



## The Strategist

### 1 step forward, 2 steps backward

**Drastic measures to restore market stability.** Over the weekend, the government announced drastic measures in an effort to stabilize the A-share market after the Shanghai A-index plunged almost 30% in three weeks.

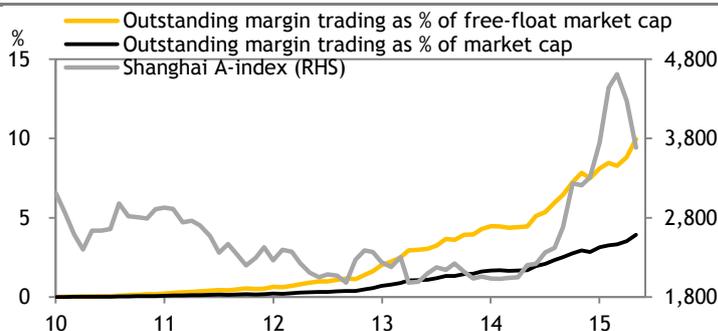
**Levels of margin financing remain high.** We expect the measures, including a fund to buy big caps, to improve market sentiment in the short term. However, while margin financing has declined, the chart below shows it still accounts for 10% of A-share free-float market cap. In our earlier report ([The circle game: a wealth effect by retail, for retail](#)) we already highlighted the risk of margin financing. The unwinding of unregulated margin financing could hurt the performance of small caps. This could also drag down the big caps because people could be forced to sell down their holdings to meet margin calls or redemptions. So the risk is on the ChiNext index.

**Why drastic measures?** China's economic data remains uninspiring and overcapacity means capex remains muted. Also, external growth remains weak. Fiscal spending has started to pick up slightly this year but it remains at low levels. The issue is that a strong A-share market could increase retail sales growth and help corporate deleveraging. An A-share collapse therefore risks continued economic weakness.

**Implications.** As the market is very oversold, we expect the newly announced measures to help the market rebound. Over the past month, materials, industrials, healthcare and consumer discretionary are the most oversold. Given brokerages will not sell their holdings as long as the Shanghai A-index is below the 4,500 level, so does it mean above 4,500 is a cap on the upside? Therefore we recommend investors to sell their holdings in this rebound.

The key question now is not only how to lower the levels of margin financing and market volatility but also government credibility, the future of financial reform, moral hazard and the speed of capital market opening. These measures could also impact the timing of the CNY's inclusion into the SDR basket and China A-shares being included in the MSCI equity benchmarks.

#### % of outstanding margin trading in A-share markets



Source: Wind, Bloomberg, Maybank Kim Eng Research

#### Analyst

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## Drastic measures to restore market stability

After the A-share market plunged almost 30% in three weeks, the Chinese government announced the following measures over the weekend to restore market stability:

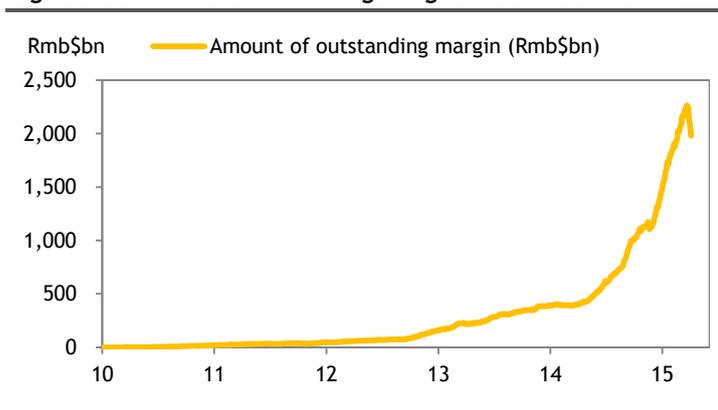
- 1) Suspending IPOs;
- 2) The 21 largest securities brokerages will form a CNY120b fund by 11:00 am on Monday (6 July, 2015) to help stabilize the stock market. The fund will invest in ETFs of big-cap stocks;
- 3) The listed securities companies among the 21 brokerages will also actively buy back their shares; and
- 4) The brokerages will not sell their holdings as long as the Shanghai Composite index is below 4,500 points.

In addition, the CSRC also said it will revise QFII and RQFII rules to attract overseas funds. The China Securities Finance Corp, which manages the nation’s short selling and margin trading, also increased capital from CNY24b to CNY100b to maintain financial market stability and to expand its business. The government has also relaxed brokers’ margin requirements. The Central Huijin Investment, a unit of China’s sovereign wealth fund, also confirmed it has been buying ETFs since 29 June.

## Are these measures enough?

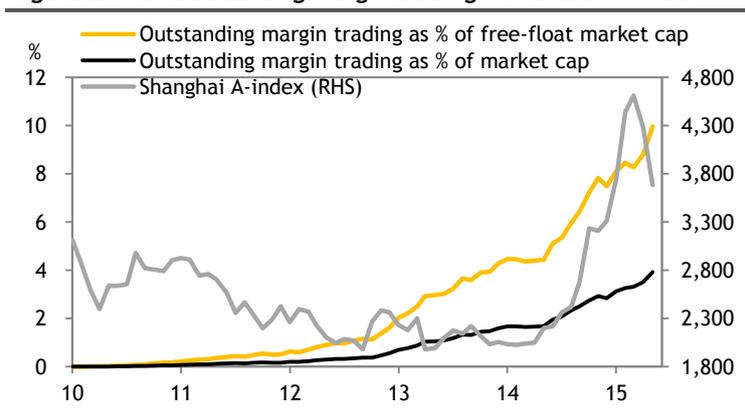
In our earlier report ([The circle game: a wealth effect by retail, for retail, April 16, 2015](#)), we highlighted the risks in A-shares because of increasing margin financing. The following charts show that outstanding margin in China has fallen recently but is still at very high levels. Up to 2 July, the amount of outstanding margin financing was CNY1,980b and it still accounted for 10% of the A-share market’s free-float market cap.

Figure 1: Amount of outstanding margin in A-share markets



Source: Wind, Bloomberg, Maybank Kim Eng Research

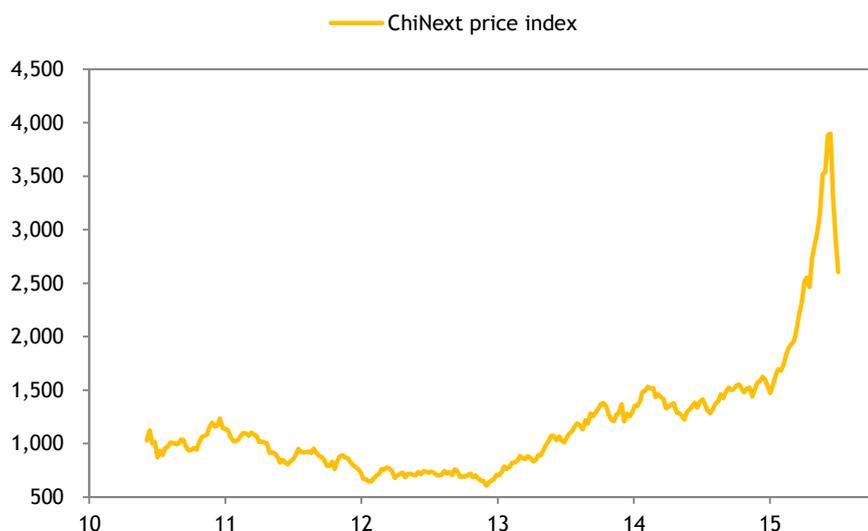
Figure 2: % of outstanding margin trading in A-share markets



Source: Wind, Bloomberg, Maybank Kim Eng Research

However, the above data does not include the amount of OTC margin financing (or unregulated margin financing). As their leverage ratios are higher than the regulated margin financing and are focused on small-cap stocks, we see the key risk is on the ChiNext index.

Figure 3: China ChiNext price index



Source: Bloomberg, Maybank Kim Eng Research

During the global financial crisis in 2008, because of liquidity issues, the correction in small-cap stocks forced fund managers to unwind their holdings in big-cap stocks due to redemptions. Therefore, the aforementioned measures could support the big-cap stocks for a while. However, we need to be aware that the valuation for ChiNext is at 83x FY15 PER and the market still has a lot of leverage to unwind.

**No growth in export and capex**

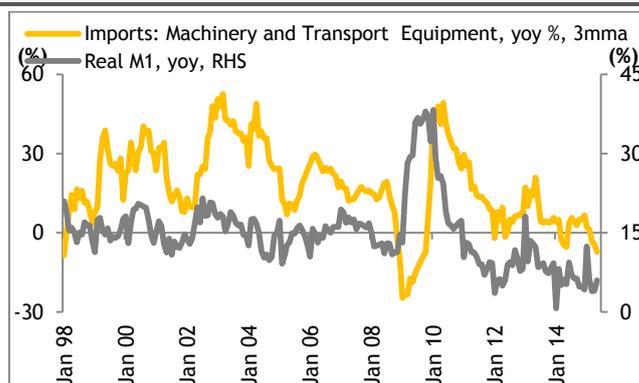
China’s economic data remains uninspiring and overcapacity means capex is set to be muted. The following charts show both external growth and capex remain weak.

Figure 4: Export growth YoY%



Source: CEIC, Maybank Kim Eng Research

Figure 5: Real M1 and imported capital goods



Source: CEIC, Maybank Kim Eng Research

**Fiscal expenditure is also weak**

Fiscal spending in year-on-year terms also peaked out in 2012. The government has tried to increase spending in 2015 but it remains weak.

Figure 6: China fiscal expenditure YoY (%)



Source: CEIC, Maybank Kim Eng Research

### Equity rally and the wealth effect

A strong A-share market could increase retail sales growth ([The circle game: a wealth effect by retail, for retail, April 16, 2015](#)). We have seen some improvement in the property market in the past few months.

However, participants in the stock and property markets are likely to be the same group of people. A negative shock for stocks could therefore translate to negative activities in the property market.

Figure 7: China retail sales & Shanghai A-share

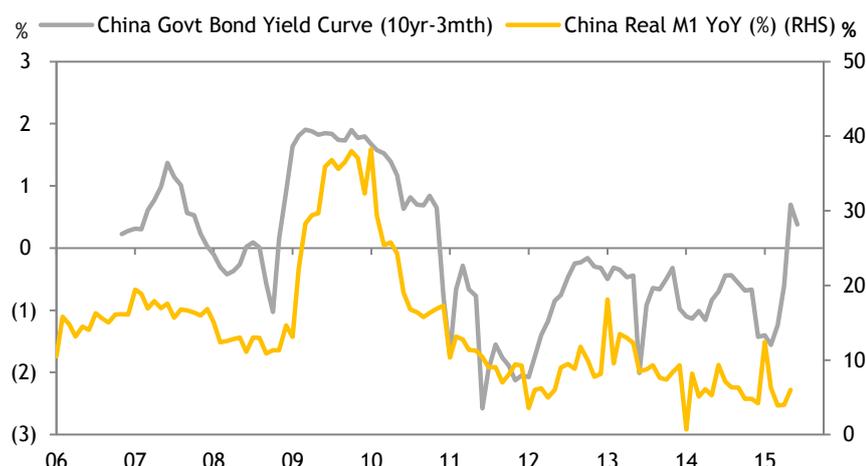


Source: CEIC, Bloomberg, Maybank Kim Eng Research

### Steeper yield curve without money supply increase?

In our previous report ([The Beijing put? A little market sell-off and a rate cut already? June 29, 2015](#)), we argued that to see a sustainable recovery, we would need to see money supply increase. So the clock is ticking.

Figure 8: China money supply and bond yield curve



Source: CEIC, Bloomberg, Maybank Kim Eng Research

**Implications:**

As the market is already quite oversold, we expect a rebound. The coming ETF buying will focus on big-cap stocks and the following table shows materials, industrials, healthcare and consumer discretionary are the most oversold sectors.

Given brokerages will not sell their holdings as long as the Shanghai A-index is below the 4,500 level, so does it mean above 4,500 is a cap on the upside? Therefore we recommend investors to sell their holdings in this rebound.

Figure 9: Equity performance by MSCI China sector - absolute and relative

Name	Index	Absolute performance (%)		Relative performance (%)	
		-1w	-1m	-1w	-1m
MSCI China	72	(4)	(10)		
Energy	543	(2)	(9)	2	1
Materials	710	(8)	(17)	(4)	(7)
Industrials	164	(6)	(17)	(2)	(7)
Capital Goods	96	(7)	(20)	(3)	(11)
Transportation	483	(5)	(11)	(1)	(1)
Consumer discretionary	218	(5)	(15)	(1)	(5)
Automobiles & components	1,671	(2)	(14)	2	(4)
Retailing	254	(16)	(27)	(12)	(17)
Consumer staples	1,077	(4)	(4)	(0)	5
Food/staples retail	74	(1)	7	3	16
Food/beverage/tobacco	739	(4)	(8)	(0)	2
Health care	142	(14)	(19)	(10)	(10)
Financials	549	(4)	(10)	0	(0)
Banks	293	(3)	(7)	1	2
Diversified financials	246	(9)	(21)	(5)	(12)
Insurance	550	(5)	(12)	(1)	(2)
Real estate	752	(4)	(11)	0	(1)
Technology	356	(4)	(4)	0	6
Software services	298	(3)	(2)	1	7
Tech hardware	224	(5)	(13)	(1)	(3)
Semiconductors/equipment	87	(4)	(7)	(1)	3
Telecoms	154	(1)	(7)	3	3
Utilities	698	(4)	(9)	(0)	0

Source: Maybank Kim Eng, MSCI, FactSet data as of July 3, 2015

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