# Investment Insight

## China's share market volatility

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*"Market interventions, while well intentioned, generally have a poor history."*

***Many companies incorporated in China are dual listed, with their shares traded on both mainland China (Shanghai and Shenzhen) and Hong Kong exchanges. Shares listed on the Shanghai exchange are called A shares and are largely accessible to only Chinese mainland investors. Company shares listed on the Hong Kong exchange, referred to as H shares, are accessible to non-Chinese, offshore investors. The majority of this article refers to the A shares - listed on the Shanghai exchange.***

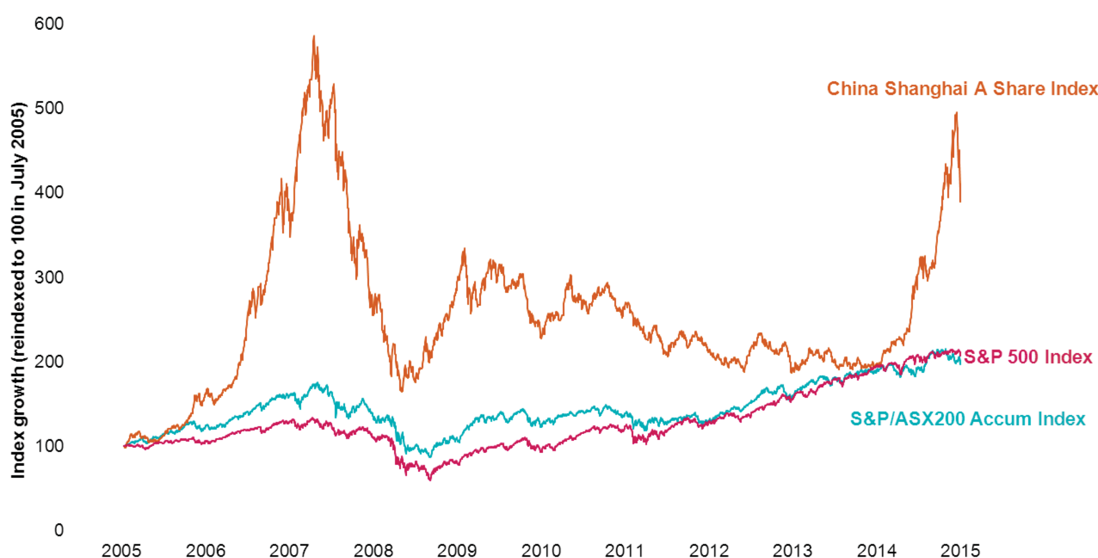
Over the last month, the Chinese share market experienced the kind of free-fall not seen since the 2008 drop in global markets. Investors may be worried that this is the start of something more sinister and go beyond the Chinese market. We maintain that it was an inevitable correction due to a rise in unsustainable economic incentives introduced by China's government since 2009, and a rite of passage for any economy in transition. The direct consequence of volatility in the Chinese share market to Australian investors is low. Most Australians can't access the Chinese share market directly due to foreign ownership restrictions, and the allocation to emerging markets (where the fallout is mainly being felt by investors) accounts for generally very small allocations in most portfolios.

### What's happened so far?

Mainland China's share markets, in Shanghai and Shenzhen, have delivered extraordinary investment returns over the 12 months to June 2015. Share prices had risen strongly but steadily in the nine months to March before doubling in price between April and June, fuelled by an explosion in margin lending to inexperienced retail investors. By mid-June the Shanghai market had risen by around 150% from June 2014 levels. By June 2015 valuations were looking extremely stretched in a number of sectors in the context of underlying earnings prospects. The average market Price to Earnings (PE) ratio (a common measure of share market valuations) of around 30 times (the long term average for American shares by comparison is 16 times) somewhat masked the speculative valuations in 'new economy' sectors, including IT, Healthcare and Media where PEs averaged closer to 60 times. Smaller companies were trading at more than 100 times future earnings.

The extreme volatility in the Chinese share market provides a timely reminder that policy makers are not infallible; and that their ability to manipulate their way out of the consequences of past policy shortcomings may not be as great as they would wish. As we have commented in the past, the policy response to the global financial crisis (GFC) has resulted in China becoming over-indebted with much of that debt being unproductively deployed by state-owned enterprises (SOE) and local governments. The consequence has been over-building with surplus capacity in those areas driving growth – notably real estate, which has been the main driving force of the economy. This is being dealt with via a planned rotation away from investment led growth towards consumption. This rotation inevitably means that debt problems (for example many property developers are technically insolvent) are being revealed and both credit and economic growth are slowing (growth is certainly well below the official 7% target, it may be no more than half that level) with contractions in particular in the SOE and local government sectors.

**Chart 1: China's share market bubble has burst**




Source: JANA Corporate Investment Services Limited. Past performance is not a reliable indicator of future performance. The value of an investment may rise or fall with the changes in the market.

## China has been encouraging share ownership to stimulate the economy

Given the desire of central Chinese authorities to stimulate the economy, in new more market driven ways, they have encouraged share ownership. This has included offering participation in under-priced initial public offerings (IPOs) which has had the unfortunate effect of pulling money out of the secondary market and making it vulnerable to a sharp decline. The plan was that while the share market continued to rise, it could help boost consumption and in a best case scenario, help bailout debtors. Though the share market is a fraction of the size of the property market, an ability to swap SOE and other debt for equity, potentially provides a means of easing the debt burden. This might help explain the rather extreme measures used to stem the share price slide.

A raft of measures (including China's state-owned banks lending $209bn and the suspension of trading in more than 1,400 companies) have been deployed in a demonstration that the authorities were prepared to do whatever it takes to manipulate share prices higher. It is not clear how normal market functioning will be restored given the complex array of non-market measures. An example of this difficulty was the 8% fall in the Shanghai market on Monday, 27 July. This result came after a few weeks of strong gains, and while many trading restrictions were still in place.

Ironically, some of the measures introduced are in contradiction to the Chinese government's intention to allow the economy to become more market driven. This episode further erodes much needed international confidence for China to reach its full potential as a major financial centre. It will also likely delay its entry into the MSCI global index – a critical requirement to attract global fund flows to the domestic share market. Many investment strategies only invest in countries and exchanges represented by the index.

## History shows us that share market interventions are never smooth

Interventions, while well intentioned, generally have a poor history – even outside China. During the Great Crash of 1929 in Wall Street, the banking houses of James Pierpont Morgan and Guarantee Trust Company committed their resources to propping up the US share market. That experiment was not a notable success; the Dow Jones Industrial Average fell 13% the following Monday and dropped another 34% over the next three weeks. The Chinese intervention fund, led by CITIC Securities Co. and Guotai Junan Securities Co., faces a similar uphill battle; the war chest represents only one-fifth of the Chinese market's daily trading volume.

## What impact does China's share price volatility have on Australian investors?

Volatility levels in the Chinese share markets should have limited overall impact for Australian investors. That is because foreign ownership restrictions have restricted the ability of Australians to directly own mainland listed Chinese shares. Further exposure via emerging markets where the heavy brunt of China related losses have been felt, is small for most Australian investors in well diversified portfolios. For Australia it's the broader Chinese economy that counts most. Australia is not only vulnerable to a slowing Chinese economy, but moving from investment intensive growth to consumption impacts demand for Australian resources. That has the potential to lead to a weak economic outlook for Australia, including a fall in income and significant negative risks for the Australian dollar.

As mentioned earlier, the volatility in China affects global share indices. China (mainland companies listed mainly in Hong Kong, Singapore, London and New York) accounts for 24.8% of the MSCI Emerging Markets Index and 2.6% of the MSCI All Countries World Index as at 30 June 2015.

## What does it mean for MLC investors?

While we cannot control the behaviour of Chinese domestic investors or the central authorities, we remain focused on ensuring that clients have exposure to prudent managers, who will focus on individual company fundamentals and balance the risks soundly at the total portfolio level. Implicit in this approach is a belief that regardless of the market, company fundamentals will eventually drive returns once shorter term noise has dissipated.

The pricing of A shares have exhibited much greater volatility and valuation extremes than the H shares. This is not surprising as the Hong Kong market is more open, mature and has greater depth whereas the Shanghai market is relatively young and volatile. As a result, it's common to see substantial price differences for shares of the same company between the two exchanges, with the A shares usually priced much higher than the H shares.

MLC's global share strategies (in the MLC Global Share Fund and MLC Horizon portfolios) have no exposure to A shares. There are a handful of H share company investments in the portfolio but collectively they amount to just 1.5% of the MLC global share strategy and none of the stocks in the portfolios have been suspended. Two of the companies the portfolio is invested in are also listed on the New York Stock Exchange.

MLC's investment team and our investment managers continue to monitor the situation for any investment opportunities that may emerge, as well as being vigilant that any unrewarded risks are eliminated from the portfolios.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