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CHINA TAKES HEAVY-HAND TO SETTLE MARKET

Highlights

- China's Shanghai A-Share exchange has fallen roughly 28% since hitting a peak on June 12th, after having risen 152% over the previous year. This is a classic case of a frothy stock market that is coming back down to earth, and it partly reflects the immaturity of markets in China in general.
- For all its losses over recent weeks, the Shanghai index is still up roughly 52% since November 2014. Volatility will likely persist, but given how aggressive the authorities appear to be in trying to restore market order, further large scale declines are increasingly unlikely. While it is too early to assess the exact impact on China's economy, the rout poses an additional downside risk to GDP growth.
- The potential impacts for the rest of the world are mainly through commodity markets and trade channels. In the case of Canada, lower oil prices at a time of otherwise sluggish economic growth are another downside risk facing the economy. For the U.S. whose economy is only modestly dependent on international trade, the economic impact is limited. However, substantial fallout from the rout on China's economy does add a potential hurdle for a September rate hike.

China's Shanghai A-Share exchange has fallen roughly 28% since hitting a peak on June 12th, after having risen 152% over the previous year. This is a classic case of a frothy stock market that has come back down to earth, and it partly reflects the immaturity of markets in China in general.

The seeds were sowed last year. As high as investment is in China at 47% of its economy, national savings are even higher at 49% of GDP. This results in excess savings, which are largely restricted from being invested abroad. Previously, the savings were funneled into the housing market and opaque wealth management products (shadow banking). With the authorities making an effort to clamp down on shadow banking and with home prices turning south in 2014, investors instead funneled money into equities.

This shift was helped along by the expectation of greater foreign investment in domestic equities following the Shanghai-Hong Kong stock connect and expectations for easier monetary policy with the PBoC cutting rates in November 2014 for the first time in 2.5 years. Rapid gains in margin lending, where individuals borrow to invest in the market in anticipation of future gains, further fuelled the bubble. According to the IIF, from May 2014 to early June 2015, margin lending had quadrupled to $350bn, representing more than 8.5% of China's stock market free float, compared to less than 3% in the U.S.

The Shanghai index peaked on June 12th, with the run-up halted in large part due to government influence. Authorities had become concerned with the amount of margin lending and on that date, they released draft rules to limit the amount of margin trading

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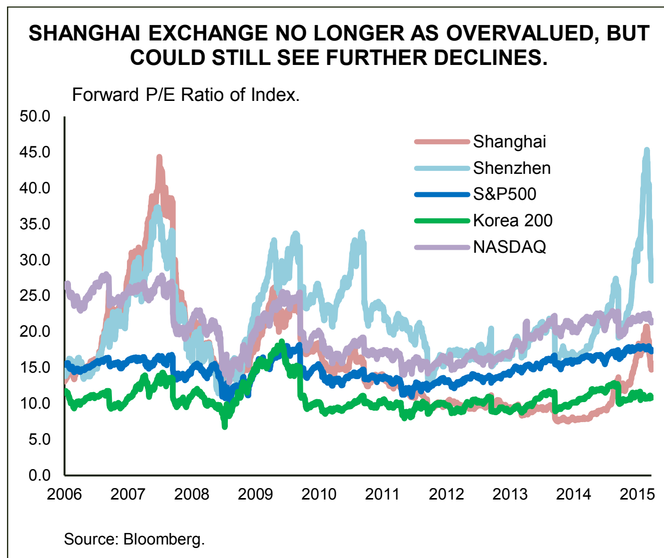


brokerages could provide. As a result, retail investors began to doubt the government's support for the market, leading to a sell-off. The sell-off was further exacerbated by large-scale sales by levered investors, who had purchased on margin.

In order to stem the panic, the government implemented numerous measures. These included interest rate cuts, suspensions of IPOs, plans for the state pension fund to invest in equities, creation of a market stabilization fund, and banning of share sales by company executives and investors owning more than 5% of a company's stock, among others. The lack of improvement and somewhat haphazard appearance of these policy announcements has raised fears over the ability of the government to adequately provide support to the market, further intensifying the sell-off. It does appear that the government measures have finally provided support this morning, with the market up 5.8% in Shanghai. However, we have seen previous daily gains of this sort during the decline, and therefore market volatility may yet reassert itself.

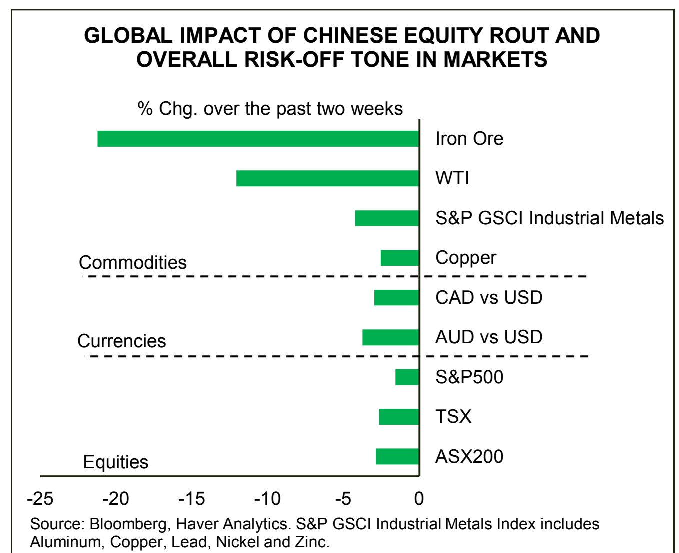
Given the uncertainty already present across global markets as a result of Greek exit risks, the abrupt sell-off in Chinese stocks has further encouraged the risk-off tone. Safe haven flows have further boosted the Japanese yen relative to the U.S. dollar (USD), while China-sensitive commodities and commodity-linked currencies have been hard hit. The iron ore Chinese benchmark price has fallen roughly 21% over the past two weeks, copper is down a milder 3.5%, while WTI is down 13.1% to $52.4 over the same period. These moves have in turn pushed the Canadian and Australian dollars down roughly 3 and 4 cents relative to the USD, respectively.

Spillovers to world economy contained so far

The most obvious questions are how much more market volatility can China experience and what are the knock-on effects to the rest of the world? For all its losses over recent weeks, the Shanghai index is still up roughly 52% since November 2014. Volatility will likely persist, but given how aggressive the authorities appear to be in trying to restore market order, further large scale declines are increasingly unlikely. The authorities still have several tools in their toolbox, and at its extreme, could directly intervene in the market by purchasing shares using the PBOC's balance sheet, either with the substantial FX reserves they have at their disposal or with newly printed money.

From a fundamental standpoint, the Shanghai index forward P/E ratio has come down substantially in recent days to 15.6 This is below its 2006-2015 average of 15.7, but does not preclude further adjustments given that it remains above its 2010-2015 average of 11.7, and far higher than the 7.9 it was at in June 2014 when some analysts judged it undervalued. As a comparison, the forward P/E ratio of the MSCI Emerging Markets (at June 30th) is 11.8, while the S&P500 and S&P/TSX Composite are at 17.4 and 17.8, respectively. The Shenzhen Index – the Chinese Nasdaq – has far higher valuations. However, its market capitalization is only roughly 1/5th that of the Shanghai index.

In terms of the market volatility impact on the Chinese economy, total margin lending represents only 1.2% of total banking assets, with official margin lending accounts typically having low leverage and high collateral. This limits the potential contagion to the domestic banking system. The risk in terms of Chinese consumer spending is larger, but



limited by several factors. First, the wealth created by the rapid rise in the equities occurred over a brief period (since November of last year) and therefore it is not clear that the positive wealth effect it would have generated materially impacted consumption. In fact, the evidence suggests it did not, since consumer spending has been unimpressive so far this year. Second, the IIF has noted that equities account for less than 15% of household financial wealth. Just as in the rest of the world, this is likely disproportionately held by wealthy households, who tend not to adjust spending abruptly[1]. Third, overall the market capitalization of the Shanghai and Shenzhen exchanges remains 15% of GDP higher than it was in November, suggesting that while some investors incurred losses, wealth has been created overall.

The decline in the market does come at a particularly inopportune time for China's economy. Recent economic indicators have been pointing to an improvement after the first quarter slump. While it is too early to assess the impact on China's economy, the market rout poses an additional downside risk to GDP growth this year. Our current forecast is for real GDP to grow by 6.9% on the year, but we will monitor upcoming data for any changes.

In terms of international contagion, the Chinese equity market – more specifically, the A-shares traded in Shanghai - remains largely closed to the rest of the world. This limits the spillovers to other economies as far as financial markets are concerned. However, potential impacts through commodity markets and trade channels remains. In the case of Canada, the main channel is through lower oil prices. At a time of otherwise sluggish Canadian economic growth, this is another downside risk facing the economy (for our latest provincial forecasts, see here), and another reason supporting another insurance rate cut by the Bank of Canada next week.

For the U.S., the main impact would largely be felt through trade. Still, exports to China account for only 8% of U.S. merchandise shipments. Even coupled with the indirect effects on global trade, the U.S. economy remains only modestly dependent on international trade, which is expected to be a drag going forward regardless. At the same time, U.S. business and consumer confidence is unlikely to be materially frayed by a localized Chinese event. Having said that, substantial fallout from the rout on China's economy does add a potential hurdle for a September rate hike.

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End Notes

1) IIF. Beijing Shifts into Higher Gear: Assessing the Macro and Market Impact of the Stock Market's Fall. July 8, 2015.

https://www.iif.com/publication/html-publication/beijing-shifts-higher-gear-assessing-macro-and-market-impact-stock

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