

# China Equities. Fundamentals Positive. Valuations High In Places. IPO Activity Sapping the Market.

- Long term positive China on reform and liquidity.
- Medium term volatility from valuations and IPO issuance.

1. There are reasons to be optimistic about the Chinese economy in the long run due to structural reform. Current growth rates will slow but China is reorganizing itself to a more durable model.

- a. Political reform, notably the leaning away from rule of Party to rule of Law. The renewed importance of the Chinese constitution.
- b. Economic reform. Refinancing the local governments, lowering debt service costs. Rebalancing leverage away from over leveraged local governments and corporates towards households and central government.
- c. Financial market reform. The introduction of market discipline such as fewer bailouts and thus more use of the bankruptcy code.

1. The PBOC is in the midst of expansionary policy.

- a. QE lite via LTR0s with muni bonds as HQLA collateral.
- b. Cutting interest rates
- c. Cutting RRR.
- d. General deregulation of the banking and savings industry.
- e. This will favor the banks.

1. The stock market has been very volatile.

- a. Valuations in parts of the market have overshot fundamentals.
- b. The market has simply run up too high.
- c. IPOs are sapping fund flows.

1. Not all parts of the market are overvalued.

- a. HSCEI is trading on 9.4X 2015 est earnings.
- b. SHCOMP is trading on 17.5X
- c. Shenzhen is trading on 36.9X
- d. ChiNext is trading on 97.2X

Today we take a look at IPO activity.

- 1. Market capitalization is rising faster than SHCOMP due to the increased volume of IPOs.
- 2. June MTD China announced IPOs total over 75 billion USD (as at 26 June). This compares with an average of 27 billion per month for the last 12 months.
- 3. We estimate the 12 month cumulative IPO volume as a percentage of market capitalization in the second chart below\*. IPO volume is definitely diverting capital away from the market.

Chart 1: Normalized Market Cap, SHCOMP and IPO issuance.



Chart 2: IPOs as a percentage of Market Cap. 12 month moving sum.

