Will the Stock Market Bubble Burst?

This is the second in a series of articles on the Chinese and global markets by Justin Lowes

On February 27th 2007, when China's main stock market index fell by 8.8 percent, it sent shudders around the world. All markets suffered as investors took fright. For a moment, it looked as if we were about to see a major correction. Instead, nerves quickly disappeared and the markets took off on another bout of seemingly effortless increase.

The media line at the time was that concerns over the health of the Chinese economy, allied with fears of a sub-prime implosion in the States, had been the cause of investors' concerns. To most, this sounded like abject nonsense. The sub-prime market had hit the headlines weeks before. Also, surely people knew that the Chinese stock market was not symptomatic of the overall rude health of the Chinese economy? Yes, it may be in an obvious bubble situation. But everyone knew that and government ministers had recently begun to warn openly about the dangers of a possible collapse in share prices. A fall in the Chinese domestic market would badly affect those that invest in the Chinese domestic market. It would mean little for global economies and little for China's overall economy.

Or so I believed then. Now, I'm not so sure.

On February 27th the fall took China's index from a then record high of 3,048 to 2,771.79. As I write this article, China's index stands at 4,151 - a gain of 49 percent. Given that prices were already considered to have become somewhat divorced from reality, where do we stand after a further near 50 percent rise? And what might the consequences be should things come tumbling back to earth?

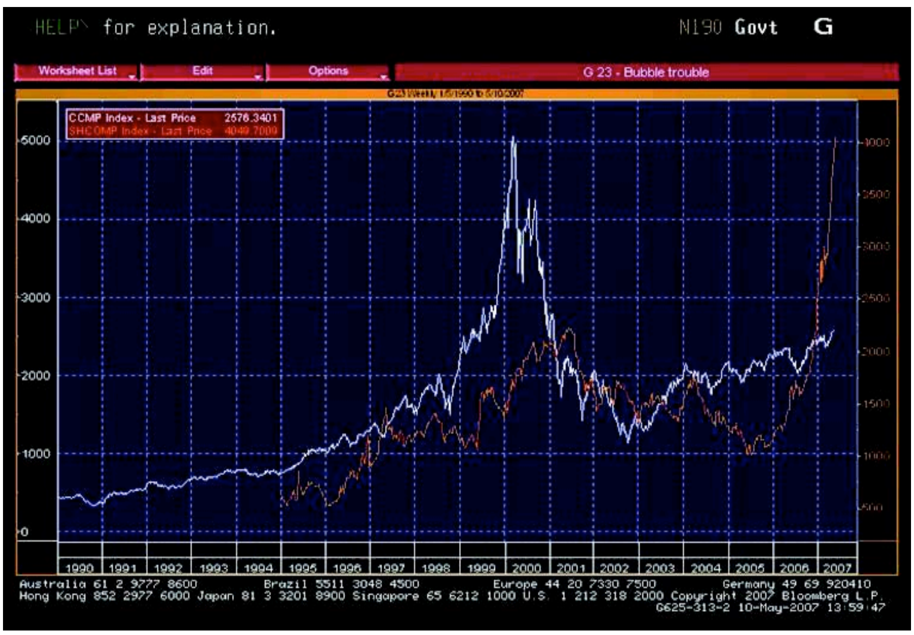
Lessons from the Past

Let's put things into perspective. On Monday 24th May 2005, the Chinese index was at 1,066. On 23rd May 2007, 2 years later, the index closed at 4,173 - a gain of 291.46 percent. On 11th March 1998 the NASDAQ was at 1747. On 10th March 2000 the NASDAQ hit 5048, a gain of 188.95 percent. So the Chinese market has, in the last 2 years, substantially eclipsed the performance of the US NASDAQ in the final two years before the bursting of the technology bubble.

Does this mean that we are bound to see a crash in the immediate future? Not necessarily. There's a classic saying; "Markets can stay irrational longer than investors can stay solvent". There is US$ 4 trillion of deposits in Chinese banks so there is plenty of fuel for the fire yet. The government is, understandably, unsure of how to deflate this bubble and bring about a soft landing. However, the more things are allowed to inflate, the worse the eventual fallout is likely to be when the bubble finally bursts.

Global Impact

But what about the impact of a market crash in China on the global economy? China is now Japan's biggest trading partner and is an increasingly important export market for countries like the US and Germany. More and more it is a key driver for global prosperity. The worry is that with tales of nearly 400,000 new trading accounts opening each month; with stock market volume that has increased from US $5Bn to $50Bn per day; with ayis, students and pensioners getting into the market; with unregulated loan sharks reportedly lending money to farmers so that they can trade; that a bursting of this particular bubble could wreak havoc across a huge swathe of society, leading to social instability. The unwritten pact of providing increasing prosperity in return for little or no increase in representative government could come under threat.



Does this look like a bubble? NASDAQ (white) and Shanghai Composite (orange)