affecting other countries. This would most likely occur as a negative chain reaction consisting of capital outflows and a sharp drop in the yuan's value that cause asset prices to fall worldwide. The Economist and Financial Times articles say that capital controls are needed in order to stop this chain reaction.

The most important aspect of China today is a substantial decline in the economic growth rate. This is why the country requires monetary easing. Easy money policies would stop the economy's slowdown and prevent the real estate bubble from bursting. Powerful monetary easing measures would obviously bring down China's interest rates. Combined with US interest rate hikes, the result would be a flight of capital from China.

China today has loans totaling $4 trillion from overseas lenders (overseas debt excluding securities investments totals $4 trillion). Lenders want these loans repaid quickly because a weaker yuan would lower the amount of principal that can be recovered. This is why all foreign lenders are attempting to take their money out of China at once. In addition, people in China as well want to hold foreign currencies rather than yuan in order to keep asset prices steady. This is another reason that capital is leaving China. Consequently, despite China's economic problems, there is an increasing volume of capital leaving the country.

In this environment, more monetary easing to aid the Chinese economy would result in more money flowing out of the country and a weaker yuan. Even if China provides an ample supply of money within the country, the money would escape to other countries. Monetary easing would be ineffective as a result. This is why China is unable to allow unrestricted foreign exchange transactions while implementing monetary easing. Adopting this stance would permit capital to flow freely to other countries, which would create a contradictory and untenable situation.

This situation is the primary cause for the concerns of the world's financial markets since the start of 2016. Therefore, China has only two options. One is to halt monetary easing and prevent the yuan from weakening. The other is to implement monetary easing while stopping outflows of capital in order to prevent the yuan from weakening. Which one should China choose? The Financial Times thinks the answer is obvious. China's only option is to enact capital controls.

There is no way that China can enact tight money policies in order to protect the yuan's value. But if nothing is done and the yuan plummets, the possibility of China triggering a global financial crisis would increase. And if China selects neither of these options, the only other course of action is restrictions on capital. This is what the articles in the Economist and Financial Times have said. This was also my position in the January 8 bulletin. China must halt the outflow of capital, which is the fundamental cause of the global crisis. Today, this issue is finally beginning to become the focus of attention. Now that opinion leaders are urging China to restrict the movement of capital, I think the possibility of capital controls becoming actual policies is increasing.

Niizeki: Would these controls stop stock prices from falling around the world? What is needed to end the global stock market downturn?

Musha: I think capital controls in China would end the current sharp worldwide drop in stock prices for the time being. I also think this could be followed by a steep rebound in stock prices. We need to think about the causes of the global stock market downturn in January. Whether you believe the cause is China or low crude oil prices, the scenario of a severe economic recession like the one that followed the collapse of Lehman Brothers has become plausible. I think stock prices have fallen to factor in this scenario. Naturally, there is little doubt that speculators have conducted very organized activities to fuel a market sell-off by working hard at making people aware of the bad news and potential negative outcomes. As a result, investors need to become confident that we will not suffer from a global economic recession on a scale of the one that occurred a few years ago. Once investors gain this confidence, stock prices will stop falling and we will see a strong rebound.

This leads to the question of what is needed to eliminate the possibility of a global recession. I think there are only three requirements. First is a clear improvement in the real economy. We must see unmistakable signs that the economies of the United States, Europe and Japan are healthy despite China's economic problems. I think that economic statistics, corporate earnings and other economic indicators will eventually start to improve. However, I expect this improvement to be very slow and to take a long time. On the other hand, the bottom could fall out of the market or the yuan could collapse before these signs of an economic upturn start to appear. If this happens, then prior to an improvement, there is a possibility of an economic decline as financial markets head downward. This is why I believe that, from a short-term perspective, we should not have any hopes about an end to this bear market due to improvements in the economy and corporate earnings.

The second requirement is a strong determination among developed countries to enact policies needed to prevent a sharp economic downturn. Japan must implement its third round of quantitative easing, increase public-sector spending and push back the consumption tax hike planned for 2017. If Japan takes these three actions, I think there is a possibility of a steep rebound in the stock prices of Japanese companies. But this applies only to Japan. Actions taken by Japan alone will not be enough. Similar coordinated measures by the United States and European countries will be needed, too. I think there will be a dramatic shift in the atmosphere if the United States postpones interest rate hikes and enacts a fourth round of monetary easing to be prepared for a worst-case scenario. In Europe, ECB President Mario Draghi said that another phase of monetary easing may start in March. All of these measures must take place at the same time. In other words, coordinated policies among the developed countries are needed. This is the second requirement for a dramatic change in the current environment.

The third requirement involves China, which is the source of a variety of problems. If China does what it should do, I think we will see a dramatic change. First of all, China must stimulate economic growth. However, there have been no benefits so far despite numerous initiatives. Prospects are poor for a full-scale economic rebound in China. So what is the most important action that China can take now? The answer is to control capital properly. While implementing these controls, China will have to demonstrate that its monetary easing will not cause the yuan to weaken. I think this would block all channels for speculators to create a market selloff. This is why stronger capital controls by China could be the third requirement for a major turning point.

I want to make one more point. An upturn in the real economy will take time and is not likely to occur at this time. But decisive and coordinated economic measures by developed countries, which are the second requirement, may take place. Capital controls in China are the third requirement. I think financial markets could stage a strong rebound if any one of the three requirements is fulfilled. But the one that is likely to occur very soon is capital controls in China. Based on this outlook, I think that an end to the stock market downturn may not be far away.

Niizeki: Please explain the basic stance of Musha Research concerning the market outlook.

Musha: There are six points concerning our outlook. First, there is absolutely no change in the long-term trend of rising stock prices in Japan. At some time, the Nikkei Average will surpass ¥20,000 and, in a few years, this index is very likely to reach ¥30,000. The reason is that the true value of Japanese stocks is at these levels. The earnings power of Japanese companies justifies these prices. There has been no decline at all in this earning power due to the current turmoil in financial markets.

Second, Musha Research believes that China's economic downturn, falling stock prices and capital outflows will not stop until capital controls and other measures are tightened.

Third, the US economy will remain healthy even as various events occur. I think there is no need to worry about a US recession. Of course, a recession is possible if the market selloff cannot be stopped. But I think the stock market downturn can be stopped.

Fourth, I think that additional economic stimulus measures and the third phase of Abenomics are very likely to prevent a recession in Japan. The Abe administration and the Bank of Japan have promised that they will do whatever is needed to end deflation. I do not expect them to renege on this promise.

Fifth, stock prices have started to factor in the possibility of the global bear market leading to a worldwide recession that originates in China. Market sentiment will shift once this possibility no longer exists.

Sixth, I think stock markets will stage a powerful comeback once countries start to implement the necessary policies. It is possible to assume that the problems I have discussed could cause the Nikkei Average to drop to ¥16,000 or even as low as ¥13,000. But once policies are enacted and the market turns around, we could see a rapid upturn to ¥20,000. The upturn may even propel the Nikkei Average to ¥23,000 or ¥24,000.

These are the six key elements of the stance of Musha Research now.

Niizeki: What is your outlook for stock prices?

Musha: I think prices will continue to decline for a while. I think the enactment of various policies will be the only way to turn the market around. The reason is that a change in policy is unlikely to take place when the stock market is strong. This is why I think an even deeper stock market drop, a weaker economy or even more pain among consumers will be needed for governments to take actions. Stock prices may fall or remain low for the next few weeks or months. However, despite this period of weakness, I don't think the bottom of this bear market will be much below the current level.

Afterward, I expect the real economy to improve significantly. As I explained earlier, the drop in the price of crude oil is extremely good news for the global economy. In Japan, for instance, fossil fuel imports in 2014 were 3.4% of the GDP. If the cost of this fuel is cut in half, this would equate to a 1.7% boost to the GDP. Right now, the price of crude oil is half to one-third of the level before the downturn started. At one-third, Japan's economic growth rate would be raised by more than 2%. The United States and Europe are receiving similar benefits. Consequently, once the dark clouds of January go away, we can expect to enjoy bright, sunny days.

China will impose restrictions on the movement of capital. At the same time, I think China will rigorously implement an easy-money policy. This will, at least for now, stop the unprecedented economic and financial sector declines. Investors therefore should keep in mind the possibility that the upcoming short-term market decline will be followed by an enormous bull market in the second half of 2016. The key to this outlook is the policies that governments implement.

Niizeki: What sort of attitude should investors have during the big drop in stock prices that we are currently seeing?

Musha: We have seen a remarkable change since the start of this year. Stock prices have plunged more than anyone anticipated. People worldwide have been so worried that they are even thinking about the possibility of an economic collapse in China. The price of crude oil has fallen so rapidly that no one can foresee the bottom. In this environment, people have been paralyzed by extreme anxiety. I think this is a surprising development that no one could have foreseen.

I want to stress the following four points regarding this subject. First, in this type of environment, there is an increasing gap between the true value of stocks and market prices as prices fall. In other words, we are about to witness an unprecedented opportunity for bargain hunting. Prices after the collapse of Lehman Brothers are an excellent example of this situation. Stock prices worldwide plunged 60% during the global financial crisis. Early in 2009, after this price drop, stock prices were far below the true value. Investors who bought stocks at that time saw global stock prices double during the next two years and triple over three years. Stock markets therefore have substantial potential for a big upturn. This is a very attractive opportunity for investors. Stocks with solid value can be purchased at significant bargains. So I think that, first of all, investors need to realize that they must not miss this opportunity.

The second point is that tighter regulations will be good for China. Most people think that China will improve by easing regulations in order to transition to a market economy. They want China to enact reforms to go in this direction. But stricter restrictions will be essential to ending the current crisis. These restrictions are a type of emergency escape measure that could also be called a contingency plan. Almost every country dealing with a crisis has made proper use of tighter restrictions. After the financial crisis, the world returned to stability because of stricter regulations and the use of government power for interventions. If China uses these measures, the current crisis will probably quiet down for a while.

The third point is that Japan is virtually certain to take a number of policy-related actions. A consumption tax hike is planned for April 2017. Before the Abe administration makes a decision about this hike, there will be an upper house election in July. There may be a lower house election at the same time. At a time like this, it is critical for the ruling party to create a reality at all costs that demonstrates the success of Abenomics and shows that Japan is certain to eradicate deflation. To accomplish this, the Abe administration and the Bank of Japan will probably use a variety of initiatives.

The fourth point is that downside risk is small. At this stage, I can now visualize a scenario in which prices stop falling once certain conditions are met. I think that the emergence of the positions of the Economist, Financial Times and

other publications that I discussed earlier show that many people are beginning to see the upcoming bottom of this bear market. This sentiment probably means that the end of this downturn is not far away.
To summarize, the first point is that this is an opportunity to buy stocks at prices far below their true value. Second, China needs tighten controls and is very likely to do so. Third, Japan is virtually certain to take a number of policy-related actions. Fourth, there is very downside risk at the stage of the downturn. I think that investors should keep these four points in mind.

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