Is China a Market in a Bubble?

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The spectacular rise of the local Shanghai equity market — collectively known as the A-shares China market — and its dramatic 30% fall in three weeks has many observers painting the broad Chinese equity market as a stereotypical bubble.[1]

There were many stocks with extreme valuations, a large rush of unsophisticated traders, a surge in stock trading with borrowed money and, critically, a general sense that there was not sufficient (if any) underlying growth in the economy or corporate profits to justify this surge in prices.

Yet not all Chinese equities are the same, and there are some pockets of what may be considered deeper value segments of the global opportunity set in the Chinese equity market.

A-Shares/H-Shares Disconnect

Notably, there has been a huge discrepancy in performance between the stocks trading in Shanghai and the exact same stocks that are trading in the Hong Kong market (where most international investors are able to trade).

Part of the flow in the local A-shares market this year was based on speculation that more index providers are going to add China A-shares to their indices. Vanguard, which utilizes FTSE indices in its emerging market benchmark tracking strategies, was the first major index provider to adopt provisional indices and to add A-shares to its emerging market strategies. On June 10 2015, MSCI announced that it was considering adding A-shares but thought the market was not quite ready. The fact that more than 1,000 companies suspended trading — basically because they did not like the market activity in early July — probably will not provide much comfort to MSCI in adding A-shares.

WisdomTree has an emerging markets index, the WisdomTree Emerging Markets Equity Income Index (WTEMHY), which selects from more than 1,200 emerging market dividend payers in an effort to find the lowest-priced segment of the market. The Index ranks eligible stocks by their dividend yield and then selects the top 30%. This is a deeper value selection standard than simple market cap weighting or choosing just dividend-paying stocks. Back in 2008 and 2009, Chinese companies represented a very small portion of this index — representing no more than 3% of the index weight at a time when broad market cap-weighted indexes had as much as a 20% weighting in China.

Today, China is the largest country in this value index with weights over 20%. The reason: a number of the H-shares Chinese stocks, particularly banks, have dividend yields north of 5%. The weighted average yield of the Chinese stocks in the WTEMHY index is 5.3% with a weighted average price-to-earnings (P/E) ratio of less than 8x. On a valuation basis these stocks do not look like a bubble; rather, they may be relatively lower priced if they can maintain their current earnings and dividend levels.

The Chinese stocks in the WTEMHY index are absolutely not the same “bubble” stocks trading on the local ChiNext (tech-heavy) exchange, which had median P/E ratios around 100x and dividend yields of 50 basis points.[2]

Interestingly, the same high-dividend Chinese stocks in WTEMHY also have corresponding A-shares trading on the local market. The same stocks trading in China — offering ownership in the same companies — have a dividend yield of just 3.7% (160 basis points less than the H-shares) and a P/E ratio over 12x (approximately 55% higher P/E multiple).

One can see the dramatic differential in performance between H-shares and A-shares over the past year. China Construction Bank A-shares were up 89% over the year, while the same H-share was up just 20%. [3] The weighted average performance of all the A-share versions of stocks in WTEMHY was 96% over the prior year, while the H-shares in WTEMHY were up just 19%.

Valuation and Return Differences between H-Shares and A-Shares

If you look back over 15 years, there is an interesting comparison between the Shanghai Composite of A-shares and the MSCI China Index. Following the market crash in 2008, the Shanghai Composite languished and underperformed the H-shares MSCI China Index significantly over the next five years. Starting in late June 2014, that performance gap started to close with very strong returns in A-shares; the performance of A-shares recently eclipsed H-shares’ performance cumulatively.

Index Performance Comparison

With the Chinese market regularly moving 5% every day, it is tough to call what will happen in the short term. One thing that is clear though is that not all stocks in China are in high-valuation bubble-like territory. Certainly the volatility makes investing there highly uncertain, but it looks like there are good value stocks to be had in diversified emerging market strategies that focus on relative valuations in China.

Investors sharing this sentiment may consider the following ETF:

- WisdomTree Emerging Markets Equity Income UCITS ETF (DEM)

All data is sourced from WisdomTree and Bloomberg, unless otherwise stated.

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