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ADVANCE ECONOMIC SPOTLIGHT ON…

CHINA

JULY 2015

The past month has seen the Chinese share market lose more than 30% of its value (around US$3 trillion), a fact overshadowed by the recent events in Greece. As Australia's largest trading partner though, China's fortunes have a range of implications for investors.

Background

China has seen extraordinary economic growth over the past 20 years, driven by aggressive investment in infrastructure and population movement to urban areas. The stock market has been more volatile. It underwent one boom-bust cycle between 2006 and 2009, rising five-fold between 2006 and 2008 and then losing most of those gains. Before 2006, Chinese households directed most of their investments towards the property market but they shifted to the equity market when the government introduced measures to curtail property investment.

The stock market was then relatively subdued until late last year when it started bubbling again. The renewed interest in the stock market again reflected a switch out of the property market by households. There was also a perception that the government was supporting the stock market by allowing more trading accounts and margin lending.

This combination has seen retail investors in China dominate the share market. This is a contrast to share markets in other countries which tend to be dominated by institutional investors. Retail investors tend to speculate more than institutional investors and have a poorer understanding of what they are investing in which can make for a more volatile movements. Much of the growth of the Chinese share market has also been a result of the volume of investors pouring into the market and many have used margin loans to access shares.

The current situation

As the share market rapidly rose from the flood of investors, the Chinese government became concerned about the potential of a bubble and brought in measures to control it in 2015.

January:

- The minimum cash required to trade on margin loans was raised.
- Strict enforcement of margin trade regulations.

April:

- Introduced a ban on brokers helping their clients to evade the limits on margin trading using specially designed financial products like umbrella trusts.

June:

- Limited the volume of margin lending that stock brokers could do.
- Reinforced the ban on using financial products to get around the limits on margin trading.

After the June regulations, the Chinese share market has rapidly declined. This has already started to affect other markets with commodities particularly affected by the Chinese share market sell down.

Government intervention

The Chinese government has responded with a number of interventions to restore share market confidence.

Monetary investment

- $US42billion investment in the share market via brokerage firms. This is in addition to money pledged by the Securities Association of China.
- Reduced the official cash rate (to encourage borrowing).

Regulations

- Reduced the limits on margin lending and allowed investors to use their houses as collateral for investing in shares.
- Capped short-selling shares.
- Encouraged pension funds and the social security funds to invest more in shares.

Other temporary measures

- Paused new initial public offerings.
- Allowed large numbers of companies to suspend trade in their shares.
- Ordered all large shareholders (with stakes of more than 5% in a company) not to sell shares for up to six months.

While these measures have not completely stemmed the flow out of shares, there are some tentative signs that the drop is slowing. China is likely to continue to introduce new measures until the market does stabilise. Fully functioning capital markets are critical to the outlook and further development of the economy.

Implications if the Chinese government is successful in managing the slide in the share market

- In the shorter term, volatility across markets should ease and commodity prices should recover somewhat (with particular benefit to Australia).
- Longer term, the support measures that have been introduced will need to be rolled back otherwise they could eventually cause another surge in the equity market.

Implications if the Chinese government is not successful in managing the slide in the share market

- If the slide in the share market continues, volatility globally is likely to remain elevated as investors respond to the risk contagion within China and seek “safer” assets. This sort of market can be challenging for share markets across the board but can create opportunities for alternative strategy style investments.
- Investor losses of this magnitude can lead to social unrest and damage the government’s plans for economic and cultural reform.
- On the flip side, this may open buying opportunities for blue-chip shares in China that may see their price drop alongside the market.

Something to note is that the Chinese share market is still up more than 80% compared to 12 months ago[1]. Some spectators viewed it as slightly undervalued to begin with so this situation may be a slight correction to true value.

Managing China in the Advance portfolios

Advance has monitored the growth in Asia over a number of years and continues to view a number of opportunities across the region, including in China, despite challenges ranging from transparency concerns to politics. Allocations are diversified across Asia and not dependent on a single country in the region.

We are monitoring the potential of a “risk-off” contagion which may lead to broader global market weakness and lead to a flight to “safer” assets. Our market outlook currently considers the prospect of flights to quality bonds (such as Australian bonds) and currency (in favour of the US dollar). These have been captured in the positioning of the Advance portfolios.

For more information, please speak to your Advance State Manager.

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1. Bloomberg, 9 July 2015.

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