

Chinese stocks too hot to handle

Chinese stocks were passed over for ascension to the MSCI world index last week; a move that came as little surprise in the wake of the recent market volatility.

- Implied volatility of 90 day ATM options written against the A50 index has doubled in the last 12 months
- Investors are using options to protect against price falls in the wake of the recent strong run
- Chinese A shares now have twice the implied volatility of corresponding MSCI Emerging Market Index option

Last week saw the MSCI's yearly market classification review [pass](#) on admitting China into its emerging market section for near term. Although the index provider largely focused on ongoing technical issues such as capital quota, liquidity and ownership rules as its main roadblock for inclusion this year, the recent volatility of the country's stocks must have played a part.

This is particularly relevant given that a decision to the contrary could have seen international investors commit to purchase billions of dollars' worth of Chinese equities - at a time when talk of a possible Chinese equity bubble are growing [louder](#).

While the cause for the recent surge in Chinese equity remains unclear, investors are treating Chinese equities with increased caution in the wake of the recent price surge.

Volatility jumps

The shaky base on which Chinese equities currently stand is best exemplified by the options written against the iShares FTSE A50 China Index ETF, which has seen its implied volatility surge in the last 12 months according to Markit Daily Volatility.

90 Day ATM Option Implied Volatility



90 day at the money (ATM) options for the ETF, which had been one of the best ways to gain exposure to mainland Chinese shares prior to the Shanghai connect, have nearly doubled in the last 12 months to 37% as of latest count. The current levels of implied volatility are hovering around the yearly highs seen in the opening week of January.

This recent surge in volatility has seen investors price Chinese A options with the highest amount of implied volatility since October 2011, during which Chinese shares were in the midst of a bear market.

Skew showing increasing weariness

The shape of options term structure also indicates that investors are increasingly wary of Chinese A shares. Just before to the surge in volatility, investors were paying a 15% more for 10% out the money calls than corresponding than for similarly out the money puts. Such a skew indicates that option market participants were more

concerned with capturing potential upside than protecting against a market selloff.

90-110 Option Skew

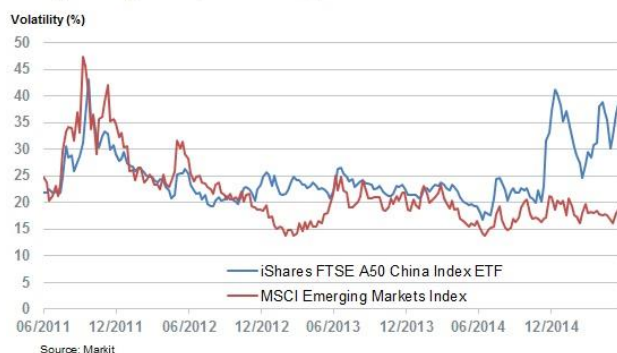


This phenomenon has since reversed and investors have in fact been paying a premium for downside protection in May.

Chinese volatility exception

The spike in option volatility seen Chinese shares runs against the wider emerging market, as gauged by options tracking the MSCI Emerging Market index.

90 Day ATM Option Implied Volatility



90 day ATM implied volatility in A shares used to track the wider emerging market index, but the surge in volatility, combined with a fall in the Emerging Market Index means that Chinese A shares now see twice the volatility of the index which recently passed them over for inclusion.

Simon Colvin

Analyst

Markit

Tel: +44 207 260 7614

Email: simon.colvin@markit.com

For further information, please visit www.markit.com

The intellectual property rights to this report provided herein is owned by Markit Group limited. Any unauthorised use, including but not limited to copying, distributing, transmitting or otherwise of any data appearing is not permitted without Markit's prior consent. Markit shall not have any liability, duty or obligation for or relating to the content or information ("data") contained herein, any errors, inaccuracies, omission or delays in the data, or for any actions taken in reliance thereon. In no event shall Markit be liable for any special, incidental, consequential damages, arising out of the use of the data. Markit is a trademark owned by the Markit group.

This report does not constitute nor shall it be construed as an offer by Markit to buy or sell any particular security, financial instrument or financial service. The analysis provided in this report is of a general and impersonal nature. This report shall not be construed as providing investment advice that is adapted to or appropriate for any particular investment strategy or portfolio. This report does not and shall not be construed as providing any recommendations as to whether it is appropriate for any person or entity to "buy", "sell" or "hold" a particular investment.