

Weekly Report



Macroeconomic Analysis

A brief analysis of the Chinese slowdown

Chinese Q3 GDP figures were released this week and despite surpassing analyst expectations, they are a far cry from the average annual double-digit growth witnessed during the first decade of the 21st Century. The Chinese economy grew by 7.3% in the third quarter year-on-year, making it the slowest period since the first quarter of 2009 when growth was a dismal 6.6% in the aftermath of the global financial crisis. As always it is diligent to approach Chinese economic data with a slight dose of scepticism as there have been accusations in the past of the figures being manipulated to project a more positive environment than what is so.

Although it was inevitable that such impressive growth could not be sustained forever, it is still worth exploring why the Chinese economy is slowing down. In response to the financial crisis the government embarked on an incredible, debt-fuelled investment spree in an attempt to keep unemployment figures low (Western demand for Chinese exports dropped dramatically, threatening millions of Chinese jobs). The construction industry was a notable beneficiary during this period, recording a CAGR of 21.5% between 2008 and 2012.

The real estate sector is estimated to have accounted directly for 16% of 2013 GDP and is a key driver of commodity demand. However, the result of this over-investment has been an oversupply of property and the ramifications are beginning to materialise. Chinese house prices have fallen in five consecutive months and the consensus is that people seem reluctant to purchase in anticipation that the market has not yet reached a floor. Despite this the ratio of house prices to annual income is excessive: in prominent cities such as Shanghai and Beijing the ratio is over 10, higher than London or New York. Many of the houses that have been developed have been snapped up by investors yet remain uninhabited.

On a more positive note it seems as though a reshaping of the economy is occurring. For the first time ever consumption has risen above 48% of GDP which is indicative of a transition, albeit a steady one, to a developing service sector. Many believe that the key to unlocking future Chinese growth is through domestic, private consumption however this could be difficult considering China's average disposable income for urban consumers currently amounts to less than \$6000 per household.

The consequences of a slowdown in the world's second largest economy obviously have a significant global impact. Some estimates suggest China is currently accountable for one quarter of global economic growth. This is unsurprising given the unquenchable demand China has demonstrated for raw materials from resource-rich regions such as Australia, Africa and Indonesia over the last few years. It will be interesting to see how these economies fare in the future given the diminishing demand of their most significant trading partner. China is expected to narrowly miss the government's target of 7.5% (it is estimated to grow 7.4%) this year and the growth rate is set to decline further next year to a rate of 7.1%. Chinese Premier Li Keqiang has emphasised that while a gradual slowdown is not disastrous, a destabilising effect on unemployment could warrant further stimulus measures.

Argentina: Debt Problem? (Update)

For an earlier overview on Argentina, please see the final weekly of Summer Term 2014, published in June.

After failing to reach an agreement with holdout creditors, Argentina entered into default on the 30th of July. The initial market reaction was calm, due to the technical nature of the default and the specific Argentinian nature of the problem. Argentina's benchmark bond due in 2033 remained, even at present in October, at roughly 82 cents on the dollar (60 cents is typical for defaults).

Argentine efforts to resolve their predicament have so far proved fruitless. Attempts to replace Bank of New York Mellon as the trustee for its restructured sovereign debt, with Banco de la Nación Fideicomiso (a local state owned bank), were deemed illegal by the US judge responsible for the case, Thomas Griesa. Issues of a "Rights Upon Future Offers" clause in the bonds, implicates a danger that a restructuring deal with holdouts would need to be offered to all bondholders. This clause expires at the end of the year and analysts nevertheless believe it to be an overblown excuse for the lack of Argentine will to settle. Moreover, political intransigence appears to be blocking any chance of a resolution being quickly reached, with President Cristina Kirchner more concerned with worries of a US assassination attempt against her...

The key economic impact on Argentina is a shortage of dollars, as Argentina will continue to be shut out of international capital markets in the long term. Exports are Argentina's main source of foreign currency. However, soya, one of Argentina's biggest exports is suffering from a four year price low. Capital controls have limited the amount of dollars available, fewer dollars available means imports have fallen. This has hit industry, as Argentina imports a range of inputs (e.g. car parts), meaning sectors such as the automobile industry are down by 34.6% year on year in production. Agriculture exporters may stand to gain however, as the peso continues to weaken. Inflation is expected to reach 40% for this year alone. Argentinian Congress's reaction to overall economic worries was to pass a bill, known as the "supply" law, that empowers the state to control prices, profit margins and production.

The "supply" law is indicative of the economic imprudence rife within the Argentine government. Elections at the end of 2015 seem to hold the only hope for an Argentinian economic turnaround.

America's Tax Inversion Problem

What is it?

Tax inversion is the alteration of a company's official legal address from one country to another in order to minimize tax costs. Everything else in the business largely remains the same afterwards, so nothing else moves and the company is run in the same way as it was beforehand. America has one of the highest corporation tax rates in the developed world, so it is no surprise companies engage in tactics to move abroad. Tax inversion has been cited as the main reason behind the seven-year global M&A high.

During the tax inversion process, a US based company sets up or buys a rival company in a country where corporation taxes are more favourable and then subsequently moves their headquarters to this new country. As a result, the company doesn't have to pay taxes to the US government on profits made outside of America. Following a tax inversion deal, many firms engage in "hopscotch" loans to further minimise the tax obligations by packaging U.S earnings into loans made to their new foreign parent company.

Why are companies doing it?

At 35%, US corporation tax is staggeringly high in comparison to other developed nations such as the U.K where Chancellor George Osborne has set the tax to 21%. As a result it is inevitable, that companies will take advantage of the American tax loophole that authorizes tax inversion deals. US companies can also use the tax inversion process to enlarge their geographical converge by expanding into Europe and creating further cost cutting synergies with former competitors. In reducing such tax cost, companies can become more competitive with their international counterparts and deliver higher returns to shareholders. AbbVie's CFO Bill Chase claims the planned acquisition of the Irish based Shire, could potentially increase annual dividends by more than 15%.

In the last 10 years, 47 U.S companies have undergone the tax inversion process, more than the preceding two decades combined. The latest of these is Burger King, which is set to acquire Tim Hortons, a Canadian based doughnut and coffee chain. The new deal will create the world's third largest fast-food company with 18,000 restaurants in 100 countries. Burger King's headquarters will move northwards to Canada, where KPMG has found total tax costs to be 46.4% lower.

The White House Response

Following the recent rise in tax inversion deals, the White House has announced a set of new rules in the crackdown on the tax avoidance deals:

- Newly tax inverted non-American companies have to be more than 50% owned by foreigners
- Before tax inversion can be completed the American company's value must be less than 80% of the new combined company value

If tax inversions are not confronted, the treasury expects tax revenues to fall by \$2 billion a year. However when considering this loss constitutes less than 0.07% of America's \$3 trillion tax revenue intake, tax inversion does not pose a significant threat to treasury budgets in the future.

Conclusion

As more and more countries move their headquarters away from America, this will diminish the power and prestige of the world's largest economy on the global stage. Senators in Congress have pushed for the United States to switch to the territorial tax system that has been adopted by countries such as the UK, whereby tax is only paid where the revenue is created. Due to current tax system, I believe American firms operating on an international basis are at a severe disadvantage compared to their European counterparts, especially in the increasingly competitive attempt to expand into the emerging markets.

Events

Germany and the Eurozone

In light of Germany's growth forecasts for 2014 and 2015 being lowered, Wolfgang Schaeuble, the finance minister, has called to increase investment in order to improve Germany's international competitiveness – particularly in infrastructure. However, Germany will not do if it has a significant impact on their debt levels.

Two camps have emerged in the Eurozone: the differences in attitudes to avoiding the growing threat of economic stagnation are pronounced among the Eurozone leaders. Germany's preference for trying to encourage billions of euros of private spending - and its reluctance to agree to more government debt - is not agreeable to many, most prominently France and Italy.

As a result of the EU summit this week, the EU leaders have until December to come up with a plan for structural reform. If done properly, this will be used to effectively implement the European Commission's future plan for better coordinating the member states' economic policies.

Bank of England

Due to the UK currently being the fastest growing economy in the developed world – the economy grew by 0.7% in the third quarter - it would not have been surprising if the Bank of England raised interest rates in their October meeting; however, the Monetary Policy Committee voted 7-2 to keep interest rates at 0.5%. The minutes from that meeting, released this week, show that little evidence of inflationary pressures and concerns over the slowing Eurozone prevented the committee from voting for a rate hike. Members of the Committee who voted to keep interest rates at 0.5% expressed their concern that raising rates could increase the UK's vulnerability to any future shocks to the economy.

The decision is understandable. Partly due to the slowdown in the Eurozone, growth in the manufacturing and services sectors fell over the quarter, and a slowdown in inflation last month (1.2%, down from 1.5% in August) drags the Bank of England even further away from its 2% target.

An increase in the interest rate is expected sometime next year.

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