FOR WHOLESALE INVESTORS – 11 July 2018

A-SHARES TANKED. WHAT'S NEXT?

Panic causes tunnel vision. Calm acceptance of danger allows us to more easily assess the situation and see the options.

Simon Sinek

At the time of writing, CSI 300 was down by more than 20% from its peak on 24 January 2018, while the S&P500 was only down 4% from its peak on 26 January. The trigger for the turn in the A-shares' fortune was a combination of a slowdown in domestic growth momentum, when weak economic data started flowing in May, and a rise in Sino-US trade tensions, though we have been expecting the growth slowdown since April. The market just piled this onto the prevailing worries about deleveraging, defaults and liquidity squeeze.

While the probability for a full-blown trade war (with China retaliating on Trump's tariffs on all Chinese exports to the US) remains low at this point, at around 10% in my view, the probability of a resolution is probably even lower. This means that there is more than 80% probability for long drawn-out negotiations to keep Chinese stocks apprehensive/volatile.

Fears rise as growth momentum weakens further

Since May, credit growth and macroeconomic indicators have weakened further from an already soft trend (Charts 1 – 4), reflecting a self-inflicted slowdown by Beijing's deleveraging policy that has hit shadow banking especially hard (Chart 5). The impact of the contraction in shadow financing has fallen largely on the private sector and, thus, hurting "animal spirit" (or private investment incentive) and market sentiment badly.

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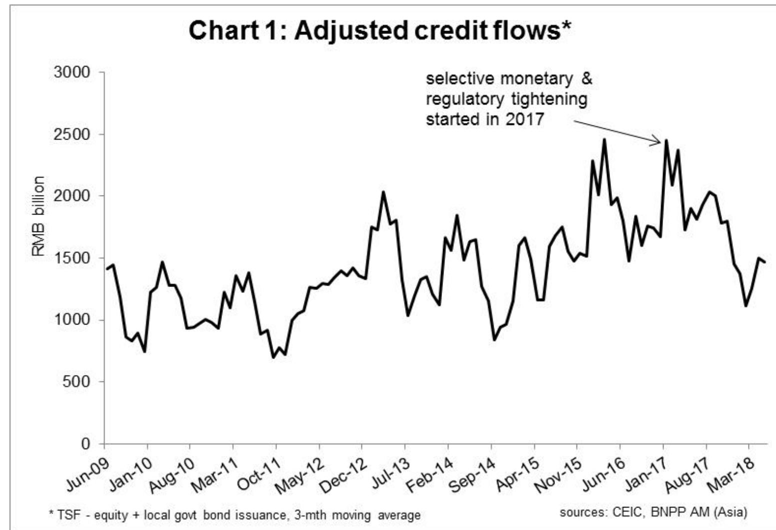


Chart 1: Adjusted credit flows*
selective monetary & regulatory tightening started in 2017
RMB billion
3000
2500
2000
1500
1000
500
0
Jun-09
Jan-10
Aug-10
Mar-11
Oct-11
May-12
Dec-12
Jul-13
Feb-14
Sep-14
Apr-15
Nov-15
Jun-16
Jan-17
Aug-17
Mar-18
* TSF - equity + local govt bond issuance, 3-mth moving average
sources: CEIC, BNPP AM (Asia)

Chart 2: Retail sales growth*
total
urban
rural
%YoY
21.0
19.0
17.0
15.0
13.0
11.0
9.0
7.0
May-10
Nov-10
May-11
Nov-11
May-12
Nov-12
May-13
Nov-13
May-14
Nov-14
May-15
Nov-15
May-16
Nov-16
May-17
Nov-17
May-18
* data series in 3-month moving averages
sources: CEIC, BNPP AM (Asia)

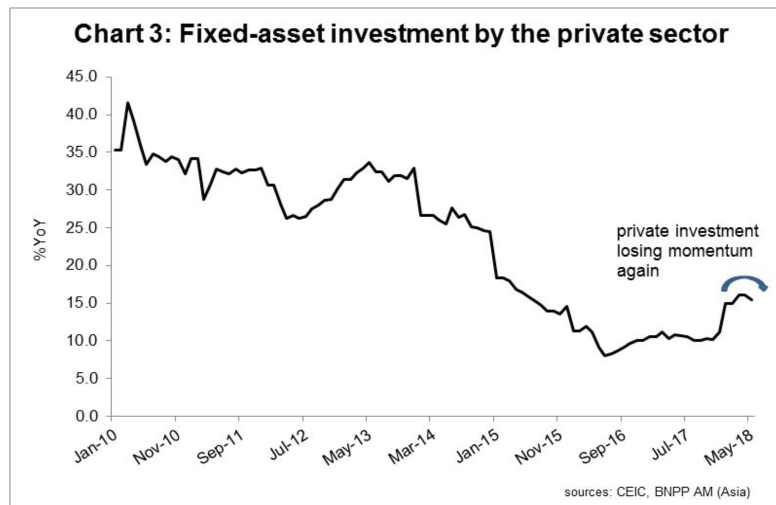
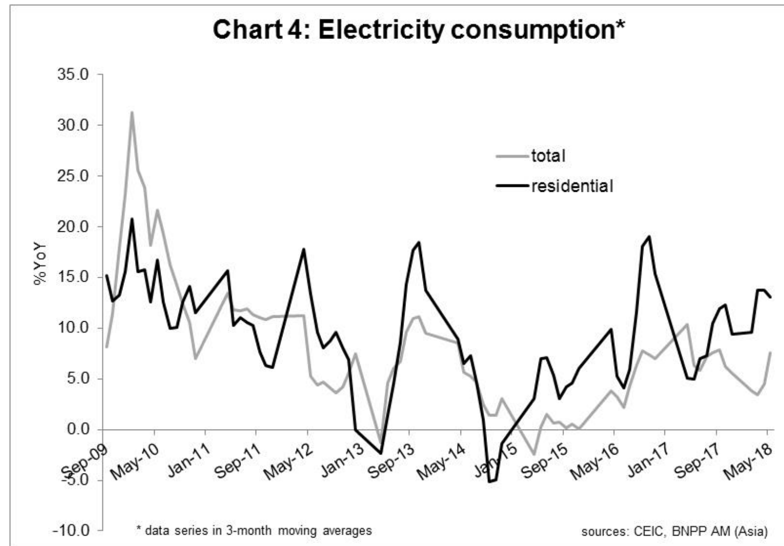
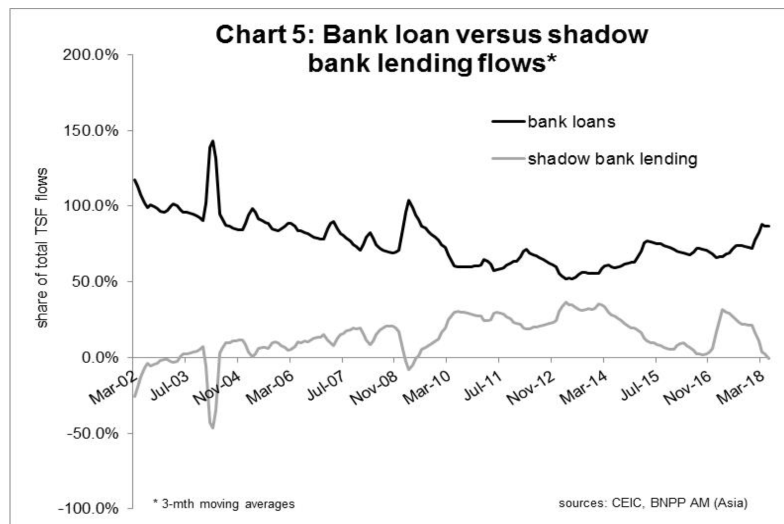


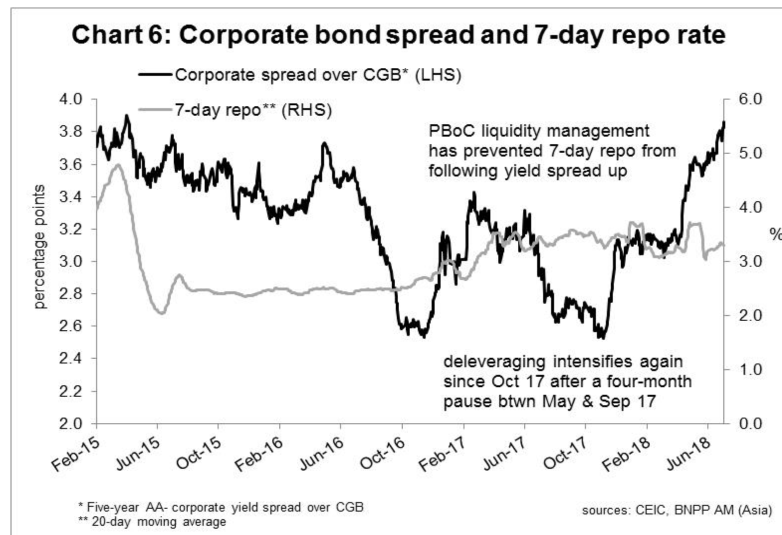
Chart 3: Fixed-asset investment by the private sector
private investment losing momentum again
%YoY
45.0
40.0
35.0
30.0
25.0
20.0
15.0
10.0
5.0
0.0
Jan-10
Nov-10
Sep-11
Jul-12
May-13
Mar-14
Jan-15
Nov-15
Sep-16
Jul-17
May-18
sources: CEIC, BNPP AM (Asia)





Credit spread has widened (Chart 6) and corporate defaults have risen, though in absolute terms the number remains small. According to the PBoC, about RMB66 billion worth of corporate bonds, or 0.4% of the bond market cap, had defaulted on coupon payments in 1H 2018. But the trend of rising defaults is creating jitters about declining credit growth creating an upward default spiral.

Fears have also been heightened by the increase in the so-called pledged lending. Since 2016, many major shareholders in listed companies have pledged an estimated RMB5 trillion worth of their A-share holdings (or 10% of the A-share market cap) as collateral for bank loans. In a market sell-off, the banks would issue margin calls. They would start selling the shares collateral if the borrowers cannot meet those calls, thus risking a downward spiral in the stock market. And if liquidity were to dry up, massive suspensions would result and repeat the nightmare of the 2015 market crash.



Easing will help bonds more than equities

On the back of these fears, the PBoC has shifted its policy bias towards easing. It has cut the bank reserve requirement ratio twice since April this year, despite a rising interest rate environment externally; and more easing is in the cards. It has also enlarged the collateral pool for its lending facilities by accepting lower-rating corporate bonds and pumped liquidity to prevent the 7-day repo rate from rising along with credit spread (see Chart 6).

Barring an economic hard-landing, Beijing's debt-reduction policy has ruled out any massive reflation which would go against the purpose of deleveraging. The PBoC's easing bias only aims at alleviating the economic pains of structural changes and deleveraging but not eliminating them. So the expected incremental easing will unlikely improve equity market sentiment much in the short-term. But it will be bond positive.

Interbank rates are expected to stabilise under incremental easing. But this would not be enough to improve corporate access to credit significantly because the contraction in shadow financing, which works through the interbank market, is unlikely to be offset by any rise in bond financing. Net corporate bond issuance has indeed contracted recently due to concerns about rising defaults pushing up credit spread, harming demand and raising funding cost.

Credit growth is expected to slow down further, dragging on the cyclical growth momentum. Barring a full-scale trade war, the official 6.5% growth target (1Q 18 growth was 6.9%) for 2018 is still within reach, in my view, as the impact of the policy easing should filter through the system by 4Q 18. Under this scenario, the biggest beneficiary of monetary easing in the coming months is likely to be the CGBs and high-grade bonds, with the 5-year CGB yield expected to fall further below the current 3.3% level. Meanwhile, credit spreads are expected to rise until the fears about defaults stabilise.

The market has been complacent about China's growth slowdown while other risks in the system have been known for some time. The rise in the Sino-US trade tension has shaken up this complacency. From this perspective, the recent sharp decline in the A-shares is mostly driven by sentiment, which seems to be pricing in an economic hard-landing. This outcome is unlikely, in my view, because Beijing has the tools and financial resources, and is aided by a relatively closed capital account and a financial system that is still largely influenced by the government, to help prevent it from happening.

What to watch for a market turnaround?

1) Stabilisation of growth momentum
2) Falling bond yields to ease the financing situation, and
3) even a revival of some legitimate shadow bank activities to help ease the liquidity squeeze on the SMEs/private sector
4) Easing of the Sino-US trade tension

In terms of valuation, since the recent correction, MSCI China has been trading at 13x this year's earnings, 10% below the start of the year; trailing PE of CSI 300 is at 11.5x, which is not far above the levels seen in deep market sell-off in late 2015 and early 2016 when weak external demand, currency depreciation and capital outflows weighed heavily on market sentiment. Today's economic and corporate fundamentals are better, corporate profitability is stronger, FX reserves are recovering, macroeconomic policy coordination is better and structural reform and debt-reduction drives are stronger.

From a longer-term structural perspective, the current market turmoil can be considered as an entry point for all the reasons we already know: A-shares inclusion in the MSCI, onshore bond inclusion in international indices, RMB internationalisation, structural reform, debt-reduction etc. The trick is to focus on low-debt, strong cash-flow, companies within the structural reform direction. Meanwhile, the risk for short-term trading is volatility with a downside bias until market sentiment settles down.

Chi Lo, Senior Economist, BNPP AM

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