Equity Insight.

A bubble in China

It is more than a year since we first mentioned the words "bubble" and "equities" in the same sentence. At the time, internet stocks appeared to be very frothy. Things have calmed down a bit since then, but perhaps it only seems that way because internet stocks have been eclipsed by an even greater and frothier bubble in some Chinese equities.

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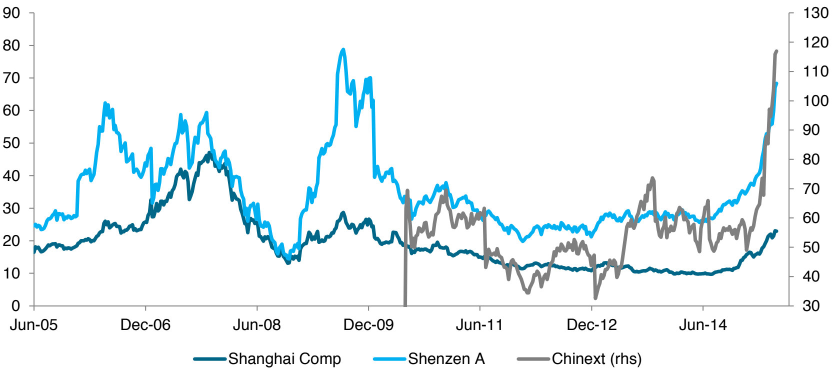
We feel quite confident in saying that there is a bubble in significant parts of the Chinese equity market, but timing its implosion is much more difficult. Let's start at the beginning: how can we be sure that there is a bubble? There is no set definition of a bubble, but China ticks the box on many factors often associated with bubbles.

The first and most important indicator of a bubble is extreme valuation. A brief look at the technology-heavy Chinext Index trading on a p/e ratio of 120 and the small cap dominated Shenzhen A Index p/e ratio of 70, both of which exceed the valuation of the Nasdaq at its 2000 peak, is all that's required to tick this box (see **figure 1**).

Figure 1. P/E ratios in different parts of the China A-share market



Source: LGIM, Bloomberg L.P.

Trading activity in Chinese equities is reaching frenzied levels. Around 4.5 million new A-share accounts are currently being opened every week, exceeding the peak speed of account openings during China's last bubble in 2006/07 by three times (see **figure 2**). And these accounts are not sitting idle, with trading volumes adjusted by market capitalisation also making new highs.

Higher trading activity is fuelled by increasing leverage. There is no perfect way to measure the total amount of leverage being used, but even what is captured by official margin debt and equity derivative statistics has shown incredible growth rates over the past few years. When adding conservative estimates for the more opaque umbrella trust products, Chinese leverage already exceeds that of US markets and growth rates have not yet shown any signs of slowing down.

Prices are de-coupling from fundamentals. The rally has been exclusively driven by multiple expansion. This is perfectly normal when investors anticipate a

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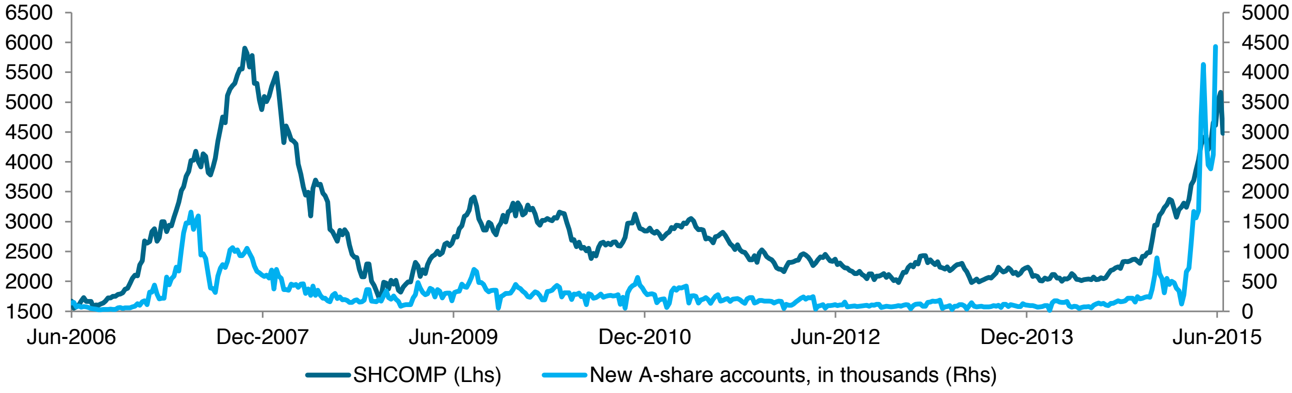
Figure 2. New A-share account openings



Source: LGIM, Bloomberg L.P.

sharp acceleration in earnings growth, but that's not the case in China. While there are some extremely bullish bottom-up analyst forecasts for individual companies, from a top-down perspective there is little in the Chinese macro story to give us confidence in an earnings improvement on the scale required to justify the 150% rally in the Shanghai Composite.

Bubbles are often built on heroic assumptions like the new-growth paradigm in the TMT bubble of the late 90s. In China's case the assumption seems to be that corporate fundamentals don't matter because the government is underwriting the rally; an impression easily gained when listening to policymakers' comments over recent months. It seems clear that the government wants a strong equity market for a variety of reasons, chiefly to achieve a less debt-heavy corporate funding mix and to facilitate the reform of state-owned enterprises. It is also fair to say that the government is not actively acting to deflate the bubble, despite having the tools to do so.

While it seems clear to us that we are dealing with a bubble in some parts of the Chinese equity market, not everyone agrees. One of the main counterarguments is that foreign investors have not participated and that this could still happen, boosting share prices further in the process. To us, it seems more likely that this will not happen beyond some index-driven buying as A-shares are gradually included in global indices. But even if one buys into this bullish argument, it is not something that is likely to prevent the bubble from imploding; rather the catalyst will be something that upsets the confidence of domestic investors.

The second counterargument is that we should not worry because the government is in control of the equity market and will be able to engineer a gradual bull market and prevent a sharp correction. While policymakers are clearly powerful, there is little evidence the Chinese government has been successful at preventing drawdowns in the past: the Shanghai Composite fell 72% when the 2007 bubble imploded and there was a 50% decline from 2009 to 2013.

Finally, some argue that the bubble is concentrated in specific parts of the Chinese market, but has not (yet) spread to all stocks. This is true but, while valuations of broad indices like the Shanghai Composite look less extreme than for the Chinext or Shenzhen A, at 20 times earnings they are also far from what would be considered cheap. Additionally, and arguably more importantly, the history of bubbles shows that this would offer little to no protection if the bubble in isolated pockets were to implode; there tends to be very little differentiation in such situations.

From an investing perspective, timing the end of a bubble is extremely difficult; how crazy is too crazy? Correctly diagnosing a bubble, but being too early in betting against it carries some risk as well. To us, there are two factors that are most likely to end the bubble. Bubbles don't tend to burst because of overvaluation; it requires a catalyst. For most bubbles, that catalyst has been, or has coincided with, the end of the global bull market. But, given that the Chinese bubble has been predominately driven by domestic investors, the catalyst could be anything that undermines the key assumptions behind the sharp rally, which is that the government is stimulating the economy and is underwriting the equity market.

From our perspective, we are mindful of the Chinese equity bubble. At this stage the implications of the bubble bursting for global growth should be limited, but this assessment can change if the rally continues and spreads to the wider Chinese market. At the very least, we prefer to stay well clear of exposure to assets that meet the criteria outlined above.

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