Insight

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China struggles to calm 'manic' bourse

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What is causing panic in the Chinese stock market?

There is no doubt that there has been a 'mania' in recent months in the domestic Chinese share market, particularly the so-called Shanghai 'A' market (generally open only to domestic investors). This market has attracted a very large number of novice or non-professional investors, partly because of a deliberate (and, in principle, a sensible) government policy of encouraging household investment in the stock market.

To avoid over-borrowing by investors, the government has long had a 50% limit in place for the amount that could be borrowed for this purpose and has closely regulated the market. However, over recent years the Chinese government has gradually relaxed most requirements that restricted the amounts investors could borrow on margin, while investors more recently have even found ways to get around the 50% limit.

In effect then, margin lending has accelerated over the past year in particular and the share market responded in kind, with the Shanghai 'A' market rising around 150% over the year to 12 June, when it peaked at an index level of 5166.

On 12 June, however, in response to what was clearly an over-cooked market, Chinese financial authorities introduced tough new rules restricting the quantity of transactions that brokers could implement through the use of margin lending.

This had an immediate negative effect on the market and the market began to slip lower and was over 30% down by 8 July. This though was a mania in the other direction and, for good reason, was something the financial authorities had to try to counter.

What are the counter measures being implemented by Chinese policy makers?

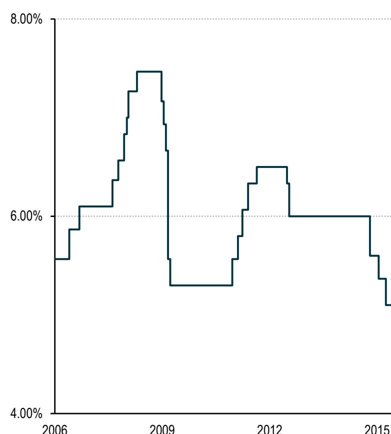
In recent days various measures have been implemented:

1. a relaxation of margin trading rules
2. direct intervention into the markets by brokerages
3. a large injection of liquidity through the central bank into the China Securities Finance Corporation (a state-owned company that finances margin trading)
4. selling restrictions on many entities (such as the country's social security fund), and
5. prohibition of 'short' selling.

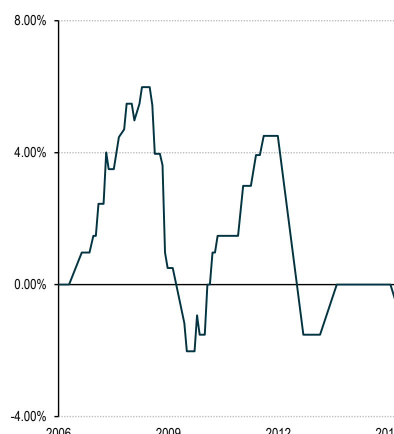
As well, more broadly aimed measures, including interest rate cuts and a loosening of prudential banking requirements, have been introduced. In total these measures are likely to be successful in stabilising the share market, even if the government probably does not want to see the market start to move strongly upwards again in the short-term.

We have not shifted our mild overweight position in international shares within our diversified portfolios

China's Benchmark One-Year Lending Rates



Required Reserve Rate 12 Month Changes



Source: PBOC

Does this market chaos have implications for the Chinese economy and, in consequence, for the global economy, including Australia?

One likely effect of the volatility in the Chinese stock market is that consumer and business confidence could be negatively affected for a time, unless the market is quickly stabilised. In an environment in which the Chinese economy has been slowing anyway, this is clearly something that the Chinese authorities would like to avoid.

In recent weeks, the Chinese have already begun to move strongly towards stimulus measures to bolster economic activity. Such measures have included reductions in interest rates, reductions in the reserve requirement ratio for banks (which have an immediate and positive effect on bank lending) and effectively the implementation of a form of 'quantitative easing' through direct purchases of equities by government financial institutions.

We anticipate that such measures, if sustained, could soon begin to lift economic activity, while additional measures are also being taken to greatly lift infrastructure spending, which should also in time have a positive effect on economic growth.

In the short term, however, commodity exporting nations, such as Australia, could continue to be affected by reduced demand and lower prices for key merchandise exports, including iron ore and coal, although over the longer-term there should be a return to healthy demand growth.

Will this affect our portfolios and how is Fiducian responding?

Direct exposure to China is limited in our diversified portfolios. The Chinese (Shanghai) stock market is still categorised as an emerging market and, as such, there is limited direct exposure to this market by our major diversified funds or by our international shares fund.

Exposure to so-called 'H' shares (Chinese stocks listed in Hong Kong) would be slightly higher but still minimal within our diversified portfolios. To the (limited) extent that our portfolios do have exposure to China, it is likely (as discussed) that these markets are already close to stabilisation.

Hopefully, the Chinese financial authorities will soon be successful in their bid to stabilise this market

Furthermore, in valuation terms, the Chinese market now appears to be fair value, with the Shanghai 'A' market currently trading at a price-to-earnings (PE) ratio of around 14 times, while the 'H' share market as a whole is currently trading at a (relatively cheap) PE of around 9 times.

At Fiducian we have not shifted our mild overweight position in international shares within our diversified portfolios, as there is potential for market recovery, as well as potential for some gain from currency movements.

The graph shows the boom-and-bust performance of the Shanghai 'A' market over recent years, including the recent correction that the market has experienced. Hopefully, the Chinese financial authorities will soon be successful in their bid to stabilise this market.

A Shares v H Shares

Source: Iress Data

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