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China Market Strategy

Market Rescue: Will It Work?

Hao Hong, CFA
hao.hong@bocomgroup.com
(852) 3766 1802
Head of Research

Shanghai reeks of calls to "bailout", and is attempting to stage a technical rebound. The series of speeches by top policy makers, the accompanying array of new policies to stem the hemorrhage, and more importantly, the swiftness of the rollout of these policies all suggest the resolve to "rescue" the market. For instance, it only took four days for the People's Congress to change the corporate law to make ways for stock repurchase by listed companies. Brokers are disallowed from forced selling those shares pledged but cannot meet margin calls, and they are readying funds to relieve those "worthwhile" companies of which shares are heavily pledged.

Will it work?

Our quantitative analysis shows that the amount of shares pledged and the percentage of total market capitalization pledged have been rising since early 2015, even though the stock market bubble burst only managed to put a fleeting dent in the share-pledge practice. The percentage of the market pledged rose until March 2018, then began to fall sharply (**Figure 1**). It appears that as the market plunge accelerated, margin calls on shares pledged increased – it was like stepping on the gas pedal.

That said, given that the entire emerging market has been under pressure since late January, and that the percentage of market pledged has been rising in tandem as the market recovered from the 2015 crash, it is unlikely that these share-pledged loans are the reason for the bear market, although they must have aggravated it. Meanwhile, the surging volatility in the US market has not helped – the consequence of the colliding economic down cycle in China and the peaking cycle in the US (*"The Colliding Cycles of the US and China", 20180903*).

Will the swift changes of corporate law to allow easier share repurchase work? Our analysis suggests the answer is unclear. We compare listed companies' net cash on balance sheet with their current liabilities. If net cash is positive, the companies will have the ability to buy back shares in the open market. We find that the listed companies only have RMB325bn of net cash, or 12.3% of the corresponding companies' free-float market cap, but less than 1% of the entire market's capitalization of over RMB40tn. This figure has fallen from just over RMB400bn, but the percentage remains stable – a result of a falling market (**Figure 2**). As such, the net cash that can be deployed for share buyback is limited, despite the change of law. It could help those companies with some excess cash, but these companies are strong in their own right, and thus probably less prone to support their own shares.

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In sum, these tactics are likely to support the subdued market sentiment. But they have not touched the essence of the issue confronting China's stock market – the stock market has not always been an inclusive pursuit to give the hoi polloi the opportunity to participate in wealth creation via the growth of listed companies. Instead, it has been a game of "rip-off", of the rich over the poor, the haves over the have-nots, the insiders over the outsiders. And the Chinese retail investors, often in good spirit, nickname such a game "harvesting chives" (because chives grow fast and can be harvested over and over).

In recent history, there have been two great bull runs in the Chinese stock markets – one from mid-2005 to late-2007, and another from mid-2014 to mid-2015. The fundamental reason for these bull markets is that there was structural change prior to the inception of these bull markets - to include retail investors in the pursuit of wealth creation. In 2005, it was the stock ownership reform to resolve the status of the restricted shares held by the state; and in 2014, the significant growth of margin lending, rightly or wrongly, let a great many soar from rags to riches, and then back to earth.

The reason why the Chinese favors property as an asset class over stocks, and property has done exceedingly well, is not just because property is the most legitimate way to take on leverage, even for a working class. It is because property is probably the only fair game that has been consistently letting the most number of people participate in wealth creation. It started from the housing reform in 1998, when the state transferred significant wealth to the masses through selling state-owned property titles at a token price.

In our report titled "*The Market Bottom: When and Where*" more than two years ago (20160604), we re-defined the market bottom as relative to a long-term economic growth rate. We showed that a log-linear relationship between the Shanghai Composite and the implicit GDP growth target implied by China's Five-Year-Plan since 1986 (**Figure 3**). Interestingly, the time when Shanghai touched its bottom twice in the past, 2005 and 2014, coincided with the structural changes we discussed above. In this report two years ago, we wrote that the theoretical market bottom should be around 2,450, should the historical relationship persist.

On 19 October 2018, the Shanghai Composite plunged to 2,449.197 before it rebounded. In the past two years, we documented a mysterious force that has prevented the Shanghai Composite to arrive at its theoretical bottom, and had presented our findings to top policy makers (**Figure 4**). Recent public filings showed that the "National Team" had left the market.

After the First Session of the Twelfth National People's Congress on 17 March 2013, Premier Li Keqiang commented while answering questions from the press: "*sometimes stirring vested interests may be more difficult than stirring the soul*". It is a candid and vivid assessment of the challenges that the Chinese market is facing. With the short-term policy tactical maneuvers, the Chinese market will attempt to heal, albeit hampered by overseas volatility. But before we see structural changes that "stir the soul", the return of the great bull market remains elusive.

Figure 1: China's shares-pledge problem.

Source: Wind, BOCOM Int'l

Figure 2: Listed companies have limited net cash for share repurchase.

年份	2015	2016	2017	6/30/2018
上市公司个数	2,799	3,026	3,464	3,556
数据完整公司个数	2,752	2,969	3,402	3,484
现金>流动负债公司个数	569	685	712	577
现金>流动负债主板个数	214	261	307	269
现金>流动负债中小板个数	161	198	184	132
现金>流动负债创业板个数	194	226	221	176
现金>流动负债市值总计（亿元）	80,877	84,600	82,166	67,294
数据完整市值总计（亿元）	456,328	433,874	479,058	428,613
市值占比	17.7%	19.5%	17.2%	15.7%
现金>流动负债净现金总计（亿元）Net Cash	**2,955**	**4,031**	**3,973**	**3,252**
现金>流动负债流通市值总计（亿元）	32,567	32,823	31,670	26,445
现金>流动负债的公司净现金总计/流通市值总计（%）Net Cash%FF MV	**9.1%**	**12.3%**	**12.5%**	**12.3%**

Source: Wind, BOCOM Int'l

Figure 3: Shanghai is at its long-term trend line. The ann. compound rate of the rising trend = GDP target.

Source: Bloomberg

Figure 4: Mysterious force in 2016. Now Shanghai is oversold, but its bottom tends to be protracted.

Source: Bloomberg, BOCOM Int'l

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BOCOM International

10/F, Man Yee Building, 68 Des Voeux Road Central, Central, Hong Kong

Main: (852) 3766 1899 Fax: (852) 2107 4662

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