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No Ordinary Times

2 Big Issues

China's 3Q GDP grew 6.5% and yet the stock market is in bear market territory. Pessimism has been so entrenched that the market's sell-off on certain days could not be explained by economic or corporate fundamentals. This short note will try to direct the spotlight on the key fundamental forces and the actors of the stock market. Amid this seemingly irrational market behaviour, hopefully the reader can understand the rationale and rationality of the actors' actions, and in turn market behaviour.

Market strategists have a tendency to look at every possible causative factor and weave them together to look for a pattern. Similarly, quants like to predict the future direction of the market by building multi-factor models. Whilst these approaches do work sometimes in some markets, they can disappoint dismally in China and there are valid reasons for it.

Safe to say that this bear market was actually triggered by deleveraging; admittedly a reaction delayed till February because most investors had thought that deleveraging was positive for bank earnings. APS did not subscribe to this flawed analysis and misplaced optimism, and hence did not buy a single bank stock. That said, the long-term benefits to banks and to the entire financial system is undeniable, but not without first bearing the brunt of deleveraging.

Even before deleveraging celebrates its first anniversary, the PBOC has reversed course, at least temporarily by lowering interest rates and injecting liquidity into the system. The PBOC is of course not fickle-minded, but it is rather concerned about the negative economic effects arising from an escalating Sino-US trade war, and possibly a cold war.

Chinese policy makers over the last 3 decades have proven themselves to be competent in tackling most domestic and international issues. On the domestic front, they have been particularly impressive. However, this time it might not be easy for them to handle a cold war, especially one that is launched by the world's strongest economic and military power. They are probably feeling this already. Likewise, it can be said that the US will also find this cold war to be its toughest conflict since World War 2. Besides being the world's second largest economy, its adversary has built USD3 trillion of foreign reserves, while also having a huge domestic market that can support its dynamic and buoyant corporate sector. China has also has built up its nuclear capabilities since the 1960s.

On top of all this, the American corporate sector has also built a deeply entrenched symbiotic relationship with China. Can it be decoupled by a few decisions in Washington? Apple, for instance, will surely face an existential crisis not because 20% of its revenue is derived from China, but because all of its products are manufactured in China. It is estimated that including lower tier suppliers, there are thousands of component suppliers to a smart phone. As much as President Donald Trump and his generals might want the entire supply chain to be built in the US, it is not a commercial possibility. The CEOs of GM, Ford, Intel, Micron, and Starbucks et al in recent months must also have been watching with grave concern the deteriorating US-China relations.

Like in the past, Chinese policy makers still have many levers to pull in tackling domestic problems. Investors therefore should not be unduly worried about a credit crunch, or economic crash, or consumption collapse. At the point of writing, the Chinese Ministry of Finance has provided more clarity about tax cuts.

What is most difficult to predict at this point is the will of Washington to fight and see out a full-fledged cold war. Is Washington willing to bear the full political and economic costs of its actions to stop China's rise? Has it correctly assessed the iron will of President Xi Jinping and his team in Beijing? Even if it did, is it too late in the day for this cold war strategy to succeed?

The greatest uncertainty currently faced by the Chinese stock market is Washington's imminent measures against China and China's responses.

Selling begets more selling

Recent market volatility can be better understood by examining the various market actors and their modus operandi. First, private fund managers (PFMs) operating domestically in China run funds with a stop-loss provision typically triggered when the NAV falls to 75%-80%. Put simply, the fund will have to be liquidated if the stop-loss limit is reached, and the residual capital returned to investors. To avert this fate, PFMs will sell down equities and raise cash in order to avert the fate of liquidation when the fund nears its stop-loss NAV. Paradoxically, the more the market declines, the more selling we will see from this group of investors. Recent market estimates place the average cash position of PFMs at around 70%! As they own about 5% of the free float, their selling inevitably will have a major impact on the market.

Retail investors are short-term traders. It should not come as a surprise that China's market volatility is unmatched by most major equity markets, when retail investors account for 80% of daily trading.

In normal times, stock forecasters can ignore the actions of owners of listed companies. However, the actions of owners in recent weeks have become a force to be reckoned with. Many pledged their shares as collateral for loans to expand their business. This bear market has led banks to demand more collateral and for those who are unable to stump up the additional assets, their shares had been dumped in the market. It has become so severe, especially among the tech companies, that the Shenzhen government has come up with a fund to help these companies tide over this difficult period. Lender ICBC, prompted by the PBOC, also has come up with a similar fund, on top of devising a debt-for-equity swap scheme.

The last group of market actors is the regulators. While they don't trade stocks, their influence on the market through regulations and speeches can't be emphasised enough. In jittery, nervy and panicky times, confidence is probably the biggest market mover. It happened in Japan after Black Monday and in Europe following the US sub-prime crisis. Markets can quickly return to sanity after reassuring statements from regulators and politicians. The Chinese stock market is no exception; the market stabilized from last Friday after the CSRC and PBOC provided a few words of assurance. It is good that Chinese regulators are taking appropriate actions to restore market confidence.

Because of these key actors and their behaviour, it is only natural that bull and bear markets in China have tended to be sharp and short.

Portfolio Strategy

The distressed selling by the PFMs and corporate owners seemed to have run its course in the short term. In the medium term, we believe investors should monitor closely Washington's further moves against China because Chinese equity investors have not gotten their heads around this cold war scenario. In this environment, we believe it is prudent to overweight the domestic names such as Maotai (white liquor), Huace (movie production), Venustech (cyber security), Beijing Orient (Big Data) and China International Travel Services (duty-free shops). These companies are likely to report strong earnings growth for the next 2-3 years. The biggest risk to this strategy is when US hawks such as Jim Bolton, Wilbur Ross, Robert Lighthizer, or Peter Navarro change course, or when Wang Qishan makes a trip to Washington.

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The Founder and CIO, Wong Kok Hoi, has over 35 years of investment experience, including CIO at Cititrust Japan, Senior PM at Citibank HK, and Senior Investment Officer of GIC. He was the recipient of the prestigious Mombusho Scholarship in Japan, and graduated with a Bachelor of Commerce (Honors) degree from the Hitotsubashi University (1981). Mr. Wong also graduated from the Investment Appraisal and Management Program at Harvard University (1990).

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