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Flash Notes

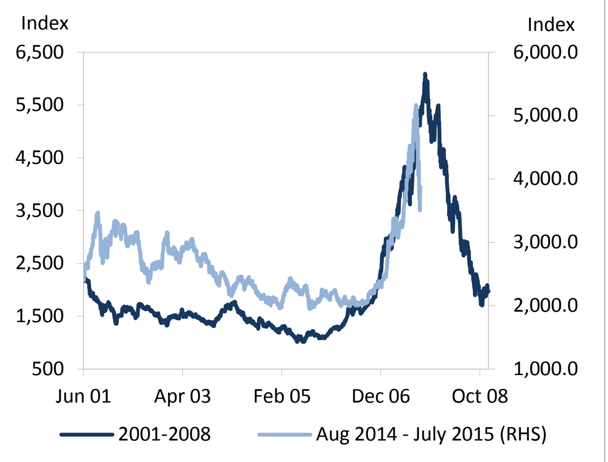
China: Equity Market Boom-Bust – Now What?

Equity Market Boom Then Bust…

China's equity markets in recent weeks saw some of the wildest price swings in its history. After the Shanghai Composite Index (SHCOMP) peaked at 5,166.35 on 12 Jun 2015 for a year-to-date (YTD) gain of nearly 60%, it was all downhill from there as concerns over leverage, valuation and the rapid ascend of prices sent investors rushing out of the market. The selloff could also be accelerated by MSCI's announcement on 10 Jun that it would not be including A shares into its emerging market index, though the move was largely as expected given the limited access to China's equity markets by international investors. Nevertheless, the month-long price declines saw the SHCOMP index level falling 32% by 8 Jul from the peak, and wiping out USD3.9tn of market capitalization, or about 1/3 of China's nominal GDP. In the process, the YTD gain at one point narrowed to just 8.4%.

It should be noted that such market boom-bust trends are not unusual in China. For example, SHCOMP also went through a similar boom-bust cycle in 2006 to 2008. This is largely due to the close nature of China's financial markets, which have yet attained the level of maturity and sophistication in other more developed markets.

China: Shanghai Composite Index



Source: CEIC, UOB Global Economics & Markets Research

China's equity market currently is dominated by retail investors, which are estimated to represent 70-80% of investor base, which tend to disregard fundamentals especially when the action turns "red hot".

For example, price to earnings ratio (PE) for Shanghai's A shares surged to a peak of more than 24x in Jun, from around 9x in mid-2014, before the selling hit, pushing the A share PE to around 18x. In contrast, the largest 50 A share companies' PE was below 15x at the peak in Jun, from less than 8x a year ago in 2014, falling to around 12x currently. This shows that the "panic buying" turned to "panic selling" as market conditions change, worsened by investors that bought on margin financing. After these recent sharp adjustments, the levels of PE are now more in line with other major markets' PE, for instance 12.7x for Hang Seng and about 18x for the S&P 500.

So What's Next?

With the recent spate of Chinese government measures (see table), market sentiment appears to have stabilized, with the SHCOMP recovering 4.5% on Fri (10 Jul), bringing YTD gain back up, to 19.9%. However, these market measures may be counterproductive, as prices may not have adjusted fully via market mechanism. We believe these measures are mainly to prevent a massive loss of confidence in the financial market, more so than providing a floor to equity prices. In addition, the authorities are aware of the inherent risk of "moral hazard" in any form of market support. As such, we do not expect more market measures to be forthcoming unless market confidence deteriorates.

As an aside, our recent meetings and conversations with China-based clients suggest no panic among this group of investors even after such a major market fallout. In fact, these "smart money" clients are looking for opportunities to wade in and bottom pick in the A share markets. This anecdotal evidence shows that while confidence may be dented, especially among the smaller investors and late comers, there is still value-conscious money "waiting at the sidelines" that could limit further, massive losses ahead. This is further reinforced by more "reasonable" valuations such as PE compared to a month ago.

As for outside China, the recent moves have not caused significant reaction in non-China equity and FX price actions. In fact, most of the attention has been on Greece and its post-referendum negotiations with creditors. Indeed, Asian currencies are more closely correlated to EURUSD trends than with SHCOMP since the beginning of 2015. This is partly due to closed capital accounts of China, as well as limited foreign participation in China's A shares markets. However, with China expanding its market access to foreign investors, such as picture could change in future.

Recent Key Developments in China's Equity Markets	
Wed, 10 Jun 2015	MSCI announces it would not be including China A-shares in its emerging market index on concerns of market accessibility
Fri, 12 Jun 2015	Shanghai Composite Index (SHCOMP) ends at 5,166.35 – the highest since the close of 6,092.06 on 16 Oct 2007 – for a YTD gain of 59.7%, after the index rose 52.7% for all of 2014
Fri, 19 Jun 2015	6.4% fall in the SHCOMP raises fears of an equity correction
Wed, 24 Jun 2015	PBoC scraps 75% loan-to-deposit ratio cap
Sat, 27 Jun 2015	PboC cuts interest rates by 25bps and made a 50bps reduction in RRR for select banks
Mon, 29 Jun 2015	SHCOMP opens 2.3% higher before reversing course and plunging as much as 7.6%, ending the session 3.3% lower; China announces after market close that it will allow pension funds managed by local governments to invest in the stock market for the first time, potentially channeling more than RMB1 trillion
Tue, 30 Jun 2015	SHCOMP declines to more than 5% intraday, before surging 5.5% by the close for its biggest one-day gain since 2009
Wed, 1 Jul 2015	China Securities Regulatory Commission (CSRC) says it no longer requires securities brokerages to force the sale of stocks held by clients with insufficient collateral, and will allow "reasonable roll-over" of margin trading; the stock exchanges also announce reduction of transactions fees by 30% starting 1 Aug
Thur, 2 Jul 2015	SHCOMP falls as much as 6.4% intraday then closes 3.5% lower to 3,912.77, below the 4,000 level for the first time since April
Fri, 3 Jul 2015	SHCOMP retreats 12% for the week; China Financial Futures Exchange (CFFEX) suspends 19 accounts from short-selling for one month
Sat, 4 Jul 2015	IPOs are suspended, major brokers pledge to launch a RMB120bn market stabilization fund and the PboC announces liquidity support for margin finance
Sun, 5 Jul 2015	China state-owned investment company Central Huijin Investment Ltd says it has recently purchased exchange-traded funds (ETFs) to support the market and will continue to do so; CSRC announces that PBoC will inject liquidity directly to the state-backed margin finance company – China Securities Finance Corp – to stabilize the stock market
Wed, 8 Jul 2015	CSRC bans shares sales by major investors for six months; trading suspended in more than 1,000 stocks; SHCOMP slumps 5.9% to 3,507.19, the lowest since 17 Mar 2015, for a YTD gain of 8.4%
Thur, 9 Jul 2015	The CSRC tells banks to roll over loans backed by equity collateral
Fri, 10 Jul 2015	SHCOMP advances 4.5% to close at 3,877.80 for a weekly gain of 5.2% and YTD gain of 19.9%
Source: Various news wires; UOB Global Economics & Markets Research	