The Chinese economy continues to stumble, with GDP growth falling and the stock market in freefall. Commodities and the economies that produce them have been the major losers. How long can the rout continue?

In our March 2015 update we argued the case for investing in India, having held a zero weighting to China and other Emerging Market (EM) countries ever since Ben Bernanke's "taper tantrum" (signposted impending end of quantitative easing) in mid-2013. India is an exception but our negative outlook for China (as first mentioned in our June 2014 overview) and other EM markets continually grows. This month we assess the impact of an ever slowing Chinese economy on global commodities and the economies reliant upon supplying them. We also examine the implications for the global economy and markets, which have this month already started to price-in the impact of a slowdown in the world's largest economy.

Lurking behind the news surrounding a possible Greek Eurozone exit, in 2015 the Chinese stock market has both risen spectacularly and more recently experienced an enormous correction as the bubble suddenly burst.

With the property market sagging, loose monetary policy and continued fiscal stimulus, Chinese investors spent the first quarter of 2015 piling into equities. Over the 12 months to April this year the benchmark Chinese index, The Shanghai Composite Index, doubled in value. Also China's Shenzhen Composite Index, composed predominantly of technology companies, had nearly tripled in value for the 12 months ending in May this year. Having opened to foreign investors for the first time in November 2014 it has been the domestic Chinese market that has been the major beneficiary. Nearly eight million domestic brokerage accounts were set up over the period and many listed Chinese firms were quick to rebrand, adopting "tech" sounding names in an effort to win over new speculative investors looking to make a quick gain. One such example was that of a real estate company electing to rebrand as "P2P Financial Information Services Co" despite no involvement in peer-to-peer lending. Their shares leapt 10% as a result! Valuations in China reached dizzying heights in April with underwear manufacturers on 90 times earnings and a school uniform/ketchup maker on 330 times earnings (Unilever by comparison trades on 15-16 times earnings)! Of the shares listed on the Shenzen Composite, one in six had doubled in price or better with only nine stocks (there are c 1,420 stocks listed) having fallen over the period.

However, this meteoric momentum-based rally has come at a time when the fundamental economic story in China has been faltering for over 18 months. Chinese shares have been in freefall since their mid-June high, losing nearly 30% and wiping out over $3 trillion in value (approximately equal to UK GDP). This has prompted the Chinese government to intervene to artificially support the stock market, which allowed some respite for beleaguered Chinese equities. However this painkilling injection just helps to emphasise how overvalued Chinese equities have become and nobody outside of the domestic market has really been fooled.

The fact is that real growth in China has decreased markedly since the financial crisis. In 2007 China's real GDP growth was at 14.2% whereas last year, by comparison, GDP had nearly halved to 7.4%. Let's face it, on the surface 7.4% is a strong headline growth number, however savvy investors are rightly concerned at both the size of the decline in GDP growth but also the credibility of the data being released (some analysts estimate that GDP growth could be as low as 3%).

The hole becomes ever deeper. Commodities continue to fall as China slows further….

Contributing to the slowdown, as documented in our June 2014 overview, the property market in China has been in free-fall for over a year. As a sector, property and construction makes up c30% of China's GDP. In addition the enormous "shadow banking" sector (estimated in 2013 to make up anywhere between 43% and 80% of Chinese GDP) has started to cause major concern. Unregulated, poor quality investment products have been pedalled en masse to profit hungry consumers, resulting in a huge number of defaults and uncompensated fraud claims.

Investors' concerns are mounting, and not just in China about whether the People's Bank of China (PBC) can effectively support the stock market but also whether the "shadow banking" sector can be adequately controlled. Also, credit growth in China is slowing and has declined from 17.3% in Jan 2014 to 13.5% by Jan 2015. This suggests that corporate activity, including M&A and general expansion plans have been downsized as the economy struggles.

As well as cutting interest rates four times since November 2011, over the last ten days China has also started to devalue its currency in an attempt to become more competitive. This is a very worrying sign. The dreaded "currency wars" between the US and China, with each attempting to weaken their respective currency in an attempt to wrestle economic market share from the other, had all but fizzled out over the last few years. This recent move threatens to reignite this battle. However, more worrying is that they have had to resort to this action at all in order to prop-up their ailing economy given the political sensitivity of such a move.

A weaker yuan means lower prices for those buying from China and in theory this move should help importers in developed markets. However the move also "exports deflation" by lowering prices for importers of Chinese goods (this is positive) but significantly hinders those economies that are net exporters to China as their goods become more expensive. This is negative for economies that are still sensitive to deflation, including some Eurozone economies.

We think that the move signifies more reason for caution certainly in China but also in EM more broadly as the dependence on China – both from its demand for commodities and as an importer of EM exports – is fundamental for much of the growth in other….

….EM countries.

The impact of slowing growth in the world's largest economy is being felt broadly across all asset classes and in particular in commodities, an area that we have continued to avoid since our sale of Gold in 2013. In many ways, owning commodities can be seen as owning a leveraged play on China, not great news when China is in freefall economically. The Bloomberg Commodity Index (which is a broadly diversified commodity price index) has fallen 53.4% since its post-crisis peak in early 2011 and over 65% since the financial crisis in 2008. Commodity prices are now back to levels seen in 2009.

A significant proportion of this fall can be attributed to Chinese demand. In China, demand for primary products used in housing and infrastructure such as coal, iron ore, steel and aluminium are slowing. Coal, in particular has suffered in other ways, namely China's problem with air pollution and the government's recent actions to combat much of China's smoggy skies. Copper, used in everything from electrical wiring to alloys and pipework (and often seen as a barometer for construction growth) has fallen c50% since 2011. It's a similar story across other metals primarily involved in global industrial manufacturing.

Gold has also suffered, as Chinese demand for the safe-haven precious metal has fallen to a 6-year low. The price of gold bullion, c$1,123 at the time of writing, has followed a similar path to other commodities, falling by 40% since 2011. Also whilst gold in the past has been used as a safe haven protecting portfolios during times of conflict (e.g. unrest in the Middle East and the Russia/Ukraine conflict) this historic relationship has broken down and investors have instead preferred to seek safety in other assets, namely government bonds.

Falling commodity prices has had a knock-on effect on other economies that supply China with raw materials, a notable victim being Australia. China is Australia's biggest trading partner, mainly due to China's (previous) strong demand for iron ore, coal and liquefied natural gas. Australia's mining boom has been the catalyst for 23 years of continued growth in the economy however for the last quarter of 2014 growth was a meagre 0.5%. This weak growth figure coupled with decade low iron ore prices (Australia's ….

….most valuable export) led the Reserve Bank of Australia (RBA) to cut interest rates in February with further cuts made in May of this year in a bid to revive the economy and weaken the Australian dollar to improve export competitiveness. The Aussie dollar has fallen 35% against US dollar since 2011 and the domestic stock market is off 10% as the China effect kicks-in.

The broad weakness in commodities has affected not only Australia but also the likes of Russia (still feeling the effects of the conflict in Eastern Ukraine and the drop in the oil price), Brazil (plagued by political concerns and a weakening currency) and South Africa (riddled with unemployment and with mining accounting for 50% of SA's exports).

Unfortunately, you haven't had to be a buyer of commodities directly to also be suffering the consequences of the broad commodity markets fallout. The halving of the oil price since the summer of last year has dragged down the oil majors in the FTSE 100 and the iron ore price is also having a significant impact on UK mining companies such as BHP Billiton and Rio Tinto. Firms in mining and oil and gas make up c19% of the FTSE 100 and these commodity price falls have helped to dampen the returns of the UK index as a result. Other large constituents such as Unilever and Diageo derive much of their earnings (57% and 39% respectively) from EM.

Over the last two years we have avoided both broad exposure to emerging markets and direct investment in commodities. Whilst this has meant missing out on some upside in China in the short-term, as long-term investors we are always mindful of the economic signals indicating troubles ahead, most of which are now manifesting themselves in terms of market declines in the region and a knock-on into other global markets. We have certainly avoided significant losses as a result of avoiding EM and our overweight to the developed markets, including US, UK and Japan have been of great benefit to us relatively.

We know that there will be an excellent buying opportunity for both mining stocks and emerging market equities in time however investors wishing to catch this falling knife may be better served stepping aside and waiting until it hits the kitchen floor.

Chinese GDP & Commodities - moving in tandem