China. Opportunities and Lost Opportunities. Prospects for China Equity Markets.

I have been optimistic about the development of China as it matures into a middle aged, consumption led, economy governed by rule of law and subject to market forces.

What I like most about China was what I see as a genuine desire for reform, to govern by rule of law, to allow markets to be policed by demand and supply, to modernize corporate enterprise law. Evidence of this can be found in the form of the elevation of the constitution in last November's Fourth Plenum and again earlier this year when officials would be required to swear allegiance to the constitution and not just the Party. I continue to see the anti-corruption efforts carried out with determination. The efforts to include the RMB in the SDR will also open up the country's capital account more and allow the currency to find a market clearing level.

Even with the economy slowing from 7.5% to 7.0% this year, perhaps weaker than that, the Chinese economy would create more incremental nominal output than the US economy growing at 3%. At that rate, corporate profits would come under pressure. Among the HK H shares, PE multiples were 8 times in 2014 and expected to be stagnant at 8X in 2015 improving to 7.3X in 2016 implying a tepid 9.6% earnings growth. In the Shanghai A shares, PE multiples were 18.8 times in 2014 and expected to be 15.3X in 2015 and 13.5X in 2016 implying earnings growth of 22% in 2015 and slowing to 13% in 2016. These are aggregates of course and hide a wide range of numbers.

The main driver of equity markets was going to be liquidity and the PBOC put. Fundamentals while unexciting were sufficiently robust to hold the market in line while central bank efforts to drive the real economy would also drive down interest rates and cost of debt boosting valuations. My view therefore relied on the general economy being on the weak side, growing at between 6.5% to 7.0%, to do two things, one, generate sufficient nominal output growth to sustain the employment and investment, and two, be sufficiently weak to keep the PBOC in expansionary mode.

The PBOC is currently operating a number of market friendly policies. One, it is in rate cutting mode. It has cut the deposit and lending benchmark rates three times this year and the banks' required reserve ratio (RRR) twice from 20% to 18.5%. With interest rates at 4.85% and an acutely high RRR, the PBOC has a lot more room to cut rates. Two, cutting rates is a blunt instrument as market rates may not react. The PBOC is actively operating open market operations, basically repo operations, to bring down market rates of interest to lower debt service across the board. Pledged Supplementary Lending, Medium Term Lending Facility, et al, are all expansionary open market operations designed to improve liquidity and lower borrowing costs. Third, the PBOC is encouraging a wide ranging rebalancing of where credit is deployed in China. Currently, corporates and local governments are over leveraged whereas small and medium enterprises are starved of credit and consumer credit while growing is yet small. The government's local government debt swap, essentially refinancing local governments' high debt service off balance sheet liabilities to lower cost, more transparent, on balance sheet municipal bonds is not only lowering the debt burden for local governments but is improving credit quality for creditors the large extent of whom are the country's commercial banks. The municipal paper also serves as capital efficient eligible collateral for the PBOC's repo operations.

The above led me to the opinion that China equities were a good investment. The question is, why did the market fall so much and what is the current prognosis?

Why did the market fall so much? When the tech bubble burst in 2000, Nasdaq fell 75% over the space of 3 years. The S&P, however, was not immune and lost 45% in the same time frame. There is a tech bubble in China. The ChiNext market has fallen some 42% since June; in the same time the Shanghai Composite has fallen 32%. ChiNext PE ratios were at 130 while the Shanghai Composite traded at 26X. Retail investors and margin investors which include corporate investors led to a bubble in some sectors which are now bursting. Margin calls are causing leveraged positions to be unwound.

What do I think of what the Chinese government is doing to support the market? In the face of collapsing markets, governments around the world and throughout history have always sought to intervene. The Americans did in during the Great Depression, they and every major economy did it again in 2008. Ireland bankrupted itself saving its banks. The question is, will it work? The answer, today in China as before in America and Europe and Japan, is no. The market must find its level. All bailouts do is delay the process of finding that level. Even the current state of the American and European markets is one where the overhang from 2008 has not been

fully worked out. In the short term, market intervention can arrest a falling market. China of all countries has the financial firepower to support markets. One feature of note is that there has b
een no contagion. Credit markets remain stable and open, the currency is also stable. The weakness in the equity market has been isolated to just the equity market. Longer term wealth effects may take hold but these are likely to be less of an impact.

Do I think that the Chinese market intervention represents a setback to the reform efforts? Given that the intervention in markets is no more intrusive than the actions of the Fed or the BoE or the ECB in 2008, I think not. **I think the Chinese government will continue with market and political reform.** The reform will just have to be adjusted around any bailouts of the equity or bond markets. Just like anywhere else. China's reform efforts are not based on altruism or a change of philosophy. The Communist Party sees the reform, the change to rule of law as opposed to rule by Party, as a strategy to avert an existential threat to the Party in the face of a maturing populace. It will not stop now.

What is the current prognosis? Have I changed how I think of the Chinese equity markets?

Yes. **I think that fundamentals are poorer than I thought and that part of the reason is the sharp fall in equity markets.** Retail investors' margin trading participation was manageable, circa 8.8%, in relation to the total market capitalization. What I have no transparency into is the magnitude of leverage exposure in corporates. A common means for smaller companies to raise debt is to provide their equity as collateral. This type of activity was prevalent in the 1980s and 1990s in South East Asia. Now if the proceeds of these loans are used to invest in operating assets then while the capital structure of the business may be weakened, the operational model is not. If, however, companies invest proceeds in the stock market then clearly there is a serious issue with business models. Companies in South East Asia prior and up to the Asian crisis in 1997 were engaged in these investment practices. While not all companies did this, it introduced a feedback loop which greatly increased volatility in earnings, balance sheets and equity market pricing.

I do not see much more downside. I think that the Chinese government will **not countenance lower prices as it would destabilize the real economy**. Also, if my suspicions about where some companies have been deploying their capital, in financial assets rather than in operational assets, then the government will have to address the issue of corporate balance sheets and put a floor under equity markets.

I do not see too much upside. When the PBOC expanded policy in 2014 it was its intention to boost the real economy and lower borrowing costs specifically for local governments and small and medium sized enterprises. It was not its intention to inflate the equity market. In fact the PBOC recognized that the rising equity market was at some level when valuations outran fundamentals an undesirable side effect of its expansionary policy. Unfortunately, its attempts at deflating the equity market, and there were several attempts, were not sufficiently determined and a bubble inflated. The government will not allow another bubble to inflate and will therefore **likely introduce cooling measures if equities should rise sharply or substantially from current levels.** The behavior of the currency makes a good example of how the market can be subdued by sufficiently determined policy. The A share market is still only semi-open and thus can be supported or indeed suppressed by policy.