Sujet: La bourse chinoise sur le point de rebondir / Chinese equities set to rebound

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CHINA ECONOMICS UPDATE

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CAPITAL ECONOMICS

How much should we care about Chinese equities?

- **We expect a big rebound in Chinese equity prices in the second half of 2010 as fears about policy tightening wane and the economy heads to a soft landing. However, rising prices will not give much of a boost to spending in China. Markets elsewhere may benefit from rising optimism, but limited foreign involvement in Chinese markets means the direct spillover to global markets will be small.**

- The price/earnings ratio of Shanghai equities has dropped below 20 for only the third time in a decade as fears of policy tightening have dragged prices lower. We think these fears are overstated. Both consumer and house price inflation look set to peak in the next few months, without the need for further tightening. Meanwhile, economic growth is set to slow as the impact of stimulus measures wanes, but a hard landing is a remote possibility. Loan growth remains strong and the campaign against property speculation could end up driving new flows into equity markets. Of course, Chinese equity markets do not function well as a barometer of the outlook for the economy (or, for instance, commodity demand). **But the macroeconomic data suggest the stage is set for what could be a strong rebound**.

- If we are right, the ride will still be bumpy. Consumer price inflation will continue to rise for a while, which means overheating fears will not vanish. Interest rate hikes are unlikely, but required reserve ratio increases, which are widely (if wrongly, in our view) interpreted as a form of policy tightening, will continue, particularly if renminbi/dollar appreciation resumes. Negotiations within government on the implementation of a property tax will prolong investor uncertainty. **We expect the Shanghai Composite to rise 20% over the rest of 2010 to finish at 3100, but acknowledge that uncertainties abound.**

- What impact would such an equity market rebound have on China's economy and on markets elsewhere? Just as fundamental economic conditions are only weakly reflected in China's equity market performance, so **there is little sign that rising equities have much impact on the real spending behaviour of Chinese households**. For example, the Shanghai Composite doubled in 2007 but real retail spending growth held steady. This was probably partly due to the speed at which markets then moved – investors had little time to adjust to the increase on their portfolios' paper value before the market turned. The markets are also relatively small – the tradable portion of the Shanghai and Shenzhen markets is equivalent in value to around 45% of GDP, well below the global 64% average. (See Chart 1.) Equities make up a very small portion of most Chinese households' financial assets.

- China's economic size means that its markets account for a significant share of the global total. The tradable portion of the Chinese markets was equivalent to 6.0% of the global total at the end of 2009 (9.6% if Hong Kong is included) compared with 8.8% for Japan, 7.4% for the UK and 33.1% for the US. **Even so, capital controls ensure that share movements in China have little direct impact on the portfolios of international investors.** Direct foreign involvement in China's markets is limited to the $17bn currently invested through the Qualified Foreign Institutional Investor scheme, forcing overseas investors to seek exposure through proxies, such as the shares of Chinese firms listed abroad. (See Chart 2.) **That said, movements in Chinese markets do on occasion affect markets overseas through their impact on investor sentiment. In the short-term then, substantial gains in China might help markets elsewhere, but limited direct links suggest the long-term impact on global markets will be small.**

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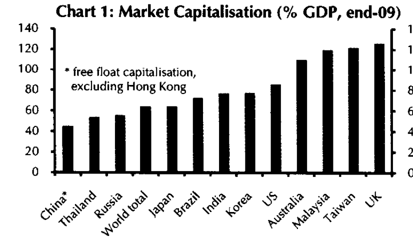
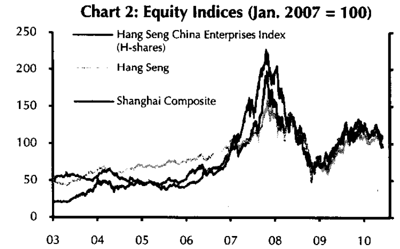
Chart 1: Market Capitalisation (% GDP, end-09)



Sources – Thomson Datastream All Share market capitalisation, IMF

Chart 2: Equity Indices (Jan. 2007 = 100)



Source – Bloomberg