IE

Global Investment Event

10 December 2014

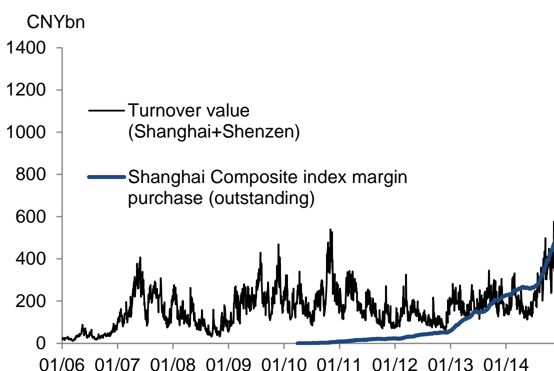
Volatility grips Chinese markets on regulatory change and profit taking

- The Chinese equity market lost 5.4% on 9 December 2014, following increasing investor concern that the recent rally might have been driven by overly enthusiastic retail investors and a significant rise in margin financing.
- The spillover impact of stricter regulation on the ratings of bonds that qualify as eligible collateral for repo transactions also contributed to the equity sell-off.
- The new rule should help reduce speculation and leveraged positions and improve the differentiation of credit risk pricing in the longer term. However, in the near-term it could reduce liquidity, and put upward pressure on interest rates and bond yields.
- Despite increased market volatility, we remain positive about the outlook for Chinese equities because current valuation remains attractive and we expect macro economic policies to remain supportive and the reform agenda to continue.

The facts

On 9 December 2014, the Shanghai Composite Index dropped the most since August 2009, closing down 5.4% at 2,856. The fall came after a sharp rally of 22% between 24 November and December 2014, following the first benchmark interest rate cut since July 2012. Increased concerns about the recent strong market rally being driven by overly enthusiastic retail investors and the significant rise of margin financing, led to profit taking. A rise in global risk aversion, due to concerns about the growth outlook and the sharp fall in crude oil prices, also weighed on investor sentiment. Consequently, market volatility rose, driving market turnover to new highs.

Figure 1: Equity market turnover and margin financing



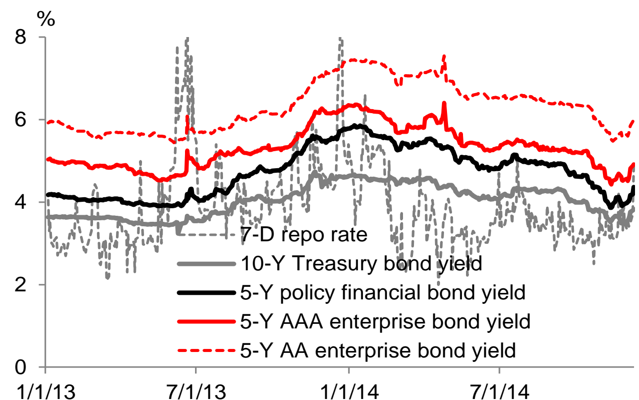
Source: CEIC, Bloomberg, data as at 8 December 2014. For illustrative purposes only and does not constitute any investment recommendation.

The introduction of stricter regulations on the types of bonds that qualify as eligible collateral for repurchase (repo) agreements also contributed to the sell-off in the Chinese equity market. Higher borrowing costs raised concerns about credit and default risks and the stricter regulation led investors to scale back their expectations of further monetary easing.

The China Securities Depository and Clearing Corporation (CSDC) issued a new rule on 8 December 2014 to strengthen risk control for bond repo businesses, following the State Council's decree in early October to enhance the management of local government debt. The CSDC stipulated that only enterprise bonds with the highest rating of AAA, and those issued by firms with a high rating of AA and above, qualified as collateral for bond repos. Local Government Financing Vehicle (LGFV) bonds are covered by the new rule and many of them will likely be impacted.

The tightening of repo collateral requirements triggered a wave of deleveraging and a surge in bond yields and swap rates. But interest rates had already moved higher over the past few weeks, due to some reallocation of funds from bonds to equities and stronger year-end cash demand. Rising demand for margin financing to buy stocks also pushed funding costs higher in the rates market.

Figure 2: Interbank rates and onshore bond yields



Source: CEIC, Bloomberg, data as at 8 December 2014. For illustrative purposes only and does not constitute any investment recommendation. Past performance is not indicative of future returns.

The CNY and CNH weakened against the USD on 9 December despite stronger fixing set by the People's Bank of China (PBoC), amid sentiment spillover from the rates market.

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Investment implications

The tightening of repo collateral requirements will reduce the demand and liquidity for lower-rated bonds, increasing liquidity and risk premiums, and putting upward pressure on yields. There will be greater differentiation between high-grade and low-grade corporate bonds and there could also be some spillover into interbank liquidity and bond markets including some higher-rated bonds.

However, we think the overall liquidity impact should be modest and largely short-lived, because the reduction of low-rated bond collateral positions will be gradual and the exchange-traded bonds/repo market is relatively small compared to the interbank bond market. Financial institutions are likely to sell low-grade bonds and switch into higher-rated ones in response to the new rule. Furthermore, we believe that the PBoC will act to prevent any liquidity squeeze and will not tolerate persistently higher interbank rates, as lowering financing costs for the real economy is one of the government's top priorities in the near term.

We expect the PBoC to continue providing abundant liquidity, via its various liquidity tools, to lower market rates and support a reasonable level of credit growth. We also think the CNY500bn Medium-Term Facility (MTL) loans that are about to mature in mid-December could either be rolled over or the liquidity gap be filled by some other type of liquidity injection, including a possible cut to the reserve requirement ratio. An additional rate cut is also possible if necessary. Overall, given the macro backdrop and outlook – a combination of weak domestic demand with downside growth risks and low inflation - we expect continued supportive monetary policy.

The tighter enterprise bond repo regulation could help prevent liquidity injections going into speculative and leveraged bond and equity positions rather than the real economy. The new rule, together with policy efforts to manage local government debt risks, will also help differentiate credit risk pricing and develop a healthier bond market in the longer term.

We remain positive on Chinese equities as current valuation remains attractive, especially for large caps. Market volatility is likely to remain high in the near term, driven by the outlook for policy, growth and reform domestically and an uncertain external environment. Concerns about economic challenges and debt overhangs are likely to persist. However, continued supportive macro policies and more decisive reform could help ease corporate debt servicing burdens, reduce downside growth risks and improve macro stability. We think investors should focus not on short-term economic fluctuations, and market volatility, but on reform initiatives. Effective reform implementation could prompt a reform-driven rerating of Chinese equities.

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