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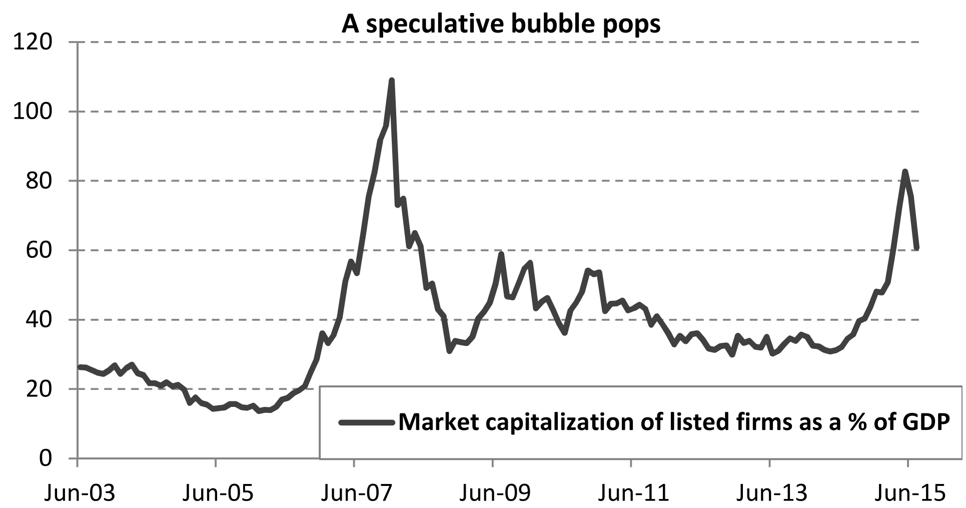
China's stock market crash: a speculative bubble pops

Investors' appetite for China's stock market is quickly unwinding. Since the peak almost one month ago the Shanghai composite index lost 32% of its value. Just like there were no fundamental economic reasons that could explain the earlier steep increase in stock market prices, the current crash has not been triggered by worries about an imminent collapse of the economy. While we would certainly not dismiss this risk as futile and already think growth will slow down faster than consensus estimates, the impact on economic activity looks set to remain fairly modest.



- Since the start of the equity rally last summer until its recent peak almost one month ago, Chinese stock prices more than doubled. This always looked like a very suspicious move given that economic activity continued its downward growth trend. Industrial production growth decreased from almost 9% (yoy) in the second quarter of last year to just 6% during the spring. At the same time, consumption growth also slowed down further. Official GDP growth in the first quarter of 2015 came in at 7%, down from 7.5% witnessed one year ago. Looking forward, economic growth in China will continue to decrease from current levels. The fast rise in income levels seen over the past decades (limiting the country's future catch-up potential), the rebalancing of the economy towards consumption away from investment and China's rapidly ageing population will all play an important role in this.

- Admittedly, this does by no means imply that stock markets should have moved in the same negative direction. First of all, it can be argued that China's stock market was far from expensive one year ago. Indeed, traditional valuation measures including the price/earnings ratio or the market capitalization of listed firms relative to GDP both suggested in fact the Chinese stock market had become fairly cheap. Moreover, despite slower growth, the rebalancing of the economy towards consumption away from investment is a positive evolution and one that makes future growth more sustainable. At the same time, however, there were also several reasons to be skeptical, not least because Chinese policymakers had difficult times to make sure economic growth would not slow too abruptly. Importantly, it cannot be denied that a lot of (official state) media attention has been given to the attractiveness of China's stock market while policymakers were putting further rebalancing measures in place. In other words, Chinese leaders have interpreted rising stock market prices as evidence that their strategy was playing out fine and have not refrained from underlining this. Moreover, the fact that the housing market was struggling at the same time has also helped to drain

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savings into China's stock market. All this in combination with the prospect of more capital account openness and bigger representation of Chinese equities in global equity indices has fueled a speculative stock market bubble.

- Since its peak mid-June, the Shanghai composite index has fallen by around 32%. Since the start of the year, however, the index is still up more than 8%. Over the last 12 months, meanwhile, equity prices are still up more than 70%. The big challenge and difficulty of course is to see what comes next. Authorities are now taking measures to support the equity market. What's also obvious is that this is proving very difficult, especially when at least a significant part of the money invested is debt-financed. Several observers are now predicting an imminent collapse of the Chinese economy. We would not dismiss this risk as futile. Japan's exploding equity bubble at the start of the nineties serves as a very important warning in this respect. But while concerned, we think the impact on economic activity so far will remain fairly limited. There's hardly any evidence that the speculative equity rally contributed to stronger consumption in the first place (rising wealth effect). In fact, household consumer confidence is now only slightly higher compared to a year ago while consumption growth continued to slow down further. As pointed out earlier, stock prices are still up more than 70% since the summer last year, so there's little reason to expect a big confidence hit at this point.

- Of course, equity prices could fall further. Indeed, while authorities try their best to stop the panic, there's a clear risk for this to happen. Even after the stock market crash witnessed so far, Chinese equities still don't look particular cheap according to the same traditional equity valuation measures. In this scenario, it's easy to see how further falls could impact confidence more significantly. In any case, our base case scenario is already that growth slows down faster than consensus estimates. Whereas consensus puts growth at 6.5% in 2017 we think this could already happen this year. We see growth in 2016 and 2017 gradually slowing down further to 6% and 5.5% respectively. The upshot is that the stock market bubble has been driven to an important extent by implicit government support (fitting into the government's strategy to rebalance the economy). Though we remain far from convinced that authorities now face a simple task to prop up the stock market, the authorities' determination and available policy room should make sure that the unwinding of this speculative bubble occurs more gradual. All in all, for reasons explained earlier, the impact on overall economic activity should remain fairly limited at this point. That said, recent turbulence once again underlines how difficult it is for Chinese leaders to deal with the huge imbalances stemming from the unsustainable credit boom following the 2008-2009 crisis.

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