HEALTH WEALTH CAREER

CHINESE EQUITY MARKET

JANUARY 14, 2016

MAKE TOMORROW, TODAY

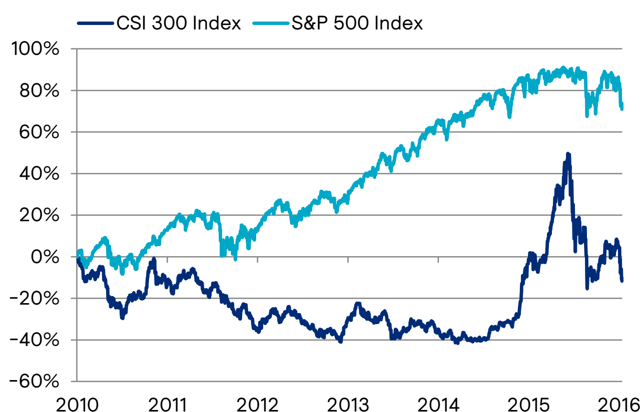
Financial markets had a nervous start to 2016, with most equity markets falling sharply. The S&P500 Index was down 6.0% in the first week of trading in January, while the CSI 300 Index, a mainland index of Chinese stocks fell almost 10%. This is about the worst start to the year ever.

It is not easy to hold your nerve as you watch share markets plunge – but `don't panic' really is good advice. It is best to take a step back and calmly assess what is behind the recent market moves, and whether these factors are likely to persist.

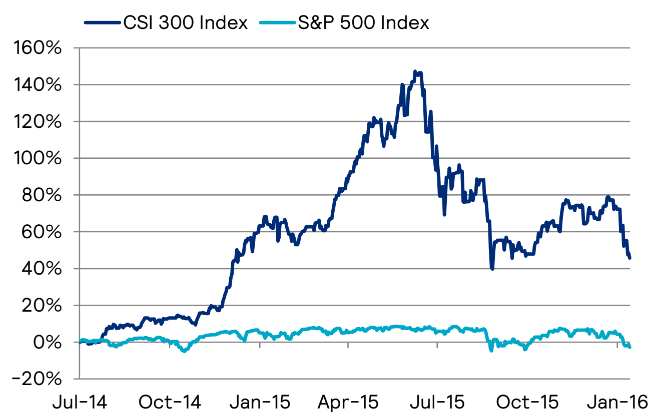
The recent decline in equity markets appears to be driven by events in China. An unofficial measure of manufacturing activity released on Monday, 4th January showed that the Chinese manufacturing sector continued to contract in December (and by more than expected), while another survey showed that capital outflows from China reached a record in the fourth quarter. This prompted a strong reaction from the Chinese equity market, falling 7% on January 4, the maximum level allowed before prompting "circuit breakers" to suspend trade for the day. Chinese equities were up slightly over the following couple days, before falling another 7% after only 29 minutes of trade on January 7. This prompted authorities to dump the circuit breakers altogether. Somewhat counterintuitively, this action prompted Chinese equities to actually post gains on January 8, up 2% for the day.

S&P 500 AND CSI 300 INDEX

January 2010 through 2015



July 2014 through January 2016

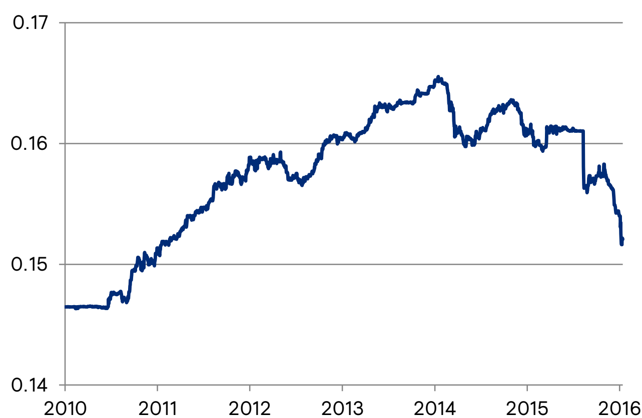


Source: Bloomberg

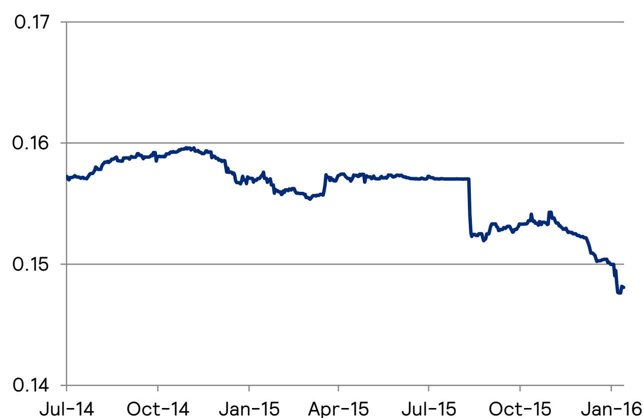
While January 4 was all about economic data, a key factor behind the selloff later in the week was the decision by authorities to allow the Chinese currency to devalue. The daily fixing of the Chinese currency, the Yuan (also called the Renminbi), relative to the US dollar, has been watched closely since the last China-related panic in August last year when the People's Bank of China (PBoC) shocked markets by devaluing the Yuan by over 1%, two days in a row. The daily fix is the middle of the +/-2% range within which the currency is allowed to trade. Last Thursday the PBoC lowered the fix by 0.5%, prompting fears by some that Chinese authorities were possibly attempting a competitive devaluation to boost their exports. Since the initial devaluation last August, the Yuan has depreciated by a total of 7.3% against the US dollar.

CHINESE RENMINBI (USD PER CNY)

January 2010 through 2015



July 2014 through January 2016



Source: Bloomberg

While the data and currency movements would be expected to lead to some losses in Chinese equity markets, the panic like nature of the selloff seems overdone. As we have noted in various commentaries before, a slowdown in the Chinese economy is widely expected and has been well telegraphed. The country is transitioning from an export-led to domestic consumption-based economy. At the same time, efforts to crack down on corruption and reduce pollution are also thought to have weighed on growth. Also, generally speaking, as an economy becomes more developed its natural rate of growth tends to slow.

Nevertheless, it is worth pointing out that the Chinese equity market is unique. Unlike most developed markets, equity market turnover is dominated by domestic "mum and dad" investors, many of whom have a short time horizon and limited experience in trading shares. Fortunately though, shares only comprise about 17% of average household wealth, meaning that even large declines in the equity market only have a small impact on household wealth. Further, very few Chinese companies are reliant on equity markets as a source of finance. In fact, only 2% of non-financial corporate financing is done via the equity market. It is therefore not surprising that there has historically been very limited correlation between the strength of the Chinese economy and returns in the Chinese equity market. For example, during the strong growth period between 2010 and 2012 when the economy was growing between 8 and 12% p.a., the Shanghai composite lost around 7% p.a. Meanwhile, over the year to June 2015 when the economy grew 7.0% and was expected to slow further, equities gained over 50%.

Outside of China, developments so far in January have been positive in aggregate. Importantly, on January 8 it was reported that US employment increased by 292,000 in December, well ahead of market expectations for 200,000 and continuing a run of strong jobs data. The US unemployment rate remains at 5.0%, while there are also tentative signs of higher wage growth. In addition, the US Federal Reserve released minutes of their December board meeting at which they raised interest rates for the first time since the Great Financial Crisis. The minutes confirmed that the Fed expects to raise rates only gradually going forward and remain alert to the risk that inflation could fall short of their targets. So despite the strong employment numbers, the Fed is likely to closely monitor the impact of their December hike on markets before increasing rates again.

The size of equity market falls may seem disproportionate to the news released since the turn of the year, but it illustrates the nervousness of investors regarding the implications of a slowing Chinese economy. In that sense, we have reverted to the market psychology of last August and September, when global equity markets fell around 10%, only to recover most of the lost ground by the end of the year (although notably Emerging Markets lagged during this recovery). Providing the Chinese authorities recover their poise and the slide in economic data is arrested, there is a reasonable likelihood that equity markets will bounce back to reflect the improving economic picture in the developed world.

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