

# Chinese tightening spooks markets

By Tom Stevenson, 13 January 2010

## **Investors start to look beyond easy money.**

You have to be something of an expert in monetary policy to understand what is happening in financial markets these days. Yesterday's surprise move by the Chinese was not an increase in interest rates but it sent the same message – the period of easy money is coming to an end.

China's central bank – the People's Bank of China – actually increased the amount of reserves it obliges commercial banks to hold with it. It did so sooner than expected in response to a surge in bank lending, which the Chinese government has said it wants to slow in a bid to prevent its economy overheating.



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Not only are Chinese banks rushing to lend, GDP is growing at more than 10% a year, which is faster than the government would like, and inflation has turned positive and is rising fast.

The actual mechanism used by the Chinese government is not important. What mattered to investors was that it suggested that the world's fastest-growing major economy is poised to slow from its current break-neck pace. The Chinese stock market fell by 3% in response.

It is tempting to think that this does not matter to investors in the rest of the world, but in a globalised market these kinds of apparently inconsequential moves can have far-reaching effects. Markets across Europe and the US also fell yesterday as sentiment was further dented by an unexciting start to the American corporate reporting season.

Among the parts of the market hardest hit by the Chinese move was the commodity sector where the oil price fell back to \$81 a barrel and copper hit its lowest level in a week. Gold also slipped back as the dollar strengthened against the currencies of big commodity producing countries like Canada and Australia.

One of the reasons that commodities have been hit is that a key part of China's stimulus of its economy has been through massively expanded infrastructure spending. If it chooses to rein in the building of bridges, roads and the like then it will need a lot less copper and steel.

The big question following the Chinese monetary tightening is whether it marks a new tightening cycle around the world. Australia has already started pushing its interest rates higher and all eyes are on the change of monetary direction in places like the US and UK.

The consensus opinion remains that the authorities in the US and UK will be in no hurry to raise interest rates for fear of pushing the economy back into recession – the so-called double dip. Some think that rates could even

stay at rock bottom levels until 2011.

The danger for investors is that this expectation of rates staying lower for longer is factored into the prices of risky assets like shares. If tightening comes sooner than expected – or investors fear it might – then markets could be vulnerable.

The flip side of this anxiety, of course, is the reason why there is upward pressure on interest rates. Were it not for the economic recovery looking more and more secure, there would be no need for higher rates. It is a classic case of investors choosing whether to see the glass half full or half empty.

It is hard to remember a time when there was such a divergence of views about the outlook. Experts make equally strong arguments for recovery as a lapse into recession, for inflation as deflation, for markets being good value by historic standards as for them being too expensive. One thing is for certain, small pieces of apparently unimportant news from the other side of the world will continue to have a big impact on our investments throughout 2010.

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