

Schroders TalkingPoint



Schroders Quickview: Correction in Chinese shares highlights irrational exuberance

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The liquidity-driven rally in the China market has finally ended with a crash. Here, we analyse what has happened and what may lie ahead

Back in May we argued that the liquidity-driven rally in Chinese share prices was not justified by the underlying fundamentals. We also expressed our concerns that A-shares were already at vulnerable levels in light of their frothy valuations, increasing issuance of initial public offerings (IPOs), rising margin financing and deteriorating corporate fundamentals. Furthermore, we shared our view that a change in the stance of regulators, such as the tightening of leverage trading, could be one of the potential triggers to cause a major correction in the market.



Since reaching a multi-year high on 12 June, Chinese A-share markets have been in freefall, with the Shanghai Composite index falling nearly 32%. Whilst we have been expecting to see a market correction, the bubbles in A-shares have burst faster than we had expected. This is mainly due to the following factors:

Highly leveraged equity market

The recent run-up in A-shares was fuelled not only by broker margin financing but also other informal financing channels. The data on broker margin financing, which peaked at about 2.2 trillion renminbi (RMB, as of mid-June), is more transparent and well-known to the market. Other than that, there are other types of informal financing channels, such as so-called umbrella trusts issued by banks and other private lending. The total amount is unclear and is estimated to range from RMB 1.4 -1.7 trillion. The recent sharp fall of the A-share market was triggered by such deleveraging activities.

Increased pace of IPOs

China's securities regulator had increased the pace of IPOs from one batch per month to two batches in the period from April to May. Some mega IPOs took place during the month of June and further drained liquidity from the market; for example, the IPOs of China Nuclear & Guotai Junan raised RMB 13 billion and RMB 30 billion respectively.

Insider selling and company placement

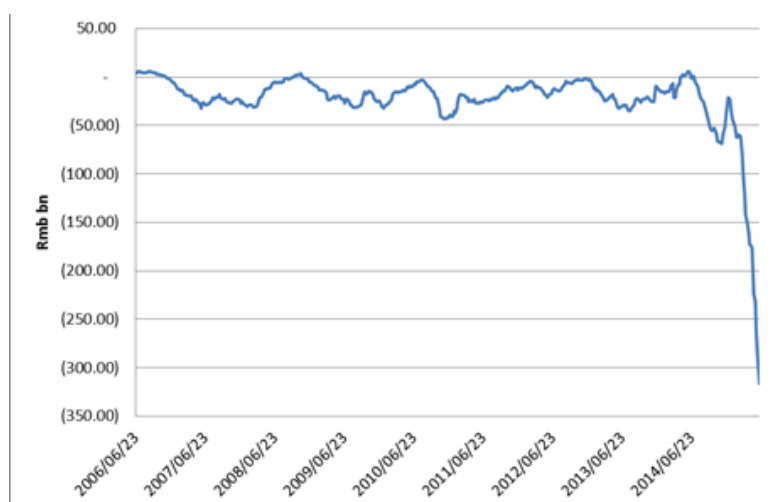
Listed companies' major shareholders / management had cumulatively sold a total of RMB 400 billion worth of shares year-to-June, which is an unprecedented volume in A-share history. Cumulative new share issuance is estimated to be RMB 510 billion on a year-to-date basis (as of July 2015). We have also seen aggressive insider selling and corporate placement in Hong Kong as they are trying to benefit from the market strength and higher valuations in the first half of this year.

(continues below)



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A-share cumulative 3-month selling by listed company shareholders



Source: CICC, data as of June 2015

Why have supportive government measures not worked so far?

This recent market correction has been triggered by an increase of equity supply and high stock valuations and further exacerbated by the deleveraging and unwinding of margin financing. A series of announcements has recently been made by the government in an attempt to stem stockmarket falls and shore up investor confidence. These include:

- 1) Cutting transaction levies
- 2) Suspension of IPOs
- 3) Suspension of new short positions
- 4) Brokerages are encouraged to relax their margin enforcement level
- 5) People's Bank of China (PBOC) to provide funding to China Securities Finance (CSF), a state-owned entity that makes margin financing available to brokers. This vehicle will be used to buy into stocks in the market.
- 6) Brokerages launched a RMB 120 billion fund to support the market by jointly investing in blue-chip exchange-traded funds (ETFs).
- 7) Encourage shareholder buybacks and restrict major shareholders from selling in the next six months

However, these actions appear to be uncoordinated, confusing and not substantial enough considering the amount of margin positions and the size of the A-shares market (which has a free float of RMB 40 trillion). The frequent changes of policy and rules have furthermore brought about confusion in the stockmarket and underscored the lack of institutionalisation and deficiencies of the China A-share market, which could further delay MSCI including A-shares in its benchmark indices.

In addition, another challenge is that government buying is now mostly focusing on blue-chip stocks, which are trading at more reasonable valuations. However, most of the selling pressure has been concentrated on the overvalued mid /small cap theme-driven stocks as well as the Chinext stocks, the "darlings" of the domestic fund managers and retail investors. This has clearly caused an obvious mismatch of what the government is supporting and what the investors are selling.

Given the scale of problems and the leverage involved, there is definitely a need to call for more comprehensive and better thought-through packages from the government to deal with the situation. A failure to break this margin deleveraging cycle could increase the risk of a systemic risk in the financial system. In our view, a large scale fund backed by government financing is required to provide a floor to the market, restore investor confidence and break the downward margin spiral.

We have seen this being done in other markets from the previous market cycles. For example, Hong Kong used its foreign exchange reserves to defend the peg of Hong Kong dollar to the US dollar in 1998. Taiwan authorities also previously set up a "national stabilisation fund" to mitigate the market downfall.

When will the A-share market bottom out?

In our view, the surge from 2000 to 3000 points of the Shanghai Composite index was primarily driven by market fundamentals and loose monetary policy. The market subsequently witnessed a fast and furious rally, spurred on by margin financing and the state-owned media's talk of "a government-driven bull market" to encourage retail participation from March to June.

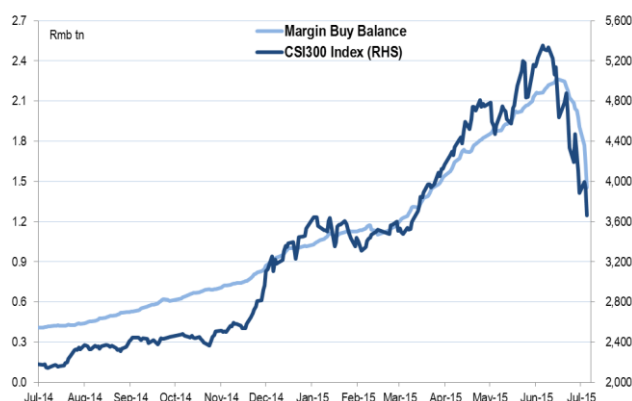
The official margin positions have so far come down to RMB 1.46 trillion (as of 8th July) from RMB 2.2 trillion. Although

leverage amounts from other informal financing channels is not certain, we believe a big portion of this has probably already been cleared given the recent market plunge and high leverage ratios (3-4x gear) of this lending.

As of the 8th of July, more than 1300 stocks, or 40% of A-share stocks, are under voluntary or involuntary suspension in fear of “catching the falling knife”. Unfortunately, this will only further disrupt the market clearing mechanism and exacerbate the liquidity problem. This unprecedented corporate behaviour also highlights the “emerging nature” of China A-share market.

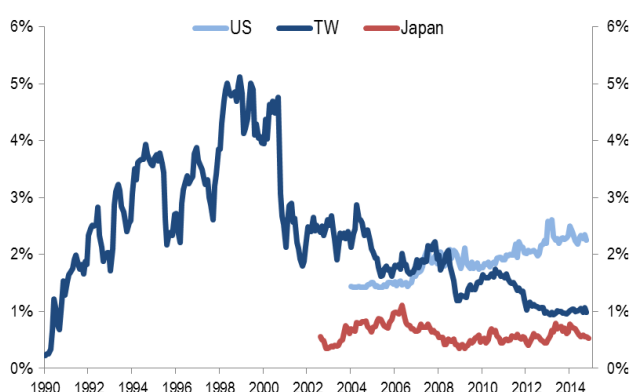
In the short term, A-shares will remain under pressure amidst various challenges and a weak economy. In reference to other stockmarkets, we think a more “normal” level of margin financing as a percentage of market cap is probably around 2%, which translates to a margin level of around RMB 1 trillion. In terms of valuation, we expect the Shanghai Composite to find some fundamental support at around the 3000 level. The A-share market benchmark CSI 300 now trades at 13.5x 12-months forward P/E, and non-financials at 17.5x, derated significantly from previous highs of 18.6x/26.5x respectively, and is at 9% and 5% discount to their respective 10-year average. We see value in some blue-chip companies whilst valuations of Chinext stocks and many mid-cap stocks remain expensive. (continues below)

Brokers' margin balance versus CSI 300 index

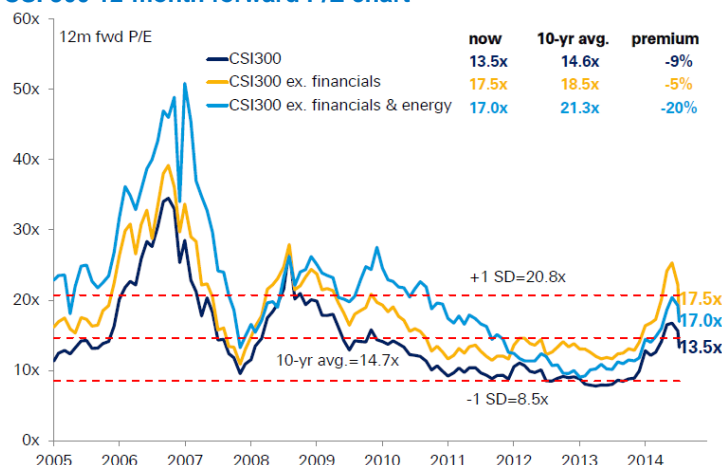


Source: CEIC, Wind and Citi Research, data as of 8th July 2015

Brokers' margin balance as a % market cap for other markets



CSI 300 12-month forward P/E chart



How about Hong Kong H shares?

The Hong Kong listed China stocks have also been hit hard this week amidst the double whammy of intensifying global uncertainties and negative drags from A-share market sentiment.

The rapid market drop has been triggered by several factors:

- 1) Worries over “Grexit” which reduced investor risk appetite
- 2) Spillover of negative sentiment towards A-shares into the Hong Kong/China stocks and the deleveraging impact of unwinding of margin financing position.
- 3) Suspension of the A-share stocks have further made the Hong Kong stocks and the US listed Chinese ADRs “the ATM machine” for raising cash.

The mid cap theme-driven stocks favoured by Chinese investors have been particularly hard hit in the recent market correction. Meanwhile, the broader Hong Kong blue-chip names have been less volatile. In general, the Hong Kong stockmarket is more institutionalised and disciplined. The Hong Kong market has lagged the China A-share market rally in the first half of this year, with the share price discount of the dual-listed China companies widened compared to their A-share counterparts during the period.

In the near term, the MSCI China will continue to be influenced by the A-share market sentiment as well as external factors, including a potential “Grexit” in the eurozone and the potential interest rate hike by the US Federal Reserve. However, we see more value in Hong Kong-listed China stocks for longer-term investors as their valuation has become attractive after the recent correction. MSCI China now trades at 1.3x trailing P/B, close to one standard deviation from its 10-year average.

MSCI China valuations in terms of P/E



MSCI China valuation in terms of P/B



Source: Datastream and Citi Research, data as of 8 July 2015

Investment implications

We would argue that the recent panic-selling in the Hong Kong stockmarket has created a good buying opportunity for longer-term investors.

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