The Significance of China's Stock Market Crash
17 July 2015
Volume 822

The Significance of China's Stock Market Crash

WRITTEN BY: Rashaad Tayob, portfolio manager at ABAX Investments.

1) The Chinese Stock market has crashed after a phenomenal bull run.

2) China's economy is slowing as government spending. The investment-led growth model has reached its limits.

3) A booming stock market and private sector investment had the potential to keep growth at high levels, but now that the market has crashed it is inevitable that growth will slow.

4) Since 2007 growth has been accompanied by an enormous increase in debt. This greatly increases the risk of a financial crisis.

5) China has been the main driver of world growth in recent years. The lower level of growth and its changing composition will have significant knock-on effects on the global economy.

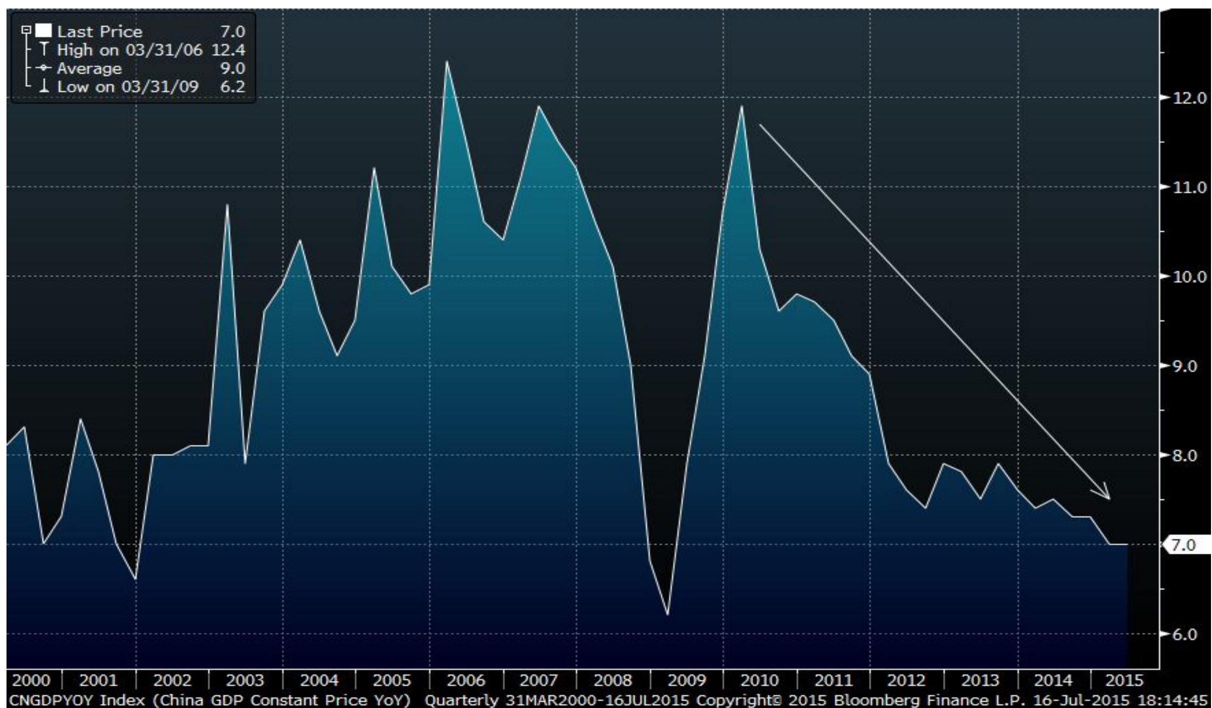
While the financial markets have been occupied with the turmoil in Greece, a potentially more serious development is the crash of the Chinese stock market after its phenomenal run. Up to May 2015 the Chinese market had delivered 154% over a 12-month period and valuations of medium and small companies reached extremes. The market began selling off on the 15th of June and the crash continued despite measures by the officials to prop up the market using a broad range of measures. These included interest rate cuts, short selling bans, IPO bans, insider and large shareholder selling bans and finally stock buying programmes.

Many companies took the strategic decision of suspending trading in their stock in order to prevent them falling further. At one stage over 1000 stocks, out of a listed universe of around 3000, had their shares suspended. This level of suspension of trading is unprecedented as the action is generally used for companies in liquidation or business rescue.

The broad market had fallen 32% from its peak before these various measures finally managed to stem the decline. This is tremendous destruction of value given that the Chinese market is second only to the US in terms of market capitalisation. While the market has calmed somewhat and trading is normalising as stocks get unsuspended, valuations in certain sectors such as Healthcare, Telecoms and IT remain excessive and prices have further room to fall.

The information contained in this document has been recorded and arrived at by Glacier Financial Solutions (Pty) Ltd in good faith and from sources believed to be reliable, but no representation or warranty, expressed or implied, is made as to its accuracy, completeness or correctness. The information is provided for information purposes only and to assist the financial intermediary to submit an investment proposal to the client and should not be construed as the rendering of investment advice to clients. Glacier information provided in this document.

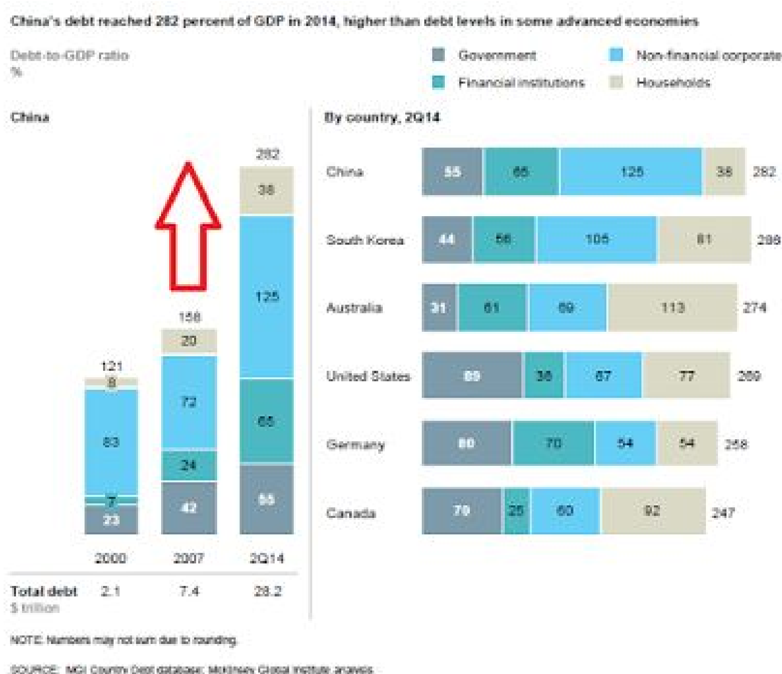
China's economy slowed in 2008 as the global recession caused net exports to fall dramatically. The government responded to the slowdown with a stimulus plan which drove up investment and enabled growth to recover strongly in 2009. Since the financial crisis, net exports have actually detracted from GDP growth and the "investment" component of GDP has been keeping growth at its current high levels. China is in the process of shifting its growth model so that more emphasis is on the private sector investment and consumer spending as opposed to government spending and government directed investment. Expectations are that economic growth in China will remain strong (between 6% and 7%) during this growth transition and the equity bull market reinforced these beliefs.



The information contained in this document has been recorded and arrived at by Glacier Financial Solutions (Pty) Ltd in good faith and from sources believed to be reliable, but no representation or warranty, expressed or implied, is made as to its accuracy, completeness or correctness. The information is provided for information purposes only and to assist the financial intermediary to submit an investment proposal to the client and should not be construed as the rendering of investment advice to clients. Glacier information provided in this document.

The large swings in the Chinese market and the high levels of volatility are not an accurate reflection of economic activity, but rather a reflection of a young and undeveloped market where prices are driven by retail investors. As the stock market rose to record levels the government seems to have encouraged the euphoria as opposed to playing a stabilising role. The speed of the market's rise and fall and the relatively low level of participation by the broader populations mean that the direct effect of the crash is likely to be minimal. However, the significance of the crash lies in the fact that the booming stock market had the potential to boost economic growth. New stock offerings (IPOs) and stock issues by listed companies pull savings into businesses, which they can then invest. High valuations lower the cost of equity and therefore the required return on prospective investments. This causes companies to ramp up investment, which is a component of economic growth. There was some hope that the deluge of money being pumped into equities would stem the decline in GDP growth as private sector investment replaced government investment. With the market crash this hope has now disappeared.

It is critical for China that its growth does not slow, as since 2007 the country has amassed a large amount of debt. The Chinese government reacted to the global recession by significantly increasing borrowing and investment in an attempt to maintain its high growth rates. They succeeded in boosting growth, but at the expense of a massive increase in the debt levels. A McKinsey report earlier this year highlighted the extent of the borrowing binge (http://www.mckinsey.com/insights/economic_studies/debt_and_not_much_deleveraging). The debt to GDP ratio has increased from 158% in 2007 to 282% in 2014, which means that debt levels in China now exceed those in developed markets such as the United States, Germany and Canada.



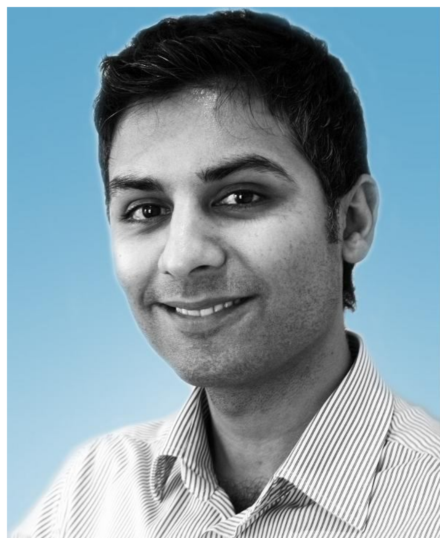
The speed and quantum of the debt increase have only a few precedents in history, with no nation in a comparable position able to escape an economic slowdown and most experiencing a credit crisis. (http://on.ft.com/1aYv5KM). A country with a high level of debt is very dependent on growth as any slowdown can impact the ability to service the debt load, which would precipitate a financial crisis.

While China's debt-fuelled boom has been under scrutiny for several years, investors have generally believed that the government will be able to deal with any fallout due to the low level of government debt (55% of GDP), the current account surplus (more exports than imports) and the size of their foreign exchange reserves ($3,7 trillion). Despite these

The information contained in this document has been recorded and arrived at by Glacier Financial Solutions (Pty) Ltd in good faith and from sources believed to be reliable, but no representation or warranty, expressed or implied, is made as to its accuracy, completeness or correctness. The information is provided for information purposes only and to assist the financial intermediary to submit an investment proposal to the client and should not be construed as the rendering of investment advice to clients. Glacier information provided in this document.

fundamental positives and the fact that the economy and credit growth have continued to grow at a rapid pace this year, I believe that a slowdown is now inevitable and there is a meaningful risk of a hard landing brought about by a financial crisis. Over the last five years China has contributed 30-40% of the world's economic growth and the consensus among economists and market participants is that this is likely to continue. A significant slowdown will be quite unexpected with massive knock-on effects for the global economy.

Glacier Research would like to thank Rashaad Tayob for his contribution to this week's Funds on Friday.



Rashaad Tayob: Portfolio Manager at ABAX Investments

Rashaad is a portfolio manager at ABAX Investments. Rashaad completed a Business Science degree, with Honours in Finance, at the University of Cape Town (UCT) in 2001 and was awarded the CFA designation in 2005. He has 14 years of experience in the financial markets and manages a range of domestic and international portfolios.

The information contained in this document has been recorded and arrived at by Glacier Financial Solutions (Pty) Ltd in good faith and from sources believed to be reliable, but no representation or warranty, expressed or implied, is made as to its accuracy, completeness or correctness. The information is provided for information purposes only and to assist the financial intermediary to submit an investment proposal to the client and should not be construed as the rendering of investment advice to clients. Glacier information provided in this document.