

Is China a Market in a Bubble?

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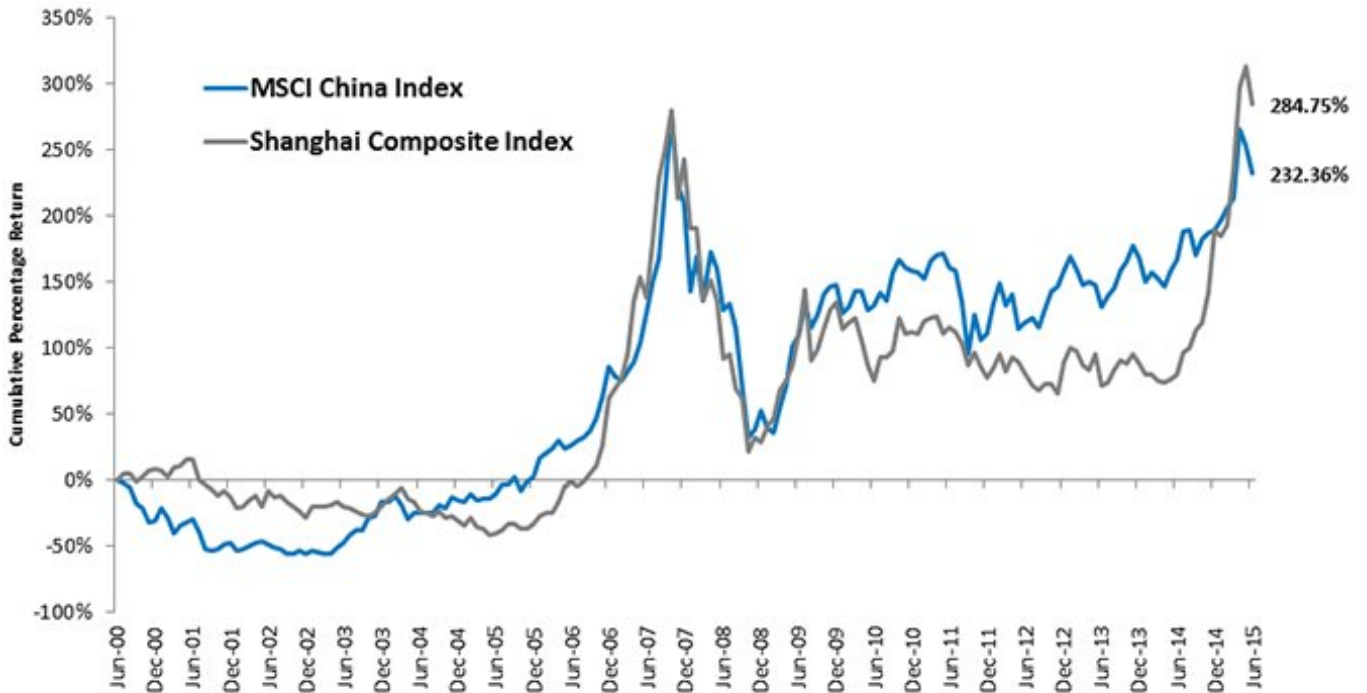
The spectacular rise of the local Shanghai market—collectively known as the A-shares China market—and its dramatic 30% fall in three weeks has many observers painting the broad China market as a stereotypical bubble.¹ There were many stocks with extreme valuations, a large rush in unsophisticated traders, a surge in stock trading with borrowed money and, critically, a general sense that there was not sufficient (or any) underlying growth in the economy or corporate profits backing this surge in prices. Yet not all China is the same, and there are some pockets of what may be considered deeper value segments of the global opportunity set in the China 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 just in the Hong Kong market, where most international investors are able to trade. Part of the surge in the local A-shares market this year was speculation that more index providers are going to add China A-shares to their indexes. Vanguard, which utilizes FTSE indexes in its emerging market benchmark tracking strategies, was the first major index provider to adopt provisional indexes to add the A-shares to its emerging market strategies. MSCI announced June 10 that it was considering adding the 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 the 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 market cap weighting or choosing just dividend-paying stocks. Back in 2008 and 2009, China was a very small portion of this Index—representing no more than 3% of the weight when broad market cap-weighted indexes had as much as 20% in China. Today, China is the largest country in this value Index with weights over 20%. The reason: A number of the H-shares China stocks, particularly the banks, have dividend yields north of 5%. The weighted average yield of the China stocks in the WTEMHY is 5.3% with a weighted average [price-to-earnings \(P/E\) ratio](#) of less than 8x. These stocks on a valuation basis do not look like a bubble; rather, they may be relatively lower priced if they can maintain their current earnings and dividend levels. The China stocks in the WTEMHY 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 China 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 last one year. China Construction Bank A-shares stock was up

89% over the one year, while the same H-share was up just 20%.³ The weighted average performance of all the A-shares 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**

	WTEMHY Weighted Average	China Construction Bank Corp	Industrial and Commercial Bank of China Ltd	Bank of China Ltd	Bank of Communications Co Ltd	China Petroleum & Chemical Corp
Weight in WTEMHY	19.74%	4.93%	3.80%	3.05%	1.89%	1.34%
H-Share Premium/Discount	-30.94%	-27.56%	-20.81%	-38.39%	-31.14%	-31.27%
H-Share Return						
1 Year	19.01%	20.35%	17.31%	29.17%	45.73%	-12.17%
3 Year	14.43%	14.21%	16.38%	21.77%	18.83%	11.84%
5 Year	5.62%	6.30%	5.18%	7.95%	2.95%	9.74%
A-Share Return						
1 Year	96.35%	88.87%	70.17%	127.74%	137.32%	47.93%
3 Year	26.72%	28.34%	21.68%	34.71%	32.34%	23.22%
5 Year	13.50%	16.65%	14.15%	18.61%	15.02%	8.84%
Dividend-to-Price (D/P)						
D/P on H-Share	5.30%	5.89%	5.78%	5.50%	4.69%	4.09%
D/P on A-Share	3.70%	4.27%	4.58%	3.39%	3.22%	2.80%
Price-to-Earnings (P/E)						
P/E on H-Share	7.76x	5.5x	5.6x	5.7x	6.6x	16.8x
P/E on A-Share	12.05x	7.6x	7.1x	9.6x	9.5x	22.7x

Sources: WisdomTree, Bloomberg, 7/9/15. Returns are calculated in U.S. dollars. You cannot invest directly in an index. Past performance is not indicative of future results.

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 the very strong returns in the A-shares, and the performance of A-shares recently eclipsed H-shares' performance cumulatively. **Index Performance Comparison**



Sources: WisdomTree, Bloomberg, 6/30/00–6/30/15. You cannot invest directly in an index. Past performance is not indicative of future results.

With the Chinese market regularly moving 5% every day, it is tough to call what will happen in the short term for China. One thing that's clear to me, 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. 1Source: Bloomberg, 6/12/15–7/8/15. 2Source: Bloomberg, 7/9/15. 3Source: Bloomberg, 7/9/14–7/9/15.

Important Risks Related to this Article

Investments in emerging, offshore or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments. Investments focused in China increase the impact of events and developments associated with the region, which can adversely affect performance.