Chaos in China’s Stock Markets

Executive summary

- Local stock markets in China have been experiencing a significant correction and are down 30 percent to 40 percent, since peaking in early June. However, these markets soared during the previous year, and are still up over 8 percent year to date in 2015.

- We view this as mainly a domestic event—with minor impact on global stock markets. An estimated 97 percent of all Chinese A-shares are owned by local Chinese investors, which amounts to only 3 percent to 5 percent of the total urban population.

- We think this correction is primarily due to the immature state of Chinese stock markets versus being a harbinger of significant problems with the Chinese economy.

- Long-term investors who can weather a continuation of likely high volatility in the near term may be rewarded by growth and maturation of Chinese markets.

The situation

- Local Chinese stock markets, plummeting during the last few weeks, have halted trading or imposed trading restrictions on as much as 70 percent of the stocks listed on local exchanges.

- One of the primary reasons for the market correction is the unusually rapid growth of margin use within local Chinese stock markets, reaching 3.6 percent of total market capitalization.

- Another factor that may have led to the current Chinese stock market correction appears to be the fact that a large percentage of domestic Chinese investors are individual consumers. Chinese investors tend to be relatively young, inexperienced and under-educated in regards to investing, all of which may result in more volatile market behavior.

- The rapid appreciation of domestic Chinese markets, up 160 percent on a year-over-year basis from June 2014 through June 2015, has likely been a result of central government support. Governmental support doesn’t necessarily create strong fundamentals to maintain markets. With markets now in major correction, the central Chinese government has become very active, using a wide variety of strategies to attempt to slow price declines.

Scenario analysis

- We expect Chinese stock market volatility to remain high for the foreseeable future despite massive government interventions, which unfortunately seem to have become shorter term in focus.

- Despite the recent market correction, local Chinese stock markets appear to still be trading above their 200-day moving averages.

- Currently, the correction in local stock markets doesn’t seem to have affected other Chinese financial assets, such as currency or sovereign bonds.

- Our base case expectation is that the stock market corrections in China are isolated events and do not have significant adverse effects on other financial markets in China, or the economy as a whole. Rather, these corrections may stimulate the central government to make revisions to Chinese stock markets, which may be beneficial in the long term.

- Our outlook for long-term investment objectives is that the fundamentals in China are likely to continue to trend higher, potentially benefiting investors who can stomach likely near-term market volatility.
**Investment implications**

- The local stock market corrections currently appear to affect primarily Chinese investors.
- China continues to move through an important economic transition, which we see supporting China’s long-term growth trajectory over many years.
- One of the most powerful results of China’s high growth has been a general improvement in wealth throughout China and the emergence of a significant middle class, which is likely to generate healthy demand for Chinese goods and services in the foreseeable future.