Market Focus

BPI Asset Management Research

China A-Share Slump Explained

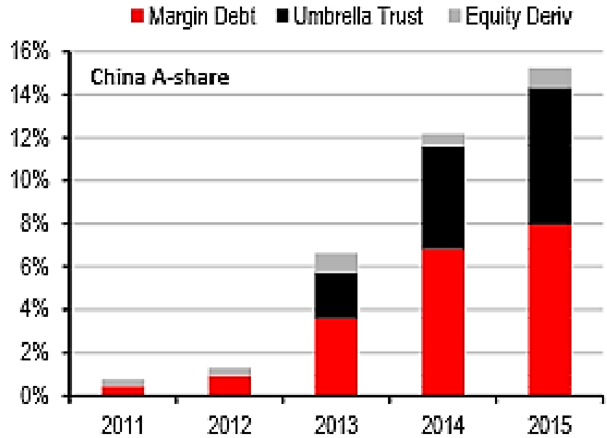
July 15, 2015

The recent sell-off in China A-Shares (-32% in the last 4-weeks) and the subsequent government response has caused more uncertainty about the prospects of Emerging Markets (EM) going forward and, more specifically, its potential negative impact on Philippine financial assets. One could argue that the events of the past few days were self-inflicted after it became evidently clear that the A-share market (Shanghai Stock Exchange Composite Index) enjoyed policy support from Beijing, which cut interest rates 4x in the last six months (in a bid to boost the domestic economy via positive wealth effect from a surging stock market). Together with recent reforms in the A-share market such as the Hong Kong – Shanghai Stock Connectivity, changing the IPO process from approval based to registration based and introduction of ETFs on the Shanghai Stock Exchange (SSE50) (on a trial basis) it was inevitable that retail investors accumulated debt to take advantage of the trading opportunities. In 2014 alone, the Shanghai Composite Index rose 52.9% year-on-year as retail investors benefitted from increased market liquidity brought about by the lower interest rates.

We answer key questions by understanding the source of the A-share sell off in the first place, likely subsequent government actions and its ramifications on Philippine assets.

1. What caused the sell-off? Concerns about ballooning debt financed trades (margin trading), leverage on A-shares, and umbrella trust products (a new form of wealth management product that allowed investors to maximize leverage from the normal 2x to as high as 4x) caused regulators to review its current position on leverage trading given that it was deemed excessive. **At the peak (18 June 2015), margin trading amounted to USD440Bn or 16% of tradable market capitalization. Typically in the US, according to NYSE data, cash margin debt is consistently managed to 2% of tradable market capitalization. If you include the notional value of the derivatives market (including options and futures contracts equivalent to 11% of the tradable market capitalization) total leverage in the NYSE would rise to 13% of the tradable market cap.** The China Securities Regulatory Commission (CSRC) recognized the extent of leverage in the financial system, and imposed borrowing limits and collateral requirements to reduce the risks going forward.

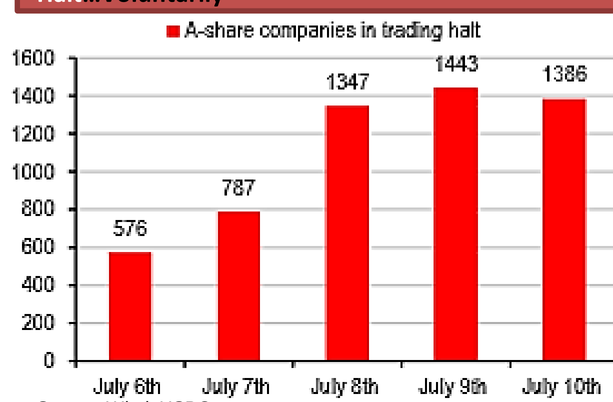
Leverage In The A-Share Market Has Surpassed The US (Cash + Derivatives)



Source: Wind , HSBC, China Trust Association

2. What has been the government response? The investor deleveraging caused the SSECI to contract 32% in the last 4-weeks. The sell-off would have been more pronounced if not for confidence boosting measures from the government, which were deemed necessary to avoid systemic risks. These measures included cuts in interest rates and stamp duties, banning of short selling activities and suspension of IPOs. At the same time, **state-owned pension funds and sovereign funds were seen actively participating in large cap issues in an attempt to boost the index. The PBOC (China's central bank) also recently funded the China Securities Finance Corporation Limited to buy stocks, without any pre-set limit in amount or timeline. The China Banking Regulatory Commission (CBRC) likewise allowed banks to roll over loans secured by shares and adjust the collateral requirement.**

Close to 43% of A-Share Companies Are In Trading Halt…Voluntarily



Source: Wind ,HSBC

3. How much lower can the Shanghai Composite Index go? The SSE CI rallied +13.8% in the last three days, which would imply the government's corrective measures have had the desired soothing effect on the market. Questions arise, however, as to the extent of further downside risks considering almost half of the listed A-shares (1,400 companies) were in trading halt (voluntary suspensions) the last three days (companies can stay in suspension as long as they like). **We suspect widespread trading halts were triggered by major shareholders of listed companies who borrowed against their shares as collateral with banks (stock pledge).** The shares were valued at 50%-60% of their market value and the recent market volatility effectively threatened the loan to value ratio of many of these loans. **To date, margin debt balance it is still significantly high at 8.1% of the A share market free float.** We argue that while the A-share market will consolidate for a while, the worst is over from the point of view of extreme market volatility given that the regulator now has exercised some of the options at its disposal to stabilize the market. **Moreover, now that capital calls have been deferred to a large extent, there is less pressure for investors to raise cash or redeem funds.**

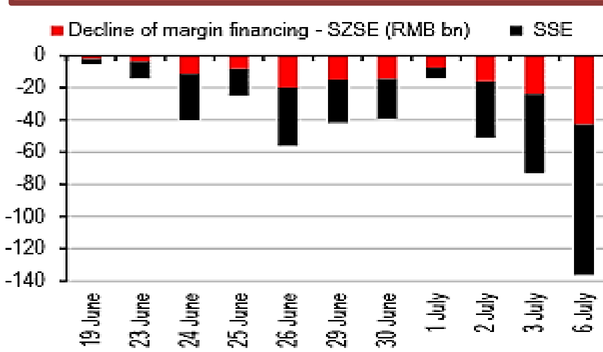
4. What is the likely impact of the deleveraging activity on China's economy? Last week's events could potentially undermine efforts to have A-shares included in the MSCI index. However, despite the scale of the recent decline in stock prices, **the expected fall out is expected to be minimal since retail exposure is relatively small compared to the size of bank deposits. Chinese household deposits stood at USD8.5tn (end-May 2015) while the total market capitalization of the A-share market stood at USD2.9tn.** We question, on the other hand, the ferocity of the government's response to the crisis, which suggests the threat of systemic risk (and shock) to the financial system might have been higher than initially thought. We believe the difficulty lies in estimating the size of leverage that was actually used to support the stock market given the widespread underground and over-the-counter borrowing activities that took place in the 1H2015. **To illustrate this point, stock pledge activity alone has risen 10x in the last 10 years.**

Consumption is also at risk given that 80% of China's urban household invested in stocks or equity funds (equity exposure is now equivalent to 30% of household liquid assets). It will take a while for retail investor confidence to return given the recent volatility. The longer the stock market consolidates, the greater the risks that households will sell their fixed assets (property) to settle their short term liabilities (margin debt) and reduce consumption behavior.

Negative wealth effects from the A-share debacle could result in downgrades in China's economic growth rate which the IMF expects to expand by +6.8% year on year in 2015 (real GDP growth rate) and +6.3% year on year in 2016.

5. What is the likely impact of China's A-share problems with regard to Philippine assets? The volatility in the A-share market will do little to diffuse the risk off sentiment in EM counters. Uncertainty over SSE CI will keep investors cautious about investing in EM in the short term despite our view that the first Fed rate increase will now be delayed to December 2015. Falling exports leading to slower recoveries in private sector investments and weaker domestic demand in EM economies (particularly Indonesia, Malaysia and Thailand) will fuel concerns about the mounting downside risks to GDP growth rates in the 2H2015/2016. As a result, we expect the Philippines to see a greater share of EM flows by virtue of its more resilient economic (+5.75% yy 2015) and corporate earnings growth (+9.6% yy 2015) for 2015/16. The USD is expected to strengthen in line with the expected Fed rate increase, which should result in stronger remittance flows leading to a more robust consumption growth rate (+6% yoy) in 2H2015. Technically, the PSEI is well supported at 7,239 by domestic institutional investors holding as much as 8.0% cash in their portfolios. Domestic liquidity levels are still high with system wide loans to deposit ratio at 68% (end1Q2015). **Any market weakness due to the China A-share issue is a window to add equity position.** We expect the PSEI to end the year at 7,800 (21x PER based on 2015 earnings), despite the 52.74% premium to the rest of EM Asia on the back of expectations that the economy and corporate earnings will expand in 2016 at 6.0% yoy and 12.8% yoy respectively.

Leverage Has Reduced 16% From Peak (6July 2015)



Source: CEIC ,HSBC

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