China Equities – Volatility Likely to Continue

Following the dramatic slide in Chinese equity markets, we asked CIBC Asset Management portfolio managers for their insight into the current situation, and the potential impact for Canadian investors:

Equities

Mark Lin
Vice President, EAFE Equities

- The Chinese equity markets have dropped sharply in recent weeks, but, to put things in perspective, on a year-to-date basis: the Shanghai composite is still +8%, Shenzhen composite +33% and Hong Kong's Hang Seng slightly negative at -0.4%. On an annual basis (from July 9, 2014 to July 8, 2015), both Shanghai and Shenzhen are still up more than 70% in local currency terms, and over 100% in Canadian dollar terms. With such a sharp appreciation over the last year, a correction at a certain point seemed inevitable.
- Unlike many large equity markets, the Chinese market has a high participation rate of retail individual investors versus large institutional investors—domestic Chinese markets are not easily accessible to overseas investors. This tends to add momentum to both bull and bear markets and increases volatility.
- The Chinese government has been actively providing measures to stem the markets from further declines and to restore investors' confidence, including: cutting interest rates to a record low, purchasing equities, suspending new IPOs to preserve liquidity, and cutting bank reserve requirements.
- Based on a decelerating GDP growth rate, and an economy that is early in the deleveraging cycle, we would be surprised to see continuous strong performance of Chinese equity markets, without highly stimulative macroeconomic measures from its central bank.
- For Canadian investors, there is no direct impact from the current correction in the Chinese markets at this point. However, if the Chinese equity market correction continues, business confidence and the deterioration of capital market-related industries such as banks and other businesses—that require access to the equity markets to fund their operations—might constitute a further drag on the Chinese economy. In turn, this could reduce the demand for major commodities produced by Canada.
- All our Chinese securities that we hold in the CIBC Asia Pacific Fund are listed either in Hong Kong or the U.S., not Shanghai, and have not seen the same level of wide swings as those listed in mainland China. In our EAFE or Global SRI products (offered via institutional channels), we have a very manageable mid single-digit exposure to U.S. and Hong Kong-listed Chinese companies.

CIBC Asset Management

Market Insight

Asset Allocation & Currency

Marco Lettieri
Assistant Vice-President, Asset Allocation and Currency Management

- The Chinese equity bull market started in Q4 2014, propelled by a new easing cycle by the Chinese central bank and the opening of the Shanghai-Hong Kong Connect program. Other positive developments (e.g. news that a massive swap program was being initiated to deal with local government debt), generated a favourable environment for equity markets. It was clear that this new bull market had the support of policymakers, and this led to massive increases in margin account openings and the rising use of leverage that pushed prices higher. The result was a rise in the Shanghai Composite Index, which jumped approximately 120% from the start of Q4 2014.
- By late Q2 2015, the Chinese market reached a point of excessive overvaluation. A consolidation in prices was expected, but the speed and size of the market movement was a surprise. This led to significant government intervention and the halt in trading of over 1,000 listed shares. As of July 9 the Shanghai composite index is down approximately 27% since June 12, 2015. However, it was down as much as 34% from June 12 to July 9.
- Going forward, we expect additional intervention from policymakers to support the domestic equity market, as the government wants to promote the stock market as a alternative investment channel for domestic savings.
- Looking ahead, the People's Bank of China is likely to undertake additional monetary policy easing, which will provide another dose of stimulus to support both economic growth and improve equity market sentiment. In the near term, however, soft economic data could lead to additional contraction in equity prices.

Fixed Income

Jeffrey Waldman
Managing Director, Global Fixed Income

- Events in China are adding to the negative geopolitical backdrop and giving further impetus to the safe-haven bid for North American bonds.
- The deflationary impact of lower commodity prices supports both global bond markets and stimulative monetary policy by central banks, including the Bank of Canada.
- The additional instability in global capital markets will complicate the debate on the timing of an interest-rate increase by the U.S. Federal Reserve.
- Government of Canada bonds are outperforming other bond sectors, which is typical when there is a safe-haven bid.