

The China Story and the Current Stock Market Valuation

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Despite the nearly 20% correction in the recent two months, the performances of the Chinese stock market is impressive. At its recent peak on Aug 4, the Shanghai stock index went up by 80% since this year and almost doubled from its trough in November last year. Such a strong rebound has raised the hope around the world that China, with its aggregative government stimulus package, may lead the world out of its current recession. Unfortunately, in spite of strong recent rallies in equity and property markets in China, the world's hopes will more likely than not be disappointed. Not only will it be a slow process to build China's domestic consumer economy, but there is strong evidence that the stock and property markets have powerfully overheated, with a strong correction quite probable.

Current market valuation and the "China story"

The current market rebound has three phases. The first is between January and April, during which the market went up steadily by 30% from 1900 to 2500, reflecting moderate optimistic sentiment driven by the stimulus plan and, perhaps, increased liquidity due to loosened monetary policies. The second phase is in May. It is a critical phase of the rebound, during which the bulls and the bears were fighting to dominate the direction of the market. During this period, although the index was moving up and down within a tight band of 100 points or so around the 2600 level, many individual stocks, especially natural resources and real estate stocks, ran up much more sharply. The bulls eventually won. Since then the market entered its third phase: capital flooded in, pushing the index up to close to 3500 within two months. By mid-June, the valuation of hot stocks, mostly natural resources and real estate, already reached the level of the 2007 bubble. Since then the market started to turn to "restructuring stocks," i.e., stocks with potential (or hope) of injection of assets from either government or parent companies. The trick is, for these stocks, there is nothing like rational pricing, everything hinges on imagination.

The usual pattern of recovery from a bear market is that "value" stocks take the lead. These stocks are typically in boring industries such as utilities, tobacco, with stable earnings, low growth, and high dividend yields. Investors are often drawn back to market when dividend yields become well above bank deposit rate. Other counter cyclical stocks such as pharmaceuticals would also do well.

In the A-share market, however, hot stocks do not show any "value." Compared with the rest of the market, stocks that are more than doubled since last November saw their earnings dropped more than one third last year (vs. -12% for the rest of the market). Their ROE is only 1% on average, whereas the rest of the market has an average ROE of 6%. In fact close to 20% of them have negative earnings (14% for the rest of the market). Nevertheless, the average market-to-book ratio for these stocks reached 8 (the median is 6), the level at the peak of the 2007 bubble.

Equally strikingly, the hot stocks are disproportionately concentrated in natural resources (e.g., oil and precious metal) and real estate industry, and most recently restructuring stocks. Although the international market for natural resources has gone up significantly since the beginning of this year, it is far below the 2007 level. More importantly, a fully recovery in this market depends on the economic recovery in U.S. and Europe, which is at most bottoming out. Real estate stocks are cyclical and also depend critically on the overall economic condition. As to the recent run up in “restructuring stocks,” i.e., they appear to be the ideal target to be driven above fundamentals, since there are no fundamentals to speak about.

Few of these stocks are part of “Chinese domestic demand” or “Chinese rescue plan” story, which pumped optimism into the market in the first place. What drives the current rebound is, obviously, liquidity and, together with it, “confidence, confidence, confidence” as the country’s premier Wen Jiabao advocated. In the first-half year, 150 billion Yuan flowed into newly formed mutual funds. Insurances companies, another big player, greatly increased its stock market allocation. For example, by the end of June, the market value of stock investment in China Life and Ping An went up by 70 billion and 14 billion, respectively. While part of the increase in value reflected capital appreciation, the new investment flows were substantial. Social security fund, QFII, and retail investors all become active in the market. More importantly, a significant portion of the 7.5 trillion new bank loans, as high as 20% by some estimates, was directed to the stock market. The trick is, however, liquidity or confidence is self-fulfilling. Liquidity drives up prices, which attracts more money. But when money leaves the market, things can turn bad equally quickly.

The bottom line is that the optimistic sentiment can be sustained only if there is a full and, perhaps speedy economic recover both in China and aboard.

Recovery in China and the developed world

China’s economic stimulus package is nothing new. The government used exactly the same strategy during the Asian financial crisis, that is, huge amount of bank loans to keep sectors with overcapacity afloat plus massive investment in infrastructure. But at that time, China was lucky because the crisis was restricted in Asian countries and export growth driven by US consumption (which in turn driven by internet bubble and then housing bubble) soon absorbed the excess capacity. Will this happen again this time?

This time the crisis affected US (and Europe) directly and there are several reasons to believe that the economic recovery in the West would not be a speedy one.

First, while the US housing market is showing signs of stabilization, it remains weak. Sure housing prices delivered its first gain in 34 months and construction and sales volume went up for four and five consecutive months respectively. There is doubt about whether the recent increases in demand, helped by tax credit and low mortgage rates, is sustainable. On the supply side, thanks to record-level foreclosure, the current inventory

represents 9-10 months supply. More supply could come in the coming months from currently delinquent (but not yet foreclosed) mortgages, homes with negative equity, and new foreclosures due to another round of reset of adjustable-rate mortgages including Alt-A and option ARM (often with negative amortization). Moreover, while housing prices have come down by 30% nationwide, it is by no means “cheap” according to historical standards. At the peak of the housing boom, affordability measured by mortgage payment as a percent of household stand almost 40% higher than historical affordability limit of 38%. Rental income was 3.48% as opposed to long run average of 5.04%. Thus there is a room for a further 5-10 percentage points decline to the long-term trend.

Second, consumers surely need to de-leverage and change their consumption patterns. According to my own research forthcoming in Review of Financial Studies, 40% of the US consumption growth between 2000 and 2006 was driven by a wealth effect from the housing market. Thus even if the economy recovers, there is no way for US consumers spending to return to its pre-2007 level in the many years to come.

Third, it takes time for the financial system to recover and to lend again. If the Japanese experience in the 1990s is any guidance, it took Japanese banks a decade to emerge from the damage of burst of asset market bubbles. Rising delinquencies and negative-equity homes do not help either and may bring more banks under water.

Finally, large fiscal deficits, consequences of massive rescue plans, can bring inflation and crowd-out private investment. Currently, US fiscal deficit is estimated to be 13% of GDP in 2009 and government debt is 85% of GDP, both above the commonly accepted “prudent” level of 3% and 60%. In Europe and Japan, government debt has reached 72% and 160%. As the US baby boomers enter retirement age, the room for cutting spending is limited in the future. Or can economic growth and thus increased government revenue bring down the deficit? As the renowned economist Paul Krugman put it, the lesson from past bubbles is that recovery is export-led, which is not likely to happen “unless we can find another planet to export to.”

Outlook of A-share market

Market is unpredictable. But there are useful parameters that one should watch. For the A share market, the most important parameter is, of course, liquidity, which drove the market this high in the first place. There are two types of liquidity. One is the “liquidity stock”, i.e., cash allocated to the stock market but not yet invested, in large insurance companies or mutual funds. The other type is liquidity flow, i.e., the new flow of cash into the market, through say mutual funds or individual accounts. The first type of liquidity has dried up, a direct cause of the recent market falls. For example, the stock investment of major insurance companies is close to, if not exceeding, the commonly accepted limit of 10%. China Life’s current stock allocation in market value is 14%. Although at a cost basis the allocation is lower but should be close to 10%. New IPOs, tightened rules on use of bank loans further drain liquidity. The current decline in the

market is the result of such liquidity concerns. While it is not impossible for the new flow of liquidity to pick up the slack – indeed more than 20 new funds are opening to the public subscription. This type of liquidity depends critically on current market performance and with the recent corrections it may not realize. At this point, one uncertainty about liquidity is foreign capital, which has been very bullish recently. There is evidence money is flowing into the region. For example, Hong Kong Monetary Authority has to inject USD19 billion worth of local currency into the money market. Conceivably, a significant portion of this money will find its way into the Chinese market.

The other parameter to watch is, of course, government policy. The government, however, has conflicting objectives. The top priority is stability, which is often placed ahead of another obvious objective – market efficiency. This is why in the past the government did not take actions at early stages of bubbles. Also useful to keep in mind, though, is that there is a limit as to what the government policies can do. Last fall although the government started to introduce measures to boost confidence when Shanghai index was at 2500, it was not able to prevent the market to drop below 1700.

When the Shanghai index was at its peak of 6000 in 2007, I maintained that, even if the Chinese growth can last forever, the Shanghai index can only sustain a level of 3500. Given today's weaker fundamentals, a correction, is over due, although it is possible for liquidity and government policy to support the market for a sustained period. However, however, only means when the correction does come, it will be a greater one.