Russell Investments

Market Update

Volatility in China: What you need to know

9 July 2015

While news about Greece's economic crisis has dominated headlines over the last few weeks, turmoil in the Chinese markets has also raised concerns. In this short article, we'll provide an overview of what's happened, why it matters to global investors and our investment strategists' views on short- and long-term impacts.

Background: What's happened in the Chinese stock market?

The China A-share market—the market used by domestic Chinese investors—has dropped sharply since mid-June 2015 following 150% in gains over the prior 12 months. Keep in mind that the China A-share market does not reflect the experience of most foreign investors into China (who mainly invest in China's H-share market).

Before recent declines, the China A-share market was driven disproportionately by monetary conditions rather than by economic growth, as the economy finally slowed and as monetary policy was finally eased.

Chinese stocks had crashed in 2008 in tune with the rest of the world; but in contrast to Wall Street in particular, they continued to languish near financial crisis lows right through to mid-2014. This outcome was despite an ongoing debt-fuelled expansion in the Chinese economy over that period, and resulted in part from the backdrop of relatively tight Chinese monetary policy through those post-crisis years.

How could recent declines in the Chinese market affect global investors?

Current developments in the Chinese equity market and economy matter to global multi-asset investors from a range of perspectives including:

1. **The direct impact of falls in the Chinese domestic equity market.** This is relevant because the recent sharp falls:
   - **Create losses for the small subset of global investors who are relevantly licensed, and who are invested directly in A shares**. Overall, Chinese market returns are still positive for 2015 as a whole however.[1]
   - **Dampen Chinese consumer sentiment.** Around 80% of the A-share market is held by individuals, rather than institutional investors. Cooling sentiment is consistent with Russell Investments' expectation that Chinese GDP growth is slowing from a 7.0 – 7.5% rate in 2014, to around 6.5% to 7.0% in 2015.
   - **Are triggering distress in finance companies and stockbrokers at the heart of the boom-turned-to-bust.** Aggressive, targeted policy easing by the Chinese government is mitigating this risk.
   - **Will likely elicit ongoing monetary easing**, which will be supportive of the economy and – eventually – of equity prices.

[1] As of 9 July 2015.

2. **A more modest impact on China's H-share market.**
   - Just as the extreme swings to the upside in the China A-share market were only very modestly mirrored in the China H and MSCI China Indices (i.e. the indices to which most foreign investors are exposed), so too the downside is proving to be more muted in those indices.
3. **Sentiment impacts on other global equity markets.**
   - We believe that volatility in China could have relatively contained impact on sentiment in other global equity markets– just as the extraordinary boom in the Chinese market from June 2014 through June 2015 was itself idiosyncratic.

What are the implications for New Zealand?

If the Chinese economy slowed very meaningfully, it could trigger a drop in Chinese imports from New Zealand. In our view, that is a lower risk because of the stimulus instruments being deployed in China (e.g. interest rate cuts, cuts to reserve requirement ratios and directives for Chinese pension funds to invest in shares). Declines in New Zealand's exports to China may reflect weakness in the New Zealand dollar along with a fall in underlying volumes.

What does Russell Investments expect going forward?

In the shorter term, there may be more declines in Chinese markets to reflect the country's economic and earnings slowdown – and that is what we are witnessing here, in mid-2015. An unwinding of the euphoric, margin-fuelled buying excesses of the first half of 2015, is also required, and is now occurring.

Further short-term volatility is certain, but we are optimistic about the medium- to longer-term value and growth opportunities in the China A-share market. Over the next one to two years, we expect monetary easing to steady the slowdown in the Chinese economy and to restore better growth in activity and earnings.

FOR FURTHER INFORMATION:

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