Q&A from Matthews Asia

July 9, 2015

China Market Update with Andy Rothman

China's equity markets have been in steady decline for several weeks, raising a lot of questions about the potential impact on the world's second-largest economy. Given that China accounts for more global growth than the U.S., Europe and Japan combined, this topic is important for investors. Andy Rothman, Investment Strategist at Matthews Asia, answers some of the questions.

Q **Where are the China markets today?**

A As of the Thursday, July 9 close, the main index for A-shares, the Shanghai Stock Exchange Composite Index (SHCOMP), was down 28% from its June 12th peak. This index is still up 15% YTD and is up 82% from a year ago.

Q **Where will the China markets go from here?**

A As the market is driven primarily by retail investors, it is impossible to predict how their sentiment may evolve.

Q **Is this the bursting of a bubble?**

A From a valuation perspective, many Chinese stocks are in ridiculous territory. Commentators often focus on the ChiNext market, where 79 companies have a forward price-to-earnings (P/E) ratio of more than 100, and the median forward P/E is about 63. This is clearly very high. Commentators, however, often neglect to mention that everyone in China understands this is a very small, very speculative, tech-heavy market, with only 460 companies overall. Chinese who own those stocks know they are gambling, and very few foreigners play that game.

The A-share market is much bigger (about 2,800 companies) and is much more broadly held. But it is also driven by retail investors, who account for 80% of turnover. Institutional investors play a minor role, and foreign investors account for only about 3% of holdings. This, too, is an expensive market, with a median forward P/E of companies which are covered by at least one brokerage analyst (to remove the most speculative stocks) of about 54.

If we cross the border into Hong Kong, where there is more institutional and foreign investment, the median forward P/E falls to only 14. This is the market (with about 1,800 Chinese companies) where most foreign exposure to China takes place.

More importantly for us—and we are the largest Asia-only investment manager in the U.S., with about US$31 billion under management (as of 30 June 2015), and about 30% of that in Chinese equities—the median forward P/E of our China holdings is 17. Coincidentally, the median forward P/E of the S&P 500 is also about 17. (These P/E ratios are as of late May/early June, before the market correction began.)

Q **Is margin debt a serious concern?**

A Yes, primarily because a falling market leads an increasing number of investors to have to sell to repay their margin loans.

The scale of margin trading, however, should be manageable. The margin balance outstanding is now about RMB 1.8 trillion (US$285 billion). This accounts for about 3.5% of total market cap, or about 4.3% of free-float market cap (according to the Chinese securities regulator) or about 9% of the free-float excluding Chinese government holdings (according to Bloomberg).

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Regulations limit margin trading to those with at least RMB 500,000 in their accounts (US$80,000), although some brokers may have lent to smaller investors.

While a continuing decline in the market will lead to painful losses for some investors, the total number of retail punters using borrowed money should not be very large. And to put this into context, total margin positions are equal to about 3% of total household bank deposits.

Q How many Chinese people are at risk?

A The majority of Chinese are not in the market. There are about 50 million active individual investors, which is equal to about 4% of the total population or 7% of the urban population.

And most investors are punting a fairly small amount of money. As of last November, 66% of active accounts had less than the RMB equivalent of US$15,000 in them, and less than 1% of accounts had more than US$1 million. Very few Chinese are likely to be betting anything close to their life's savings, and I imagine all of them are aware of recent history: in 2007 the A-share market rose even more sharply than this year, and then in early 2008, it crashed hard.

Another interesting indicator is that as the market has soared, the growth rate of household bank deposits has slowed only slightly, to an average of 10.2% YoY during the March – May 2015 period, from 11% during the same months in 2014.

Q What will be the impact on consumer spending?

A Given the relatively small number of retail investors, and given that two-thirds of active accounts had less than US$15,000, I expect only a modest impact on retail sales growth if the market continues to fall.

Even including margin trading, consumer debt is very low and savings very high. Household bank deposits are the RMB equivalent of US$8.5 trillion, which is greater than the combined GDPs of Brazil, Russia, India and Italy.

It is worth noting that in the 12 months after the 2008 A-share market crash, inflation-adjusted retail sales rose at a faster pace than during the 12 months when the market was booming. I do not expect retail sales to re-accelerate this time, but this historical comparison is another reason to believe that a continued market decline will not result in a collapse in consumer spending.

Q What will be the impact on GDP growth?

A A continued equity markets decline will have a small but material negative impact on GDP growth.

The financial sector accounted for 7.4% of China's GDP in 2014, with that share rising to 9.7% in 1Q15, and it is likely that the securities industry drove most of that increase. A very rough estimate is that in the last quarter of 2014, the booming A-share market accounted for about 5% of GDP growth (0.4ppts of 7.3% GDP growth).

If the market remains weak, leading to low trading turnover, this could slow 2H15 GDP growth by about the same amount.

Q Does the Communist Party's effort to put a floor under the market signal that it is abandoning its economic reform agenda?

A Not in my view. The Party's attempt to intervene in China's equity markets is futile. But it isn't surprising, as the Party has long used its power, as well as its control of major brokers, to try and move markets. The futile aspect is the Party thinking it can micromanage a stock market where 80% of turnover is by retail investors in the same way it micromanages the RMB's exchange rate.

We can imagine Party leaders responding to this criticism by noting that the U.S. Government intervened to support American markets during the Global Financial Crisis. But that analogy is weak, as China's economy is healthy today, with double-digit retail sales growth, 8% real income growth, and GDP up by more than 6%. The rise in China's markets did not generate a significant wealth effect, so the market's fall shouldn't have serious negative economic consequences. There is no valid macro reason for the Party's intervention in the market.

There is, however, a good reason to believe that the Party will not halt its push towards creating a more market-oriented financial system: the Party's continued rule depends on continued reform. With the private sector accounting for 80% of employment and all new job creation, as well as most investment, more financial sector reforms are required to support entrepreneurial firms. The Party understands those reforms are key to continued economic growth, which is key to the Party remaining in power.

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