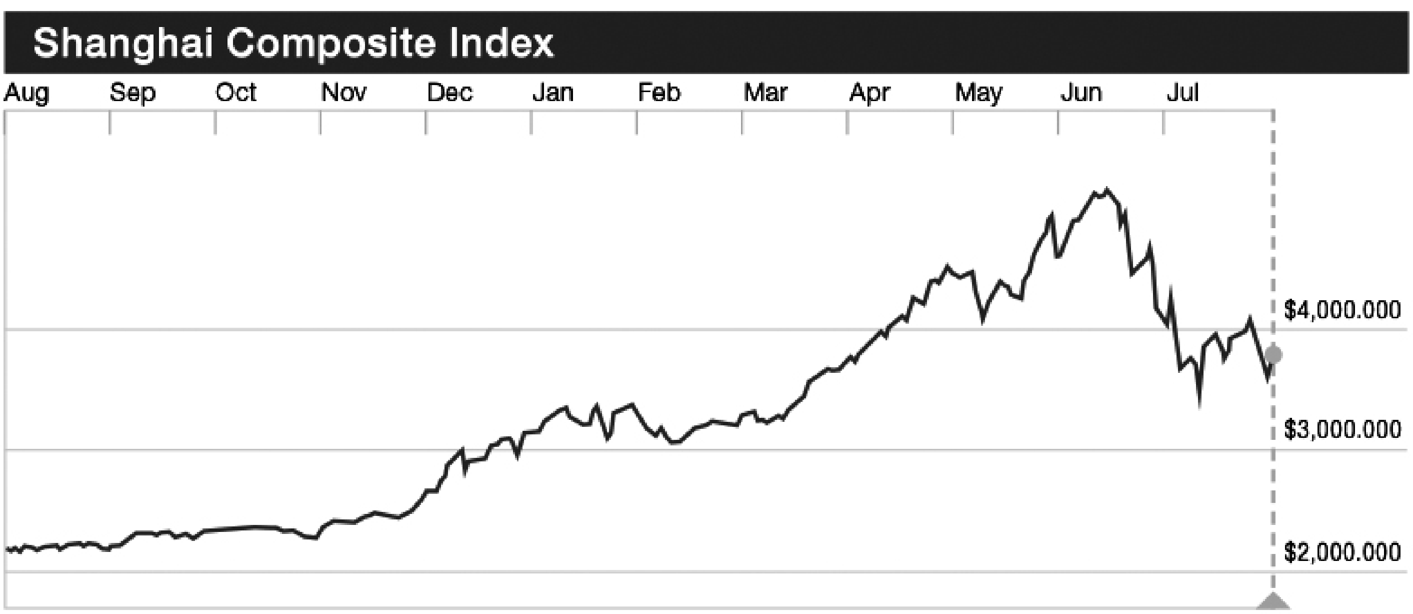
In the space of a generation China has gone from economic backwater to global heavyweight. But as its stellar growth begins to slow, the Chinese government has been trying to finesse the transition from a construction-based economy to one based on domestic demand. Part of that strategy involved talking up Chinese-listed shares.

Wealthy Chinese households responded by borrowing to the hilt and piling into shares – until June, when the bubble popped and panicked investors rushed for the exits. After climbing 150 per cent in the year to June 12, the Shanghai Composite Index fell 30 per cent in under four weeks.[i]

As the graph below shows, prices have rallied and fallen again since then but only after some extraordinary intervention by the Chinese government. New listings were suspended, more than 1300 companies were put in a trading halt and the central bank gave additional funds to stock brokers so they could extend margin loans to clients.[ii]



(Source: Bloomberg, http://www.bloomberg.com/quote/SHCOMP:IND)

What just happened?

While it's tempting to write off the Chinese sharemarket as a casino unrelated to economic reality, its recent tremor sent shockwaves through global investment markets already nervous about a possible Greek exit from the Eurozone. Which begs the question – what just happened in China and does it matter to Australian investors?

This latest bubble is not the first, or the worst, for the fledgling Shanghai stock exchange. Between 2005 and 2007 the benchmark Shanghai Composite Index jumped sixfold from

1000 points to 6000 before falling back to 2000.[iii] While this burst of exuberance coincided with the height of China's development boom, the latest surge was not supported by economic growth.

China's economic growth has been slowing from double-digits at the height of the boom to an annual rate of 7.4 per cent in 2014 to a six-year low of 7 per cent in the June quarter.[iv] However, this latest figure was better than feared, which should boost investor confidence in China and abroad.

Debt levels soar

The big difference between now and the last sharemarket crash is the number of newly-minted shareholders armed with margin loans.

More than 40 million stock market accounts were opened between June 2014 and May 2015, taking the total number of trading accounts to 90 million.[iii]

When you add debt to the mix, share price rises and falls are bound to be magnified. By June this year, Chinese investors had bought US$350 billion worth of stocks with borrowed money. And it's not just individuals gambling with margin loans.[iii]

Chinese listed companies have been using their own stock as collateral for bank loans to bet on the sharemarket or commodities. This means they were hit with margin calls even as their share prices and the broader market fell.

The fallout for Australia

Even though China's sharemarket is not directly linked to the global economy and financial system, instability in China's financial system and uncertainty about how the Chinese government will respond is of concern to Australia.

As China's share bubble popped, the iron ore price shed more than 30 per cent in a fortnight to a six-year low of less than US$45 a tonne before recovering some ground. One reason given for the slide was that commodities are often used as collateral for bank loans and investors were forced to sell commodities to meet margin calls on their shares.[v]

Another reason for iron ore's heavy falls is the slowdown in the Chinese property market as it digests an oversupply of apartments. Residential construction is a major consumer of Australian steel.

Australia's iron ore majors, BHP Billiton, Rio Tinto and Fortescue Metals Group all suffered heavy share price falls in the four weeks to mid-July but have since recouped some of their losses. Price volatility is likely to remain until it is clear that the iron ore price has bottomed.

Australian property

Some of the big losers in the Chinese sharemarket fall were Chinese property developers active in the Australian apartment building boom.

Residential and commercial construction has been doing much of the heavy economic lifting in Australia as we attempt our own transition from the mining investment boom. It remains to be seen if the flow of Chinese money into the Australian property market by developers and wealthy individuals slows.

The dollar

Amid the uncertainty in China and Europe and falling commodity prices, global capital is flowing into safe haven assets such as US bonds, pushing up the value of the greenback. In the wake of the Chinese market crash, the Australian dollar fell below US73c for the first time in six years.

The jury is still out on the long-term impact of China's market turmoil on the world's second largest economy and Australia's major trading partner.

China's rapid rise from developing to developed nation and more open markets is bound to have some hiccups along the way. What this latest market meltdown exposed is the need for further economic reforms. It also serves as a reminder that what is good for China's economic development is good for Australia and Australian investors.

If you would like to discuss the issues raised in this article in the context of your portfolio, please give us a call.

i "China's stock bubble burst' by Anthony Fensom, Morningstar 10 July 2015.
ii 'Whiplashing week takes world markets for a riotous ride' by Vanessa Desloires, Sydney Morning Herald, July 11-12 2015, page 8.
iii Vox http://www.vox.com/2015/7/8/8911519/china-stock-market-charts
iv CommSec Economic Insights, July 15 2015
v 'Dr Copper calls double trouble' by Karen Maley, AFR 11-12 July, page 34.

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