

**Chinese markets – speculation versus investment**

The setback in the Chinese stock market has put the spotlight on to investors' concerns about the sustainability of China's growth record. While understanding these concerns, they should be viewed in terms of a still-developing economy's efforts to support growth in the face of global recession and the risk of a depression. Overall, we are optimistic, recognising that the Chinese economy has recovered well and continues to offer attractive investment potential. Yet the nature of future growth and the domestic Chinese market suggests there will be further swings in sentiment which will provide additional trading opportunities.

Economic news has remained strong, with growth back around the 8% target (growth was 7.9% in the second quarter) and set to stay strong in the second half. Yet the Shenzhen stock market A-share index is 21% down from its last month's high. By comparison, the MSCI China index (which represents shares available to international investors) has fallen less than 10%. The market decline coincided with a sharp fall-off in loan growth in July, with 356 billion renminbi (RMB) of new loans, against RMB 1,530 billion in the previous month. That suggests a peak to the explosive growth of liquidity this year.

We conclude that the domestic Chinese stock market's performance can best be understood in the context of the supply of money within the economy. Spare cash is diverted by companies and individuals into speculation on the stock market. Thus the domestic market seems to be driven more by the availability of cash than by considerations of valuation or economic outlook. This interpretation is supported by the lack of development of the domestic investment market, the limited participation of Chinese institutional investors and, of course, the absence of international investors.

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**Chinese money supply & domestic and external equity markets**



In terms of China's growth, we remain positive on the outlook. Growth has been supported by massive government spending in the 'four trillion yuan budget' and by supportive monetary policy. This has pushed growth quickly back towards the 8% target rate. While China has often been seen as too dependent on exports, growth has been sustained despite the global recession. Although exports are now recovering, imports are rising faster, so the narrowing trade surplus represents a negative contribution to growth. This means that Chinese growth is unlikely to hit the previous peaks of export-supported, double-digit growth seen before the global crisis. Yet it also means that the Chinese economy provides greater support to the growth of its regional and global trading partners.

The recent correction of the Chinese stock market seems to reflect the reduction of available liquidity to overheating domestic asset markets. Such a policy of avoiding liquidity excesses is good macro-economic management. While risks remain to investment in China – as elsewhere – following the global recession, we remain positive on the outlook for the Chinese economy and stock market.

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