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MACROCOSM

China: Toil and Trouble, but No Bubble

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Donald Luskin

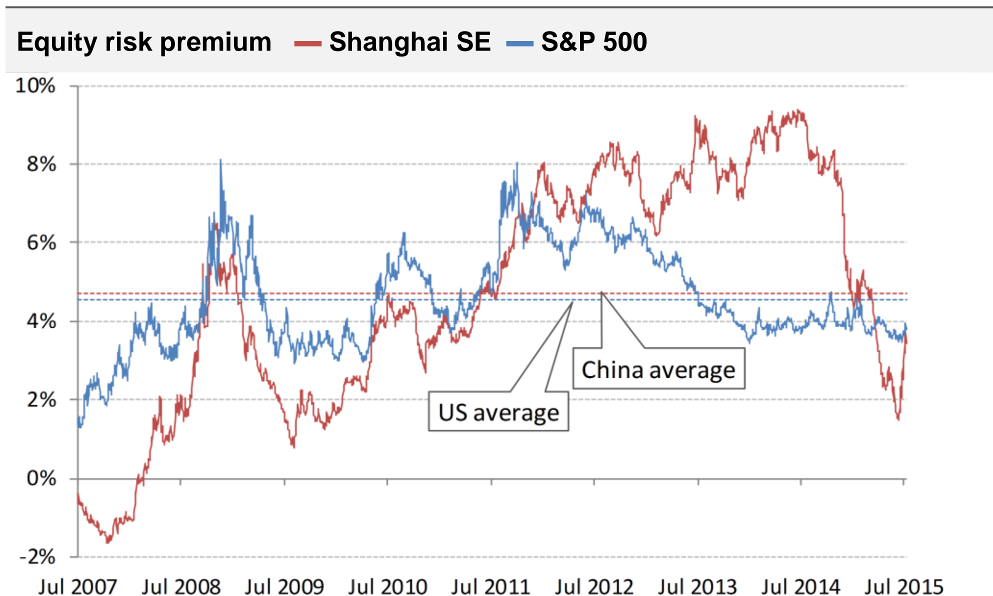
A blow to confidence, but Chinese stocks are now valued about the same as US stocks.

We can't bring ourselves to get especially alarmed by the crash in Chinese stocks. To be sure, all booms are eventually followed by busts -- and the China boom of the last two decades has been the biggest boom in history. But everyone has been looking for tipping points, black swans, canaries in the mineshaft and last straws for so many years now, when one finally comes along, how will we know *that* particular event was really the warning signal? It might be like looking through a shuffled deck of cards waiting for the ace of spades to come up. You know it will eventually. But if the three of diamonds happens to be the card that comes up just before it, when the ace of spades shows up next should we think the three of diamonds somehow caused it to?

Why would a stock market decline that just brings prices back to where there were about three months ago cause an economic calamity? And the Shanghai Stock Exchange Composite Index's free float market cap is only about 18% of China's GDP (compared to the S&P 500, which is 106% of US GDP). So we see this as a small event occurring within a small context.

And we don't see how Chinese stocks can be called a bubble. There may be valuation anomalies in individual companies or sectors, and great

Equity risk premium — Shanghai SE — S&P 500



Source: Bloomberg, TrendMacro calculations

Update to strategic view

EMERGING MARKETS STOCKS, EMERGING MARKETS MACRO: The crash in Chinese stocks is an overblown bear narrative. On the Shanghai Stock Exchange, stocks merely returned to where they were three months ago. The run-up to the mid-June peak was a long overdue catch-up after years of being the most undervalued stock market in the world. Today the Chinese equity risk premium is about the same as that of the US, and the Chinese price/book ratio is more favorable. This episode has been a blow to confidence in both stocks and the Chinese authorities. But in time memories may change on that, and investors may conclude that a put is firmly in place. And China should continue to benefit from lower oil prices. Too soon to catch the falling knife, but we are generally optimistic.

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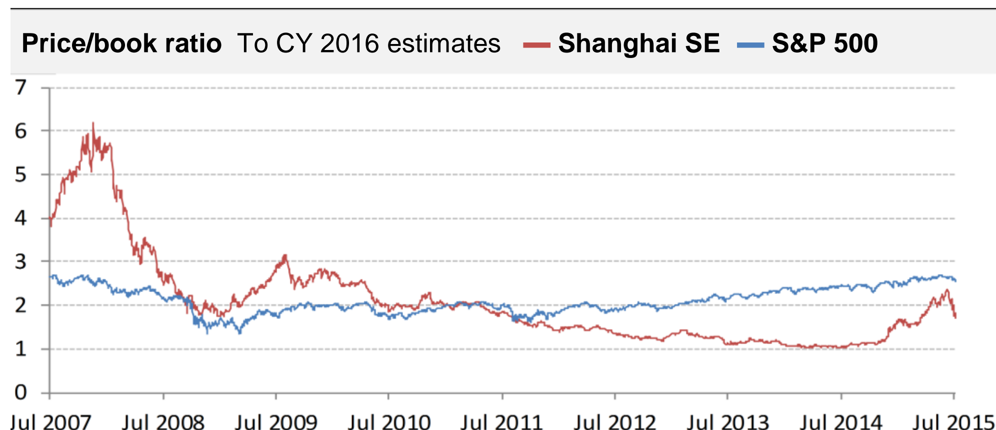
enthusiasm by retail investors. But in the aggregate, the Chinese equity market's valuation looks pretty similar to that of the US.

- The equity risk premium -- the forward earnings yield minus the 10-year government bond yield -- for the Shanghai Composite is about 3.43%, which is 1.29% below the crisis-era mean (please see the chart on the first page). For the S&P 500, the equity risk premium is only slightly higher at 3.81%, which is 0.75% below the mean.
- The price/book ratio of the Shanghai composite is 1.79, well below the S&P 500's 2.56. Even at the peak in mid-June, Chinese stocks were cheaper by this measure (please see the chart below).

Price/book ratio To CY 2016 estimates — **Shanghai SE** — **S&P 500**



Source: Bloomberg, TrendMacro calculations

- *By both metrics, Chinese equities were substantially cheaper than US equities from 2012 to 2014. What appears to be a massive run-up this year is, in fact, more of a catch-up.*
- Indeed, we have noted all along that Chinese stocks were the most undervalued of any market we follow -- but were concerned that they were a value trap. We started getting interested a little early, in March of last year, as we saw emerging markets having fully survived the "taper tantrum" (see "Crimea River" March 4, 2014). We singled China out particularly as we thought through which countries would be the biggest beneficiaries of the new regime of cheaper and more abundant oil (see "2015: Oil Change for the Global Economy, Non-US Edition" December 31, 2014).

The worst thing that we can say about it is that it is a risky blow to confidence in the omnipotence of China's central planners, who are seen by many -- rightly or wrongly -- as the only force keeping China from collapse. We've heard many clients opine that the stock market run-up was somehow deliberately engineered to replace the deflated real estate bubble -- and now this bubble has deflated too, so the authorities have run out of runway. But we know of no actual evidence for that theory.

But whether or not the authorities made stocks go up in the first place, they have done themselves and the markets a grave disservice by making so many highly visible inventions to arrest the crash. Doing so takes investors out of the rational domain of fundamentals and valuations, and forces them

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instead to guess what arbitrary actions various institutions will take. Such "regime uncertainty" was, arguably, a terrible accelerant of the financial crisis of 2008 and 2009 (see "Death by Rescue" November 17, 2008), when from weekend to weekend investors had no idea which firms would be rescued (and why, and how), and which not (and why not).

So in China, as stocks continued to fall -- supposedly despite the interventions -- investors lost confidence in the authorities, who were seen as powerless, and concluded that stocks must have been extremely weak to have not responded to the authorities' efforts. Then for the last two days as stocks have recovered -- supposedly because of the interventions -- investors don't gain any true confidence in them, because rising stock prices are seen as artificial. So stocks up or stocks down -- confidence is eroded either way.

Where does all this leave us? Basically, we see Chinese stocks as valued about like stocks in most developed markets such as the US. But we still see China as a prime beneficiary of lower-price and more-abundant oil, especially as the RMB peg to the US dollar confers upon China all the benefits (which are partially devalued away in Japan and Europe). To be sure, confidence in China and Chinese stocks has been dealt a blow. But if the volatility of the last three months proves *not* to be the long awaited canary in the Chinese mineshaft, then oddly this episode might do much to restore confidence. With benefit of hindsight (which consists in large part of forgetfulness), investors may conclude that the implicit put option conferred by the authorities proved its mettle in this episode.

It feels to us a bit much to take this exact moment to try to catch the falling knife, despite two days of countertrend rallying. We'll watch and wait, but our general predisposition is optimistic overall.

Bottom line

The crash in Chinese stocks is an overblown bear narrative. On the Shanghai Stock Exchange, stocks merely returned to where they were three months ago. The run-up to the mid-June peak was a long overdue catch-up after years of being the most undervalued stock market in the world. Today the Chinese equity risk premium is about the same as that of the US, and the Chinese price/book ratio is more favorable. This episode has been a blow to confidence in both stocks and the Chinese authorities. But in time memories may change on that, and investors may conclude that a put is firmly in place. And China should continue to benefit from lower oil prices. Too soon to catch the falling knife, but we are generally optimistic.