

# Is the great fall of China a bigger problem than Greece?

By Valentina Romeo 24th July 2015



With the Greek debt crisis dominating the national news cycle in recent weeks, the world has all but overlooked another potential market setback: the Chinese stock market crash.

The nature of the Chinese stock market fall has sparked debate over whether it is only a domestic problem or could turn into something more serious for the global economy.

So, is China's risk everybody's risk?

JP Morgan Asset Management director of investment management solutions Patrik Schöwitz says: "The situation in China has been somewhat shadowed by developments in Greece.

"Let's not forget that China accounts for 17 per cent of world GDP on a Purchasing power parity basis, compared to Greece at 0.3 per cent. We are only starting to get our heads around the fall out."

Standard Life Investments chief economist Jeremy Lawson says a hard landing in China would create a "large negative shock" for the global economy.

He says Australia, Brazil, Canada, Chile and Peru stand to lose the most if the country fails to stabilise growth. In manufacturing, Lawson warns Hong Kong, Korea, Malaysia, Singapore and Taiwan are most exposed.

However, for others, the Chinese market's fall and the Greek crisis are little cause for concern.

UBS Global Asset Management head of fixed income economics Joshua McCallum argues the Chinese economy is "not as crucial to the economy as elsewhere".

JP Morgan Asset Management chief market strategist Stephanie Flanders adds: “Greece and China pose more of a political and symbolic threat than a real challenge to global equity market fundamentals.

“As this rally has been driven by liquidity rather than by economic or corporate fundamentals, we are advocating a disciplined approach to investors’ exposure to China.

“The timing of the current correction in Chinese stock markets was always going to be difficult to predict, but the magnitude of it may be less of a surprise. The market is dominated by retail investors armed with the ability to leverage, making it more inherently volatile.”

Flanders doesn’t see market deterioration but a “tempering of mass exuberance about the markets”.

### **More opportunities?**

Flanders believes although it is difficult “to draw a line” on when this volatility will calm in the near-term, there are more investment opportunities in the Chinese story in the long-term.

She says: “We continue to see the merits of investing in China over the long-term as structural developments such as middle class consumerism and renewable energy are part of the long-term growth story.”

As for another prolific investment source, the Hong Kong H-shares still represent good value, adds Jupiter head of global equity strategy Stephen Mitchell.

Compared to A-shares, which are listed on the Shanghai exchange and are largely available only to domestic investors, H-shares are currently widely believed to be a better buying opportunity.

These type of shares are listed on the Hong Kong Stock Exchange and are mainly available to non-Chinese investors.

PineBridge Investments’ Desmond Tjiang, portfolio manager of Hong Kong and Greater China equities, warns volatility will be “huge” as H-shares are increasingly correlated to A-shares.

“Note this kind of market correction also provides a lot of opportunity to accumulate good quality stocks at a huge discount,” he adds.

“Chinese property developers for example, are now trading at more than a 40 per cent discount to net asset value, compared to 20 per cent around April and May.”

In fixed income, the recent volatility could also support the onshore bond market.

The A-share market’s sharp correction has, in fact, not directly deteriorated the credit quality of Chinese companies, says PineBridge co-head of emerging markets fixed income and head of Asia ex-Japan fixed income Arthur Lau.

Flanders, however, questions whether the latest volatility represents a healthy correction or a sign of further losses to come.

For this reason, some fund managers insist on limiting their exposure to China.

Premier Asset Management senior investment manager Jake Robbins, who manages the £85m Premier Global Alpha Growth Fund, says: “We had reasonable exposure to emerging markets because their valuations were cheap, but in recent months we have reduced it from roughly 10 per cent to 3.5 per cent as valuations are less attractive.”

### **Government intervention**

The Chinese government has introduced a number of measures aimed at stabilising the A-shares market, starting with the People’s Bank of China cutting interest rates and the reserve requirement ratio.

This was followed by the suspension of IPOs, the injection of liquidity into the China Securities Finance Corporation to help support the market, and the creation of a ‘stabilisation fund’ by onshore brokers which collected 120bn yuan (£12bn).

In addition, the Government has banned major shareholders from selling their own shares.

McCallum says: “If China wants to transform into a market economy, the authorities will have to learn to let the market set the price.”

### **Head-to-head: Is the China crash a flash in the pan?**

**Yes**

#### **Jonathan Davis, managing director, Jonathan Davis Wealth Management**

Put yourself in the shoes of the Communist Party Politburo: You have a billion people you need to keep content, your manufacturing and construction have slowed down so much they might even be in recession long term, the West is not buying as much stuff as they did and they do not look likely to be able to reverse that, permanently.

What do you do? You build your financial economy, which means stock prices. How do you achieve that? You make lending on shares easier and easier, evidenced by margin debt soaring over the past year. Also, you reduce lending rates and you allow more and more assets to be useable as a security to borrow in order to invest in the stockmarket. Thus, your stockmarket rises.

How do you keep it going? You create inflation by means of debasing your currency. This does two things. First, it helps exporters compete against other south-east Asian countries as well as your arch rival Japan, whose own currency is long term debasing having lost around 40 per cent of its value in just the past two years. Indeed, the Yuan is being managed down and this looks as if it will be long term. Second, inflation fuels the stockmarket, as it is thought of as an inflation hedge.

So, long term, the politburo needs a strong stockmarket. As far as we see it, they will do whatever it takes to achieve it. The recent and ongoing correction was to be expected with the astonishing rally from last Autumn, with such manic buying activity – with added leverage. The new normal service will soon be resumed and for the long term.

**No**

**Patrik Schöwitz, director of investment management solutions, JP Morgan Asset Management**

We are only starting to get our heads around the fall-out in China. It's always the same: most foreigners thought the pumping up of the Chinese stockmarket would end badly. But only now that it's happening are investors getting around to thinking of the consequences.

As far as China is concerned, this must further increase the fragility of the financial system. Consumer confidence is likely to be affected negatively, as happened in previous market falls, even though the stockmarket does not account for a large share of household assets.

The damage to the corporate sector is harder to predict – there will be confidence issues here too, but with at least some Chinese corporates known for playing the stockmarket there may be a direct feedback loop into corporate balance sheets that does not exist in most other markets.

There are almost certainly more angles to this, and there will surely be unintended consequences from the plethora of measures to prop up the market. Still, we can't rule out that the authorities might manage to pump the market up again in spite of the obvious deleveraging pressure – they're having their own 'whatever it takes' moment and certainly do not want doubts over their effectiveness to spread.

We have been very underweight emerging market equities all year, and the implications of the crash could range wider still. Outside China, there would certainly be a direct trade impact from any weakening Chinese growth if that transpired. But with commodities seen as China proxies by many, commodity prices have come under pressure as pre-existing oversupply worries are exacerbated by doubts over China's status as a reliable source of demand.

One thing we are beginning to think about is what happens if this were to persist and derail the expected recovery in inflation in the US and Europe – this could have implications for monetary policy.