ETF Securities Equity Research
The good, bad and ugly of Chinese markets

Summary

- China’s macroeconomic indicators are signalling a positive inflection point, however the debt overhang highlights a looming risk.
- China needs to maintain the balancing act between its new consumption led economy and slowing investment driven economy to stem the pace of credit expansion.
- Chinese stock market valuations are disguised by low earnings multiples of the state owned financial sector.
- Greater transparency and clarity of communication about policy is the only way to draw international investors back to the Chinese Equity markets.

Green shoots emerging

Following a challenging start to 2016, official macroeconomic data released by China, ranging from GDP, fixed asset investment, industrial production and retail sales (led by auto and internet sales) are now suggesting that the economy may in fact be at an inflection point. A concerted government effort to restore growth in the real estate sector via cuts in mortgage rates, down payments and a surge in lending has driven a rebound in housing sales. Rising ‘floor space started’ has also provided evidence that growth in construction is catching up. Overall business activity in China expanded for a second straight month in April albeit at a slower pace than March. The rate of new orders growth was the strongest seen in three months.

Clearly a domestic consumption driven economy is trying to fill the gap left behind by manufacturing activity. While an uptick in the majority of the macro indicators are signs of green shoots emerging, China’s persistent and rising debt load poses a serious threat to the economy.

237% and counting

Debt has been financing the extraordinary growth rates that China has sustained so far. China’s credit growth has surged to 237% of GDP today from 164% in 2008, far above emerging market counterparts and is still growing. While there are countries with higher debt levels, the reason for concern in China’s case is the recent pace of credit growth, coupled with the declining quality. The dilemma facing the Chinese government is whether the new consumption led economy can support growth if credit is cut off from the private sector. In 2016, China faces a record 3.7tn yuan (US$567bn) of local bond maturities through year-end and this comes amidst deteriorating investor sentiment following news of seven companies reneging on their obligations so far this year. Non-performing loans (NPLs) have reached a record 1.3tn Yuan and account for 1.7% of total loans, and anecdotal evidence suggests this number is higher than disclosed. While most countries have seen their NPL loan growth decline recently, China remains an exception as highlighted in the chart below.

Chinese bank NPL loan growth soars

Investments may go up or down in value and you may lose some or all of the amount invested. Past performance does not guarantee future results.
relieved the big four state banks by buying these NPLs with government backed 10-year bonds. China’s rapid pace of expansion in the 10 years since 1999 helped shrink the debt levels from 20% to nearly 5% of GDP. However, since the maturity of those bonds came in the midst of the financial crisis in 2009, it seemed prudent at the time to roll over their maturities (to 2019) rather than recognize the losses. The Chinese authorities have recently announced their intention to deal with these non-performing loans in the banking sector with an Equity-for-Debt Swap (EDS) and securitisations of NPLs. The EDS will enable banks to swap bad loans on their books for equity stakes in the stressed corporates. While this will certainly allow banks to reduce the need to provision for loan losses aiding better use of their capital, it is hard to assess the time it will take for the stressed corporates to recover. We believe these are not comprehensive solutions by themselves and simply delay the inevitable to a later date.

**Margin trading magnified market volatility**

Stratospheric margin lending up 305% since September 2012 - fuelled the MSCI China A shares index to attain a record high 5458.9pts in June 2015.

**Margin trading drives China’s stock markets**

Daily data, Sep 2012 - May 2016

Source: Bloomberg, ETF Securities

The balance of margin financing outstanding as a percentage of market capitalisation in June 2015 reached a record 4.09%. These high levels of leverage explain the fast run up to the peak and its subsequent decline thereafter. Rising stock prices made it easy to repay margin interest rates however when these stocks reversed their trend, investor losses exceeded their margin payments forcing them to liquidate their equity holdings and exacerbate the downward slide. In an effort to contain these risks, the securities regulator capped the size of margin trading and short selling for the first time at 4x a brokerage’s net capital. Since the start of 2016 the outstanding balance of margin transactions has declined by 35% and has had a direct repercussion on the market.

**Market meddling leads to lacklustre trading**

Chinese stock markets got off to a turbulent start in 2016 that forced it to suspend trading activity twice in a matter of a week after 7% declines tripped a new circuit breaker mechanism. While the initial intention was to avoid panic selling, it appeared counterproductive forcing the mechanism to be withdrawn just days after being introduced. The lack of transparency from the stock market regulator caused more harm than good resulting in a loss of investor confidence.

**Equity valuations not so cheap**

The MSCI China A Shares Index currently trades at 18x earnings - seemingly attractive on the surface. The reality is that financial stocks, which account for 35% of the index, tend to deflate the index valuations due to their low valuations, at 4x earnings. By stripping out the financial sector and applying the valuation gap (difference in P/E’s of MSCI China A shares index excluding financials and the MSCI China Financial Index) we obtain a more realistic valuation of 28x earnings for the MSCI China A shares index.

**Conclusion**

While there is rising evidence that a majority of macroeconomic indicators are benefiting from China’s accommodative monetary policy, we believe it will eventually have to contend with its rising debt load. Credit expansion has expanded at an alarming rate, this coupled with the declining quality of debt makes it imperative for China to transition from an investment to a consumption driven economy. The lack of clarity and transparency by Chinese stock market regulators has subdued investor sentiment. From a timing perspective, Chinese stock markets are not as cheap as they appear since their valuations are flattered by financial stocks. For the time being we remain cautious on Chinese equities until the emerging green shoots become more established.

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