Markets from China, media commentary from Uranus

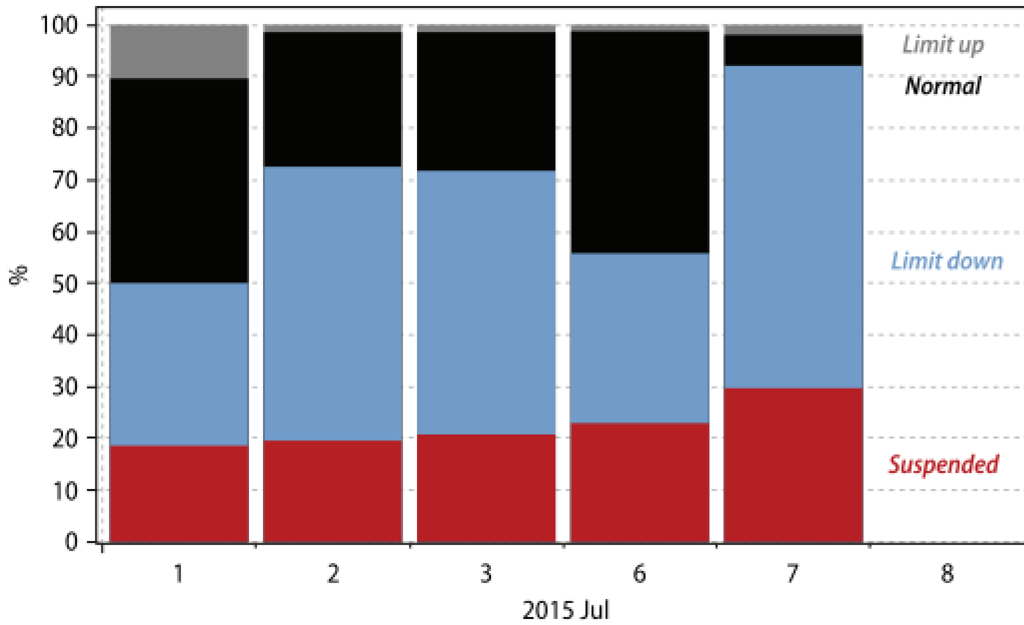
Louis-Vincent Gave | GaveKal | 10 July 2015

At one point in the movie Uranus, the central character played by Gérard Depardieu exclaims: "I am a bar-owner, a Communist Party member and a Freemason. That should tell you how much BS I have heard in my life... But this takes the cake!". This is a little bit how we feel looking at all the ink that has been spilt over the recent collapse in Chinese equities. So to recap the most important points:

1. The Shanghai and Shenzhen markets are basically the playthings of a limited number (for China) of local investors. Foreigners barely participate. According to the latest numbers from the China Securities Regulatory Commission, China today has around 89 million open brokerage accounts. Allowing for the dual nature of the market (one account for Shanghai, another for Shenzhen), and the fact that active investors typically have multiple accounts (to get bigger allocations in initial public offerings), we can assume that the pain of the crash is affecting probably no more than 20 million to 30 million Chinese households, most of which range from upper middle class to very wealthy. In other words, it is hard to see the crash having massive immediate economic consequences.
2. This is all the more true since, unlike companies in the US and other developed markets, Chinese corporates typically do not fund their capital spending and expansion plans with equity issues, but either through generated cash flows or bank loans.
3. This is not to belittle the pain inflicted by the crash on the 20 million or so investors now caught like deer in the headlights. As Joyce highlighted last week, so far the Chinese equity market crash has mostly affected smaller cap stocks which rose exponentially and then rolled over just as aggressively (see The Unequal Sell-Off In Chinese Stocks). Since Joyce wrote her paper, the situation has got even worse. Of the 2781 listed A-shares, nearly 60% traded limit-down yesterday. Excluding suspended stocks, 82.5% of the market's tradeable stocks were limit-down. That left just 9% of listed A-shares trading normally (Figure 1). Clearly, behind the pain apparent in the overall index, the brokerage statements of the typical retail investor must be a truly frightening sight.
4. The silver lining to this ugly storm cloud is that the liquid, large cap, not stupidly-valued stocks that foreign investors would own in China (if they own anything at all) did not undergo anything like the kind of melt-up and subsequent melt-down seen

in smaller stocks. This divergence is illustrated by the massive recent outperformance of the Shanghai 50 Index (which essentially comprises the stocks foreigners would be likely to own) relative to the broader Shanghai Composite (Figure 2).

Figure 1: While most A-Shares are either limit down or suspended...
The trading status of Chinese listed companies



Sources: WIND, GaveKal Data/Macrobond.

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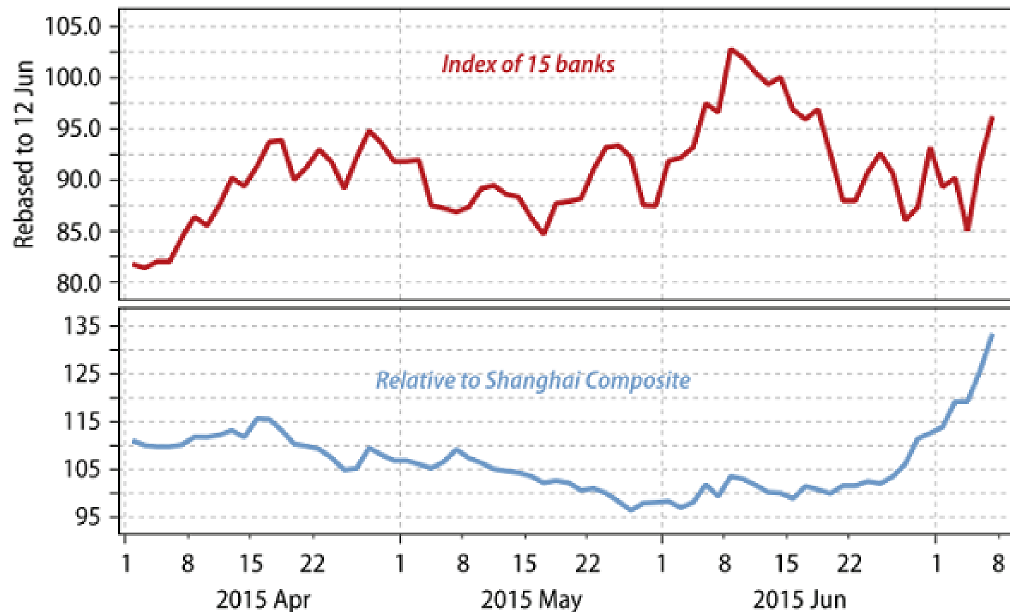
Figure 2: ...the stocks that foreigners own are outperforming
The performance of the Shanghai 50 index relative to the Shanghai Composite

Sources: Bloomberg, GaveKal Data/Macrobond.

5. On this front, the recent performance of Chinese financials is an especially interesting phenomenon. Normally in the case of a "bubble" melt-up, and subsequent implosion, and especially when the bubble is inflated by surging margin debt (as it has been in China), one would expect financials to lead the market on the way up, and then to be deeply affected once the bubble implodes. Instead, in China, we have seen exactly the reverse. To some extent, the massive outperformance of banks in the face of the recent melt-down is an encouraging sign which could signal that the sell-off is less the result of any one structural reason than of the market's crazy internal dynamics. If China were facing a significant financial crisis, it is hard to imagine that bank stocks would be cruising along relatively untroubled.

Figure 3: Weathering the storm

Index of Chinese banks listed in Shanghai, equally weighted; rebased to the market's peak



Sources: GaveKal Data/Macrobond.

This brings us to the underlying question of what happened to Chinese smaller cap stocks. Why did they soar and then suddenly crash? There are two possible answers:

a. We have just witnessed an enormous "pump and dump" operation, with retail investors convinced to pile in by the promise that a tsunami of foreign cash was set to hit the market. Understandably, they bought the illiquid names most likely to be disproportionately affected when MSCI and FTSE rebalanced their indexes to include China's onshore markets. Then, when MSCI postponed its decision on China's inclusion, and FTSE's decision turned out to be a dud, the buying of illiquid names turned into selling, hammering highly margined investors and triggering a crash.

b. The Chinese equity market is a retail playground where the marginal investor is: (i) fairly new at this game; (ii) operating on margin for the first time (equity margin financing has only been available to most ordinary investors since 2013); and, (iii) possibly more momentum-driven than investors anywhere else in the world (see The Best Of Both Worlds In Hong Kong). Hence, trying to read too much into short-term market movements is a bit of a mug's game.

The fact remains that a market, which until three weeks ago was displaying the strongest momentum in the world, is now showing the worst, which leaves investors with the questions: Is this a buying opportunity? Or an important turning point?

On these questions, two years ago, most Western investors were bearish China on the premise that "China's growth is set to slow hard" (and the economic slowdown is an undeniable reality). As equities ripped, the rationale for bearishness tended to evolve from "sell China because of weaker growth" to "sell the market because it is expensive". And, as the market continued to rip, the reason for being bearish became "sell the market because there is too much margin debt".

This last reason, it seems, turned out to have considerable merit. As the shakedown in small caps demonstrates, margined investors just got squeezed to high heaven. In turn, this raises the question whether the margin squeeze is a healthy development. Or is it a sea change, which will prompt China's investors to abandon their momentum-driven mentality, and scare the next marginal saver away from equities?

When it comes to the Chinese equity market, this is today's genuinely important question, because what drives every market price is the emergence or disappearance of marginal buyers and sellers. A few months ago, it looked likely that more and more domestic investors would continue to enter the Chinese equity market, and that they would soon be joined by foreign investors (see The World's Most Crowded Trade). Today, one could fear not only that foreign investors will keep their distance, but also that momentum-driven Chinese investors will now turn away from equities, perhaps towards domestic real estate, which seems to be on the bounce, or even towards less crazy foreign markets.

As we see it, this fear would be misplaced. With falling oil prices, lower interest rates, supportive government policies and decent global growth, there are few reasons to think that the fundamental outlook for the Chinese equity market has deteriorated markedly in recent weeks. In fact, we would argue that the fundamental outlook has improved and that as a result, the recent crash will prove to be a buying opportunity within a structural bull market - something akin to the October 1987 US stock market crash. We are comforted in this belief by these facts:

a. At a P/E ratio of 17.8, the Shanghai Composite does not appear outrageously valued (Figure 4), especially considering that inflation and interest rates are likely to continue heading lower structurally. Beyond the crazy and volatile Shanghai market, the broader MSCI China index (which includes H-shares and is much more relevant to most of our readers), trades at a P/B ratio of 1.5, a P/E of 12.5 and at a dividend yield of 2.6% - hardly the stuff of unsustainable bubbles.

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Figure 4: Not outrageously over-valued
Shanghai A-shares, P/E ratio

Sources: GaveKal Data/Macrobond.

b. The government is now clearly stepping in to arrest the market's fall. Admittedly, the market's response has been unimpressive. To some extent, that is surprising, as Chinese retail investors have historically taken their cues from the government. This leaves us with two options: 1) the investing public is so highly margined that it simply cannot respond as Beijing wants because of margin calls (my view); and, 2) the investing public no longer trusts the government, which if true would be a profound change. Staying on this thought, in recent years, each set of policymakers that set its mind to it managed to coax investors out along the risk curve, whether the US Federal Reserve in 2011, Shinzo Abe and the Bank of Japan in 2013, or the European Central Bank in 2014. Now, it seems that Beijing is joining the ranks of policymakers who have attempted to reflate their domestic asset prices. On a medium- to long-term view, does it make sense to stand in the way of coming rate cuts, easier monetary policy and potentially easier fiscal policy, and bet that Beijing will be the one government that fails where every other succeeded?

Given these considerations, we continue to believe that a year from now there will be more marginal buyers of Chinese equities than there are today. The following facts further reinforce our belief that the current margin squeeze of China's retail investors will offer global investors an attractive buying opportunity.

- Beijing is likely to continue to relax capital controls, triggering inflows from foreign investors;

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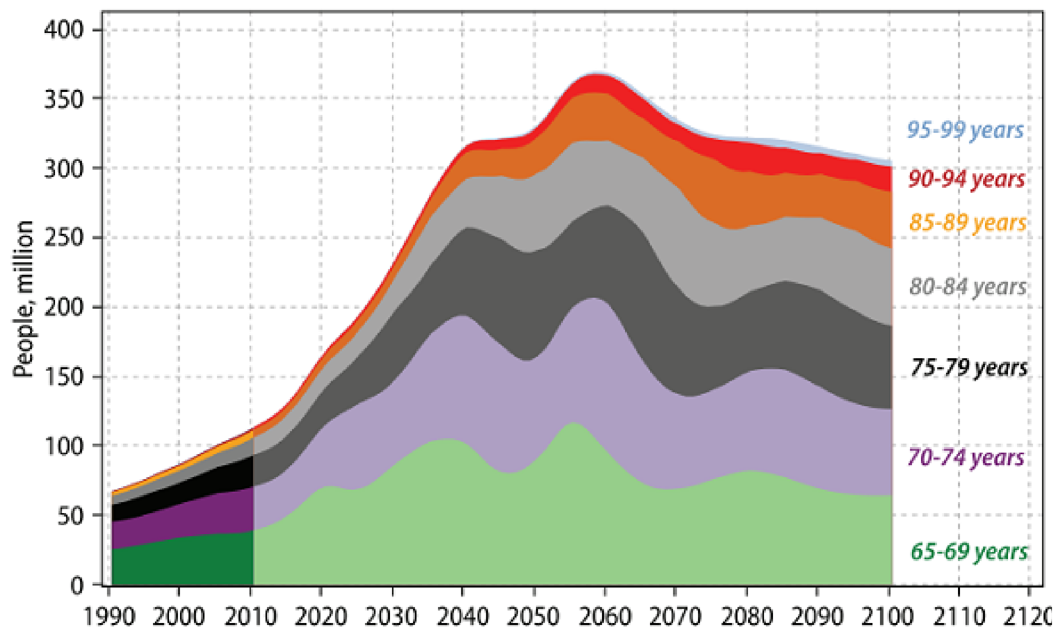
- Over the next decade, China's investor base is set to grow from some 20 million individuals today to more than 100 million; and,
- As the population ages (Figure 5) and interest rates continue to fall, Chinese investors will seek out yield wherever they can find it.

Figure 5: A population of retirees the size of the US
UN population projection for China by age



Sources: GaveKal Data/Macrobond.

WHAT LIES BENEATH
– by Andrew Batson, GaveKal, 9 July 2015

As the rout in Chinese shares has deepened – and spread, hitting markets in Hong Kong and beyond – Beijing's efforts to prop up domestic stock prices have only intensified. After an unprecedented package of market support measures at the weekend failed to stem declines, even more unprecedented actions followed. On Wednesday, the central bank pledged to help maintain market stability, and Chinese stock regulators banned company officers and major shareholders from selling shares in listed companies. All this smacks of a desperation which does not seem warranted. While the benchmark Shanghai Composite index is down −30% from its peak of four weeks ago, it is still up 70% or so over the past 12 months. So why is China's government trying so hard to push stocks back up? And, if the government is so worried about the falling stock market, should everyone else be too?

There are lots of theories about why the Chinese government is trying so hard, some more plausible than others. Here is the GaveKal Beijing team's guide to the mess.

1. The government is scared a falling stock market will hurt economic growth

This is a possible motivation, but objectively the risk does not warrant such market intervention. Any wealth effect from rising or falling stock values would be small, given that less than 7% of China's urban population owns stocks, and would be dwarfed by swings in the RMB150 trillion of household real estate assets. While the rising stock market has allowed more companies to raise money by selling shares, equities account for only 5% or so of total private sector fundraising, so a reduction would not have a huge impact. Surging profits from the financial sector did add half a percentage point to GDP growth in the first quarter - a gain that could quickly reverse. Given that growth is headed below 7% anyway (see The New Normal Will Not Be 7% Growth), the market slide certainly doesn't help. But the real issue is the sustained slowdown in investment spending.

2. The government wants a rising stock market in order to privatise state-owned enterprises, reduce reliance on bank lending, and improve the pricing of capital

While this may have been a factor behind official approval of the earlier run-up (see The Xi Jinping Put), it would appear to have gone out the window with successive attempts to micromanage the stock market. Our assessment is that pumping up the market did nothing to advance economic reform, and the frothy valuations and high levels of leverage arguably retarded it. More to the point, if the government is really concerned about the systemic benefits of a better-functioning equity market, then why does it act like its goal is to fix where the Shanghai Composite closes? During the downturn, it has frozen initial public offerings instead of encouraging them, and browbeaten brokerages into publicly supporting a specific level of the index.

3. The government wants a rising market to attract foreign investors and advance the internationalisation of the renminbi:

This could be one of the motivations, but if it is, then the authorities are going about it entirely the wrong way. Foreign investors are far less likely than domestic ones to be sympathetic to the government's heavy-handed interventions. And is the drive to get A-shares included in global equity market indexes really being advanced by regulators allowing over 1,300 companies to suspend trading?

4. Beijing is scared a falling stock market will cause a financial crisis

This is a plausible motivation, though again we think objectively it is not a huge risk. The domestic financial industry has probably exaggerated the potential downside as it lobbies

for government support. Leverage has played a big role in both the rapid rise and the fall in stock prices, and brokers have extended RMB1.5 trillion in margin finance to investors. But the banking system has limited exposure to the brokers, which are unlikely to default – brokers' own leverage is limited to four times, and their strict margin calls on investors limit their own risk. Banks also distribute wealth management products to retail investors, and some of these products are invested in equities (press reports suggest about RMB3 trillion worth). But WMPs are not obligations of banks, and if stocks keep going down, the products can simply pay out lower returns. More direct risks come from companies which have used their stock holdings as collateral for loans. As the value of their collateral declines, firms will have to come up with more collateral or repay the loan, both of which may be difficult. Again, however, the scale does not seem enormous. According to Chinese data provider Wind, companies have put up RMB2 trillion in equities as loan collateral, which on a 50% loan-to-value ratio means only about RMB1 trillion in borrowing. Relative to more than RMB90 trillion in outstanding bank loans, these are not enormous sums.

5. The government needs a rising stock market to pay off China's financial elite and to convince them to support Xi Jinping's agenda

Admittedly a speculative theory, but it's one that seems increasingly plausible. The combination of an aggressive anti-corruption campaign and a stagnant property market has closed off some of the traditional money-making avenues for well-connected insiders, so to retain their support, Xi Jinping has to give them other ways to profit.

6. Since the government has promised the public a rising stock market as part of the "China Dream", it needs to deliver what it promised

This is the most plausible theory, in our view. What the government is ultimately worried about, we think, is its credibility and public support. Though the months-long propaganda blitz urging people to get into stocks was clearly a mistake, the government may still feel compelled to support the stock market in order to show it can deliver on its promises. Unfortunately, even this series of unprecedented interventions has failed to force stock prices to go where the government wants them, and confidence continues to erode. So, the most likely result of these desperate attempts to restore credibility is, in fact, a deterioration in the credibility of the government's commitment to reforms and its ability to execute them. This is something that should concern global investors, even though few of them are invested in the A-share market.

Louis-Vincent Gave is Founding Partner and CEO of GaveKal Research. GaveKal is one of the world's leading independent providers of global investment research. It also advises several funds with combined assets of more than US$2bn. In Australia, GaveKal Capital's GaveKal Asian Opportunities Fund is available through Ironbark Asset Management.

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