

the quarterly dragon #2

July 3, 2015

Will the China equity rally continue? Yes, it may very well do so

There are some troubling signs: margin debt, irrational price movements, big intra-day swings. But the main foundations of the recent rally remain in place: government support, liquidity, declining interest rates. The recent correction is hefty but

healthy. And the long-term perspectives for China's economy are promising. Private equity investments in sectors like consumer upgrading, education and healthcare are some of the most attractive investments in China at this time.

If you ask the average investment professional what you get during a period of multiple «profit warnings», the answer will probably be «flat to lower equity prices.» So what would you have expected for China, in an economic environment where GDP growth slowed from 7.6% in Q4 2013 to 7.0% in Q1 2015, where company profits are way down, where the all-important residential property sector experienced falling prices for the first time ever, where the nominal trade-weighted Renminbi (RMB) strengthened by 9.3% between December 2013 and May 2015, and where producer prices have been dropping at annual rates of between 3% and 4.5% for the past two years?

Equity rallies between year-end 2013 and the end of June 2015 for the Shanghai Composite Index of 104%, for the Shenzhen Composite Index of 134% and for the CSI 300 Index¹ of 92%? Are you serious?

Granted, the authorities have loosened monetary policy, starting in Q4 2014. And the government's fiscal measures continue to support large infrastructure projects. But these actions have by no means been aggressive, partly because the government appears to be not too concerned about the outlook for the economy, and partly because it is seeking to achieve better-balanced

growth. These actions cannot explain such strong stock-price moves.

Non-economic drivers / «Don't fight the government»

Instead, big contributors to the recent strength of China's stock markets appear to be a combination of non-economic factors. These include active attempts by the authorities to encourage investments in equities; an easing of regulations that encourages mergers and takeovers between Chinese companies and that has triggered a surge of new brokerage account openings by retail investors; comparatively low

valuations when the rally began; and the recent price softness of the property sector, which has motivated a switch from «real» to financial assets.

As is frequently the case in China, the government was heavily involved in a major new development. In addition to verbal statements of support, many actions cumulatively have been supportive of the equity markets: reforming M&A regulations to make acquisitions by listed companies of other listed companies less cumbersome and making SOEs stronger through consolidation; re-starting the flow of IPOs and pricing them at levels which all but ensure strong trading gains on the first day; securities brokerage companies (many of which are state-controlled) raising money in the capital markets and stating publicly that the use of the majority of the proceeds is meant to finance margin lending; the stock exchanges lowering the transaction fees they charge for trading on their exchanges.

If you talk to Chinese who are plugged into economic and social developments in their country, their attitude resembles many Americans' view that it is not advisable to



¹ The CSI 300 Index includes the 300 highest-capitalized stocks on both the Shanghai and the Shenzhen stock exchanges.

«fight the Fed»². «Don't fight the government» means that, if the all-powerful government in China wants equity markets to stay at certain levels, it will systematically work to reach its goal, using all levers. So how can a government influence the trading level of equity markets, you might ask? Well, the answers to that question include facts and anecdotes which are plausible only to someone who has a solid idea of how China works.

Facts include a statement by China's securities watchdog that an «excessively fast correction» would be not healthy and the finance and social security ministries publishing draft rules that would permit the state pension fund to begin buying stocks. Anecdotes include stories that the person responsible for asset management at a large state-controlled insurance company was transferred laterally in the organisation, thus relieved of his investment decision responsibilities, after he sold a large portion of the equity positions at a time considered inopportune by his policy-sensitive bosses. This line of thought supports the case made by many observers on the ground in China that **for at least another two years, i.e. until the Xi/ Li administration has been confirmed for their second 5-year term, some degree of stability for the equity markets can be expected. Volatility will undoubtedly be high, but the «Xi put» may work in similar ways (but through different mechanisms) like the «Greenspan/Bernanke/ Draghi puts» have.**

In addition, mainland China's equity market is dominated by retail investors. Pinning down the exact percentage is difficult, as no official statistics exist. While in most equity markets in the developed world institutional investors account for approx. 80% of the shareholdings and the trading activity, some Asian markets like China and Taiwan are

different. Institutional savings simply have not been built up in China to a degree which lets them be large market participants. So the majority of the investment activity in Chinese equity markets has come from retail investors. And China's retail investors have been an incredible force, subject to strong swings in sentiment (see chart #2).

Anecdotal stories abound which tend to support the view that relatively unsophisticated investors have been active in the markets: e.g. low-priced stocks performing better than high-priced stocks, because investors think that the lower the absolute price the lower the potential losses are. Moreover, many of the holders of newly opened brokerage accounts are young, most likely without forceful memories of the crash in 2008, when the CSI 300 Index fell 66% in 12 months. A survey done by the Shenzhen stock exchange shows that **since 2014, 66% of the new individual investors were 40 years old or younger**³.

Few alternative uses of money, thus equity markets are tempting

Given stable employment, strong wage growth for two decades and low levels of personal debt, the disposable income of private citizens has grown a lot. But there are few uses for these funds: consumption, holding cash in bank accounts, buying an apartment (restrictions still apply in most parts of the country regarding owning more than one apartment per married couple) and buying stocks. With property prices softening in some markets in recent years, with cash deposit rates still largely capped and kept at interest rates clearly below 3% (which is higher than the official CPI inflation rate but lower than the inflation rate perceived by many people) and with the Chinese propensity to save money and delay consumption, equity investments with their phenomenal re-

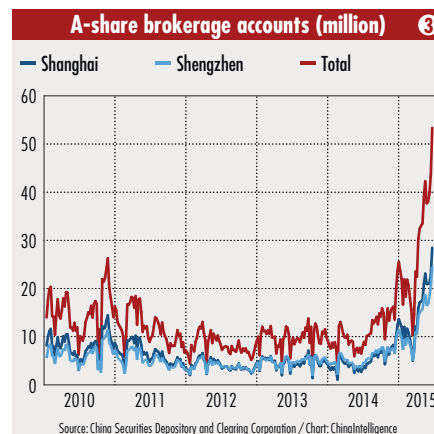
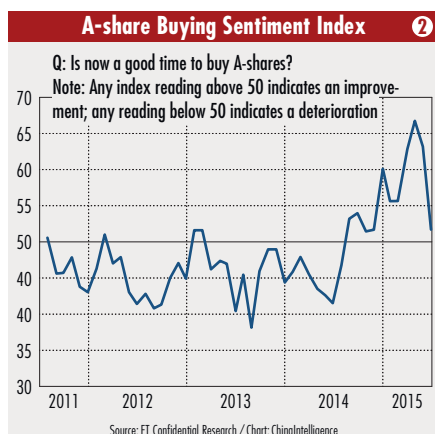
turn potential can be tempting. Add to that the ease of opening a brokerage account and the availability of margin lending, and you have all the ingredients for powerful moves in the equity markets. The resulting positive sentiment has fueled the rally over the last 9 months.

Most Chinese citizens have bank accounts, with all the bells and whistles of bank accounts in developed countries, and more (e.g. e-banking, automatic cash sweeps into money market products, ATM cards, access through smartphones; because the «glass citizen» has always been the reality in China, i.e. the government has access to all the information about everybody at all times, no privacy issues are hindering electronic banking transactions). If a bank account holder wants to open a brokerage account, he must do this with a special subsidiary of his banks, since banks themselves are prohibited from directly offering securities trading services. **Opening a brokerage account is easy, trading is convenient, and trades can be executed from the smartphone.** As a result, the equity rally increasingly started to feed on itself, especially beginning in 2015, as the strong growth in brokerage account opening shows (see chart #3).

Margin loans easy to obtain, lending values at over 70%

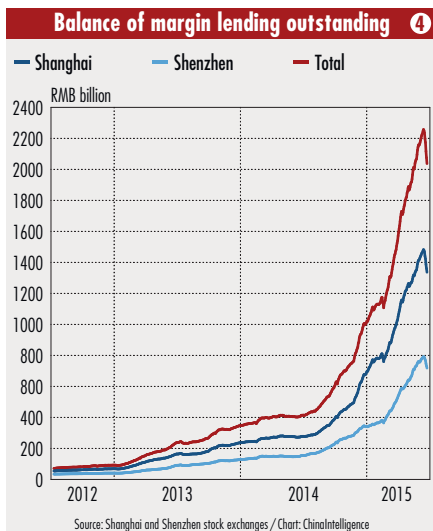
Margin lending is straightforward to obtain. The rules are set by the stock exchanges. The stock exchange issues a list of shares eligible for lending. For the Shanghai stock exchange, the so-called «maintenance collateral ratio» (cash + market value of stocks in the securities account)/(initial amount of the margin loan+ interest and surcharge) must be at least 130%. In other words, **the initial lending value for stocks is a maximum of 76%**. Once a drop in equity prices makes the «collateral ratio» fall to below 130%, the securities firm requires that the customer adds collateral in 2 trading days, and thereafter the collateral ratio should not be less than 150% (this equals a lending value of a maximum of 66%). It is clear that margin loans of 76% of collateral after such a pronounced equity rally are dangerous.

So on July 1, 2015, this requirement was



² «Don't fight the Fed» reflects the conviction of many investors in the United States and elsewhere that it is risky to take trading or investment positions that bet on market developments which run counter to what the Federal Reserve Bank intends to happen.

³ Source: Finance innovation lab of the Shenzhen stock exchange.



lifted, and the brokerage firms are now allowed to set their own rules regarding when and how much additional collateral they require. And brokerage firms, many of which are subsidiaries of state-owned banks, will certainly comply with the government's wishes to avoid stock market «flash crashes». **This somewhat diffuses one of the main risks in China's equity market today: forced selling because of missed margin calls.**

Margin lending has increased phenomenally, especially during 2015. In addition, underground lenders have reported a sharp rise in demand for margin loans in recent months. So **it is beyond doubt that a significant portion of the liquidity flowing into equities had been borrowed.** Margin balances (approx. RMB 2 trillion) amounted to almost 10% of the free float of China's stock market capitalization, a very high level. As much as margin lending fueled the rally, it certainly has contributed to the correction and high downward volatility in the market in June 2015 (-27% for the Shanghai Composite from its peak on June 12th to July 3rd).

IPOs contribute to market volatility

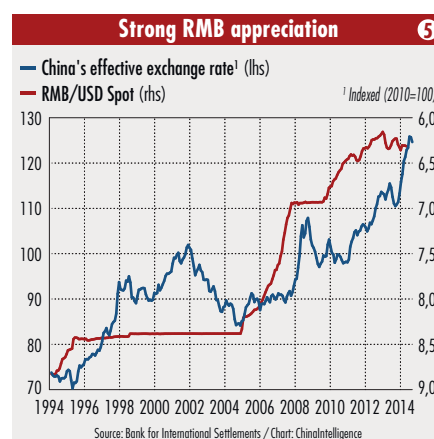
After the 2013/14 IPO moratorium to clean up the approval process, the regulator has again allowed a steady flow of IPOs to take place on China's stock exchanges. As a result, 187 companies in Shanghai and Shenzhen went public in the first half of 2015, raising a total of RMB 146.1 billion (approx. USD 23.5 billion). This is not a substantial amount of money raised, a little less than Alibaba's IPO size on the NYSE in 2014. **One of the major impacts of the IPOs, however, is that they exacerbate price volatility.** IPOs absorb liquidity, but they

absorb liquidity more in a temporary way, particularly in China: Given the invariably good post-IPO performance because all of them are artificially priced too low, IPOs are heavily oversubscribed. Subscribers have to keep liquidity in their accounts during the subscription and pricing process, leading to fluctuations in the liquidity available for trading in the rest of the market. Since IPOs take place once a month, at approximately the same time, the subscription process leads to an ebb and flow of money taken out of the market in anticipation of participating in an IPO, and then re-entering the market once the IPOs have been priced. Since most investors subscribe to IPOs but only few get their desired full allotment, the amount of money leaving and re-entering the stock market is substantial.

RMB stability is an important market driver, also for domestic investors

It is clear that the RMB's exchange rate should be an important consideration for non-Chinese investors when investing in China. But it also plays an important role for domestic investors. **If the RMB is perceived as a stable currency, most importantly against the USD, the marginal RMB will have a higher chance of being invested domestically, and thus has a chance of ending up in the A-share market.** If, on the other hand, expectations of an RMB depreciation take hold, the marginal RMB may leave the country through one of the official or less official channels. Capital flight would creep up.

The RMB has strengthened considerably in recent years, up 25% in the last 5 years in trade-weighted terms, 13% in the last 12 months alone (see chart #5). Versus the USD, the RMB has been stable for the last two years. In light of orchestrated depreciation efforts in recent years in Japan



and Europe, and given the subdued growth expectations for China, one might expect efforts by the central government to weaken the RMB. **But we do not expect a systematic weakening of the RMB.**

Increased volatility in the RMB exchange rate is conceivable as a result of the ongoing opening up of the FX market. But a weak RMB is unlikely for two reasons. For one, **the bigger picture is that RMB internationalization and «upgrading», from a shunned emerging markets currency many years ago to one of the world's reserve currencies in a few years, is one of Beijing's stated goals.** This will bring political but also economic benefits to China. If the RMB is more widely seen as a stable, fungible currency, many of the regional infrastructure projects following the «One Road, One Belt» and other infrastructure initiatives can be financed in RMB. And the cross-border trade, now still mostly invoiced in USD, will increasingly use the RMB.

In addition, a strong RMB will put further pressure on business sectors which are unprofitable at current exchange rates and could survive only with a weaker currency. This will increase the competitiveness of China's economy as a whole, a development which certainly is compatible with Beijing's longer-term goals of transforming the sector mix of its economy from low-margin, export-oriented businesses to higher-grade industries. To anybody living in Switzerland, these arguments for why a strong currency may be good in the long run for the economy as a whole sound familiar.

Even a strong equity market correction will not derail the economy – real estate prices may actually rise in this scenario

In general, a sustained equity rally may support the economy through the wealth effect. How such a transmission mechanism from gains on equity positions to economic activity might work in China is entirely undocumented. And the recent equity rally cannot yet be called sustained. Nevertheless, we suspect consumption spending may be supported by the recent equity gains at the margin.

The more interesting question is if a severe correction in the equity market has the potential to harm economic activity, thus derailing the current equilibrium in China's economy, namely a combination of gradually weakening growth, solid employment, growing wages and growing retail sales. Yes, substantially lower equity

prices would not be good news, but an interesting pattern has emerged in the last ten years: **every time after the equity markets corrected (for example in 2008 and 2010) residential real estate prices increased** (see chart #6) Why? Probably because becoming disillusioned with the equity market motivates the marginal buyers (and speculators) to allocate more money to the real estate sector. Since most Chinese live in apartments they own, the price pattern of real estate has a far stronger influence on the economy in general. Therefore, we expect that any bad news emanating from the equity market will be compensated by increased buying activity in real estate. This should cushion any negative impact on economic activity, albeit with a possible time delay.

Bifurcated valuations

Valuations are not the most important parameter in an equity market driven by liquidity, but it is nonetheless useful to look at them. The picture first shows a market that is not excessively valued when looking at a broader index like the Shanghai Composite: at between 15 and 20 times forward-looking earnings, the index's valuation is not sky-

high when considering China's overall economic potential. And these valuation levels are lower than they were at their peaks in 2007 and 2009 (see chart #7). The problem with the index-focused view is that one group of companies in particular — the banks — exhibit both a high weight in the index and low valuations. **That means that while banks' P/Es typically are below 10 times, a whole lot of companies must be trading at P/Es of 50 times or higher.** That alone may not be a reason for concern if the respective companies are in the process of conquering very large and fast-growing markets like in the E-commerce sector. But since every company cannot be doing this and be successful, the valuations of many individual companies certainly are very high and prone to disappoint investors.

So to pursue an «all-in strategy», jumping on the bandwagon with A-share ETFs, betting on the liquidity flow and higher valuations across the board, seems very risky. In addition, regarding many A-shares, an investor cannot seriously say that he knows what he buys. **Corporate governance standards at many listed companies in China are «work in progress» at best.**

But there are **reasonable arguments why a crash from current levels is unlikely and why further share price increases are absolutely possible.** Liquidity continues to be looking for a profitable home; **foreign ownership in A-shares was less than 2% at the end of 2014**, so the Stock Connect themes, allowing foreigners easier access to A-shares, could provide support; **further interest rate reductions** in China are likely and macro-economically sensible since inflation and producer prices are very low.

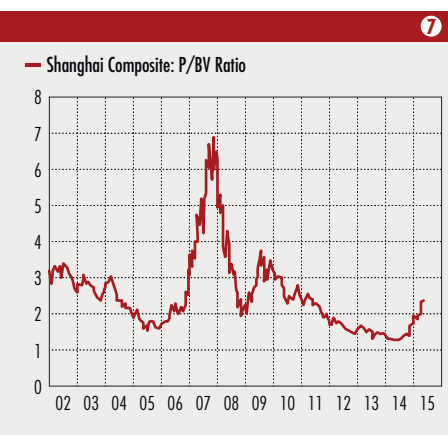
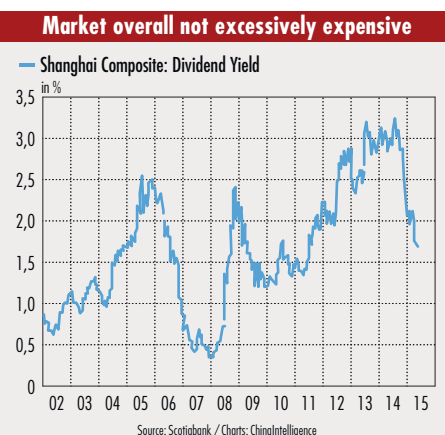
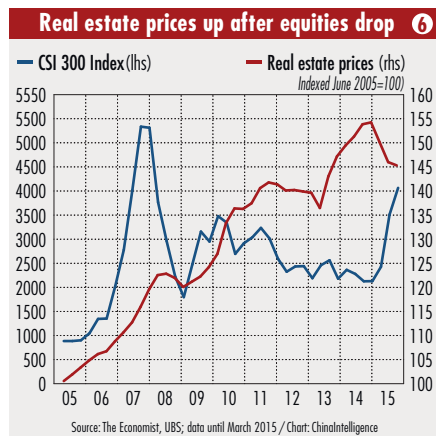
Accommodative monetary policy may be a supporting factor for equity markets a while longer, however, much has already been done on this front in the last nine

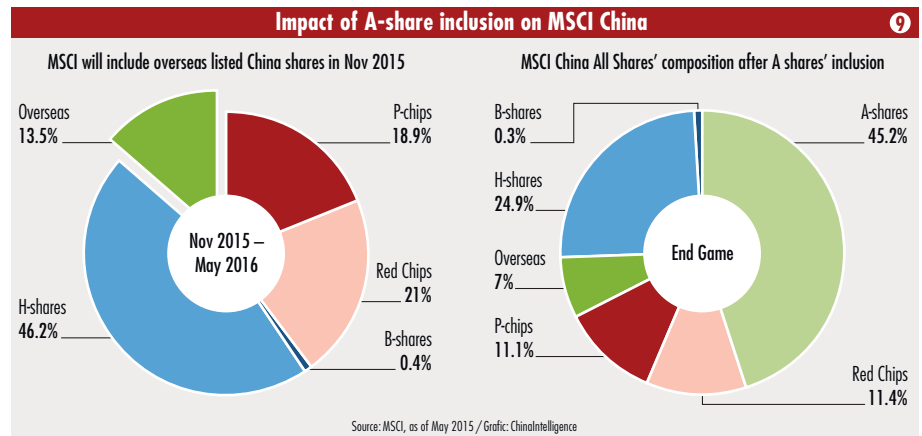
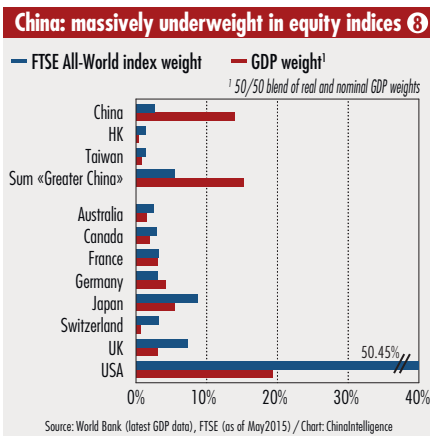
months. We do not expect China to participate in the «race to zero» interest rates which has been going on in all the major economies. China does not need interest rates at a zero level to stimulate the economy, it can do so through their policy banks and the commercial banks, which are state-controlled and state-managed.

Private equity and sector-focused strategies more promising than index products

For a better place to invest than A-share ETFs or very broadly diversified mutual funds, consider that **valuations of private companies have not increased nearly as much as valuations of public companies in the last two years.** So the «arbitrage opportunity» between the two may be the best value one can find in Chinese markets today, making private equity an attractive place to be. Superior asset management skills of private equity fund managers still can find reasonably valued targets even in today's market and work with their portfolio companies to improve operations and then find a good exit, probably by selling to a larger (often state-owned) company as part of the many ongoing consolidations in the Chinese market.

More promising than index-based investing are strategies focusing on the themes which are probable to unfold because of government policies (e.g. hukou reform, urbanization, environmental policies, lowering of tariffs for imported consumer products leading to higher consumption expenditures, especially on the ever-expanding e-commerce platforms) or unalterable developments (e.g. demographic developments, leading to higher healthcare spending). **Investments in private companies in the consumer sector, especially those focused on the upgrading of consumption patterns, education and healthcare, just to name a**





few, should provide attractive opportunities, supported by strong tailwinds and acceptable valuations.

Everybody will invest in China in the long term

Today, the vast majority of private and professional investors in Western countries are simply ignoring Chinese securities markets. And, by and large, they have not missed much, except for the last 12 months. **But the luxury to be able to simply ignore the second-largest equity market in the world will disappear.** And, as many developments in China, this may happen sooner than most people think.

The fact that only few non-Chinese investors have an investment exposure near China's weight in the global economy⁴ is an aberration. Some market observers have labelled being underweight China

as the most crowded trade in the world. This situation is driven by the low weight of mainland China's equities in global equity indices (see chart #8), which is caused by a combination of factors: currently limited access to the A-share market by foreigners, limited convertibility of the RMB and weak corporate governance standards. In addition and as a result, the general understanding of China's economy and investment markets is low. All this, however, is in flux, which will not only lead to better accessibility of investments in China, but also to **higher weights of Chinese equities in commonly used indices.** That alone will make a lot of investors, who allocate their funds according to these indices, invest in China. **It is easy to see that demand for Chinese equities may increase at that time by an amount that is considerable, even for a market with the capitalization of China.**

Prominent index suppliers have recently all but committed to increasing the weight of China equities in the foreseeable future. Just as one example, MSCI announced in early June 2015 that it will not include China A-shares in its global benchmarks for the time being. However, it expects to include A-shares soon after a few important remaining issues related to market accessibility have been resolved, and are actively working on these issues with Chinese regulators. As a first step, overseas-listed China shares will be included in the MSCI China index starting in November 2015. If A-shares were included in this index at this time, they would absorb approximately 45% of the index's capitalization, showing the magnitude of the change in index composition.

⁴ China's GDP amounts to 12.2% of the world's GDP on a nominal, and to 15.8% on a real basis. Source: the World Bank, latest data as of December 2013.

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