INVESTMENT BRIEF

Q2 2015

Strategic Investment Group®

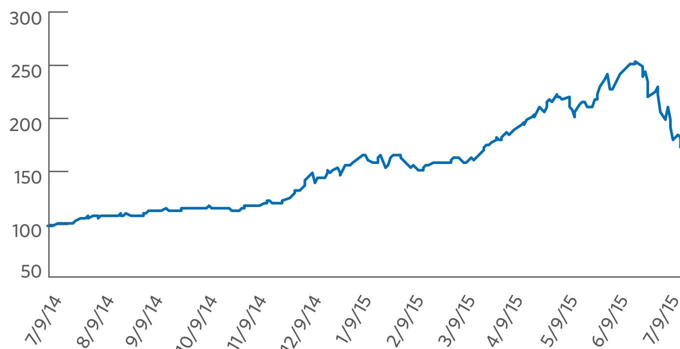
Chinese Equity Gyrations

When Mae West observed that "too much of a good thing can be wonderful," she was almost certainly not referring to asset price surges. Nonetheless, this past year's run-up in Chinese equities reminds us that outsized gains in asset prices can be too much of a good thing.

Some of the factors that make China an attractive investment – a dynamic economy in the midst of a fundamental restructuring, rapidly developing capital markets, and increased market liberalization – are also potential sources of instability. Combine these positive, but potentially volatile, fundamental forces with new market entrants chasing returns through stocks bought on margin, and the risk of wide market swings is amplified.

Exhibit 1: Shanghai Composite Index

Source: Bloomberg



We are in the midst of one of many such swings likely to materialize as the Chinese economy and markets grow, restructure, liberalize, and deepen. After rising 150% over 12 months, the Shanghai Composite Index fell by 30% over a three-week period beginning in mid-June, spurring the central bank and other regulators to take extraordinary measures to support the market and dampen speculation (Exhibit 1).

Vectors of Volatility

The meteoric rise in Chinese equities in the 12 months through mid-June had many elements of a speculative bubble. Market prices, which before the spike had represented good value, became increasingly detached from fundamental valuations as stock prices rose even as earnings stagnated. New entrants poured into the rising market, with one-third of all Chinese brokerage accounts opening in the nine months through June. Leverage was also rampant. The volume of stocks purchased on margin increased by more than fourfold in 12 months, adding a further accelerant to an already volatile mix. The Chinese authorities faced the delicate task of curbing speculation, while avoiding a market collapse and spillovers to other markets and the real economy. Limits on the use of margin and short-selling were among the first measures deployed. Other steps included increased funding to brokers, stock purchases by governmental entities, limits on stock sales by major shareholders, a freeze on IPOs, and moral suasion by the central bank and regulators. For the moment, these measures appear to have slowed the decline, while also highlighting how quickly the rules of the game can change.

Implications of recent Chinese market moves

So far, the spillover has been mainly focused on regional equity markets. Credit markets in China and the region appear not to have been seriously affected. The heightened volatility of the Chinese equity market appears unlikely to dampen economic activity significantly, as Chinese growth is not reliant on equity market funding or wealth generated from equity investments. Moreover, the market has moved so fast that consumption and investment behavior have not had time to adjust.

More broadly, however, the June sell-off in Chinese equity markets has hurt risk sentiment and contributed to global equity market volatility. Investors are recalibrating expectations for Chinese equity market volatility and reacting to the market's continued significant overvaluation. Moreover, the suspension of trading of shares representing about 40% of the domestic equity market suggests greater market fragility than expected. Recent market gyrations have also raised doubts about the adequacy of the policy and regulatory regime, highlighted the Chinese authorities' penchant for market intervention, and likely delayed further steps toward market liberalization.

Before the recent spike in prices, the Chinese equity market was attractive on a number of counts. Favorable valuations, the restructuring of a dynamic economy, and a rapid pace of capital deepening made exposure to the Chinese equity market enticing. Market liberalization, including the limited opening up of the Chinese A-share market to foreign investors through special vehicles, added to expectations for market appreciation. The opportunity for strategies to add value in a relatively inefficient but maturing market was also compelling. Many of these attractive features remain in place. Less wonderful, however, are lofty Chinese equity valuations, which remain too much of a good thing.

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