The fall in China’s onshore equity market: How concerning?

Market fall is not a surprise

Chinese ‘onshore’ market falls of a third or so (see chart for Shanghai stocks) are the least remarkable part of what has been happening of late.

It was fairly obvious, once the market started on a tear last autumn based on easier monetary and liquidity conditions, that there would be a reversal at some point. After all, underlying economic and profitability conditions had not improved to the extent that justified a significant market move up, let alone one of the size that happened. Even after such a large fall, the onshore market is still up on a year to date basis and remains substantially up on a year ago.

Market falls of this magnitude happen regularly even in developed markets of considerable depth and breadth like the US let alone one of the relative immaturity of China.

The remarkable part is the scale of official worry

The remarkable part of what has been happening is the way that the authorities have responded. In recent weeks, the authorities have tried a great number of measures to stop the market falling. Apart from cutting interest rates, the regulator CSRC stopped short selling and suspended IPO activity. Central bank money was used to support a brokerage operation to buy stock, state pension funds pledged to buy more stock, and lately, trading in a large number of stocks has simply been suspended.

All this and the market has still not stopped falling. So far at any rate, the measures appear not to be having the desired effect. Today's further large market falls occurred in spite of the fact that close to half the market is now not trading or facing a stringent daily limit for price fluctuations.

What the Chinese authorities have not done is do what Hong Kong did in 1998, which was to use foreign exchange reserves to buy stocks directly. As it happens, the intervention by the Hong Kong Monetary Authority then was highly successful, steadying the market and quashing the speculation which had been building up against the Hong Kong currency peg with the US dollar. However, there is no mystery in why Hong Kong resorted to these measures then. Quite simply, it was facing an existential crisis. China, on the face of it, is in nowhere near the same difficulty.

The intervention mystery

The mystery then is why the Chinese authorities appear to be so determined to stop the stock market falling. It is widely recognized that sectors of the market, particularly technology, had become overheated, and even at the total market level, valuations had become quite stretched. Retail investors betting on margin had become a clear issue with some stocks being bid up to dizzy multiples. The market needed to correct and it was a healthy development that it was doing so. The falls
were a necessary corrective mechanism to the speculative fever that had been sweeping through in the early months of the year.

If you intervene, as Hong Kong did, you want to be doing it only if the market is obviously failing to function, which in the dark days of 1998 may have been the case. In China's case, rather the reverse has applied.

Possible explanations

The answer to the intervention mystery may lie in four possible places. First, there may be a genuine fear that large falls in the market will directly threaten the economic recovery. This looks unlikely. China's stock market is not a key part of the economy or the financial system in the way that say the banks are. Unlike developed economies, very little household wealth is held in the form of stocks (less than 10%). Hence, even though household consumption trends are now critical to maintaining economic growth given the slowdown in exports and investment, a stock market that is blowing off some froth is no threat.

The second explanation may be that the stock market fall is embarrassing to the authorities who have promoted the cause of greater integration of Chinese financial markets with the outside world; look at the drive to internationalize the Rmb, the Hong-Kong-Shanghai connect and the China-led launch of the Asian Infrastructure Bank. Given these developments and most recently, the decision by MSCI not to include the ‘A’ share market into global stock market indices, the authorities are probably looking at these market falls with dismay as signaling to the outside world that its domestic financial markets remain very immature. There is probably something to this, but it is probably down the order of the most plausible in providing an explanation.

The third factor is closer to the heart of the matter, which is that the authorities are worried about financial stability. Though it is true that individuals trading on margin have driven the bulk of the earlier market gains, concerns are high about the way that trust funds, part of China's shadow banking industry, have financed this and the way in which they are substantially exposed to the stock market. The concern is that the potential failure of some of these trusts as the market keeps falling might feed through into wider financial instability. The context of a weak economy with profitability under strain in much of 'old China', and falling property prices (even though there has been some steadying of late), are well known concerns for the health of the financial system. As we noted in an earlier China note, the rise in China's credit to GDP ratio since the crisis and the sharp economic slowdown makes it much more likely that credit quality in the economy is likely to suffer. It is very likely therefore that the Chinese authorities are viewing this large market fall with growing unease in terms of adding to the already considerable strains on the financial system at large. Financial instability can of course impact the economy strongly and this is probably a key factor in the intervention.

A fourth explanation is also credible. This is that the People's Bank is concerned that the pace of capital outflows has picked up excessively, and that a falling stock market may encourage still larger outflows. China is, of course, attempting to encourage a gradual liberalization of its financial system and allowing its citizens some access to investment opportunities beyond China (at this stage Hong Kong), but only in a controlled manner. The pick-up in so called 'financial account' outflows, which has been happening for about a year but which was particularly large through the 1st quarter (some $159bn) provides the clue to this concern. Very low interest rates and a falling stock market may prompt larger outflows, which could transform what is normally a balance of payments surplus into a deficit. A gradual pick up in outflows is one thing, but a strong further pick up in outflows could be unsettling, potentially even impacting the Rmb in due course.
Wider implications of China's stock market troubles

Let us get to the bottom line. Does it matter that the Chinese stock market has dropped by a third and the authorities are unsuccessfully trying to stem the market falls?

Our answer is that it does, in three ways.

The first is from the impact on broader financial stability in China. So, even though the direct economic impact from the market falling is not a concern, the indirect impact on financial stability that the authorities' behavior appears to signal may well be. The People’s Bank is clearly well placed to see where the stresses lie in the official and shadow banking system and our read is that the measures taken by both the People's Bank and the CSRC will not have been undertaken lightly. As we have noted before, given the backdrop of weak economic growth, stresses in real estate, and weak export markets, China's task of navigating a path through these troubles has been hard enough already without adding to financial stability concerns. The central bank's further issue at this time is that the capital outflows could pick up even more, which presents an added layer of worry.

The second is that it is spilling over into other markets. Even though the appearance is of an equity market that operates aloof from other equity markets and other asset classes, the reality is that this is not the case. We have seen a significant impact on commodities already, particularly metals – the copper price is down almost a fifth over the past month. This is less a fear that all-important Chinese demand will weaken than it is the result of a fear that inventories of key metals like copper could be liquidated given their use as collateral against stock market investments. The ripple effects on investment exposures to the global energy and commodity complex are evident from the downturn in resource stocks in recent days. Additionally, there is a developing impact on Hong Kong, a not entirely insignificant developed market that is held in global equity portfolios. Today's large Hong Kong market falls highlight the way that expectations of further decline and the perceived failure of the authorities to arrest it can damage China’s offshore markets too.

The third impact is more nuanced. This is that China's domestic reform agenda, which has been about letting market forces take a greater role in resource allocation, is under reputational assault from these measures. To their credit, the authorities have not responded to the slowdown in the economy in the past few years by reverting back to the policies of the past. Such market intervention sets this track record back. More mundanely, it also impacts the timing of MSCI's decision to include the 'A' share market in its global indices. Later, rather than sooner, may well be the result.

Finally, and at a high level viewpoint of a global investor, how worried should we be that China's market falls will unsettle global markets? We have generally been quite cautious on China's economic outlook for a long time, and these developments do not help in alleviating these concerns. However, in and of itself, Chinese developments, in terms of what we can see (and we clearly are not able to see everything), still appear unlikely to upset global risk asset market conditions in a decisive way. However, we need to see China's market troubles alongside several other developments to gauge the overall impact - Greece/Eurozone, high exchange rate and bond market volatility, a still fitful global economy and limited support for corporate profits growth.

The conclusion we come to is that Chinese stocks' troubles are one more global spoiler that checks market gains and ignites more volatility.
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