Infomail
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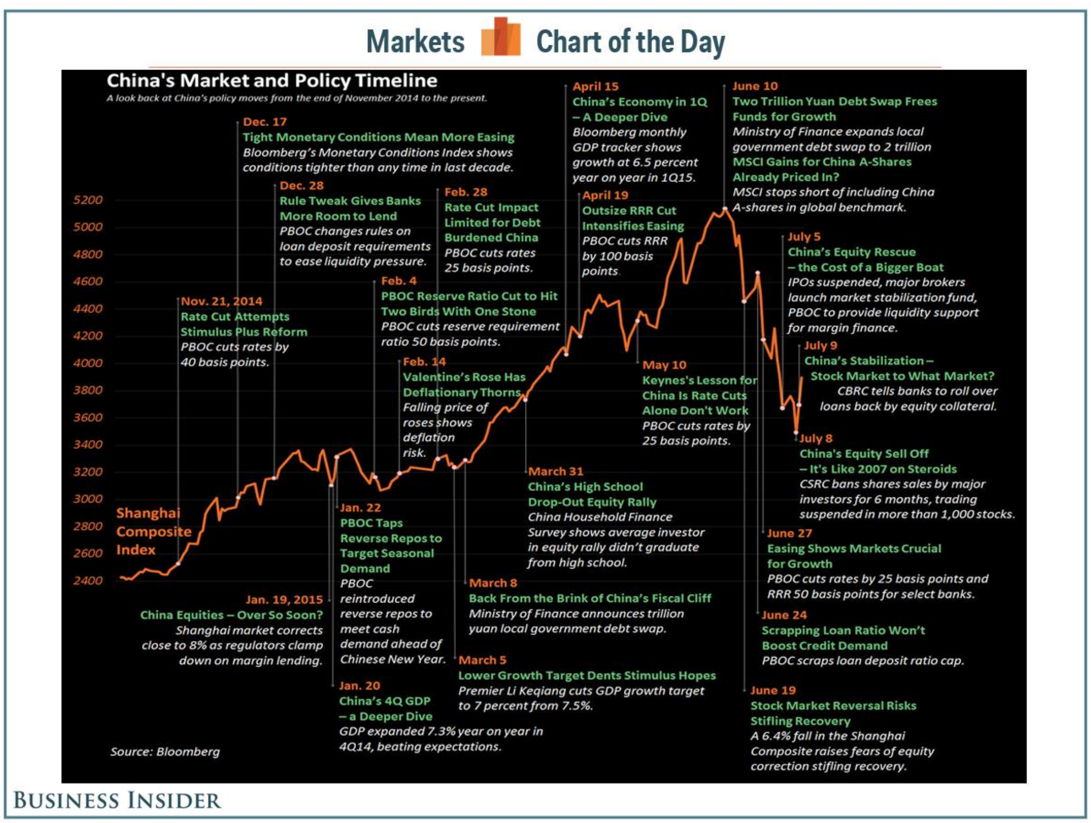
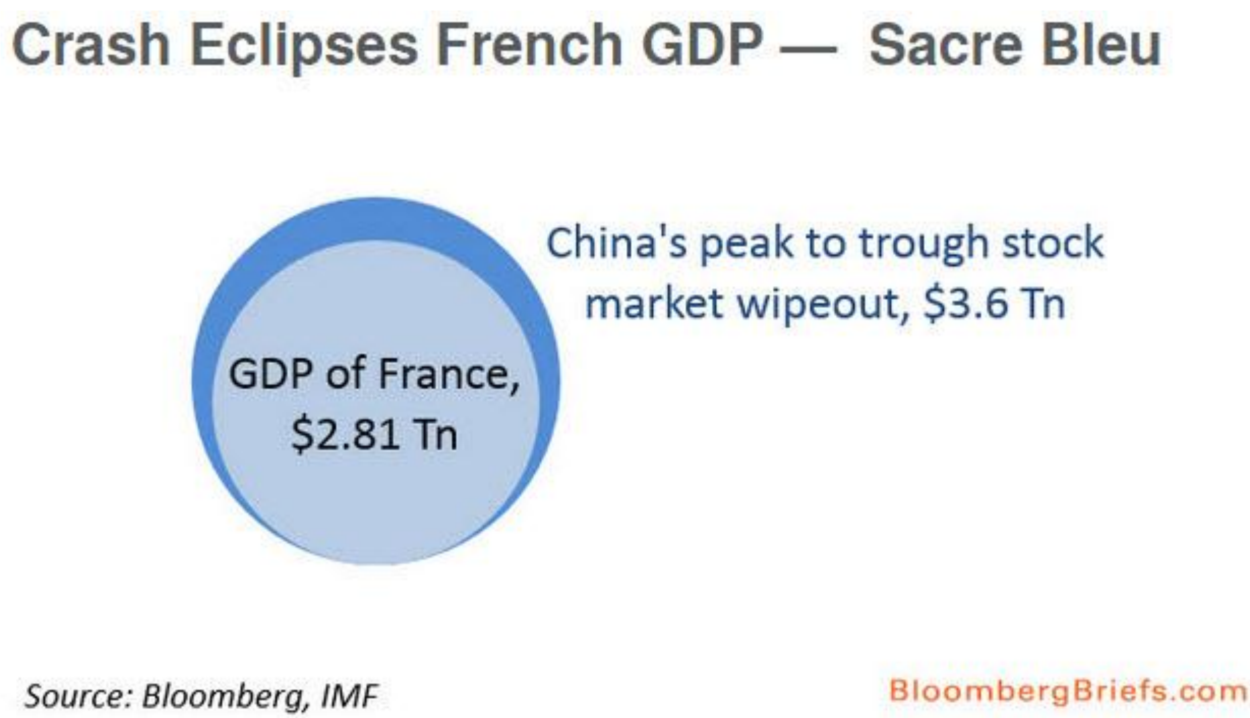
Confusion in the Land of Confucius

"In a country well governed, poverty is something to be ashamed of. In a country badly governed, wealth is something to be ashamed of"
Confucius, Chinese Philosopher 551BC to 479BC

From Sept 1st 2014 to June 12th 2015, the Shanghai Index in China had risen by an incredible 130% (in USD), while the Hang Seng Index in Hong Kong (which many Westerners use to access China) had gained a mere 12.3% over the same period. The enormous divergence can mainly be accounted for by the fact that the local Chinese market is driven almost entirely by domestic fund flows, whereas the Hang Seng is influenced by foreign international investors.



Market pundits were quick to attribute last week's market action squarely to Greece. In my opinion, I think the action in China was the major driving catalyst. Since June 12th (to July 9th), the Chinese Shanghai index shed almost 30% to the downside (Hong Kong was down 8% in the same period).



China has embarked on serious and potentially far reaching reforms. They are transitioning from a producer/export driven to a consumer/consumption driven economy. Those transitions are rarely smooth, and the recent volatility is a testament to that. President Xi in China has been leading a war against corruption, and one after another of leading Communist Party leaders in the various provinces are being arrested, charged, tried and jailed.

But despite the "panic" going on in Chinese markets, there are several important points to note:

- Foreigners own only 1.5% of Chinese shares (Source: Capital Economics)
- Despite a 30% drop in the past three weeks, Chinese markets are still up 10% (Shanghai) and 33% (tech heavy Shenzhen) for 2015
- Stocks only make up 15-20% of household assets in China. Most Chinese wealth is in cash, deposits and real estate.

- The vast majority of Chinese companies still have access to financing
- The Chinese government still has many policy tools at its disposal. The big banks are owned by the Chinese government, and they have a huge trade surplus plus cash in the bank. And they control the currency.

The Chinese government has recently implemented some actions which were intended to quell the volatility. Interventions included suspension in trading in more than half of listed companies, reducing margin accounts and higher margin restrictions, among others.

China is aiming to export its over-capacity through grand infrastructure projects around the world, but the bet on rising domestic corruption is vulnerable to bad demographics which, thanks to the one-child policy, has resulted in the world's most rapidly aging population. It's also betting its currency gets more internationally accepted, and the opening of China's financial markets to global markets.

The immediate repercussions of the recent crash (yes, I think a 30%+ drop could be called that), in a week where most of Europe and the rest of the globe have been preoccupied with Greece, have largely played out inside

China. But in a world that has come to rely on China to keep the global economy ticking, China’s risk is now everybody’s risk.

Stay tuned,

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