EDMOND DE ROTHSCHILD

ASSET MANAGEMENT

COMMENTARY

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COMMENTARY ON CHINA

For the second time in the same week, trading on the Shanghai stock market was suspended on January 7th after the index fell by its maximum limit of 7 percent. The introduction of this new circuit breaker rule on January 4th goes some way to explaining the confusion and steep fall on Chinese markets since the beginning of the year but it is not the only factor at play.

A circuit breaker was introduced on January 4th to halt trading in excessively volatile markets. It is a big shock to traditional Chinese investor behaviour. Before, the only major constraint on trading concerned shares themselves. A 10 percent fall in one day made it impossible to sell below this level but trading was not suspended as buyers could still step in to deal at this level. From now on, trading will be suspended for 15 minutes if the market falls 5 percent but no dealing is allowed until trading resumes. If the index falls by as much as 7 percent, the market closes for the day. When the market is suspended after a 5 percent fall, the risk it might continue and drop 7 percent drives nervous investors to step up selling to get out at any price before it hits that level. This creates a snowball effect. Previously, sell instructions were carried out over the session but many investors now choose "at market" orders to get out as quickly as possible.

To make matters worse, investors have no visibility on the market during the 15-minute interruption after a 5 percent drop. All orders are removed from the screen so that there are no indications of prices and volumes or changing instructions. This total fog aggravates concerns, causing investors to increase the size of sell orders and give more indiscriminate instructions. Circuit breakers exist on other Asian markets and are rarely triggered. In China, most domestic investors have less market experience and see this tool as a severe restriction on liquidity. It will take time for them to adapt. The circuit breaker is part of the move to adapt China to international market trading standards. It is a good idea over the medium and long term but creates short term market turbulence. Bear in mind that despite similar events in mid-2015, Shanghai was one of the best performing equity markets in 2015.

The confusing atmosphere on January 7th was also down to various regulatory bodies being clumsy, uncoordinated and poor communicators. As the end to a 6-month ban on large shareholders with more than 5 percent of a company selling its shares approached, concerns mounted that strong selling pressure was imminent. China's small investors over-reacted. In fact, there has not been much selling from these large shareholders. But the China Securities Regulatory Commission (CSRC) backpedalled again by forbidding them to sell more than 1 percent over 3 months, a move that only heightened confusion and has so far failed to reassure investors. CSRC just announced the suspension of the circuit breaker. However, this clumsy deployment of particular measures has overshadowed the fact that China is actually adopting international standards. Beijing is educating its big domestic investor pool to take a fresh look at capital markets in an attempt to underpin the opening up of its markets to the rest of the world.

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