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# Is the Stock Market Telling Us Something?

- **Fundamentals** do not justify the latest rout in the stock market. To be sure, the stock market was overvalued before the latest tumble. In addition, there have been a multitude of uncertainties around the world including the continuing decline in the price of oil, China slowdown, Federal Reserve tightening, geopolitical problems, terrorism, upcoming U.S. elections etc. None of these problems are serious enough to justify the sharp reaction. Hopefully the financial markets will come to its senses.
- **The plunge in the price of oil** over the past couple of years is a positive for the global economy. It shifts buying power from producers to consumers. Since the consumers are more likely to spend the extra money while the producers tend to save and invest, the overall demand should increase overtime.
- If the drop in oil price were due to falling demand, especially from China, it would be a problem. Fortunately, the demand has been rising at a steady pace. Even China, which consumes about 10 percent of the global energy supply, has not reduced consumption. The culprit is the supply side. U.S. oil production has increased over 100 percent over the past six years becoming the largest oil producer ahead of Saudi Arabia and Russia. The decision to maintain its market share and the expected increase in production by Iran are some of the reasons for the fall in price.

  The fundamental dynamics in the oil market has not changed in the foreseeable future.

- Don't judge the **Chinese economy** based on the stock market; there is little connection. There are many challenges facing the economy such as weak demographics, high debt burden, excess capacity, high property prices, disinflation, social instability and environment. In dealing with these issues, the government has penchant for intervention. It is neither market-driven, nor the market economy. The uncertainty emanating from the hybrid system undermines confidence in the financial markets.
- The fear of hard economic landing is another worry for both the natives and foreigners. The economic slowdown is in part due to the desire of the government to rebalance the economy from investment to consumption, especially services. Investment growth, including real estate, is falling faster than increases in consumption. However, services are becoming a major portion of consumption, exceeding 50 percent. In short, the composition of economic growth is more important than the overall growth rate in China.
- The Xi Administration has the goal of 6.5 percent economic growth for the rest of the decade. To achieve that goal, both fiscal and monetary tools are utilized. More funds are directed at infrastructure projects and social welfare raising the deficit-GDP ratio. The People's Bank of China (PBOC) will continue to cut the interest rate and reserve requirement ratio.

  In the longer term, the government has a lot of work to do in making the economy more efficient. Economic stimulus alone won't solve China's economic problems. Restructuring and supply-side initiatives are needed. Tax cuts, deregulation and shrinking the size of the government are necessary. Full yuan convertibility and financial market openness are other sorely needed policies. Market forces, not industrial policy should dictate the future course of the economy.

- **The U.S. economy** is in much better shape than it was in 2008. The U.S. economy has deleveraged its balance sheet. Household debt is 103 percent of income compared to 130 percent in 2007. Thanks to low interest rates, the debt service and other financial obligations for household is 15.3 percent today compared to 18.1 percent in 2007. U.S. Banks are much better capitalized. The 31 financial institutions subject to the stress test of the Federal Reserve has over $1 trillion in capital compared to $459 billion in 2007.

  Dodd-Frank has made the kind of financial shenanigans in 2007 much more difficult. The problem is that consumers are so well protected that they can't get credit easily.

- **In conclusion**, the stock market will always dance to whatever it wants to in the short-run and overreact. Eventually, the fundamentals will overpower and prevail. The state of the economy, here and China, do not support the market pessimism.