

Is China done?

Dominic McCormick | Select Asset Management | 13 August 2015

While not as controversial as [last month's Opinion](#), this month I want to look at the widely divergent views on the outlook for the Chinese sharemarket.

I have been supportive of the opportunity in the Chinese A sharemarket in recent years (see ["A tale of two sharemarkets"](#) and ["China A shares emerging from the bear?"](#)). However, even I was surprised at the magnitude and trajectory of the 150% rise in the year to early June and spent much of the first half of 2015 cutting back this position into this rally, effectively reducing exposures by between two thirds and three quarters at one point. On the recent significant weakness, we've been cautiously rebuilding some positions, albeit taking a more opportunistic and even trading approach to higher weightings.

Many have taken a much more alarmist approach to the recent sell-off, declaring the bubble has definitely burst and a new major bear market has arrived. This seems to include many investors and commentators who never participated in the rally in the first place. Some have equated the China rise and recent fall to the US in the lead up to the 1929 crash and subsequent Great Depression. Even less alarmist commentators are quickly dismissing China as a viable investment avenue and assuming the market can only fall further from here.

The question was well put by one of our key clients who in late June – when the CSI 300 had fallen almost 20% from its recent high just two weeks before – asked, "Is China Done?". (It was to fall further, to be down almost 35% in mid-July before recovering. At the time of writing, the market was down around 20% from the June high). I responded to our client by saying that it could be – but, if so, it would be one of the stranger equity bull markets in history, if it was all over in 12 months with no meaningful correction along the way before the next major bear market. Major bull markets are not normally one year events and, while China will experience another major bear market (perhaps in a couple of years), experiencing it just one year after the previous major bear market ended would be far from normal. It is worth remembering that little more than 12 months ago, China's was still in an entrenched major bear market that had dragged on for seven years with the CSI 300 index falling almost 70%.

From a short-term perspective, the gains had clearly become increasingly unsustainable. A 30% to 35% correction after a 150% rise over a little more than a year should not be seen as a major surprise. But does this mean the bull market is over?

What WAS surprising was the government's extreme (over)reaction in terms of measures to support the market. This may delay the inclusion of China A shares in some global indices.

However, Vanguard remains committed to including A shares in some of its emerging market funds later this year and the MSCI decision to include China A shares in global indices is still likely sometime over the next year.

We are somewhat concerned that the recent excessive government intervention slows financial market reform. However, a halt to the current path of reform is unlikely, although it is something to keep a close eye on in coming years. Indeed, the recent widening of the Yuan trading bands mentioned earlier has been received positively by the International Monetary Fund and may be supportive of China's push to be included in the Special Drawing Rights (SDR) the basket of currencies.

While a lot of mention has been made of the proportion of shares suspended in the recent volatility, historically, there was always around 10% of the market suspended for various reasons at a particular time, even when the market was booming. On this basis, suspensions in the high teens as a percentage of overall market capitalisation at the height of the volatility don't look as extreme as made out by the media.

Further, unlike panicked commentary, we don't believe that the fall in a sharemarket will have much economic impact in China or globally, despite the significant margin financing involved. (It's worth noting that margin lending has already almost halved since the June peak). In any case, despite the recent falls, the market is still 70% to 80% higher than it was just a year ago.

Of course, there is plenty to worry about in terms of China's economy (slowing economic growth, local government and corporate debt levels, and excess property supply in some areas), but these are only tenuously related to the sharemarket. Indeed, while the Chinese economy is enormously important for the global economy, and particularly for Australia, the relationship between China's economy and sharemarket in recent years has been extremely weak on both the upside and downside. We believe this is partly driven by the low levels of broad equity ownership by Chinese households, something which is only changing slowly. For example, Westpac points out that savings deposits account for 54% of China's GDP, while household equity holdings are less than a third of that.

After all, the economic impact of the China A sharemarket wasn't great when it fell 70% between 2007 and 2014 as China's economy boomed, and it wasn't great when it rose 150% in the year to June as the economy slowed. However, now that it's given back less than a quarter or so of those gains (and remains up 80%), it's seemingly an economic disaster for China and the world.

Another reason the current economic picture is less relevant is the global paradigm whereby government and central bank policy has a major impact on markets. In this era of "central bank omnipotence", it is true that financial markets are being used partially as instruments for economic management. That is, authorities are trying to influence economics through the market, although this does seem to be a more recent phenomenon in China. Importantly, China still has considerable scope to stimulate its economy and markets

via a variety of policy measures. There is considerable room to lower interest rates and loosen bank reserve requirements, and recent moves to loosen the Yuan trading bands suggests China may be joining the global currency wars.

Therefore, there may be more life left in this bull market yet, particularly if the combination of cumbersome interventionist measures and further policy easing help set a perceived floor on overall price levels. Meaningful corrections are necessary to weed out weak holders and set the basis for further gains.

The reality is this has been one of the most hated equity bull markets in history, at least by Western analysts and fund managers. Most global institutional investors haven't participated and they are even more reluctant now that the market is displaying extreme volatility. The government's over-reach on intervention measures is further cause for short-term concern. However, such scepticism is often a powerful fuel to propel an ongoing bull market. In focusing too much on these short-term issues, investors risk missing the longer term picture and opportunity.

History never repeats – but it can rhyme. Rather than 1929, the current situation recalls the markets of the late 1980s when the truly booming market was Japan, yet everyone expected that it would soon collapse as well as be the catalyst for problems elsewhere globally. What actually happened? Wall Street crashed 25% in October 1987, Australia's sharemarket entered years of gloom that saw it fall 50% over following years. Japan simply experienced a minor hiccup and then doubled in the following two years. Sure, it had major problems in the 1990s and 2000s, but perhaps China's sharemarket today takes a similar path to Japan's then. If so, it won't be China that we're worrying about crashing and damaging global financial markets and economies but, rather, other markets, possibly even the key US market.

Indeed, if talking about the next few decades, a case can be made that the China equity bull market may well just be beginning. Unlike Japan, the Chinese economic juggernaut is real. In 1989, Japan made up over 40% of global market capitalisation. Today, China is hardly included. No one knows the future, but with 1.4 billion people, the largest economy globally within a few years, and an agenda to continue opening up its economy and capital markets, it would be a courageous decision to exclude China from portfolios today. Recent weakness may well be looked back on as having been a great opportunity to add exposure, even if one needs to be more active in managing positions given the heightened volatility.

Through this period, the main vehicle we have used to gain exposure to China is the ASX-listed AMP China Growth Fund (ASX Code: AGF). It has recently come under pressure from "activists" to introduce measures to help narrow the large 20% to 30% discount to NTA at which the fund trades. While the volatility of the market in recent months has overwhelmed any benefit from expectation or actual implementation of such measures, we expect that more settled markets could see this provide a tailwind for returns in this fund versus other means to gain exposure to China A shares.

Further, while the current fund structure is far from immune from market volatility, the additional volatility of the price versus underlying movements can provide an additional avenue to add value when sentiment becomes extremely pessimistic or optimistic.

Of course, A shares are not the only way to play China. Arguably, Hong Kong-listed H shares currently offer a cheaper alternative. US-listed "Red chips" and China-focused companies listed on other markets such as Singapore's also broaden the opportunity set. The soon-to-launch China Asset Management Opportunities Fund and the Value Partners-run Premium China Fund are examples of funds focused on the broader range of China equity opportunities.

Investors need to be clear how they intend to play China. Those playing the long game may choose to rely on good active global, emerging or Asian managers to adjust their weighting and exposure to the various areas as appropriate. Those with a higher risk appetite or even shorter term view may look to complement these exposures with, or focus on, more focused vehicles such as those discussed above, albeit being prepared for high volatility.

While there is a good chance the China sharemarket doomsayers will be proved wrong, the China A sharemarket is not the deep value, relatively low risk contrarian opportunity it was a little over one year ago. However, looking forward to the major and growing role that the Chinese economy and capital markets will have globally, it is hard for serious investors to dismiss China. In my view, investors need to be there over time, and sensibly building and maintaining exposure to China over coming years should be the focus, not looking for simplistic excuses to avoid it.



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