Bull In A China Shop… Or A Bubble About To Pop?

(From right to left:)

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International markets have had their fair share of headlines in the last year, including the Russian issue, the Greek financial crisis, and historic moves in major currencies. Amid all of this noise, a notable story has been relegated to second-tier news – the tremendous bull market emerging in Chinese equities. Since its relative strength bottomed on 5/14/14, the MSCI China Index is up more than 50%, outpacing the MSCI All-World Index (ACWI) by more than 40%. Even more notable, in our view, more local indices like the CSI300 A-Share Index (more on A-shares below) are up more than 2x MSCI China – all the while, Chinese macroeconomic growth has continued to slow precipitously. So, what's up?

WHY ARE CHINESE MARKETS GOING UP?

- **Central bank stimulus in the face of poor growth:** Even casual observers are aware of the growth slowdown China has been experiencing worsening since the real estate downturn in mid-2014. The government, in response, has reversed its formerly tight monetary policy with a widening range of stimulus measures and rate cuts. Most recently, this came in the form of a Reserve Requirement Ratio (RRR) rate cut of 100 basis points ("bps" = 1/100th of 1%) -- an historic move that should encourage banks to increase lending. One major Chinese local investor recently suggested that the People's Bank of China (PBoC) may now be playing the same game that other major central banks have been for some time – combating deflationary forces via monetary policy – with similar potential effects on risk assets.

While certain parts of the Chinese market are exhibiting classic signs of "bubble" behavior, we believe the H-share dominated MSCI China Index is still reasonably valued and likely to remain in a bull market trend for the foreseeable future.

- **Financial market liberalization driving higher valuation**: The last few quarters have seen an unprecedented amount of free-market reform in Chinese securities, including the Hong Kong-Shanghai Connect (opening up certain local Chinese stocks to non-Chinese investors); the widening of the trading bands of the Chinese yuan; greater transparency in government bonds; and the announcement of more equity connections to follow; allowing capital to more freely move in and out of China. Theoretically, this should lead to a higher warranted valuation for stocks.
- **"Process of Elimination" theory:** In China, a nation of high savers with limited investment options, excess capital generally gets allocated to four main areas: real estate, bank deposits, higher-yielding "wealth management products" (WMP), and equities. With recent rate cuts hurting deposit real returns (and more likely on the horizon), real estate now in a full-blown bear market, and the government actively trying to rein in WMP-driven debt, Chinese stocks appear to be a logical place for capital migration -- especially given recent momentum. Given the economic boost from the "wealth effect," we believe the government privately welcomes strength and will not restrict its growth much from a regulatory perspective.

IS THE CHINESE MARKET IN A "BUBBLE"?: Chinese stock markets have a myriad of indices, share classes, and listing domiciles. One way to segregate is to look at "A-share" stock indices – stocks of local Chinese companies, denominated in yuan, which until recently were traded primarily between local investors on the Shanghai or Shenzhen exchanges -- vs "H-share" stocks, which are traded in Hong Kong Dollars (HKD) on HK exchanges and have been widely available to international investors. While there is some overlap between holdings (aka "dual-listed" shares), the A-share and H-share markets have meaningfully different sector compositions and characteristics. Not surprisingly, they also have different price action and valuations. In the A-share market, we believe real signs of froth are emerging, with valuations somewhat elevated (see Chart of the Week, below), and flow data suggesting a large number of new accounts and margin debt opened, as well as shortened holding times for accounts (signs of day-trading mania). Even more convincingly, smaller-cap, higher-tech "New China" indices, such as the SME-Chinext 100 Index and the CSI 500 A-Shares Small-Cap Index are trading at valuations we would now consider historically associated with market bubbles – trailing price-to-earnings (P/E) multiples between 30-55x, depending on index and data provider.

However, in the H-share dominated MSCI China Index (the one we follow most closely), we believe the market is NOT exhibiting bubble signs yet on a valuation basis (see Chart of the Week, below). Notably, some of the recent move may just be catch-up. Until last year, Chinese stocks exhibited disappointing recent performance; including 2010-13, when China large-caps were essentially flat, underperforming global markets by about 50% despite reasonable earnings growth.

WHY MIGHT THIS BULL RUN END?: It's difficult to pinpoint exact causes for bull markets to end; however, investor euphoria (as measured by valuation) has historically been a pre-condition. In the past, this euphoria in China has manifested itself in significant share dilution via the issuance of poorly considered IPOs drowning the market with liquidity. Thus, we will be watching valuation and share issuance very carefully. However, this dilution may be offset by increased institutional investor demand for Chinese shares in the future if index providers such as MSCI start adding local Chinese A-shares to widely followed emerging market indices, which we think is a distinct possibility in the years to come.

More broadly, a change in market psychology caused by a re-tightening of monetary or regulatory policy from the government is also a risk; however, for the reasons mentioned above, we view these as generally not near-term concerns. And while a collapse of China's shadow banking system is always a risk, China's non-democratic processes and massive amounts of foreign currency reserves may mean that debt crises in China can be dealt with more swiftly and less publicly than in other economies.

RIVERFRONT BOTTOM LINE: **While certain parts of the Chinese market (small caps and "new China" technology, in particular) are exhibiting classic signs of bubble behavior, we believe the H-share dominated MSCI China Index is still reasonably valued and likely to remain in a bull market trend for the foreseeable future. Furthermore, we believe the factors driving Chinese markets may also benefit tertiary markets related to China, including Hong Kong and perhaps Taiwan and Singapore. Thus, while we remain underweight on emerging market stocks in general, in our growth portfolios we have an overweight position in Emerging Asia (including China) relative to Latin America and Eastern Europe/Africa.**

CHART OF THE WEEK: Chinese H-Shares Not Yet At 'Bubble' Valuations

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Small-cap companies may be hindered as a result of limited resources or less diverse products or services and have therefore historically been more volatile than the stocks of larger, more established companies. Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability. Technology and Internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

Index Definitions (It is not possible to invest directly in an index.)

MSCI China Index is designed to measure the performance of the top 85% of equity securities by market capitalization in the Chinese equity markets.

MSCI ACWI (All Country World Index) is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets.

CSI300 Index consists of 300 stocks with the largest market capitalization and liquidity from the entire universe of listed A share companies in China. Launched on April 8, 2005, the index aims to measure the performance of all the A shares traded on the Shanghai and Shenzhen stock exchanges.

SME-Chinext 100 Index tracks the performance of the 100 largest and most liquid China A-share stocks listed and trading on the Small and Medium Enterprise ("SME") Board and the ChiNext Board of the Shenzhen Stock Exchange.

CSI 500 China A-Shares Small Cap Index aims to track 500 small cap companies listed on the Shanghai and Shenzhen stock exchanges.