Bear In A China Shop… What It Means For Markets

(From right to left:)

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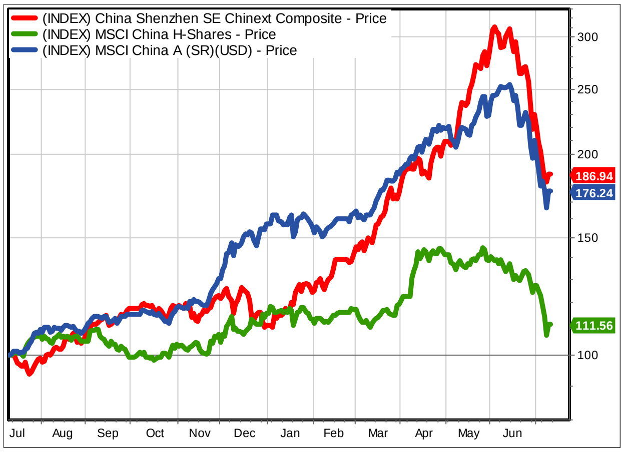
Back in April, we highlighted the curious case of the raging bull market in certain parts of the Chinese stock market (*Weekly View — Bull in A China Shop… Or A Bubble About To Pop?,* 4/27/15:). The first point we endeavored to make was that *there is no such thing as one Chinese stock market from which to draw conclusions*. Instead, China's public markets rather confusingly incorporate a wide array of indices, all with different listing domiciles, valuations and/or characteristics. To simplify, we made a distinction between Chinese "A-share" stocks (mainland Chinese shares that are listed on local exchanges; until recently, they were only available to local investors) and "H-share" stocks (companies also domiciled in mainland China, but listed on Hong Kong exchanges and thus widely available to non-Chinese investors).

At the time, we noted the meaningful valuation differences among frothy, expensive markets (such as the MSCI China A-Shares Index and other smaller cap, high-tech local indices like the China Shenzhen SE Chinext Composite, or "Chinext") versus the more modestly valued and lower volatility the MSCI China H-Share Index market. Our view was that A-shares, technology, and small caps were "exhibiting classic signs of bubble behavior" and were to be avoided, but that value still existed in the H-shares as well as some other ancillary Asian markets.

The fall has been sudden and severe; MSCI A-Shares and Chinext stocks have seen a huge portion of the year's gains evaporate *in three weeks* (see red and blue line in Chart 1, below), culminating in full-on panic on June 8 followed by two days of volatile rebound. Although H-Shares have experienced less absolute downside, they have also suffered (see green line), particularly recently as circuit breaker restrictions on trading A-shares have forced investors to sell liquid offshore assets as proxies. While RiverFront portfolios have zero exposure to A-shares and relatively little exposure to H-shares (less than 2% in our most aggressive portfolio and no exposure in our income-oriented portfolios), we think it's important to try and consider the causes and ramifications of this sell-off. Our main conclusions are as follows:

- **Avoid Chinese A-shares** – instead focus on Japan, Korea, Hong Kong and Taiwan. Contrarian investors with a long-term focus and high risk tolerance may want to keep Chinese H-shares on their radar screen as well.
- **Chinese market meltdown does not necessarily mean a global recession is coming.** Linkages in the past between the stock market and the economy have been tenuous.

CHART 1: Chinese Markets Panic



Source: RiverFront Investment Group, FactSet Research Systems
Past performance is no guarantee of future results.

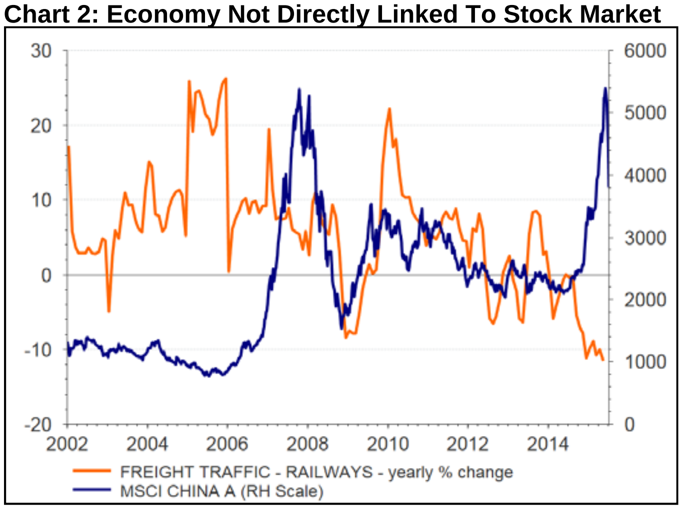
Why Are Chinese Markets Going Down So Much, So Quickly? To burst an asset bubble, two factors are needed: risk “preconditions” to set the stage, as well as catalysts to prick the bubble. As we discussed in April, one precondition for A-shares and Chinext has been elevated valuations. Margin lending growth is also a hallmark of “bubble” markets, and China’s level of margin debt is stunning; according to Goldman Sachs, China’s margin lending represents more than 9% of its overall market free float, making it the most heavily margined market in the world (and possibly ever). Margin debt and turnover increased exponentially over the past year, indicating rapidly escalating risk tolerance and a short-term trading mentality – two other preconditions for a market meltdown. Attempts by the government to slow down margin growth have been met with market volatility; more recent catalysts include: global jitters surrounding the Greek debt crisis, concerns over share dilution with increased recent IPO filings, and the decision by MSCI on June 9th not to add A-Shares to their widely followed emerging markets index.

When And Where Should We Expect The Sell-Off To Stop? Trying to time a market bottom is often a fool’s errand, especially without a valuation-based margin of safety. Technical retracement levels are also unhelpful in this case, as most Chinese markets closed on June 8 slightly below support levels suggested by Fibonacci retracement analysis. But the Chinese government is apparently intervening to try and stem losses. Since the market started its slide, the Chinese have taken what we consider drastic (some say desperate) steps to arrest the fall – jawboning, suspending trading in more than 1,300 stocks, dropping interest rates and transaction fees, pressuring brokerage firms to purchase blue-chip stocks via exchange-traded funds (ETFs), and halting filing of new IPOs, and even threatening police action against short-sellers. In a centrally-run system like China, the government enjoys *carte blanche*; and, while this offends democratic societies’ sensibilities, it also means that initiatives can be implemented swiftly. Simply put, if it is important to the Chinese to stabilize markets, we would not bet against them eventually achieving that objective – though sentiment is likely damaged to the point that a major rebound back to old highs is unlikely anytime soon, in our view. As the Chinese government is a major shareholder in many publicly-traded state-owned enterprises (SOEs) that dominate the H-Share market, it has a vested interest to see these stocks stabilize. Keys will be watching repo and other interest rates for further signs of policy accommodation and whether markets can find footing near current levels.

What Does It Mean For The Broader Global Economy? Currently, there are many ominous reports concerning the contagion risks for the global economy from this episode. While we agree that what happens in China has wider implications, there are a number of points that may mute the broader impact of the sell-off. First, the swift and sharp downturn in Chinese markets has simply taken stocks back down to where they were trading early this year. Thus, at this point, equating the Chinese price action to sustained US market meltdowns in 1929 or 2007 appears to be presumptuous. A better comparison may be the US in 2000, where an overvalued bubble in tech stocks driven by amateur investor fervor was popped, with heavy damage to shareholders but only relatively moderate damage to the economy. Further, unlike the US during that time, stock market ownership in China is not widespread; stocks represent less than 10% of Chinese household wealth, according to Credit Suisse. Therefore, the impact to consumer confidence may be more muted than many are expecting. In addition, relatively low ownership of Chinese A-shares by foreign investors (due to historical restrictions) means that the pain felt outside China may be lessened.

Beyond the psychological effects on Chinese consumption, many are wondering what this incident may suggest for the global macroeconomy. China’s economic slowdown is not a new phenomenon; China’s ”actual” rate of growth (as opposed to the “official” GDP statistics, which we largely discount) has been falling precipitously for years and has worsened since the real estate market collapsed in 2014. Despite this statistic, and China’s position as the world’s second-largest economy, global economic growth has managed to stay positive. How? First of all, the law of geometric averages dictates that the slower-growing-but-larger China of today contributes more to the global economy than the much-smaller-but-faster-growing China of 10 years ago. Second, areas such as Japan and Europe together as a bloc are a much larger economic force in terms of global GDP than China; thus, the burgeoning

Chart 2: Economy Not Directly Linked To Stock Market



Source: Thomson Reuters Datastream, RiverFront Investment Group
Past performance is no guarantee of future results.

economic rebound we see in both areas can more than offset a weak China, in our opinion. Finally, as Chart 2 illustrates, the linkages between the Chinese economy and the Chinese A-share market are historically tenuous at best; in fact, the market started its recent bull run in mid-2014, right around the same time that the Chinese economy — as represented here by rail freight traffic, one of the more reliable economic indicators for China, in our view — started to negatively inflect. Similarly, from 2002–2005, the Chinese economy was very strong but the market barely moved.

CONCLUSIONS:

- **We would avoid Chinese A-shares, Chinese technology and small caps, and assets dependent on Chinese growth.** Catching a falling knife is always dangerous, but even more so when valuation support is not available. **Instead, we would focus on cheap ancillary Asian markets that have also suffered since the global market downturn, including Japan, Korea, Hong Kong, and Taiwan.** We remain particularly bullish on Japanese equities due to reasonable valuation, strong corporate earnings and earnings revision patterns, and accommodative central bank policy. China's ongoing economic slowdown makes it difficult for us to be bullish on commodity-exporting regions such as Latin America, Australia, Canada, and Africa.
- **Contrarian investors with a long-term focus and high risk tolerance may want to keep Chinese H-Shares on their radar screen.** While valuation should not be used as a timing tool, on a price/earnings and price/book basis, MSCI China is currently one of the world's cheapest markets. Moreover, it's trading between -0.5 and -1.0x standard deviations[1] below its 10-year average. We view these conditions as "cheap" enough to help provide some margin of safety. In addition, steps that the Chinese government is taking to help shore up the economy could potentially benefit the types of companies that dominate the H-share index. This view also relates to MSCI Hong Kong — our belief is that selling restrictions on China shares are causing investors to sell more liquid HK shares indiscriminately. We think it is worth mentioning, however, that positive correlation between A-share and H-share indices means that H-shares may not materially rally until the knife is done falling for A-shares; as a result, the use of risk management stops may be a prudent strategy for any positions initiated.
- **Chinese market meltdown does not necessarily mean a global recession is coming.** China has been suffering economic slowing and fallout from various asset bubbles for a long time now, and this latest episode did not correspond to the Chinese economy getting materially worse. We believe positive economic progress from commodity-importing economies, such as the Eurozone and Japan, along with solid data from the US, should offset the lack of Chinese growth and allow the globe to grow economically in 2015 and beyond.

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[1] *Standard deviation is a measure of the dispersion of a set of data from its mean. The more spread apart the data is, the higher the deviation.*

Fibonacci retracement is a method of technical analysis for determining support and resistance levels. They are named after their use of the Fibonacci sequence. Fibonacci retracement is based on the idea that markets will retrace a predictable portion of a move, after which they will continue to move in the original direction.

Index Definitions (It is not possible to invest directly in an index.)

MSCI China A Shares Index: The MSCI China A Index captures large and mid cap representation across China securities listed on the Shanghai and Shenzhen exchanges.

MSCI China H Shares Index: The MSCI China H Index captures large and mid cap representation across Chinese companies incorporated on the mainland and traded in Hong Kong.

China Shenzhen SE Chinext Composite: Chinext was launched in October 2009. The market primarily targets innovative growth enterprises with profitability. It reflects innovative efforts in both technology and business models in China's enterprises.

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