alpha commentary

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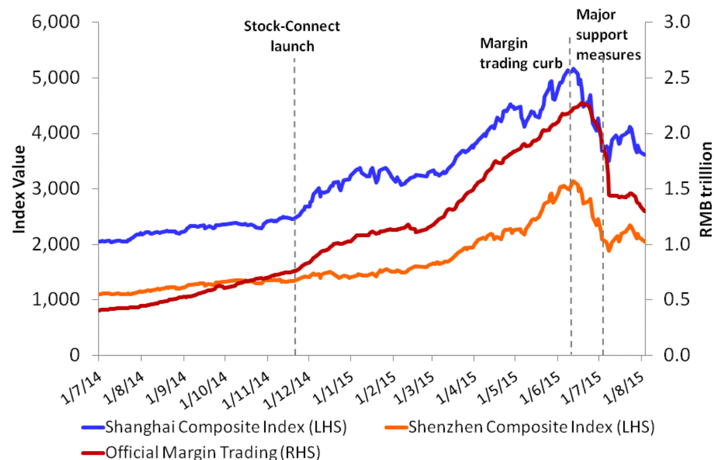
China stock market: Pace of reform in question

China's stock market rallied over 150% (Shanghai Stock Exchange) in the past one year till mid-June, spurred by the launch of the Hong Kong-Shanghai Stock Connect, easy credit from various rounds of monetary easing and margin financing which was fully allowed in 2011. It then plunged over 30% in less than a month in June, prompting a slew of support measures to stop the rout. This commentary discusses the implications of the stock market upheaval and measures.

Figure 1: China's stock market and official margin financing



Source: Bloomberg, Shanghai Stock Exchange, AIP Research

Financial risk is manageable

Total margin financing at the peak in June was estimated to be around RMB4-6trn, 2-3x that of the official margin lending amount, taking into account shadow financing and other less transparent channels. This was about 6-10% of both China's GDP and market cap at the peak. China's financial system should however be able to absorb the shock of a stock market fall because:

1) Potential loss on margin loans is limited. According to Morgan Stanley[1], leverage for margin loans from brokers is typically less than 50% of equity value purchased on margin, and around 50% of margin loans were extended before the Shanghai Stock Exchange Composite Index rose to 3500 points;

2) Banks' exposure to over-the-counter (OTC) leverage (slightly more than RMB2trn) at end June is small relative to banks' total balance sheet (RMB160trn)[1];

3) The clampdown on margin lending in July has reduced the margin debt risk. Official margin debt has fallen by over 40% by end July (Figure 1). Online financing of equity loans was found by a Bloomberg survey to have fallen by RMB0.7trn or 61% from the peak after such loans via peer-to-peer platforms and from other online lenders were banned in the same month; and

4) Both the Shanghai and Shenzhen Stock Exchange Composite Indices at end July were still higher by over 65% and 80% respectively compared to their levels one year ago (Figure 1).

[1] Morgan Stanley, Addressing investors' questions about China's stock market correction, July 2015

Economic growth impact is modest

China's stock market is driven more by government policies and public speculative expectations than by economic fundamentals. The bull run in the stock market in the past one year had taken place amidst a slowdown in the economy.

China's free float cap that was wiped out by the end of July was around RMB11trn, about 17% of its GDP size, but the free float cap was still double the amount one year ago. Moreover, equities accounted for only 5% of non-financial Chinese companies' funding compared to 62% in the US[2]. The 30% fall in the stock market or even a 60% fall will thus be negligible on corporate finances.

Nevertheless there will be some impact on economic growth. Morgan Stanley estimated that if growth in the financial sector was halved from the level of 1Q2015 which grew over 15% yoy due to the stock market rally, it would subtract 0.2ppt from the 2015 GDP growth rate. The financial sector's value-add to GDP was 7.4% in 2014.

There could also be some impact on sentiment given the backdrop of weak exports and manufacturing output. There will be renewed pressure on the finances of struggling companies and developers who may have missed the window of opportunity to replenish or raise capital during the equity surge. Although the government has now eased regulations on bond issuance and companies can seek offshore listing, this is more likely to benefit the larger and more reputable companies.

The Chinese government is thus expected to continue to support growth through fiscal and monetary policies. There is ample room for further fiscal easing (fiscal surplus was RMB3.9trn or over 6% of GDP in May)[3] and the government has pledged to continue with monetary easing.

Household wealth effect is small

The impact on consumer wealth and spending is also assessed to be low, although retail investors accounted for the bulk of stock transactions (estimated at around 80% and thus contributing to share price volatility) and there were anecdotal accounts of some of them having sold their homes or put in life savings to play in the stock market.

Only a small proportion of households held investments in the stock market. Household wealth is concentrated in non-equity assets, mainly bank deposits and real estate. Survey evidence[4] showed that only 8.8% of households held investments in the stock market as of 2Q2015 while other analysts have estimated a slightly higher range of 10-13%[5] . These estimates are low compared to almost 49% of households in the US according to a recent survey by personal finance website Bankrate.com. Hence a 30% correction in China's equity market reduces household financial assets by less than 4%.

Many households could also have cashed out before the stock market drop. In a poll of local consumers by the China Household Finance and Survey Centre (CHFS) at the Southwestern University of Finance and Economics, it was found that expectations for the stock market had fallen by over 22% in 2Q2015 quarter-on-quarter[6].

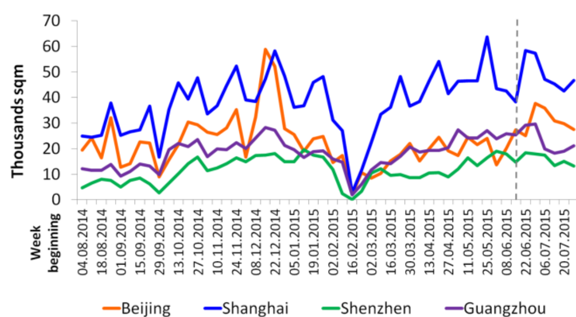
Retail sales growth thus showed no correlation to the recent ups and downs in the stock market. The growth rate was slower in the months of March-May (10.0%-10.2%) and accelerated in June-July (10.6%-10.7%).

The housing sector was similarly not adversely affected. The average price of housing in 100 mainland Chinese cities rose for the third consecutive month in July[7]. In the Tier 1 cities where more households are likely to be investing in the stock market, transaction levels remained much higher than one year ago (Figure 2). While some affected home buyers might have postponed their home purchase plans and some may be more cautious, there are others who might have cashed out of the stock market and returned to the recovering housing sector. Although there was a slight fall in volume in some cities in July, this could be due to July and August being traditionally slower months.

[2] Starfort Investments, July 2015
[3] Morgan Stanley

[4] China Southwestern University of Finance and Economics
[5] Morgan Stanley, Credit Suisse
[6] Mingtiandi, Chinese move out of stocks into real estate in Q2, July 2015
[7] China Index Academy

Figure 2: Weekly primary housing sales in Tier 1 cities



Note: Lunar New Year holiday is from 18-24 February 2015.
Source: CREIS, AIP Research

Other implications

The Chinese government intervention in the stock market raises concerns about its progress to being more market-oriented. To stem the large-scale selling in June, the government had responded with more monetary easing, relaxation of margin financing rules, suspension of IPO listing and market support through direct purchases of shares. The immediate casualty will be the development of the equity market which would have been a new source of capital and help to deepen the financial industry.

The intervention also signals the shifting of position to prioritising growth over reform, from that of striking a balance. The broader implication is whether this turmoil will delay or derail other reforms.

The intervention is also a step back from reducing moral hazard. The securities regulatory body pledged to continue purchasing shares to stabilize the stock market after the stock market fell over 8% on 27 July following reports of the government considering how to withdraw support for shares. This was despite the International Monetary Fund urging China to unwind its support measures to allow share prices to settle through market forces.

One of the recent support measures include allowing real estate to be used as collateral for margin trading, which will increase the risk to the real estate sector if this measure becomes widely used.

More significantly, there could be a loss of faith among private investors on the Chinese government's commitment to reform and its ability to manage the economy. If the stock market were to fall further in spite of the massive measures, this could further dent consumer and business confidence and accentuate the economic slowdown. There could be more capital outflows, which had already been taking place in the last five quarters, and negate the liquidity pumping efforts.

Conclusion

The impact of the stock market turmoil on the household sector is minimal. There will be some drag on the slowing economy but we think the greatest implication is the psychological impact on investors who may have less confidence on the banking system, economic growth and reform progress. The challenge for the Chinese government is to unwind the leverage while supporting economic growth and moving on with reforms.

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