



What can we learn from China's stock market meltdown?

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China has been a major contributor to economic growth and low global inflation for more than two decades. However, after Black Monday, the world is pondering whether it is a start of a new and alarming phase of a crisis that would trickle down to the rest of the world. While authorities across the world strive to mitigate the adverse effects of the crash, it is vital to reflect upon the lessons Black Monday taught us.

What happened to the Chinese equity market?

In mid-2014, China's stock market began to boom despite the country's increasingly gloomy economic outlook. The relaxation of regulation designed to prevent ordinary investors from buying stocks with borrowed money would have fuelled the boom. The Shanghai Exchange had shot up by 135 percent and the Shenzhen Exchange had gone even higher by 150 percent in less than a year.

Gradually stocks began to be a sure bet for Chinese investors who dreamt of quick wealth. With the increase in participation equity returns became much more lucrative than traditional low-interest banking instruments. Steadily rising prices delivered the current President Xi Jinping's 'Chinese

dream' (zhongguo meng) of wealth, wellbeing and power to individuals and the nation as a whole. Thus, the government large heartedly supported the boom.

Attracted by casino-like profits during the boom, more investors flocked to the thousands of brokerage houses in order to buy and sell while staring up at boards that recorded the rise and fall of equity prices. The market penetrated to the all strata of society. Most of them entered the market with borrowed money some of them even pawned their houses and land.

The Chinese government continued to provide stimulus to the overheated market through state media. In early April, China's state news agency Xinhua published four articles linking a strong stock market to a strong economy. The overseas edition of the People's Daily followed up, pushing the bull market as key for growth.

Figure 1: Movement of the SSE

SHANGHAI STOCK EXCHANGE COMPOSITE INDEX

In the last year



Source -<http://www.vox.com/2015/7/8/8911519/china-stock-market-charts>

The fact that stocks were climbing while the economy and company profits were cooling should have been an unmistakable warning of a bubble, but it caused surprisingly little concern. However, in early 2015, authorities became concerned as stocks had become overvalued. This led to unprecedented intervention by the government, which triggered the stock market decline that began in June 2015.

After peaking in mid-June, stock prices tumbled down. By July nearly US \$ 3.5 trillion of wealth was wiped off from the market (more than the total value of India's stock market).

In spite of intervention it was particularly embarrassing when stocks began to fall and it reached an eight-year low on August 24, 2015. When markets in Shanghai closed on Monday, stocks were down by 8.5percent - the Shanghai Composite's worst single-day fall in eight years. The People's

Daily, the Communist party's mouthpiece, declared the day 'Black Monday'. The roots of Black Monday lie in the Chinese Central Bank's surprise decision to devalue its currency earlier this month (refer Figure 2 and 3). In theory, this should have provided a boost to the economy by making exports more affordable to foreigners. But this wasn't enough to prevent further decline in the stock market.

Subsequently the nervousness radiated beyond the Chinese territory.

The ripple effect of Black Monday

China is too big and too deeply linked into the rest of the world's economy for its problems not to be felt outside its borders. About £74 billion was wiped off the value of the FTSE 100 and on Wall Street, the Dow Jones Industrial Average decreased by a record of more than 1,000 points. The Nikkei Index in Japan slipped by 4.6 percent. European bourses reduced by 4-5 percent. The Eurofirst 300 index has had its worst day since 2009. Germany's DAX has now lost all the gains it made in 2015.

Commodities such as crude oil and copper also tumbled to multi-year lows as investors were alarmed over signs of waning demand in the world's leading consumer of raw materials.

Figure 2- Relationship between devaluation of currency and movement in stock prices



Source -Economist

The currencies of emerging Asian economies have weakened as investors drop those assets as they feel it is riskier to hold them. It is interesting to note that the VIX index, a measure of fear in markets, jumped this week to its highest level since 2011.

Did China's regulators aggravate its recent stock market bubble?

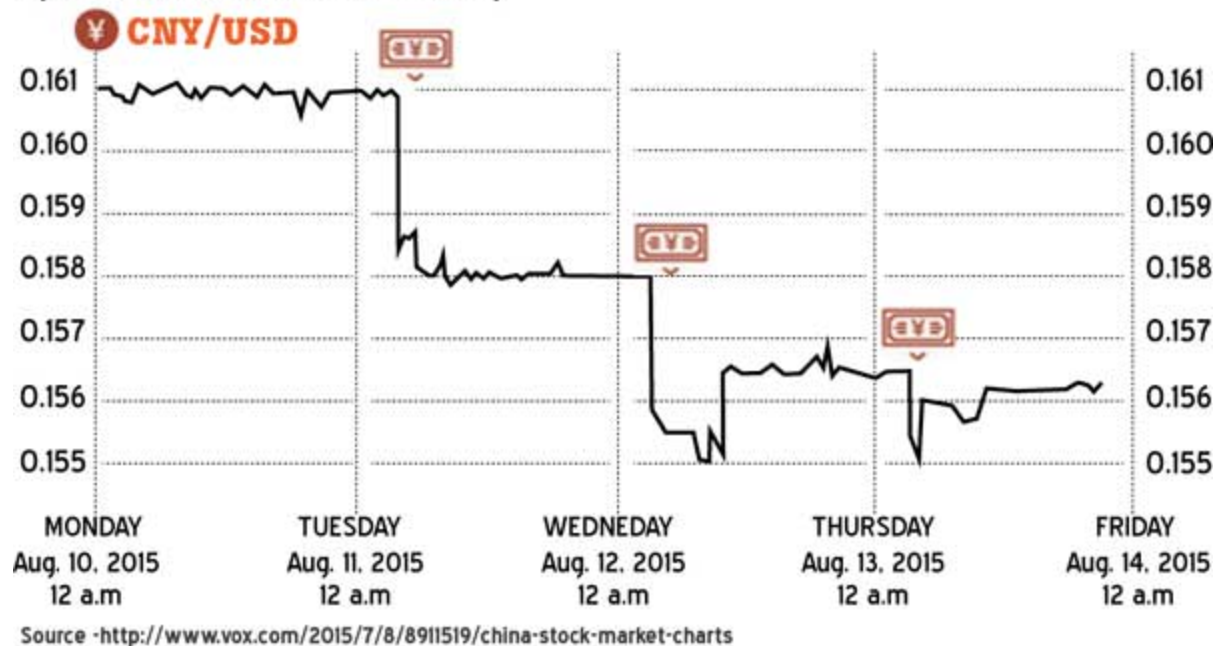
The fall of China's stock market received a lot of attention. Chinese authorities have not only taken a variety of artificial measures to try to boost the market but they have also introduced an array of regulation and policy decisions to prevent the bubble from bursting. Correction of prices within an overheated market is inevitable. However, it is questionable whether the behavior of the regulator aggravated the rise and fall of the market.

At the outset, increase in margin borrowing could be attributed to the easing of monetary policy by the People's Bank of China since November 2014. This allowed greater exposure to credit (in response to slowing growth and inflation). Chinese citizens were eager to maximize this opportunity. Nevertheless, it appears that the expected results were not achieved; instead it created a bubble in the market. One could not undermine the role of the government in encouraging investors to enter the market with the aim of projecting a prosperous economy to the rest of the world.

Once authorities realized that they could no longer fuel the market, they launched a barrage of measures to try to stop the stock market falling, which included the following:

- A 25-basis point interest rate cut and lowering of the reserves banks need to keep when they lend to companies.
- Pension funds were allowed to invest 30 percent of their net assets (equivalent to more than US \$ 100 billion) in equities for the first time in order to boost liquidity.
- China's securities regulator relaxed rules on margin financing or trading stocks with borrowed money to increase liquidity.
- China's central bank extended a 250 billion RMB (US \$ 40 billion), six-month loan to state-owned banks to "encourage banks to increase support" to weak parts of the economy.
- IPOs were restricted.
- China's central bank injected capital into China Securities Finance Corp (CSF), a state-owned company that makes margin loans to brokers.
- Authorities requested mutual funds to support the markets with their own capital.
- Regulators banned company shareholders with stakes of more than 5 percent from selling for six months. China's central bank supported the margin lending provider CSF through interbank lending, bond issuance, collateral backed financing and relending. China's securities regulator also increased purchases of small-cap stocks.
- China's banking regulator, the CBRC, allowed banks to lend money to companies using stock as collateral and ease margin requirements for wealth management customers.
- China Development Bank and the Export-Import Bank of China said they would not sell shares and look to buy more stock.
- Margin lending provider CSF continued to buy stocks to stabilize the market and the CSRC investigated "huge stock sell-offs".
- Devaluation of currency in order to boost exports.
- After Black Monday they once again attempted to increase liquidity through repurchase agreements.

Figure 3-Devaluation of the currency



Beyond Black Monday

The sudden financial panic that erupted in the market as a result of the devaluation of the currency has gradually reduced during the last few days. Stock prices rebounded in China as well as in global markets. Will the current momentum continue?

Correction in the Chinese market would continue as prices are over heated. This situation would intensify as the growth story of China has lost its grandeur.

Markets are unpredictable but financial analysts agree that increased volatility will persist after a drastic change in prices. This explains the drastic volatility in the Dow Jones Index, NASDAQ, etc.

As stated above rich-world markets have regained. But fears remain. China's economy is in deep trouble and emerging markets are vulnerable to a full-blown crisis. The long rally in advanced markets is over. Moreover, this week's panic contains the message that the malaise in the world economy is real.

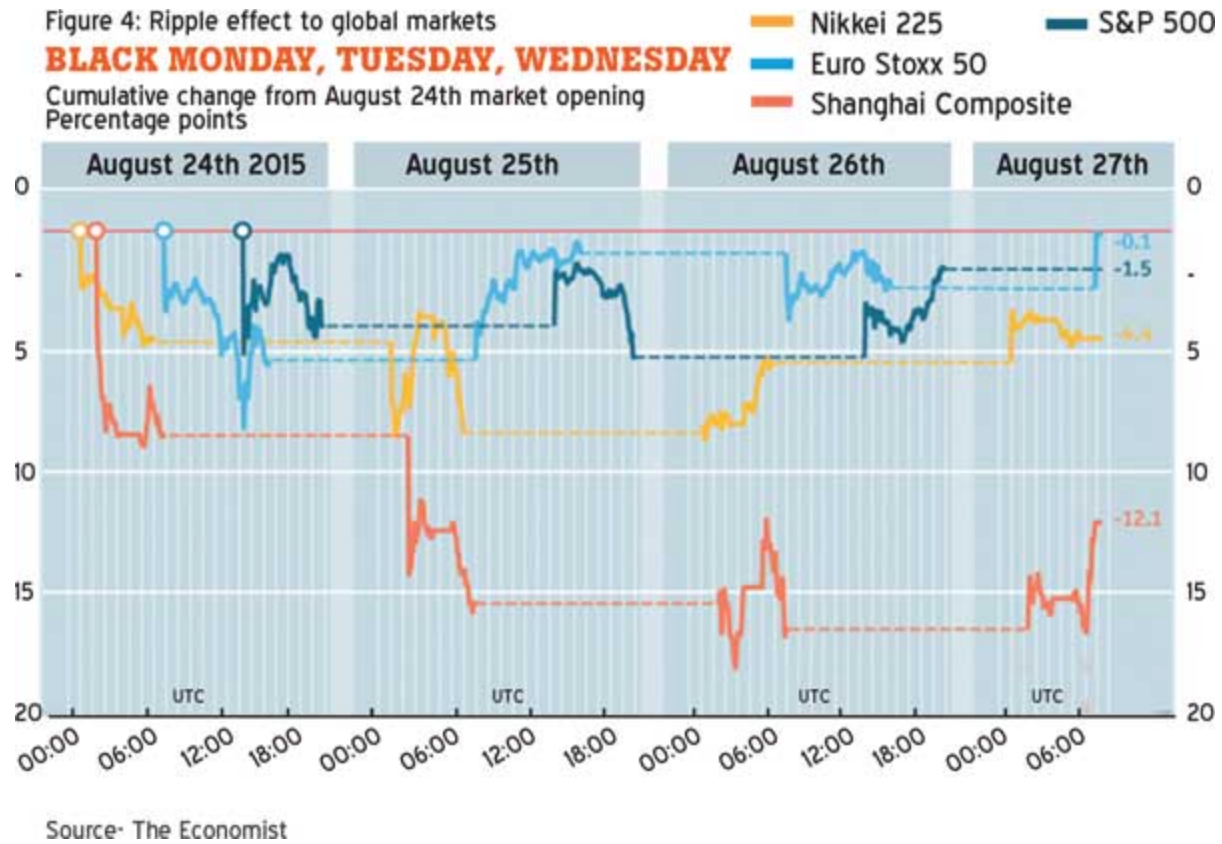
The bitter lessons

The much debated market crash/correction paves the way towards incidents other economies should ponder.

Regulator's role

Fundamentally, it is vital that a regulator clearly demarcate its role in a market. Hence, it is timely to question the dual mandate of developing the market and regulating it. The Chinese government had actively encouraged ordinary people to enter the stock market over the past year. Hence, authorities were lost for options when they saw the crash coming. This prompted them to adopt inappropriate

policies simply to deliver what they promised.



Regulations play a decisive role in an economy. Deregulation should be undertaken with caution and regulation should be consistent with the expected policies. It is undoubted that the increase in credit that was a direct result of relaxing credit policies fuelled the bubble as well as the burst. It could also be argued that ad-hoc policies adopted in mitigating the bubble would have actually intensified it. The analysis given in Figure 5 gives you a better understanding on the matter.

Sudden intervention (may it be tightening of policies or not) or even inconsistent policies could increase speculation and disrupt investor psychology that would trigger financial panic. Even Sri Lanka was faced with a similar dilemma during 2011.

The Chinese experience was also a classic manifestation of the deadly result of using financial markets to gain political advantage. It was seen how Xi Jinping's political slogan 'Chinese dream' was achieved at the cost of an overheating market. It reiterates what we addressed in our article last week.

Credit is money

It is also important to understand the gravity of investing on excessive credit. As stated, the market bubble was inflated partly due to the expansion of credit. Excessive credit could be detrimental for

the growth of a market. Along the way, margin debt surged to a record US \$ 358 billion and the number of investors passed 90 million. More than one million accounts were open (per week) at the peak of the rally. Figure 6 shows the strong relationship between stock prices and margin loans.

Margin trading is a common form of investing on credit. It might seem attractive in a bullish market. Margin service providers lend money at interest. The stocks purchased are then pledged to the margin provider. Thus, it is important for stock returns to be higher than the interest charged if we are to gain profits. This would not be possible when stocks tumble down. If the value of a stock goes below a certain level, the margin provider reserves the rights to even sell the stock to cover the loss. This could accelerate the price drop even further.

The situation intensifies if the investors obtain credit by pawning or selling valuable assets. Some of them might be the only assets they accumulated throughout their lives. It was reported that the Chinese people sold/pawned their fixed assets as houses/land and invested in the market. Some of our local investors would have learnt this bitter lesson in the recent past (especially in 2011). The Black Monday reminds us once again on the deadly price of overly trading on credit.

Figure 5: The efforts to stop the crash has failed

CHINA'S SAVAGE SUMMER

Indices (rebased)

— Shanghai Composite

— Hang Seng China Enterprises index



Source- <http://www.vox.com/2015/7/8/8911519/china-stock-market-charts>

Remember that bubbles burst

It is very dangerous to follow a hype or a bubble. Conduct your own research to form an independent opinion before you invest. This is vital if you intend to invest money on credit. With time, bubbles burst leaving many bankrupt.



Source-<http://www.vox.com/2015/7/8/8911519/china-stock-market-charts>

The market is not a casino

Many who entered the market aimed at gaining quick gains that led them to financial losses. Equity markets are generally long term and investors who don't possess the required holding capacity should reconsider their decision to enter the market. Investing with a casino mentality could also disrupt the market.

Invest in value and not junk

Investors could minimize their losses even during a boom if they focus on fundamentally strong stocks that are reasonably priced. Remember that junk stocks fall faster than the former. Investors should also be mindful about selecting junk stocks when investing on credit.

Markets move in cycles. Vigilant investors would make use of market fluctuations to maximize profits. As the market veteran, Warren Buffet stated, investors should enter the market when prices go down and exit at higher price levels. Further on, bear in mind that equity is a long-term investment, thus invest a portion of your savings.

- See more at: <http://www.dailymirror.lk/85495/what-can-we-learn-from-china-s-stock-market-meltdown#sthash.chzZkK3A.dpuf>