Confidence is key as Chinese authorities provide unlimited support for market

China's Shanghai-Shenzhen CSI 300 Index gained 6.4% on 9 July 2015, paring losses since its 12 June 2015 peak to 26.9%[1] even as the number of trading suspensions climbed to about 1,600 – meaning more than half of the 2,800 companies listed on the two indices are now laying fallow. While the gain no doubt comes as a welcome relief to Chinese investors, it remains too early to declare the market correction over and the recovery begun. After all, while the keys to this market crisis are deceptively simple, excessive leverage and loss of confidence, even as the former begins to resolve itself the latter can remain a pernicious influence. With the government and the People's Bank of China coordinating unprecedented market support measures, Ronald CC Chan, Chief Investment Officer, Equities, Asia (ex Japan) with Manulife Asset Management shares his views on where the market is headed in base-case – and worst-case – scenarios.

Policy driven markets hit roadblocks

Capital markets in China have always been heavily policy influenced. Whereas Chinese companies traditionally relied on bank loans to finance operations, tighter government regulation of the mainstream and shadow banking sectors over the past few years made bank loans increasingly difficult to access, particularly for small and medium-sized enterprises (SME). To fill this void, the central government began to promote the domestic equity and fixed income markets as financing options for companies and an investment opportunity for domestic and – as the country's capital account continued to open – foreign individuals and institutions.

As the idea of capital markets as a financing and investment option took hold, the A-share market in particular took off. Indeed, over the year preceding its 12 June 2015 peak Chinese equities gained an impressive 145.2%[2] as speculative retail investors gorged on leverage and piled in.

By mid-March 2015 it was becoming apparent that the A-share market had entered bubble territory. The CSI 300 added 44.0% between 16 March and 12 June alone and outstanding margin positions climbed by an astounding RMB1 trillion in the same period to reach roughly RMB2.2 trillion[3], not including semi-legal "off-balance-sheet" margin financing. By early June the senior regulator was concerned enough to step in and curtail new margin financing, shaking investor confidence and unwittingly sending the A-share market into a sharp correction.

Government support measures to date – which have included a 25 basis point (bp) interest rate cut, a simultaneous 50bp Reserve Requirement Ratio (RRR) cut for smaller banks, the relaxation of margin trade rollover rules, direct share purchases via major brokerages and insurance companies and curtailing IPO approval – seem to have had little effect, leaving many investors wondering where the A-shares market will go from here.

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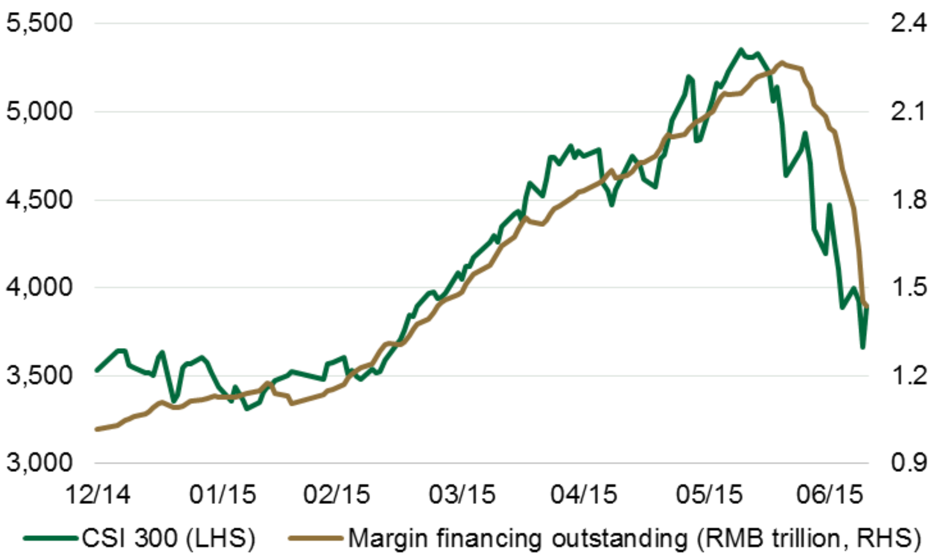
[1] Shanghai Shenzhen CSI 300 Index, Bloomberg, 12 June to 8 July 2015.
[2] Bloomberg, 11 June 2014 - 12 June 2015.
[3] Bloomberg.

Government, PBoC coordinate unlimited market support

Looking over the past month, Ronald CC Chan, Chief Investment Officer, Equities, Asia (ex Japan) with Manulife Asset Management, commented: “Policy response to the A-share market correction to date, while impressive in its scope, has been piecemeal. As we close a fourth week of declines, this is beginning to change, with the State Council and the People’s Bank of China (PBoC) stepping up to the plate with a coordinated campaign to restore market confidence by providing unlimited liquidity support for the market.”

How the latest market support gambit plays out depends largely on the actions of highly leveraged latecomers to the A-share market. As mentioned above, both margin financing positions and the market entered bubble territory over the three-month period from mid-March to the 12 June peak (see Figure 1). Assuming a 1 to 4 leverage ratio this translates into the accumulation of roughly RMB4 trillion in equity gains (based on the RMB1 trillion of leverage accrued in the period). As the 26.9% plunge in the CSI 300 since 12 June represents the evaporation of roughly RMB3.5 trillion in market value, table-napkin math suggests that roughly another RMB500 billion still has to come out of the market to unwind the “excessive” margin positions assumed during the three months.

Figure 1: CSI 300 trend vs on-balance-sheet margin financing outstanding



Source: Bloomberg, Wind Data. 31 December 2014 - 9 July 2015.

Base case? Worst case?

Chan is quick to point out that this simple yet compelling math does little to help predict where the A-share market rout may end, but explains that one of several scenarios could play out:

Base-case scenario – Roughly RMB500 billion exits the A-share market over the coming week or so, bringing the market back to the 3,200-3,300 level last seen before the leverage and market bubbles took off in earnest. At this point leverage would be back to generally sustainable levels, with smaller retail investors in particular less exposed and many still sitting on small if not spectacular gains. At this point, with the margin implications of the correction largely under control and panic hopefully having subsided, coordinated government support measures would have a much better chance of gaining traction and order being re-established.

Worst-case scenario – The flip-side of the base-case scenario would be for about RMB500 billion to exit A-shares and for the plunge to continue unabated due to continued lack of confidence. This scenario could expose the economy to systemic risk, with contagion potentially spreading to the bond, commodity and property markets as investors rush to liquidate assets to meet margin calls and to the banking sector as nonperforming loans (NPL) spike. This scenario would have severe implications for China's wider economy and even for global markets, which would surely feel the tremors shaking the world's second-largest economy.

While these scenarios are pretty clear based on the math, the difference between one and the other is the real X factor: investor confidence.

You can't build confidence with steel and cement

Over the past few decades the Chinese government has proven itself a master of the hard skills involved in fostering the nation's emergence as the "workshop of the world" via state-directed industrialisation and massive infrastructure investment. However, despite its phenomenal success building an economy that is the envy of much of the world, it is proving much more difficult for the Chinese government to master the soft skills involved in steering the markets, public opinion and investor confidence via policy statements.

The importance of soft skills is perhaps most apparent in the US Federal Reserve's (the Fed) use of "forward-looking statements" as it wound down Quantitative Easing (QE) in the second half of 2014. In this light, the Chinese government and PBoC's coordinated commitment to unlimited support for the A-share market should be interpreted as a bold attempt at "forward guidance" in support of the base-case scenario.

From any rational perspective this forward guidance should have the intended effect. As Chan explains, "In many ways the Chinese government's forward guidance should be considered more supportive than the US Fed's ever was. While the Fed's policy ammunition was largely spent at the time, the Chinese government retains significant policy tools in its arsenal – it is one of the only economies in the world with positive real interest rates, pointing to the potential for further interest rate cuts, RRRs in China remain at the 17% level compared to the developed-world average of 6-7% and its US$3.73 trillion in foreign reserves[4] is virtually unparalleled globally in terms of the potential to support direct QE should it come to that."

Short window for normalisation

While we do not expect volatility to ease overnight, we believe that the Chinese government and the PBoC have a relatively short window in which to restore a degree of market confidence. Indeed, timing is crucial as major policy meetings are approaching in the fourth quarter of 2015 – including the upcoming National People's Congress, the IMF is scheduled to announce in November whether or not the renminbi will be added to its special drawing rights (SDR) basket and Chinese companies' American Depository Receipts (ADR) will be added to the MSCI in November.

These developments represent important milestones in the Chinese government's plan to continue gradually opening its economy and capital account to the world. If they are to go forward without a hitch, it is crucial that market volatility moderate and the fruits of structural reforms and economic stimulus implemented over the past year begin to emerge. Of note, economic indicators were on a positive trend before the current sell off began and, despite the multitude of headlines trumpeting A-share market "disaster", fundamentals have not changed – we see the foundations for a stable "slow bull" market if the base-case scenario plays out.

Investment implications

With contagion effect from the A-share market correction still limited primarily to the Hong Kong market and ADRs, diversified global portfolios should be well-positioned to absorb the effects. Commenting on the impact on China-focused portfolios, Chan explained, "While it is impossible to avoid the ripple effects of the China market decline in a China- or Greater China-focused portfolio, we remain firm believers in the virtues of bottom-up stock analysis to identify companies with sound financial fundamentals and limited sensitivity to macroeconomic conditions. If the base-case scenario plays out, we believe that the Greater China region will

[4] Bloomberg, 9 July 2015.

offer many opportunities for stock pickers. In particular, Hong Kong's H-share market should be well-positioned to deliver attractive returns as it is currently trading at a relatively attractive 10x price-to-earnings (P/E) ratio with 3.3% dividend yield versus the Shanghai Stock Exchange's 19x P/E and 1.7% yield and the S&P500's 18x P/E and 2.0% yield[4]."