UPDATE ON CHINA

Views From Our Senior Strategists and Portfolio Teams

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Key Points

- The recent selloff in Chinese equities is the air coming out a speculative bubble long in the making.
- The selloff doesn't represent a systemic risk to either the Chinese or global economy. Investor sentiment in China and elsewhere in Asia has taken a hit, however. This is particularly true for commodities investors.
- Despite a rebound Thursday and Friday that left the Shanghai Composite up 5% for the week, we believe this correction has not yet run its course. It takes time for big bubbles to deflate, and along the way there will be more volatility.
- We do not believe Chinese equities represent a bargain yet for investors. We continue to be very wary of the market, particularly the Shanghai-listed A Shares, although we are keeping an eye on select opportunities in the Hong Kong-listed H market. We see more buying opportunities elsewhere in Asia, particularly Japan.

How We Got Here

Chinese equities have been in freefall in recent weeks. Despite a late-week rebound, the Shanghai composite is now down over 25% from its peak, wiping out about $3 trillion of asset value—twice the size of India's entire stock market. Let's call it for what it is: A bursting of a speculative bubble of Chinese equities.

There have long been classic signs of a bubble: Increasing margin buying, for example, and a flood of activity by individual investors, who account for nearly 85% of stock transactions. In addition, artificially low initial public offering (IPO) prices have served to increase volatility. Chinese regulators blessed low IPO prices to get investors interested, but prices that surged after initial offer are now plummeting.

Now government authorities and the People's Bank of China (PBoC) are taking a number of steps to mitigate the selling—so far to little effect. These include suspending trading in those lofty IPOs and hundreds of other stocks (about half the market's shares have been halted), and Beijing also established a market stabilization fund to buy stocks. Chinese equities did see their biggest daily gain in six years Thursday, but, again, this came after a massive rout of the market.

Implications and Outlook

The selloff in China naturally raises several key questions for investors: Does it represent a systemic risk? Will there be contagion from China's freefall? And finally, do Chinese equities now represent a bargain and a buying opportunity?

Systemic Risk. We do not believe the bursting of the Chinese equity bubble represents a systemic risk to either the Chinese or the global economy. True, a stock-market decline of this magnitude sets in motion a margin liquidation cycle that feeds on itself, damages investor sentiment and can take a long time to recover. The bad scenario, then, is that this vicious cycle could accentuate the economic slowdown in China and prove to be a greater headwind to the global outlook.

However, it is important to keep in mind that government authorities and the PBoC will continue to implement strong countermeasures. The PBoC already has reasons to continue aggressive monetary policy, particularly the concern over slowing growth, and we believe that these policies will continue. Any sign of slowing growth should be met with further easing policies.

Contagion. Investor sentiment across much of Asia has taken a hit. Commodities in particular have suffered. The MSCI ex-Japan Index, up almost 13% year to date at its peak this year, is now up only 1% for 2015. This suggests that global investors have started to price in some of the bad scenario described above. However, this is still more of a market story than an economic one.

A buying opportunity? We do not believe value has returned to the market. Remember, the Shanghai Index is still up 70% from a year ago, which supports our conviction that this correction has further to go. Despite this week's massive correction, the trailing P/E ratio on Shanghai A shares is still around 19, roughly double the low from last summer and still at a 40% premium to the five-year average. Also keep in mind

that bubbles don't really burst—they deflate, and that takes time. Finally, because price declines are coming faster than retail investors can unwind their margin positions, more pain seems inevitable. As markets typically undershoot on the way down, it is hard to argue that Chinese shares have gotten cheap enough to represent a compelling bargain.

Within China, we still prefer H shares traded in Hong Kong including select banks, property developers and new energy companies. But even these stocks could come under increased pressure too with liquidity issues in Shanghai's A-share market. We still prefer other parts of emerging Asia, as well as Japan.

Bottom Line

The curse now befalling the Chinese market could someday result in a blessing. How? The margin lending that fed the bubble absorbed some of the credit growth that otherwise should have financed real economic activity. Also, the correction might allow credit growth to be allocated to more productive use. And if the stock market stabilizes, the Chinese economy might be a more sustainable path. If valuations return to more reasonable levels, it would be sensible to jump back into the market. But not yet.

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