insightpaper

CHINESE SHARE MARKET CORRECTION

JUNE 2015

China's stock market has been plunging over the past month as Chinese authorities have sought to crack down on margin trading and other forms of leveraged investing. In this article we address the fast-changing situation in China and what this means for investment markets.

BACKGROUND

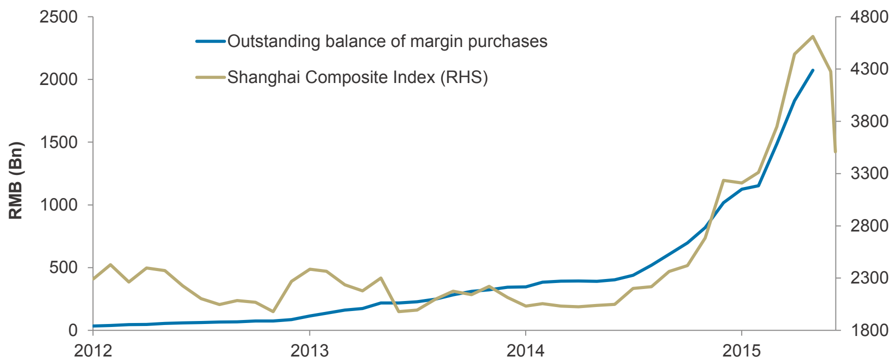
China's domestic share market is dominated by retail investors many of whom would not consider company fundamentals such as dividend yields or price to earnings ratios. When prices are going up they want in, often borrowing to get exposure, and when the market is going down they want out.

Over the year to 12 June 2015 the Shanghai Composite Index rose 150%. In the last month the market has fallen 30%, precipitated by a crackdown by the Chinese authorities on the amount of borrowing to invest in the market (that is, leveraged investing).

KEITH POORE

Head of Investment Strategy

INVESTOR LEVERAGE HAS FUELLED THE DOMESTIC SHARE PRICE SURGE

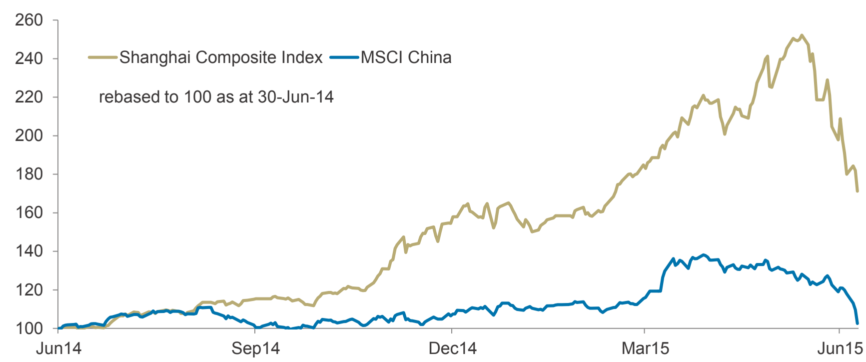


Source: Bloomberg, AMP Capital

Given the extent of the correction, the authorities are now backpedalling on the crackdown on leveraged investors. The authorities have also implemented a ban on short selling and there are reports the Chinese central bank is providing liquidity to a state owned company to support the market to "hold the line against the outbreak of systemic or regional financial risk". The seriousness of the response from the authorities suggests we have seen the worst of the market correction.

Hong Kong listed Chinese stocks (which are included in the MSCI emerging market index) has not escaped some of the recent fallout but a much greater institutional investor presence means they have not been subject to the same wild ride as domestic China stocks. Our funds' exposure to China is via US and Hong Kong listed Chinese stocks.

THERE ARE TWO DIFFERENT CHINA STOCK MARKETS



Source: Bloomberg, AMP Capital

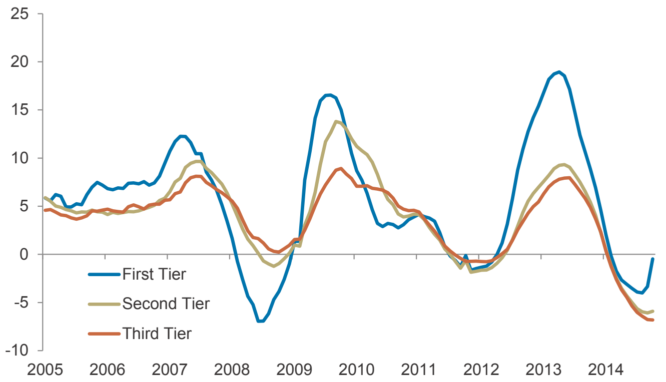
The share market sell-off is not showing any signs of liquidity or banking stress. Corporate bond markets have remained well behaved, and interbank liquidity has improved.

IN TERMS OF IMPACT ON THE ECONOMY, THE PROPERTY MARKET IS MORE IMPORTANT THAN THE SHARE MARKET TO WEALTH, CONFIDENCE AND REAL DEMAND.

Recent data suggests China's property market is stabilising, with residential property recording a second month of modest price gains in June.

CHINA RESIDENTIAL PROPERTY PRICES

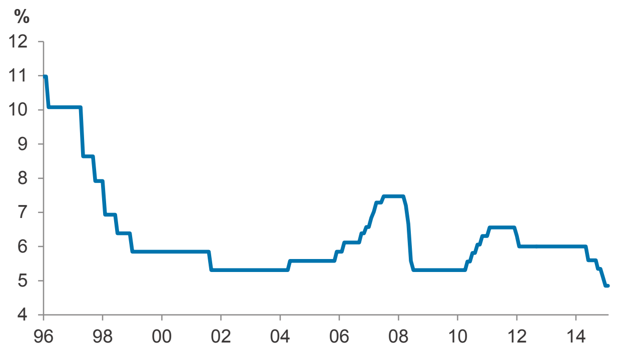
Annual % Change by City Tiers



Source: Bloomberg, AMP Capital

In addition, China's central bank cut its key interest rates again in June to an all-time low, which should help support the property market and economic growth over the next year. This is with China's business surveys suggesting China's economic growth is still running around the 6.5% pace.

CHINA 1YR BENCHMARK LENDING RATE



Source: Bloomberg, AMP Capital

CONCLUSION

Further declines in Chinese domestic stocks would have negative implications for Hong Kong listed China stocks and global stocks in general. But given the latter hasn't risen by anywhere near as much over the last year, any declines should also be fractional. Note also, Hong Kong listed Chinese stocks are trading at a 45% discount to domestic listed stocks which means they have a much higher valuation floor.

The seriousness of the response from the authorities suggests we have seen the worst of the share market correction. The property market is more important to the economy than the share market and recent policy easing should support growth over the next twelve months.

Ultimately, the Chinese authorities were right to try to limit the build-up in leverage, but they were too late in letting the market rise 150% in less than a year and were obviously surprised by the violent reaction. Following the crackdown on shadow backing last year, China is finding the right mix between too little regulation and too much a tricky balancing act. Moving from a controlled financial market to a more liberal one is not a straight path.

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