What China's stock market turmoil means for investors

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- **The spotlight China's stock market turmoil has cast on Chinese central authorities may inspire newfound commitment to reforms.**
- **Powerful technical factors have created significant dispersion of gaps between underlying fundamentals and valuations across markets.**
- **For patient investors with the resources and skill to research and investigate these situations, there may be exciting stock-picking opportunities through this "sorting-out" period.**

The recent extreme volatility in Chinese equity markets has generated a tremendous amount of attention and commentary, but given the speed at which events have unfolded and the opaque nature of high-level policy-making in China, many questions remain. The following is my attempt at a brief primer on how to consider the situation.

What's behind the stock market crash?

Chinese equity markets have fallen precipitously after a stratospheric rise over the last year. The fall has been alarming in its scale and speed. More than $3 trillion in market capitalization has evaporated in the 30% slide since mid-June, an amount larger than the total market capitalization of Spain and France combined. While this is certainly an amazing decline, one must bear in mind that the Chinese equity markets had more than doubled in the prior 18 months. Despite the size of the decline, point to point, the markets are still up quite a lot. That massive rally began with optimism in market fundamentals as a world awash in liquidity saw encouraging signs of an opening of Chinese capital markets and increasing possibilities of fundamental reforms. Chinese growth, while slowing steadily, remained high relative to a world muddling along, and there was belief in an evolution from a low-cost manufacturing model to a more consumer and services-led economy.

As the rally progressed however, it became less about fundamentals and more about momentum and levered speculation. Margin lending rose to levels exceeding any other market in the world, and the incremental buyer increasingly became a retail investor looking to cash in on the "free money" ascent. Last March, the Chinese Household Finance Survey concluded that the average investor in the Shanghai stock market hadn't graduated from high school and was largely investing with high levels of leverage via margin loans. The government openly encouraged this move through media cheerleading and consistent support for easier account opening and margin lending. A vibrant stock market has the potential to serve as a means to move China away from its heavy reliance on bank lending to enable growth. Particularly as growth slows, the equity markets can serve as a means to de-lever highly indebted corporate entities.

However, the disconnect between valuations and the underlying fundamentals eventually became too extended and, as with all speculative bubbles, the market rolled over. The speed of the market's fall clearly unnerved the Chinese authorities. They have intervened dramatically, easing rates and reserve requirements, suspending IPO activity, pledging state pension fund support, and injecting significant funds into brokerage houses to be extended as margin loans. Authorities have gone so far as forbidding any selling from insiders or major shareholders and having the Ministry of Public Security threaten arrest for those who "maliciously short sell stocks and stock index futures". While it is far from clear that we have reached a market bottom, the forcefulness of these actions did show signs of halting market free fall.

Is there risk of a meltdown or broader contagion?

In the near term, it does not appear that we are at risk of a Chinese economic meltdown or widespread contagion. Much of the margin lending excess has already come out of the markets. Valuations are by no means cheap overall, but are no longer eye-popping. And, while one can question the wisdom of such direct intervention in the markets, the central government has deep pockets and has demonstrated will that cannot be ignored. As for spillover to the broader economy, while the wealth impact of the fall will be painful to many investors, the breadth of market participation remained relatively low.

China's growth rate is clearly slowing and significant questions and challenges remain about the evolution of the economy. But the fall in the equity markets does not appear likely to cause a dramatic change in the existing trajectory. There will clearly be an impact on the levels of growth we had been seeing in financial services activity, and we may see some consumer impact. However, there have been modest encouraging signs in the domestic real estate markets and a significant amount of stimulus added in recent months that should go far in offsetting any market-related pain.

So what are the consequences?

In many ways, we are right back where we started. Chinese growth is slowing, local governments and corporations are overly levered, and there is a need to reform and evolve the economy towards a less capital-intensive, higher ROIC model. Unfortunately, the run-up in equity prices has not served to help de-lever the system or to shift influence farther from state-owned or controlled entities. The direction of China's economy from this point forward is highly dependent on the direction of policy decisions. The recent events have catalyzed arguments that the ambitious reform agenda laid out in the Third Plenum may have to take a back seat to short-term measures to shore up growth. I feel there is some truth to those thoughts. The levels of market intervention we have seen do not appear to mesh with promises to allow market forces to play an increasingly "decisive role" in Chinese capital allocation.

While we may see markets respond positively near term, there is a longer term cost in market confidence to a centrally planned economy that does not appear resilient enough to allow for smaller setbacks. Just as the overuse of antibiotics inevitably leads to "superbugs", an economic system that is not allowed to purge itself of excesses naturally will eventually fuel levels of risk-taking that collapse spectacularly. I believe that the investment community's level of faith in Chinese central authorities to manage their massive economy will be eroded by recent events. However, there may be a bright side. The embarrassing global spotlight (and widespread international criticism) these events have cast on Chinese authorities may well inspire newfound commitment to reforms such as improved corporate governance, a potentially powerful catalyst for future growth.

Finally, I would note that we are always intrigued by the investment opportunities that come from major disruptions. Powerful technical factors influencing the rally, subsequent fall, and the most recent interventions and volatility (including the halting of huge swaths of the equity markets) appear in a notable number of cases to have created significant dispersion of gaps between underlying fundamentals and valuations across markets. For patient investors with the resources and skill to research and investigate these situations, there may well be exciting stock-picking opportunities through this "sorting-out" period.