PERSPECTIVE

Story of China Still Intact Despite Market Downturn

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Mark Mobius
Executive Chairman
Templeton Emerging Markets Group

About six months ago, I was asked about China's market, which had been surging. At that time, I felt there could be a significant correction in what looked to be an ongoing bull market, but a short-term pullback wouldn't be a big concern in terms of our long-term view on China. Since mid-June, China's domestic stock market, as measured by the Shanghai Composite Index (A-share), has experienced a plunge of about 30%, while the Hong Kong Hang Seng Index (H-share) is down about 20% from its highs in May.[1] The question now is how much further is there to go in this correction. While I can't predict what will happen next given all the uncertainty we have right now in the markets, we at Templeton Emerging Markets Group believe that China's market decline is likely nearing the capitulation point, and that the investment story in China still remains compelling long term.

What Caused the Selloff

I think three things happened that contributed to this latest bout of market panic in China. First, the market went up very rapidly last year and began to break many valuation measures, prompting some investors to exit the market. Second, there were many initial public offerings (IPOs) coming into the market that were very popular and resulted in a lot of profits being made. These IPOs went up 40% in some cases, and that created a big flow of more new-share issues (when you have new- share issues, that draws money away from the rest of the market). Third, we had the entry or beginning of the Shanghai-Hong Kong Connect late last year, which allowed cross-border flows between mainland China and Hong Kong's markets. The problem related to this system was that while flows were moving south into Shanghai, domestic Chinese investors were not initially encouraged to go into Hong Kong, so there was a difference between the performance and the flows in the two markets.

In my view, the bottom line regarding the recent correction in China's markets is essentially a story of too much euphoria and a natural correction.

The Chinese government had been concerned about the market's run-up for some time, attempting to restrict or control the use of leverage amid what had been an increase in trading on margin, or borrowed funds, by some market participants. What went up came down hard, and in recent days, China's government turned to attempting to stabilize the market and stop the fall through other measures that seemed to have had the opposite effect, including a restriction on investors owning more than 5% of a stock from selling for six months, coordinated buying pledges by major Chinese brokers, and the cancellation of planned IPOs. These efforts haven't instilled investor confidence, and as the market continued to fall this week, trading in many stocks in China was suspended.

That brought even more uncertainty and fear, because many investors seemed to be thinking that if the government is taking these measures in the market, things must be pretty serious, and they'd better get out. In my view, the government probably should have allowed the market's early decline to run its course without additional interference that may have accelerated losses.

I think it's also important to note that the situation in Greece certainly had an impact on market sentiment in China, because investors there aren't isolated from global news, and certainly international investors have been on edge about the situation in the eurozone. It makes many investors think twice about doing anything; they freeze and sit on the sidelines until they think the volatility has blown over. Unfortunately, people very often sit on the sidelines too long and lose the opportunity to be in the market. People have to be careful not to be drawn into this negative atmosphere.

Our Strategy: Waiting for Value

While we are already investing in China, our strategy is to wait until prices are so attractive that it's time to look for further long-term opportunities. We believe that point is close with some stocks, but we probably haven't hit the bottom yet. The good news is that, based on market studies we've done in the past, these types of bear markets (and I would deem this a bear market) tend to be short in duration; they don't last too long, and when the recovery comes, it tends to be bigger in percentage terms.

I think we are probably getting close to a capitulation point in China. We should see at least a short-term bounce soon, and many investors who didn't get out before may use that move to do so. Then, we would expect to likely see sideways action until the market can hopefully recover, provided valuations are good.

In our view, the China story is still intact. China is still growing at a good pace, and we believe it's an important global market that we want to have exposure to for the long term. We know that China has slowed from the 10%+ growth rates it has had in the past. It's still a very big, fast-growing economy, and we believe in the merits of investing in equities in China. If we can do so at a lower price, so much the better.

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1. Source: Bloomberg LP. As of July 8, 2015. Indexes are unmanaged and one cannot directly invest in an index.