ARTICLE
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For professional investors

Chinese shares catch up with reality

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- **Mainland stocks lose one-third of their value in three weeks**
- **Rally had been fueled by private citizens with little experience**
- **Government steps in with liquidity measures to stop meltdown**

Investors who have been fixated on Greece are missing a far bigger picture: the potential for the USD 8 trillion Chinese stock market to implode, warns Robeco's head of asset allocation.

After enjoying an astonishing bull market for 18 months, Chinese stocks lost one-third of their value in the three weeks since mid-June. A major problem this time is that the rally was fueled by millions of ordinary Chinese citizens who opened equity trading accounts to try to make easy money, without necessarily having had access to investment advice.

While Greece has captured the headlines, the Chinese stock market is 34 times bigger than Greece's GDP and 23 times the size of the country's notorious debt pile, even after the recent share price correction.

The sudden fall in values has raised fears of a repeat of the 2008 crash, though the Chinese authorities will likely provide some cushion after stepping in with extra liquidity measures at the weekend, says Lukas Daalder, Chief Investment Officer of Robeco Investment Solutions.

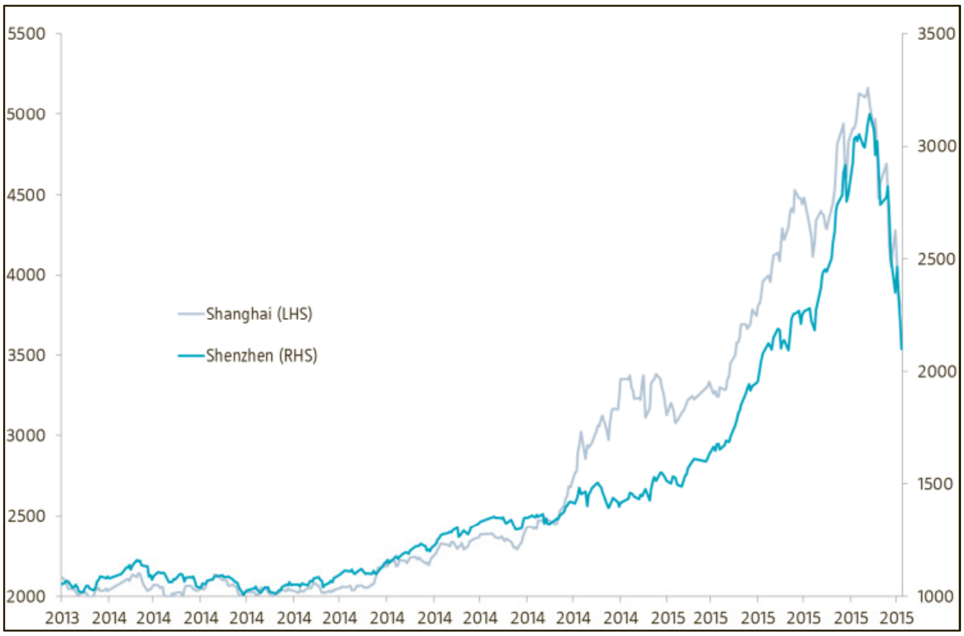
'The rally was fueled by millions of ordinary citizens trying to make easy money'

Dislocation with underlying earnings

He says the sudden fall in China's stock market also should not come as a surprise as valuations had moved heavily away from underlying earnings. And while there is currently a dislocation between the two, true Chinese growth does remain strong.

"There were numerous arguments to explain the strong rally, including economic reforms, rate cuts, low valuations (initially at least), and a shift from speculative money from real estate to equities," says Daalder. "But one argument that has been missing here is the role of the underlying economy, and how much of the rally has been based on fundamentals."

China has two mainland stock markets, the bigger Shanghai Composite and its neighbor, the Shenzhen Composite. Together, the market cap of these two indices currently amounts to USD 8.5 trillion, which makes the Chinese overall market the



biggest in the world after the US.

The bigger they rise, the harder they fall. Source: Bloomberg, Robeco

A-shares 'lead a life of their own'

"One specific characteristic of the Chinese market is that part of trading is restricted to Chinese citizens (the so-called A-shares). As a consequence, these markets tend to lead a life of their own, showing limited correlation with – for example – the MSCI China, the Hong Kong Hang Seng or the MSCI World."

He says this can clearly be seen by looking at the price development of these two exchanges over the last 18 months. From the start of 2014, the Shenzhen index rose by close to 200%, while the Shanghai index staged a 146% rally, and the MSCI China rose by only 35% in that timeframe.

"As a result of this rally, the mainland China market cap broke the USD 10 trillion mark by the end of May, which means that this is the biggest 18-month rise in absolute market cap on record, even surpassing the famous 'wealth' increase booked by the rally in the Nasdaq in 1998-2000," says Daalder. "The rally continued until the middle of June, after which the decline set in. It took the market just 14 trading days to drop into bear market territory (a drop of 20% or more), which is probably another record for a major stock exchange."

'It was the biggest 18-month rise in absolute market cap on record'

Lost relationship with production

Daalder argues that the market has moved away from equity price rises that reflected underlying economic activity, thereby creating bubbles in parts of the market. "One way to look at this is by looking at the relationship between the Shanghai Composite and the Purchasing Managers´ Index, the index that measures producer confidence, which generally is seen to be one of the more reliable indicators of economic activity," he says.

The chart below shows that whereas the 2008-2009 rally (and subsequent decline) was closely matched by underlying economic activity, this does not apply in the current situation.

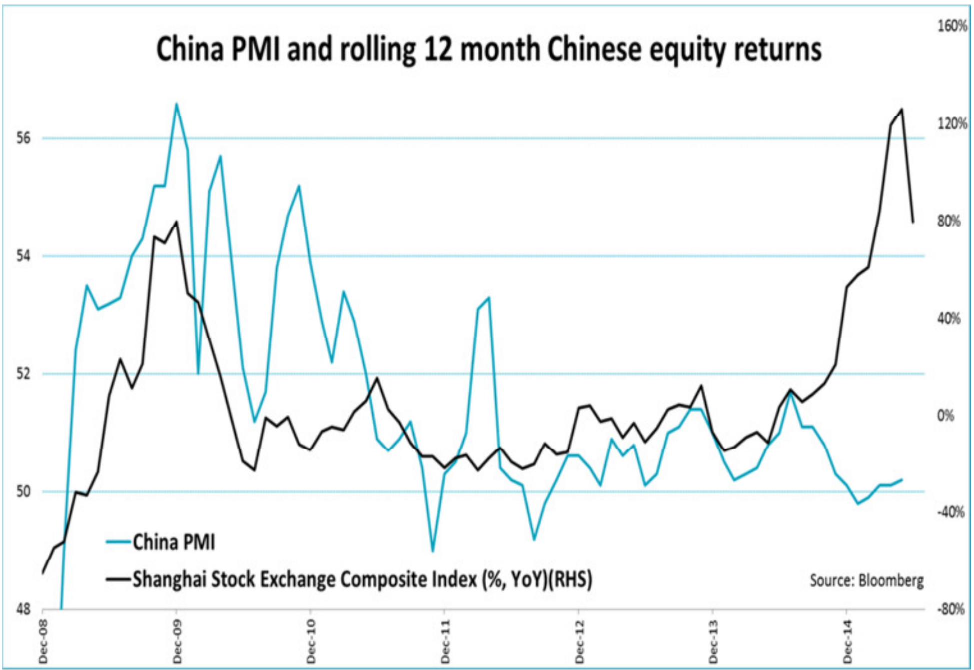


Figure 1 Figure 2 Mind the gap: stock price rises have dislocated from the economy. Source: Bloomberg, Robeco

So why then have Chinese stocks continued to rally for so long? "Partly it has been linked to the expectation of lower lending rates that the Chinese authorities would start to stimulate the economy once again," explains Daalder. "This expectation turned out to be correct, as the various lending rates have been steadily lowered in recent months. However, the most recent rate cut, administered at the end of June, failed to inspire the stock market."

"The real underlying driving force though has been the stellar rise in interest by the Chinese retail investor. In April and May alone, 14 million accounts were opened enabling retail clients to start trading in Chinese A-shares. An important element is that many of these new investors financed their purchases by borrowing money, which has led to a strong rise in official as well as not-so-official lending facilities. Another key element is that a large part of these newcomers lack market experience. It is a classic herding example."

'Many of these new

ROBECO

Bubble bursting remains painful

And the outcome may be messy for those investment newbies, he warns. "A stock market that is rallying away from fundamentals, driven by investors who are probably not aware of the risks involved, and who finance themselves by taking on debt: this sounds like a classic bubble. A bubble that is in the midst of bursting, by the looks of the sell-off we have seen during the last three weeks."

"And as we have learned in recent decades, the bursting of a bubble is a painful event. The wealth destruction, the debt overhang and bankruptcies all hamper economic growth, and even though this is a local event, we are talking about the second-largest economy in the world that is affected."

investors financed their purchases by borrowing money'

Daalder says it remains quite likely though that the Chinese authorities will act to prevent things getting out of hand, as illustrated over the weekend when the government pumped fresh liquidity into the market, enabling margin financing for stockbrokers.

"Given the negative spillover effects to the broader Chinese economy, we expect the authorities to remain interventionist as much as possible. This does not mean that they will be aiming to get the stock market back up to the levels seen in mid-June, but they have a clear interest to lower the current volatility seen in the market."

Read the full Monthly Outlook <here>