Managing the Dragon Blog Post

Putting China's Stock Market in Perspective

By: Jack Perkowski | August 16, 2015

The recent declines in China's stock market have triggered speculation that the Chinese economic miracle may be finally coming to an end. Combined with a declining growth rate in the country's gross domestic product ("GDP"), many China observers worry that that the $4 trillion loss in stock market value since June will derail the government's attempts to liberalize the economy and implement much needed financial reforms. Others believe that the recent stock market reverses represent the first black mark on President **Xi Jinping's** administration that could hamper his handling of the economy going forward. The recent devaluation of the renminbi, China's currency, only seems to confirm that China's economy is in trouble.

Beginning in July, 2014, the Shanghai Stock Exchange Composite Index ("SSE Index") increased by 149 percent, peaking at 5166 on June 12 of this year, only to decline by 29 percent during the last three weeks in June. While the common perception is that stock market volatility is unprecedented in China, this is not the first time that this has occurred. For example, in a fifteen month period beginning in July 2006, Chinese stocks surged by 269 percent, increasing to 5955 in October 2007, only to decline by 71 percent over the following year in the wake of the global financial crisis. Similarly, the SSE Index doubled over an eight month period beginning in October 2008 to 3412 in July, 2009, only to fall by 30 percent in the ensuing 12 months.

In addition to being unprecedented, the common perception is that such stock market volatility damages investor confidence and thereby threatens China's economic performance. Despite the sharp stock market declines in 2008 and 2009, however, China's GDP grew by 9.2 percent in 2009, 10.6 percent in 2010 and 9.5 percent in 2011. While this year's stock market volatility may have an impact on the country's growth rate, it's premature to draw this conclusion, particularly since there is little evidence that sharp stock market declines have had this effect in the past. The Chinese economy and China investors have survived both previous periods of stock market volatility, and will likely survive this one as well. The more important question is whether China's stock market increase, and subsequent pullback, over the past year is somehow different than the breakouts that occurred in 2006 and 2009

I believe that it is. While Chinese stocks were largely in synch with global market trends when they increased in both 2006 and 2009, the increase in China's stock market values that began last July was a uniquely Chinese phenomenon. While the Shanghai Index doubled in value during the latter half of 2014 and the first half of 2015, the Dow Jones Industrial Average ("DJIA") only managed a modest five percent increase.

In fact, except for China's stock market increases in both 2006 and 2009, China's stock market has been out of synch with major stock markets around the world for most of the past fifteen years. For example, before China's stock market began its run in July, 2014, the SSE Index stood at 2075, approximately the same level as it was in August 2000. In other words, during a fifteen year period when China's GDP increased by more than 8.5 times — from $1.2 trillion in 2000 to $10.4 trillion in 2014 — the country's stock market didn't budge! During the same fifteen period, the DJIA increased by 62 percent. Despite China's phenomenal growth as an economy, the country's stock market has not been able to break out of the 2,000 level until recently, and its stock market has been one of the worst performing in the world.

The reasons why this time it is different lie in two actions that China took in November 2014, the timing of which coincided with a dramatic uptick in prices. On November 17, 2014, China implemented Shanghai-Hong Kong Stock Connect, a mutual market access program through which investors in Hong Kong can buy shares on the Shanghai Stock Exchange and Chinese mainland investors can buy shares in Hong Kong. Shanghai-Hong Kong Sock Connect is the first effort by China to open its stock markets to foreign investment since the country launched its Qualified Foreign Institutional Investor ("QFII") program in 2002. China watchers know that Shanghai-Hong Kong Stock Connect is only a first step, and that further market opening moves are likely to follow.

On November 30, 2014, China took the second step that has helped ignite its stock market rally when it released a draft plan to establish a long-awaited bank deposit-insurance system. Under the plan, which went into effect in May, 2015, the government said that it would insure individual bank accounts up to 500,000 yuan ($78,000). Under China's deposit insurance plan, 99.6 percent of all bank accounts, but only one-half of China's $21 trillion of bank deposits, are covered. Before the plan announced in November, all bank deposits in China had a presumed implicit full-government guarantee, which has encouraged banks to run up bad loans, and investors to make risky investments, believing that the government would ultimately bail them out.

Shanghai-Hong Kong Connect and the deposit insurance plan, combined with a soft property market and four interest rate cuts since November that have lowered interest rates, have had the effect of driving more foreign and domestic capital to China's stock markets. Put in perspective, therefore, the recent gyrations in China's stock market should be viewed as the beginning of the long term development of the country's capital markets, whereby the massive amount of capital that already exists in China is recirculated to companies that can best use that capital. Any time such a major development is attempted, corrections are inevitable. Rather than focusing on the recent pullback in stock prices — and the government's efforts to deal with it — the focus should instead be on the fundamental change in capital allocation that is currently underway.

http://managingthedragon.com/?p=2407