No more ‘Wild East’: China’s Stock Market Is Growing Up Fast

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The Chinese stock market is changing at breathtaking speed and is on track to reach maturity faster than any other in history. Global investors have been reluctant to dive in, but there are good reasons to get acquainted with the companies serving the world’s second-largest economy.

A Stock Market’s Adolescence

Many investors prefer mature markets, where they can invest relatively easily, the government leaves the market more or less alone and provides consistent oversight, and companies disclose their finances, operations and risks so investors can make informed decisions.

China’s current A-shares market, which is composed of stocks that trade on the mainland exchanges, looks a lot like the US stock market circa 1965. It’s still unevenly regulated, marked by patchy governance of its listed companies, and dominated by retail investors, whose tendency to buy high and sell low can exacerbate volatility.

Those traits make many global investors nervous, but are changing fast, thanks in large part to the inclusion of Chinese stocks in the MSCI Emerging Market Index in 2018. Regulators had to make sweeping (and beneficial) changes to enable China A-shares to be included, and foreign and institutional participation has already increased as funds that track the index buy Chinese shares to match its holdings. Institutional investors, driven less by emotion than fundamentals, tend to lend stability to retail-dominated markets.

MSCI expects to continue adding Chinese stocks to the index, with the next proposed addition coming in August 2019, bringing A-shares from 0.7% of the index to 2.8%. We expect A-shares to be fully included–comprising 16% of the index–in just three to five years. That’s half the time it took South Korea (six years) and Taiwan (nine years) to reach full inclusion. (Overall, Chinese assets—including those that trade on Hong Kong exchanges—would make up 42% of the EM Index.)

Three Steps Toward Maturity

China first started moving toward market maturity by simplifying access for foreign investors. In 2014, regulators launched Stock Connect, allowing foreign investors to buy stocks traded on the mainland from Hong Kong without a license or quota. Recently, it widened another access road by doubling the quota for foreign capital investment in Chinese markets through the Qualified Foreign Institutional Investor (QFII) program.

Another sign of a mature market is that it operates more or less freely and efficiently. On that score, the government has been much less prone to meddling in the A-shares market compared with a few years ago. In July 2015, when equity markets grew turbulent, around half of Chinese companies suspended trading to avoid major hits to their share prices. Some suspensions dragged on for months. In response to investor protests, in 2016 regulators limited suspensions to three months. While months-long suspensions would be unheard-of in the US or UK, China is moving in the right direction in this regard. In November 2018, Chinese regulators announced that they would further reduce the duration of suspensions.

The government has also stopped directly intervening to support domestic equities. In 2015, regulators instructed state-connected investment firms to shore up markets by buying stocks. Their silence in 2018 during another bout of volatility spoke loud and clear.

Third, for good governance and transparency, companies in mature markets must hold up their part of a contract with shareholders. Toward that end, Chinese securities and environmental regulators announced last year that listed companies must disclose the environmental, social and governance (ESG) risks to their businesses by 2020.

Those risks have abated somewhat recently, largely due to the Chinese government cracking down on corruption and bad corporate behavior. That means punishing companies that pollute the nation's air and water, including by shutting factories down indefinitely and even jailing executives.

Forget the "Wild East"

Investors in A-shares still face volatility risks and exposure to geopolitical and trade uncertainty. Economic imbalances, including the rapid growth of debt in the financial system, wasteful infrastructure development and sky-high prices in parts of the housing market, are a continuing concern.

But the market is no longer, as many investors seem to think, the Wild East. It's a maturing market that allows investors to tap into the world's fastest-growing consumer market as well as industry-leading technology companies. It's not just that China will be too big to ignore; it's that investors won't find this kind of potential anywhere else.

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