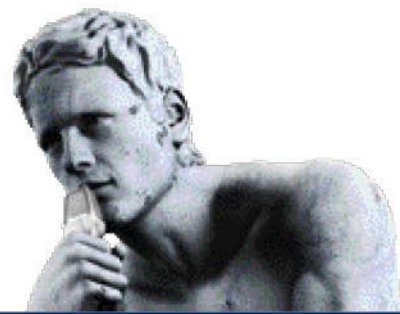


Schroders TalkingPoint



Is a bubble in Chinese stocks being inflated?

Asian Equities Team, Schroders

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The sharp rally in Chinese share prices is not justified by the underlying fundamentals but it has considerable momentum and could continue for a while yet. A surge in China's A-shares and, more recently, Hong Kong's H-shares has reignited a sense of excitement about the China equity story after five years of lacklustre performance by both markets versus global equities. However, many investors are increasingly concerned about whether this move in the markets is sustainable.

The rally in A-shares started in the third quarter of last year, seemingly due to local investors' expectations for policy easing and a shift in investment appetite away from the slowing Chinese property market into out-of-favour local equities. The launch of the Shanghai-Hong Kong Stock Connect in November 2014 provided a further sentiment boost with expectations of foreign fund flows to the A-share market.

The bullish sentiment and liquidity onshore then started to spill over into the Hong Kong market from early April. This was mainly driven by both a change in the regulation allowing domestic mutual funds to access Connect and investors' focus on the widening discount of H-shares versus their A-share equivalents. Trading volumes in the Hong Kong market have reached new highs and the broader Hang Seng Index has broken out of its post-crisis trading range in the last month.

How long will this upward move last? What could be a trigger for the bubble to burst? And how are our portfolios positioned against this market backdrop? We attempt to address these questions here.



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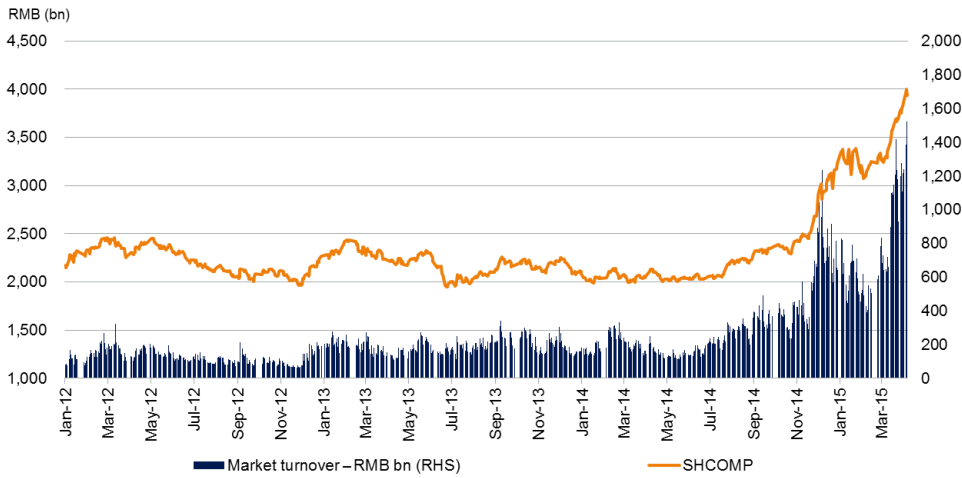
Euphoric A-share sentiment is a disconnect from downbeat economic fundamentals

The China A-share market has doubled in less than ten months while daily turnover reached as high as RMB 1.5 trillion (US\$250 billion) a day. Hundreds of thousands of new trading accounts are being opened and the equity markets are a hot topic of conversation across China.

Although aggregate price-to-earnings (PE) multiples for the broader Shanghai A-share indices are 'only' at c.22x today, well below the peaks reached in the last bubble in 2007 when they climbed to over 45x, these headline numbers are dragged down by the large-cap banks. Meanwhile, at a more granular level, over 70% of individual stocks are now trading at multiples of over 50x, while the ChiNext index, which represents small-cap growth stocks, is now valued at c.95x reported profit.



Chart 1: Shanghai composite performance & market turnover



Source: Wind, April 2015

Chart 2: A-share weekly account opening



Source: Wind, April 2015

Chart 3: A-share market valuation trailing 12-month PE



Source: Wind, March 2015

However, the weakening real economy paints a very different picture from the stockmarket euphoria. Chinese GDP continues to weaken, with various economic data such as industrial production, power generation, and cargo shipment all pointing to a slowing real economy. Consumption has also been hit hard by the anti-corruption campaign. The real economy is entering a disinflationary phase, with the producer price index (PPI) contracting for 37 consecutive months. Weak demand, coupled with high corporate leverage, continues to exert pressure on corporate earnings, especially for the more cyclical sectors, and presents significant risks to bank NPLs. Earnings revisions for the MSCI China Index, as a result, have remained negative in recent months.

Chart 4: Deflationary environment for much of the economy...

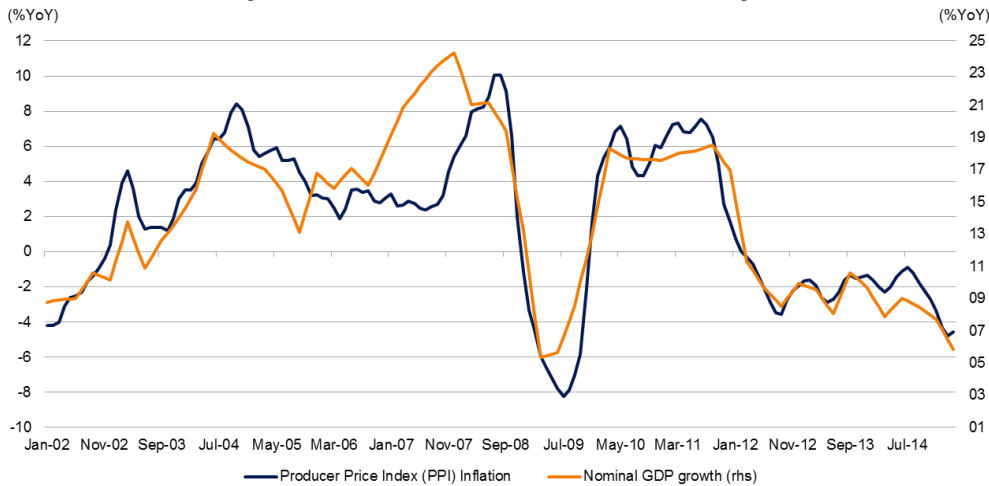
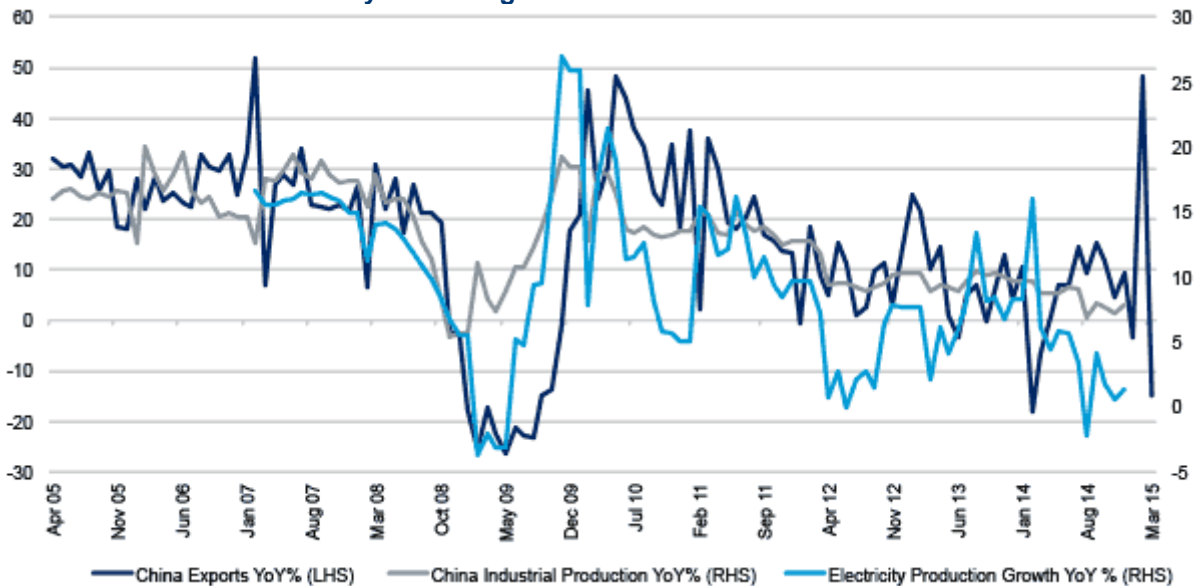


Chart 5: But the real economy is slowing



What’s driving China’s stock bonanza?

We believe that the hype in both markets has been driven by a number of factors.

‘Bad News Is Good News’

Firstly, the market has moved into a phase where ‘bad news is good news’, as weaker data are expected to trigger policy easing and broader macro stimulus from the Chinese authorities to stem the slowdown in the economy.

We had hoped that the Chinese authorities would be prepared to tolerate an inevitable slowdown in growth as they rebalanced the economy towards a more sustainable footing, with more emphasis on ‘quality not quantity’ of GDP. However, actions in recent weeks show that top-down policies in China have been very accommodative in order to stimulate the sluggish economy. In recent months, we have seen policymakers cutting interest rates and the reserve

ratio requirement (RRR) for banks, which has freed up further capital for lending; meanwhile mortgage lending has been eased, providing support to the slowing property market.

Given the real interest rate has been rising since last year, amidst a disinflationary environment, this has allowed for more aggressive monetary easing. Expectations are now very high that we will see further cuts in RRR and benchmark rates in the coming weeks as authorities look to underwrite a stronger economy in the second half of the year. There has even been talk of some form of Chinese 'QE' to improve liquidity in the system. This, however, seems unlikely given interest rates are well above zero.

Chart 6: Chinese real one-year lending rate and deposit rate*



*Both deflated by CPI inflation
Source: CEIC, CLSA, April 2015

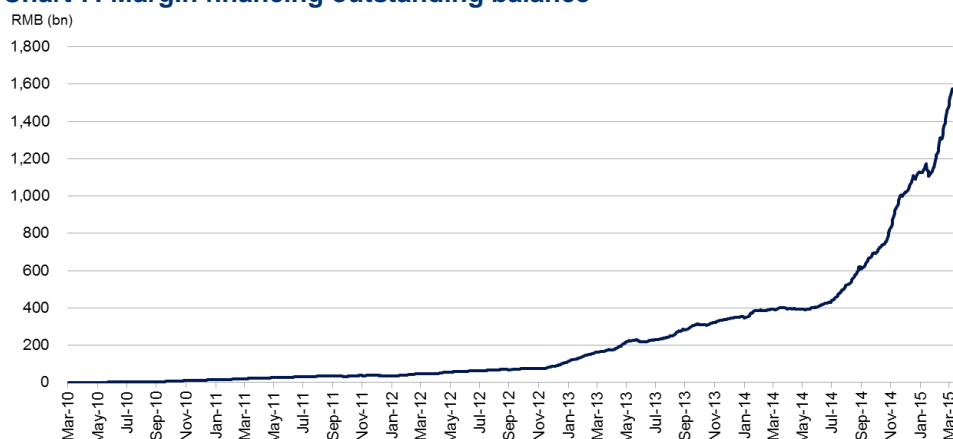
Fuelled by a surge in leveraged trading

Secondly, the Chinese rally is being increasingly financed by a surge in leveraged trading. Margin financing was not available in the previous cycle, whereas massive leverage has been a source of ample liquidity in this rally. Margin finance outstanding in the A-share market has reached approximately RMB 1.6 trillion¹, a nearly four-fold increase from the end of the third quarter in 2014.

Long margin positions now account for circa 3% of market cap. On a free-float-adjusted basis, the long margin position to market cap ratio is at an elevated level of 8-9%; above any other historical market peaks. However, margin finance is a double-edged sword. When the market starts to correct, the downside will then be amplified by the leverage impact.

¹ Source: Deutsche Bank, April 2015

Chart 7: Margin financing outstanding balance



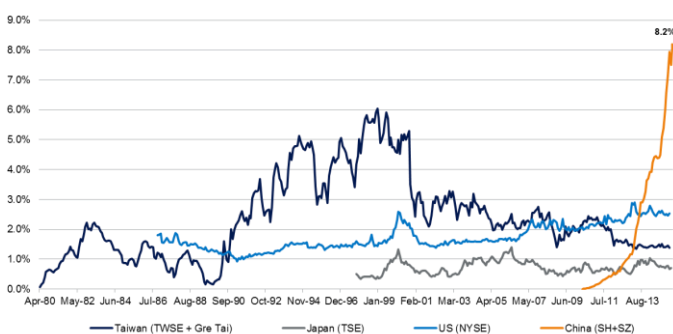
Source: Wind, April 2015

Chart 8: Margin debt as % of total market cap



Source: Wind, Bloomberg, Macquarie Research, April 2015

Chart 9: Margin debt as % estimated free float



Source: Wind, Bloomberg, Macquarie Research, April 2015

Although there have been periodic comments from the securities regulators about the need to monitor margin finance, we have yet to see any further significant clamp-down on this activity. Brokers are, meanwhile, in the process of raising significant capital to increase their fire-power.

Supportive government policies

Thirdly, compared to the previous cycle in 2007, this rally so far has been supported by the government, including market-liberalising measures such as the launch of the Shanghai-Hong Kong Stock Connect scheme.

There have also been a number of high profile news articles in China downplaying the valuation concerns and bubble risks in the A-share market, which some are interpreting as a quasi-government blessing for the bull-market. The logic

here is that a strong equity market will allow structurally weak Chinese companies and local governments to raise new equity to de-leverage, thus helping alleviate some of the structural overhangs in the economy.

The Shanghai-Hong Kong Stock Connect scheme potentially ushers in the start of a new era for Hong Kong and Chinese equity markets, allowing far less restrictive access for global investors to A-shares, and at the same time freer access for Chinese investors in Hong Kong stocks. For both markets, this could mean the introduction of massive new pools of capital over the longer term, which in turn, could have implications for valuations.

At the broader macro level, there has also been much talk about State Owned Enterprise (SOE) reform and, more recently, China's plans for regional infrastructure investment through the 'One Belt One Road' plan. Although details on these plans are yet to be unveiled, these initiatives have offered hope of further M&A and other restructuring measures, which can further excite retail investors in the current optimistic environment. For example, we have seen sharp spikes in the share prices of shipping, oil and telecom companies in recent weeks on rumours of possible industry consolidation, even though the industrial logic for creating even larger state monopolies is far from obvious. Whilst expectations of these projects are high, the real benefits are likely to disappoint.

Market momentum

Finally, momentum is a very powerful force in its own right, sucking in retail investors to A- and H-shares and global investors into the Hong Kong market. With many international investors seemingly under-invested in China after its multi-year underperformance, this sharp reversal in the market's trend has been painful for many. The more that markets rise, the greater the pain for benchmarked investors (who have under-invested in China) and the greater the temptation to capitulate and cover underweights. These powerful behavioural forces must explain, at least in part, the surge the trading volumes in Hong Kong in recent weeks as overseas funds have entered the market.

Most of the influences on the market seem likely to remain in place in the near term. Policy is set to ease further in the second quarter, with no signs yet of a change in the authorities' attitude to leverage. Meanwhile, investors' greed (for further gains) and fear (of further underperformance) are still exerting a positive feedback loop in both markets. Although the A-share rally feels quite mature, at almost 10 months old, the Hong Kong market has only really broken out of its trading range in the last few weeks. As valuations are relatively cheaper outside of domestic China, the Hong Kong market might have some more room to go up. However, we also know from past experience that powerful liquidity-driven rallies that are not matched by a pick-up in corporate fundamentals, and where valuations get seriously overextended, will ultimately fall under their own weight.

Is this time different?

The most recent example of a strong bull market was in 2006-2007 when A-shares rallied 5-6x in two years. That was a very different era for China, when GDP growth was robust at 10%+, corporate earnings were strong and property prices were rising. Concerns in 2007 were centred on an overheating economy triggering runaway inflation and policy tightening, which eventually resulted in the market downturn. This is all in stark contrast to today's economy characterised by strong deflationary forces, decelerating growth, a soft property market and much higher corporate leverage. This time, the worries are much more focused on growth and corporate earnings and whether these will respond positively to policy easing measures.

Table 1: Comparing the two bull markets

	2006-2007	2014-??
Economy	Fast growth: 2006 GDP +10.4%, 2007 +11.2%	Slowing growth: 2014 +7.3%, 2015 <7%?
Inflation	Higher inflation: 2006 CPI +2.8%, 2007 +6.5%	Low inflation/deflation : 2015 CPI <1.5%, PPI negative
Money supply	Rapid growth: 2006 M2 +16.9%, 2007 +16.7%	Slowing growth: 2014 +12.2%
Interest Rates	Rapid Increase: 1 year lending rate +200bp in 2006/07	Falling rates: 75bp cuts in 2015 YTD
Currency	Appreciating: 2006 +3.3% v. \$, 2007 +7%	Mild depreciation: 2014 (-2.4%), 2015 flat YTD
Corporate earnings	Robust	Anaemic
Property	Rising prices	Falling prices
Reforms	Stock market reforms	SOE and administrative reforms
Leverage	Low system debt:GDP	Highly levered corporates, local Government

Industry innovation	Limited	Disruptive technological change
Margin financing	Unavailable	Strong growth, highly penetrated
National policies	No	One-Belt-One-Road
Foreign inflows	Limited to QFIIs (USD 9.5 billion)	QFII/RQFII/MMA participation increased

Source: Schroders, April 2015

What could trigger a major correction?

From a global perspective, the interest rate cycle in the US will be the key factor to monitor in the near term. Should the Fed start to hike interest rates, the unwinding of the carry trade will significantly dampen risk appetite for global investors. Emerging markets, which includes China, is still perceived as a risky asset class.

In the near-term, the most likely trigger for a correction would be a change in the regulatory stance which affects stock trading, such as the tightening of leveraged trading. We have seen corrections already when the regulators have hinted at stricter controls, only for markets to rally again as these have not been enforced. The more markets run, and the more leverage is used, obviously the greater the chances of such a policy change occurring.

The market is now convinced we will see further policy easing such as rate cuts, RRR cuts, local bond issuance and possibly even some form of QE. However, if this does not come through as expected, maybe because Beijing authorities are more optimistic about the prospects for second half growth, then this could also undermine one of the pillars of the market. A more significant change for the market would be a shift in monetary policy from obviously loose, to neutral or even tightening, in response to stronger data or higher CPI numbers.

If policy is not effective in boosting the economy then clearly the probability of tightening later this year is removed. In this case, the outlook for earnings and the level of valuation comes under much greater scrutiny again and all the structural concerns that have dogged investors in China in recent years come back to the fore. These include rising corporate and local government indebtedness, overcapacity in many industries, weak margins and profitability, poor cash flows and risks to bank balance sheets.

Ultimately, it is extremely difficult to know what will tip the balance in the markets, the trigger for the correction and when this will occur. Each market cycle plays out slightly differently.

We feel that A-shares are already at vulnerable levels today in light of its frothy valuation, increasing IPO issuance, deteriorating corporate earnings and capital outflows. Therefore, we would not be chasing A-shares. As for H-shares and the broader Hong Kong market, it is less clear, although valuations are currently at a more reasonable level.

Portfolio positioning

The liquidity-driven rally in A and H shares may have further upward momentum in the near term given the likelihood of further policy easing and supportive government policy. However, we are cautious about chasing the more cyclical sectors and the latest market 'themes', where we are unlikely to see much improvement in underlying fundamentals and where expectations are too high. Valuations in many sectors of the A-share market are already stretched, and hence there is little justification to buy H-shares indiscriminately simply because they are at a discount.

We also remain cautious on banks, particularly the smaller joint stock and city commercial banks that have been the most aggressive lenders in the recent credit boom. Although there are hopes that current policy easing will reduce the tail risk of a major credit shock to the system, and so justify a re-rating of the sector, we expect to see a continued, steady deterioration in operating metrics and ROEs for the sector in coming months and years. This will happen as margins come under pressure and credit costs move higher, and we feel that this is unlikely to support sustained performance.

At the same time, we are happy to still hold those businesses where we see strong secular growth stories, which are less reliant on market liquidity for a re-rating, and where we can still make sense of valuations. Sectors such as healthcare, e-commerce, insurance and renewable energy have performed well in recent years and should continue to benefit from structural shifts in the economy over the longer term. The consumer discretionary sector also offers more value today. Admittedly, the sector performance has been disappointing amidst the headwinds of the anti-corruption campaign and a slowing Chinese economy. Nevertheless, we think the risk/reward is attractive in this sector given the scope for an improvement in consumption later this year, especially if the wealth effect from the equity market is sustained.

We have also added to our exposure to the telecoms sector this year on expectations of growing data consumption and 4G subscription and improving free cash flow as capital expenditure peaks. We continue to maintain our value discipline as bottom-up stock pickers and look to take profits where we feel valuations are significantly overextended.

Meanwhile, within our China portfolios, we have recently locked in profits in railway- and nuclear-related stocks that have witnessed strong outperformance. We have also trimmed our real estate stocks as their NAV discount has been significantly narrowed on the back of recent government policy easing. In the long term, we are still cautious on the structural issue of the sector given the oversupply situation in the lower-tiered cities. We have also narrowed our underweight in the oil sector, where performance has lagged in this rally, in view of the fact that oil prices are likely bottoming out. Elsewhere, we will revisit select NASDAQ-listed Chinese companies given they have lagged in this rally and their valuations are becoming attractive.

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