WaveFront Capital

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WaveFront Insights

Internationalizing China's Stock Market

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Global market participants have either experienced, or at least witnessed, a roller coaster ride over the last few months in Chinese equities. The Shanghai Stock Exchange Index sprinted 152% higher in the twelve-month period ending June 12, 2015, only to retrace 38% of the gain (as of 9/22/15). The underlying causes seem, at first glance, to be rather obvious, and have been widely reported in the financial press. However, like many events, there are both positive and negative aspects associated with it. A move of this magnitude in the world's second largest economy deserves a deeper level of understanding.

Structure of the Chinese Stock Market

Let's begin with some basics of the Chinese stock market. Most Chinese equities are listed on one of three Chinese stock exchanges: the Shanghai Stock Exchange (SSE), the Shenzhen Stock Exchange (SZE) and the Hong Kong Stock Exchange (HKSE). The total value (in USD) of the companies listed, as of 8/31/15, on the SSE was $4,011 billion, the SZE was $2,742 billion and the HKSE was $3,060 billion. The SSE and SZE trade "A" shares (companies incorporated in China and trade in Yuan/Renminbi, "CNY/RMB") and "B" shares (companies incorporated in China and trade in USD$ on the SSE and HK$ on the SZE). In addition, there are "H" shares (companies incorporated in China and trade in HK$ on the HKSE), "N" shares (companies incorporated in China and trade in US$ on either the NYSE or Nasdaq - think Baidu), "L" shares (companies incorporated in China and traded in BP on the London Stock Exchange), "S" shares (companies incorporated in China and traded in Singapore dollars on the Singapore Stock Exchange), Red Chips (often state-owned-enterprises that are Chinese companies incorporated outside of China and trade in HK$ on the HKSE) and P Chips (often run by private sector Chinese individuals that are Chinese companies incorporated outside of China and trade in HK$ on the HKSE).

Furthermore, the Chinese government recently relaxed restrictions on non-Chinese investors buying A-shares in November 2014 with the "Stock Connect" link between the SSE and the HKSE. The Stock Connect allows, in a manner less restrictive than QFII (Qualified Foreign Institutional Investor Program), mainland Chinese investors to purchase select Hong Kong and Chinese companies that are listed on the HKSE, and lets "foreign" investors buy shares listed on the SSE.

Sound Confusing? Well…it is.

China Strives to Create a Global Stock Market

While digesting the structure of its equity markets, it is important to remember that China is still a highly centralized, single-party government that has tasked itself with creating a fully functioning, globally focused economy. An undertaking that will require some major changes…and patience. A few of the major initiatives are summarized below:

i. A principal tenet of the Chinese government's plan for modernizing the economy is to promote a fully-fledged market economy that includes a shift away from state owned enterprises (SOEs) towards the private sector.

ii. The central government has also undertaken economic programs aimed at encouraging both urbanization and consumption by de-emphasizing the infrastructure investment that powered economic growth for many years. This is a shift, if the government is successful, towards growing a Chinese middle class that could number over 700 million individuals in a relatively short period of time. This rapidly growing segment of the economy wants certain things: employment, housing, better food, less pollution and access to goods and services.

iii. China is only beginning to develop social welfare programs. A historical lack of a government structured retirement safety net, such as social security, has created a culture in which the average Chinese consumer is a voracious saver. In fact, the savings ratio of Chinese households is among the highest in the world.

iv. As mentioned above, the Chinese government has also begun to encourage the development of a more robust private sector, which includes plans to allow State Owned Enterprises (SOEs) to function more and more like private corporations so that Chinese companies can compete in the global market. To further this objective, and using the HKSE as a model, the central government supported the creation and growth of both the SSE and the SZE. As a result, equity investment is now viewed as a potential wealth generator for a population that has relatively few investment choices.

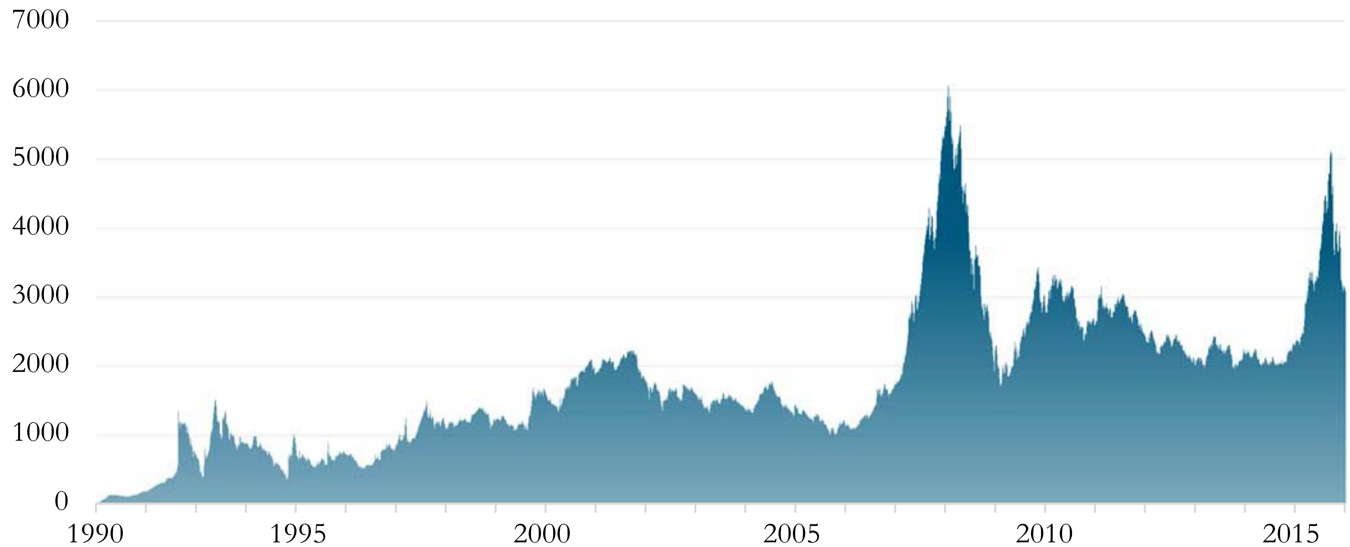
Shanghai Stock Exchange Index from 1990 Through 2015

Now that we have a picture of where China would like to take its equity markets, and their current composition, let's take a moment to examine how they've evolved up until now, including events in the summer of 2015:

Exhibit 1 presents the SSE Composite Index, both A and B shares, from its modern day inception on December 19, 1990 through September 30, 2015. Two periods stand out: 2007 and 2015. Both periods witnessed a dramatic rise in the Index over a few months and then a sharp retracement of these gains also over an equally short span. The SSE Index reached its highest closing level on October 16, 2007, and then tumbled 70% by the end of 2008. This was, of course, a period when Chinese government statistics showed the economy expanding at an annual average of nearly 12%, and Chinese households with low yielding investments were eager to own equities. The Chinese government began raising interest rates and taking other actions to dampen the lofty equity valuation in late 2007. Then China, like almost all other economies, encountered the so called "Great Recession" and Chinese equity valuations, together with almost all other global equity markets, dropped precipitously.

Exhibit 1 also shows that the SSE Index was then relatively flat, on balance, from 2009 through mid-2014, and then began rising steadily until it reached a high of 5,166.35 on June 12, 2015. It then fell to its recent low of 2,927.29 on August 26, 2015. Unlike the previous 2007 period of soaring equity valuations, Chinese equity prices, especially A shares, began rising in mid-2014 as Chinese GDP growth was decelerating. The pool of investable savings was much larger than in the earlier period, coupled with Chinese real estate prices moving aggressively higher. This did not go unnoticed by the Chinese government or the financial media, and stories abounded of individual Chinese buying multiple living units as a way of getting higher returns. The government began to discourage this type of investment by restricting bank lending and the "shadow banking" community from extending credit for residential purchases.

Exhibit 1 – Shanghai Composite (12/19/1990 to 9/30/2015)

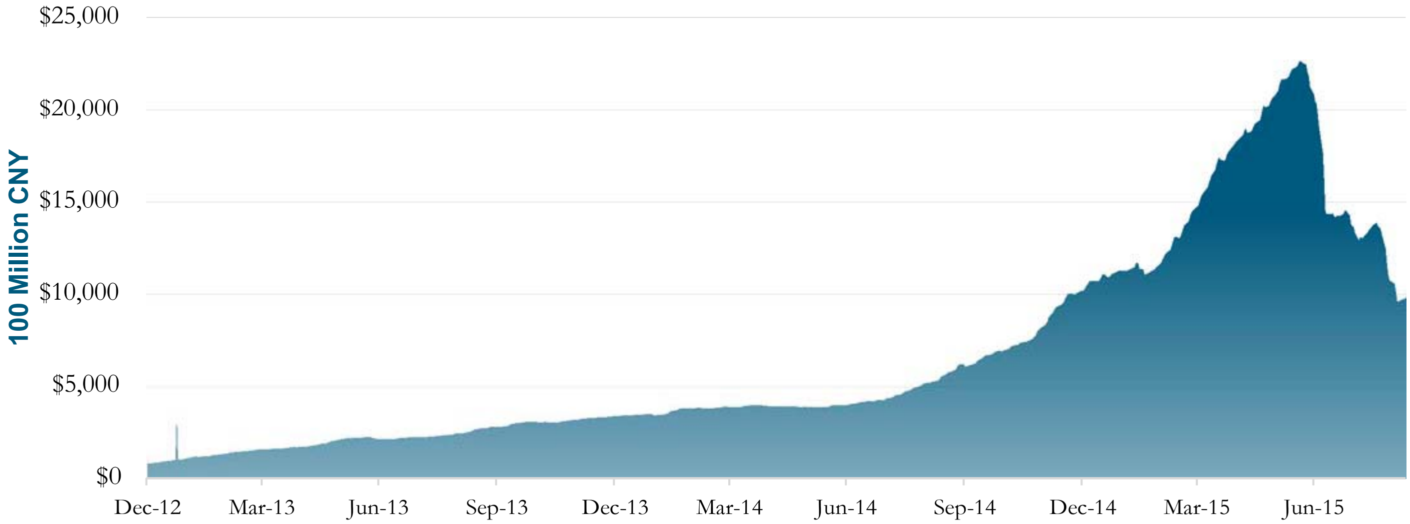


Momentum and Margin

The Chinese government initially advocated investing in corporate equities and the population responded with large net purchases of A shares issued by companies listed on the SSE and SZE. In addition to opening new investment accounts, an increasing number of Chinese investors began opening margin accounts, recently authorized by the regulatory authority, to augment their returns.

Many first-time investors became convinced that the share prices would continue to move higher because the Chinese government supported the action, and a very strong momentum-driven market resulted. Exhibit 2 shows the amount of margin credit outstanding (in US dollars) that was advanced to investors over the 2-2/3 years ending in August 2015.

Exhibit 2 - China Margin Trading Balance (source: Bloomberg)



U.S. and other global market observers, ranging from Bill Gross to Morgan Stanley, began referring to the price levels of the SSE and SZE as an equity market bubble in the spring of 2015. At the same time, the expected pace of growth of the Chinese economy was called into question by various economic forecasters. Equity market metrics (such as the price/earnings ratio of the SSE Index) increasingly looked unacceptably high. As noted above, many Chinese investors had never owned equities before, and a large portion of these market participants began investing when the prices were at or near unprecedented levels. When the bull market period finally began to roll over, the decline was precipitous and the double-edged sword of margin investing began to cut in the other direction. As the decline accelerated, many individuals were required to replenish margin balances that had contracted sharply in the decline.

Intervention

As a rush to the exits continued, various Chinese regulatory authorities began to announce policies that were, to non-Chinese observers, somewhat contradictory and some of these measures seemed to add to the selling pressures. For example, the regulatory agencies initially started insisting that margin accounts be limited and/or closed, forcing some investors to liquidate their holdings. This policy was quickly abandoned, although extensions of credit by the "shadow banking" community continued to be severely limited. The Chinese government also instituted restrictions on selling by major corporations and corporate officers. At about the same time, the Chinese government announced that it would begin allowing the foreign exchange value of the RMB to float more freely, a move that surprised international investors and caused some to liquidate their Chinese holdings. Hedge funds were singled out as a source of shorting, and government officials began examining the trading records of these and other institutions.

The Chinese stock index futures market was also "tagged" as a source of short selling, and the volume of index contracts traded contracted sharply. Individuals and some institutional investors were summarily accused of "destabilizing" the market, as traders and financial media representatives were questioned by authorities. Finally, major Chinese SOEs and other corporations have recently begun initiating large "buy" orders late in the daily trading sessions on the SSE and SZE that have, in some instances, reversed losses for those sessions.

Summary: A Reconsideration of Recent Actions

Taking a step back, it seems clear to us at WaveFront that the recent intervention by Chinese regulatory authorities has not advanced the Government's goal of "internationalizing" Chinese stock markets. The recent events can be seen as a step backwards. However, the Chinese are not the first to allow margin accounts and excessive leverage to become too large of a factor in their equity markets, and other countries have had results similar to the Chinese experience. Nevertheless, the Chinese government failed to heed the experience of other countries.

It's important to recognize, however, that the proportion of Chinese households owning equities is still quite small and margin account participation is an even smaller proportion. So, the goal of positioning China's equity market as an avenue of wealth creation for an increasing number of Chinese investors may still come to pass. Moreover, China's financial system is still in the early stages of offering households investment vehicles with professional money management. Most developed market economies have witnessed individuals moving from buying and selling individual stocks to mutual funds and other investment vehicles as a better way to participate in their equity markets. It seems likely that the recent events in China will accelerate a movement towards individual investors using financial intermediaries over the next few months and years. China is still an emerging market, and mistakes will be made. However, the true test is how China copes and adapts to change. A lesson learned can be quite powerful.

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