

China's bubble trouble: A case of missing fundamentals

Commentary

10 July 2015

- China's bubble is bursting and about time too
- This is a policy driven market – and the government has lost control
- Speculative excess is unwinding fast because of margin calls
- We invest in companies not countries and this is why we stayed out

The market rout in China is gaining momentum as efforts to stop it are failing. Why? Despite extraordinary measures – bans on selling shares, extra liquidity being directed to brokers, cessation of initial public offerings (IPOs) – when a market has no fundamental basis for going up, at some point it has to go down. This is that moment.

Eighteen months ago real growth was tanking, the property boom had run its course, lending was slowing and debts in the system beginning to build. Over-investment showed up in weakening demand for commodities. The first signs of deflation emerged. Corporate profits began to suffer.

Faced with a slowdown the government increased liquidity to banks, cut interest rates and opened the lending sluices. A rising stock market, it figured, could boost confidence. And it would help state-owned enterprises (SOEs) in peril come to market at inflated prices, neatly allowing Beijing to take private speculative money in return.

The difference this time is that prices have been too high to begin with. Greed has played its role, too. Leverage cuts both ways, as domestic retail investors, seduced by margin financing, have found to their dismay.

Western investors should have paid closer attention. The Chinese have played them well. The opening of Chinese markets to the world, first via Stock Connect (linking Hong Kong and Shanghai exchanges) and then through a potential inclusion in MSCI indices, were perfectly calibrated. All this against a backdrop of renminbi internationalisation and grandiose plans for a China-sponsored global development bank.

Don't get us wrong. We welcome China's integration into the global financial economy. But what of the actual investment opportunity? With all the attention focused on the potential inflows to China, it is easy to forget that domestic savers get a raw deal. Money flows to the stock market through lack of alternatives. China could have opened up faster to foreign investors if it weren't so worried that those now captive savings would flee abroad and leave its rickety banks in jeopardy.

On this theme, China's hitherto astonishing economic growth has never been matched by a strong stock market story. It's still an emerging market. Most listed companies are generally sub-par. They are not run for outside investors. Many are not run for profit. The state-owned ones exist to meet policy goals: dig things up, burn energy, process raw materials and employ people.

There are exceptions. Some SOEs are left alone more than others. A handful of them have oligopolistic "moats" that would make Warren Buffett weep. And there is a private sector that, typically in a state-run economy, tends to flourish in areas that seem relatively harmless and outside the confines of centralised planning – the mall operators, hotels, food companies, drugmakers and consumer companies generally.

So we've found good reason to visit companies on the mainland. We have been running dedicated China strategies for more than 20 years and we have been building our China equity research team over time. We even took the plunge recently by creating a pure A-share fund. But the fact remains that in China, transparency is low and disclosure poor.

The recent rally, therefore, bemused but did not surprise us. Its basis was political, not fundamental. By this token, we have no notion of how fast it will unwind – although indiscriminate sell-offs leading to cheaper valuations, especially in Hong Kong, which is suffering heavy collateral damage, will be increasingly to our liking.

It is galling but understandable if investors want us to be participating. No one likes to miss out on performance. But no rally is worth compromising a long-term perspective for, however painful the sacrifice to performance in the short term. Because if you buy stuff you shouldn't have bought and get found out, you will have nowhere to hide.

Flavia Cheong, Head of Asia Pacific ex-Japan Equities

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