JANUS CAPITAL Group

POINT OF VIEW SERIES

Concerns about China and Oil Prices Drag Share Prices Lower

Our Theses on China and Oil remain Unchanged

Concerns about China's economy and weak oil prices continue to lead markets down. Our views on both of these issues remain largely unchanged from the opinions expressed in both the Janus Market GPS 2016 and the POV we published on Janus.com earlier this month. While there are some concerning elements within China, we do not think its economy is unraveling. Within oil markets, we believe it will take several months but the elements remain in place for an improved pricing environment in late 2016 or early 2017.

In the meantime, we may continue to see volatility in equity prices as investors watch oil prices and the Chinese market. We believe the signals are not strong or clear enough about global growth to warrant the sell-off in the market.

Key Takeaways

- We believe the Chinese economy perseveres, but we are watching key signposts to gauge the severity of the current slowdown
- It will take several months but we expect oil prices to recover by early 2017
- Volatility in equity prices may continue as investors monitor China and weak oil prices

Time is still on China's side

The recent devaluation of China's currency (RMB) triggered the current market scare, stoking concerns about its slowing economy and the government's ability to manage the nation's long-term transition from an investment-led to a consumption-led economy. As we referenced in our POV on China earlier this month, we weren't surprised to see the devaluation in the RMB. Going forward we still expect the currency to devalue another 5% against the U.S. dollar.

Rising debt levels in China bear watching, especially because the returns on additional investment are falling. The 15-year average return on 1 RMB of new credit was 0.7 RMB in incremental GDP. Today, that number has dropped to roughly less than 0.2 RMB in incremental GDP.

Those statistics are troubling, but we believe China will experience only a gradual economic slowdown as it continues its transition toward a consumption-driven economic model. That slowdown was visible in this week's report from the National Bureau of Statistics that GDP last year slowed to 6.9%, the weakest growth rate since 2009. Going forward, China has room to cut interest rates, and Beijing can still provide fiscal support through tax cuts and increased government spending. China's $3 trillion reserve level provides ample room to control its currency. Perhaps most important, the structure of the Chinese financial system gives it time to manage its growing debt levels. As we referenced in our Janus Market GPS 2016, the Chinese banking system is funded by domestic deposits and not reliant on shorter-term and less stable wholesale funding. This affords the banking system and Chinese authorities breathing room to manage excessive loan growth.

While our base case is that the Chinese economy perseveres, we will be watching these signposts to gauge whether economic trouble is more severe:

- **A faster rate of depreciation in the RMB.** We still expect China to depreciate its currency another 5%, but a sharper depreciation would come with downside risks, such as a higher import costs and reduced consumer spending on imported goods. A rapid currency move may also export deflation as cheaper imports of Chinese goods for other countries allow prices to drop.

- **Reversal of the recent liberalization of capital controls.** This move would increase the perception that policy makers have lost control of the economy.
- **Accelerated deleveraging.** If China addresses its debt problem too quickly by reducing investments, it may strangle economic growth.
- **Slowdown in the consumer and service sectors.** China's industrial sector has slowed but areas tied to the consumer continue to grow at a double-digit rate and play a significant (and growing) role supporting the economy.

Oil Markets are Not That Far Out of Balance

As we stated in our recent Global Sector Views we expect oil prices to recover, likely to the $50 range, by early 2017. While an early 2017 recovery is our base case, we feel a quicker recovery is more likely than a slower one. Inventories of crude oil and finished products remain high and production from Iran is an additional supply risk, but only a minimal adjustment to either supply or demand would bring the market back toward balance. For instance, Janus' analysts estimate that if Saudi Arabia reduced its production by just 10%, global supply and demand would be halfway back toward approximate equilibrium.

Going forward, $30 oil prices simply aren't sustainable for most U.S. exploration and production (E&P) companies or for the national budgets of OPEC nations that depend on oil to drive their economies. We are surprised that capital markets remain open to U.S. shale producers (two U.S. E&P companies had oversubscribed equity issuances in the last two weeks), but as those markets close many companies will be forced to cease production because they cannot generate positive cash flow at $30 oil.

As we wait for prices to rebound, our energy analysts are carefully analyzing the balance sheets of E&P companies to identify those companies that could survive in a sustained environment of $30 oil and participate meaningfully in a recovery.

We also continue to favor pipeline companies. Even in a weaker pricing environment, we believe these companies will be able to maintain steady cash flow due to the minimum volume commitments associated with current contracts and volume growth as drilled but uncompleted wells come on line.

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