HEALTH WEALTH CAREER

# CHINESE EQUITY SELL-OFF

JULY 2015

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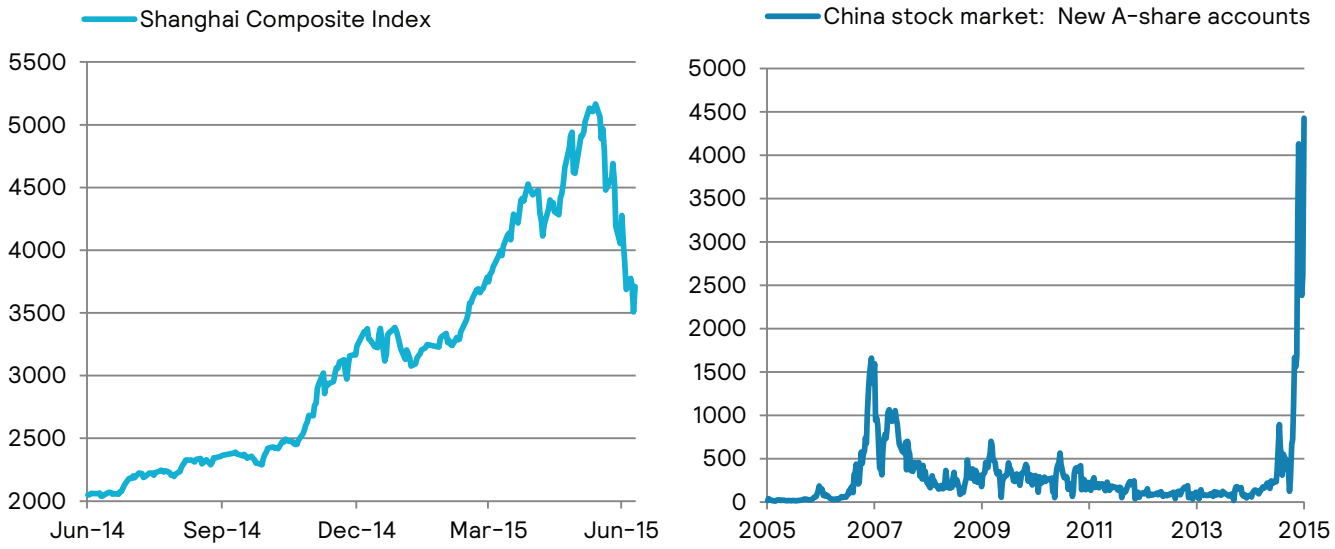
## BACKGROUND

Chinese equities have suffered very sharp declines in recent weeks. After peaking on 12th June 2015, the Shanghai Composite Index has fallen by around 30%. The price correction wiped roughly $3trillion off equity valuations, or the equivalent of the combined stock market capitalisation of France, Spain and Italy. The rapid collapse was preceded by an equally impressive rally which saw prices doubling since 21st November 2014, when the People's Bank of China (PBoC) reduced interest rates in an attempt to revive its flagging economy. This, and subsequent stimulative measures, did little to boost real economic growth, but the additional liquidity, combined with optimism over the tangible progress on structural reform (such as the introduction of a deposit insurance scheme) had a spectacular effect on the financial markets. Buoyed by the initial rise, retail investors rushed in to buy equities, often using leverage. This created the condition for a bubble which attracted yet more inflows until the high point in June 2015.

### CHINA'S EQUITY MARKET PERFORMANCE




Source: Bloomberg

There were warning signs that valuations were becoming extremely stretched as early as 19th January 2015, when the PBoC tightened margin lending to cool the market. However, the rally continued before eventually starting to unwind in June 2015. As the rout gathered pace, the authority began to intervene on 24th June 2015. After failing to calm the market with liquidity tools such as interest rate and reserve requirement cuts, a raft of unconventional policies were introduced, including directing state pension funds to buy equities, relaxing margin trading restrictions, and suspending initial public offerings to avoid diluting the market. More recently, a six-month ban on major shareholders from selling company shares was put in place, and 70% of Shanghai and Shenzhen listed stocks have also suspended trading. However, at the time of writing, these measures have had a limited impact.

## IMPLICATIONS

The increasingly radical attempts to shore up the falling equity market illustrate the Chinese government's concerns regarding its destabilising effects both politically and economically.

The Chinese government places a high priority on maintaining political and social stability, and clearly sees the current dramatic fall in share markets as undermining the public's confidence in its ability to deliver continued economic prosperity. Indeed, the government was complicit in setting the "bull run" rolling last year: it loosened rules on investment in shares as part of its financial reforms as it sought to divert investors' funds from the overheated property market. More recently it has implemented changes that allow foreigners to invest more easily in Chinese mainland shares, as well as allowing locals to invest more easily in Hong Kong shares, adding fuel to the bull market. It is understandable that the government has now stepped in to try and prevent investors' losses mounting further.

The equity market collapse also has a number of economic implications. In the short term, consumer spending may be impacted given the negative sentiment as well as the reduction in household savings, although we note that equities remain a small component of household savings. This would hamper the ongoing effort to move away from investment and towards a consumption driven growth model. The depressed prices also dampen public and private fund raising via the equity markets. For the government, it affects plans to recapitalise indebted state-owned enterprises (SOEs), whilst for the private sector it hampers the creation of new businesses which could otherwise provide new sources of economic growth.

The long term implication of the equity selloff is difficult to assess at this point. Equities still represent a relatively small portion of household wealth, so the direct impact would likely come through via a short term hit to confidence. However, China is facing a number of structural headwinds and desperately needs stay on course with its reform agenda. The concern is that the recent volatility would lead to a rethink in the pace of liberalisation as the risks become more apparent. A shift back towards the old style investment-led economy would certainly boost growth in the short term, but doing so would do little to solve China's long term challenges. Recent indications that China A-shares may be included in the mainstream indices in the coming months now looks less likely.

Finally, it should be noted that the Chinese market collapse has already caused a further setback in commodity prices, as investors worry about the future pace of Chinese growth. As the world's second largest economy, events in China now impact the rest of the world, and if commodity price falls are sustained it will further weaken the economies of commodity producers and other major exporters to China. Coupled with nervousness over the impending US interest rate rise, this could raise the risk premium required for investment in vulnerable emerging markets.

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