

# ECONOMIC FOCUS

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## Mainland China's Stock Market Revives, Could It Last?

- Share prices in mainland China plummeted by about 50% between October 2007 and mid-April this year due to the government's persistent tightening of monetary policy, the fall of global stock markets and the conversion of previously non-tradable shares into tradable ones.
- The share price fall was substantial, but was not unexpected given the phenomenal surge of share prices and all the symptoms of a stock market bubble that preceded it. Share prices soared by over 400% in the two years right up to the fall, while the price-earning (P/E) ratio jumped to 70 from 16 times, among others.
- Since mid-April of this year, share prices have rebounded by about 17% after the government intervened, such as by cutting stamp duty to 0.1% from 0.3%. Government involvement in the Mainland's stock market is not unusual, and is the major reason for the volatilities of share prices on the Mainland. Until this is changed, share prices will be more volatile than otherwise.
- If the average P/E ratio for the Shanghai A index of the last 10 years is taken as a benchmark, share prices on the Mainland are now more reasonably priced. However, slowing economic growth coupled with stubbornly high global commodity prices mean that company profits will be eroded, making it difficult for share prices to rise much higher than their present levels in the months ahead.

The stock market on Mainland China has been quite volatile in recent months as share prices moved in response to the government's market revival measures <sup>(1)</sup>. Share prices on the Mainland have plummeted since last October, falling by almost 50% by mid-April from the peak on 15 October 2007 (Exhibit 1). As was the case in the past, public pressure on the government to revive the market has been mounting as share prices precipitated.

On 21 April 2008, the government finally announced that the unloading of non-tradable shares had to be carried out via the block trading system rather than the secondary market. As a further measure to stimulate stock market activities, the government cut the stamp duty on stock trading to 0.1% from 0.3% on 24 April. In response, share prices surged almost 10% on that day.

<sup>1</sup> There are two stock markets on Mainland China, one in Shanghai and one in Shenzhen. As of end-2007, the Shanghai stock market was 4.7 times that of Shenzhen stock market in terms of market capitalization and 2.0 times in terms of trading value. Two kinds of shares are available for trading at both markets, the RMB denominated A-shares and the foreign currency denominated B-shares. But B-shares are negligible compared to A-shares in terms of market capitalization, turnover and fund raised.

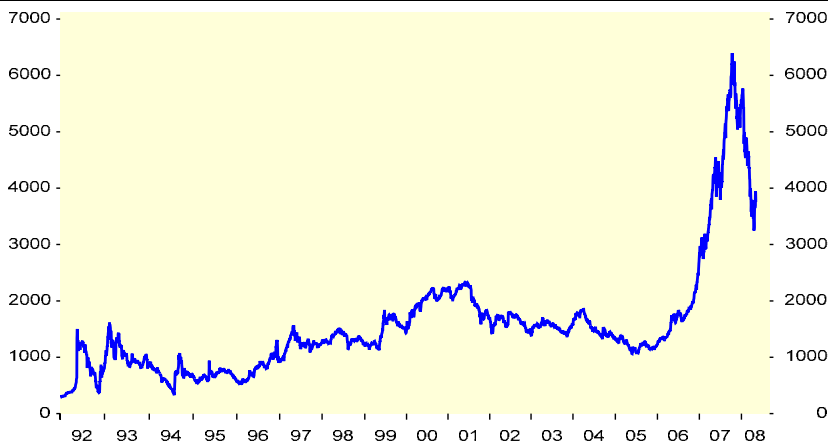


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**Exhibit 1: A-share index, Shanghai Stock Exchange**



Sources: Reuters EcoWin, Hang Seng Bank

## Unloading of non-tradable share exacerbated share price fall

While the stock market fall since last October can be traced to a number of factors, including the government's persistent tightening of monetary policy and the downturn of global stock markets <sup>(2)</sup>, Mainland investors tend to single out the unloading of restricted shares onto the market as the major culprit.

There are two types of restricted shares, namely, non-tradable restricted shares and tradable ones. The former are state-owned shares which are created when state-owned companies are restructured and listed <sup>(3)</sup>. The authorities disallow the trading of such shares for fear of losing control of state assets. For other restricted shares, such as legal person shares, trading is allowed, but only in certain markets. As at the end of March 2008, restricted shares accounted for 53% of the total number of shares on the stock market and about 70% of the stock market's capitalization.

As economic reform proceeds, however, the need to convert non-tradable restricted shares into tradable ones becomes increasingly acute. The authorities find that the dominance of state-owned shares in listed companies is a severe obstacle to the modernization of both the listed companies and the stock market. Most of the management of state-owned companies tend to object to changes that may weaken their position. Selling part of the state-owned shares to the public will help reduce such obstacles. It will also help finance the social security system. But for years, the authorities have been cautious not to flood the market with such shares for fear of depressing stock prices.

<sup>2</sup> Since 2006, for example, China's central bank has raised the required reserve ratio 17 times from 7.5% to 16.5%, a historic high, and raised bank lending rates 8 times.

<sup>3</sup> As at March 2008, non-tradable shares held by state-owned companies accounted for 83% of the total number of restricted shares. The rest were legal person shares, employee-owned shares, etc.





The authorities finally initiated a plan in April 2005 under which non-tradable shares could be transacted after compensating holders of tradable shares in the same company with bonus shares and cash, and after a lock-up period of 1 or 2 years, depending on the size of the non-tradable shares to be unloaded. The rationale was to get the support of the tradable share holders and simultaneously unload the non-tradable shares in an orderly manner. By the end of 2007, the majority of the listed companies on the Shanghai and Shenzhen stock exchanges had either completed or were in the process of completing the required share conversion procedures <sup>(4)</sup>.

The unloading of non-tradable shares onto the market was not a concern when share prices were rising. Indeed it was one of the reasons for the equity market rally in 2006 because investors interpreted the move as conducive to the long-term development of the Mainland's stock market as it implied that the problem of state-owned shares was finally being resolved. But when share prices started to trend lower in October 2007, it increasingly became the focus of the market. Investors became concerned that increasing supply of shares could exacerbate the fall of share prices.

## Share prices tumbling

Between 15 October 2007 when the Mainland stock market peaked, and 31 March 2008, the A-share index in Shanghai lost 43%. In nearly the same period, stock prices fell 33.2% in Hong Kong (from peak to trough), 23.7% in South Korea and 27.8% in Singapore. Share prices in Shanghai fell a further 11% in early April before the recent rebound. Apparently, therefore, the share price fall on Mainland China was significant in both absolute and relative terms.

At closer look, however, the Mainland's relatively large share price fall was mainly due to an equally bigger share price rally than those of other markets. Since late 2005 when stock prices on the Mainland began to soar, and October 2007 when stock prices peaked, the Shanghai A-share index rose by a total of 424%. In the same period, stock prices rose only 112% in Hong Kong, 50% in South Korea and 65% in Singapore. If stock prices were rebased at 100 on 2 January 2006 for the above four stock markets, share prices in Mainland China was still far above their 2006 levels compared with those of the other stock markets (Exhibit 2).

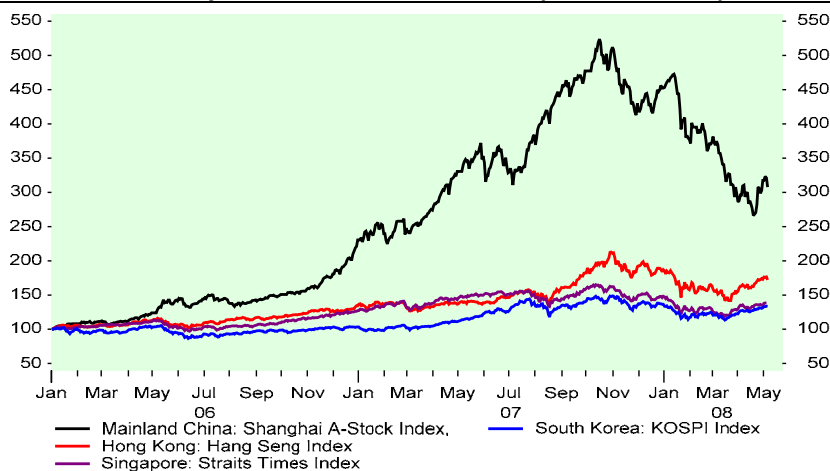
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<sup>4</sup> "China Capital Market Development Report (Executive Summary)"; China Securities Regulatory Commission.





**Exhibit 2: Share prices at various markets (Jan 2006=100)**



Sources: Reuters EcoWin, Hang Seng Bank

## Government policy changes exacerbate share price volatility

Until now, mainland China's stock market is still characterized by excessive price volatility induced by wide swing of investor sentiment in response to government policy changes. As Exhibit 3 shows, in mainland China, trough-to-peak swings of share prices of over 100% are common since the inception of its stock markets in the early 1990s.

**Exhibit 3: Major Equity Market Rallies in Mainland China**

| Period                    | A-share index in Shanghai Stock Exchange |        |          | Duration  |
|---------------------------|--|--------|----------|-----------|
|                           | Trough                                   | Peak   | % change |           |
| 2 Jan 1992 - 22 May 1992  | 293.7                                    | 1415.9 | +382.1   | 5 months  |
| 17 Nov 1992 - 15 Feb 1993 | 369.9                                    | 1615.9 | +336.8   | 3 months  |
| 29 Jul 1994 - 13 Sep 1994 | 328.9                                    | 1072.3 | +226.0   | 2 months  |
| 22 Jan 1996 - 12 May 1997 | 531.4                                    | 1569.0 | +195.3   | 16 months |
| 8 Feb 1999 - 13 Jun 2001  | 1134.6                                   | 2337.9 | +106.1   | 29 months |
| 11 Jul 2005 - 15 Oct 2007 | 1062.5                                   | 6330.5 | +495.8   | 27 months |

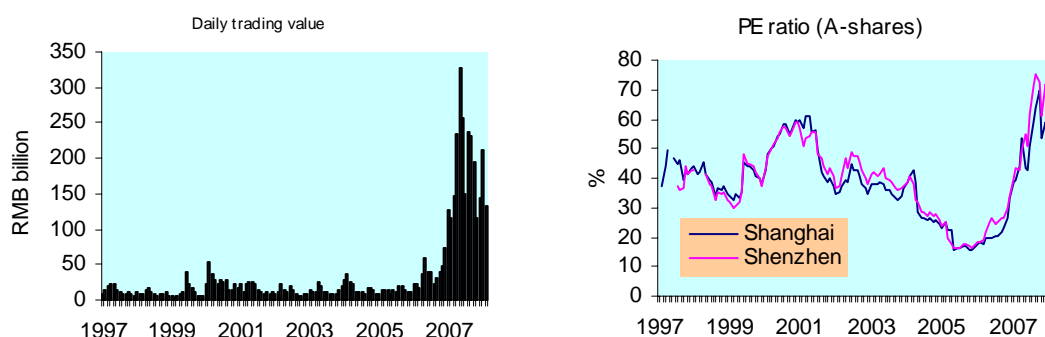
Source: Reuters EcoWin





But even by mainland China's standard, the equity market rally of the 2006-07 period was still phenomenal. During the period, the Shanghai A-share index rose by over 400% before collapsing; daily trading value soared 31 times to RMB327 billion, and average P/E ratio jumped to 70 times from 16 (Exhibit 4). The number of investor accounts also soared to 139 million in 2007 from 79 million in 2006. All the symptoms of a stock market bubble were present right before market collapse. A major market correction was just a matter of time.

**Exhibit 4: Daily trading value and average P/E ratio of Shanghai stock market**



Source: China Securities Regulatory Commission

## Prices will be more volatile in a policy-driven market

Government involvement is a feature of the Mainland stock market. Government intervention was especially obvious in the early years of the market's establishment. A major reason for this was that the stock market was initially set up for the purpose of funding the restructuring and modernisation of state-owned companies. The 1999 share price hike was a typical example of a policy-driven rally.

Faced with persistent deflationary spiral and mounting debt of state companies, the government turned to the stock market as a means of lifting personal consumption (through the wealth effect) and reviving state-owned companies. Rumours of pending policy supports were followed by official endorsement of the market rally (Exhibit 5). Between 10 May 1999 and 28 Jun 1999, the Shanghai A-share Index soared by almost 60%.





## Exhibit 5: Government involvement in the 1999 market rally

- Rumours of new policy measures to stimulate the stock market
  - Brokerages to be permitted to borrow from banks using collateral and from the interbank treasury bond repurchase market.
  - New share listing to be suspended.
  - Insurance funds to be permitted to invest in stocks.
  - Investment funds and brokerages urged to increase investment in stocks.
  - Stamp duty to be cut.
- A *People's Daily* commentary endorsing the market rally (*People's Daily*, 15 Jun 1999).
- Chen Yaoxian, vice governor of China Securities Regulatory Commission, stated that the market rally marks a return to 'normal' level of market activities (*Jinrong Shibao* (*Financial Times*), 15 Jun 1999).
- Vice premier Li Lanqing acknowledged the possibility of further interest rate cuts.
- A series of measures is being planned for stimulating the economy, including wage rises for civil servants, issuing special treasury bonds and cutting taxes.

Source: Hang Seng Bank

Government intervention inevitably fuels investor expectations, which in turn demand more government involvement. In a survey of about 50,000 people conducted over the internet by Xinhua News on 31 March 2008, almost 90% of the respondents thought the government should intervene to revive the market. It is such strong public pressure for government intervention that prolongs the policy-driven nature of the Mainland's stock market.

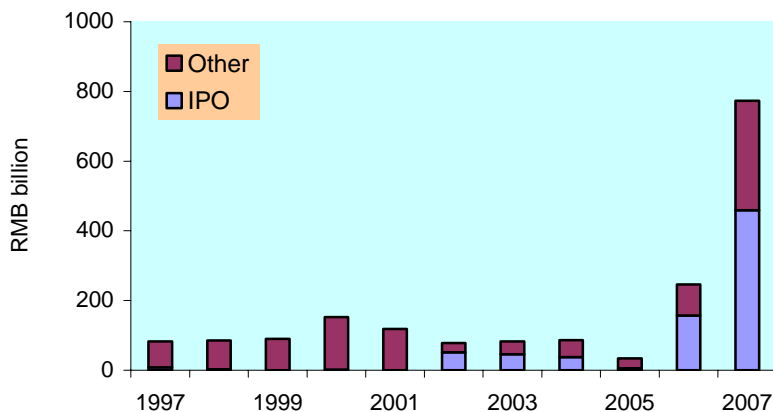
Until the stock market is free of its policy roles and investors become more mature, share prices on mainland China will continue to be dictated by the interaction between government involvement and investor expectations. Share price volatility can be expected to be greater in a policy-driven market, and will be exacerbated to the extent that the lack of other comparable investment tools will channel the majority of the country's idle funds to the stock market.

To be fair, the Mainland government has done a lot to improve the functioning of the stock market over the years. Mainland China's stock market has also served its function well as a source of financing for companies seeking capital for expansion. In 2007 alone, a total of RMB773 billion (RMB460 billion via IPO and another RMB313 billion via secondary offerings) was raised from the Shanghai and Shenzhen stock exchanges, representing almost 2.5 times of the total funds raised from the two stock exchanges in the preceding 10 years (Exhibit 6).





**Exhibit 6: Funds raised on the Mainland's stock markets**



Source: China Securities Regulatory Commission

But it will be some years before the stock market on the Mainland truly becomes a modern and integral part of the country's financial system. At present, banks on mainland China still dominate financial intermediation. The RMB773 billion of funds raised in the stock market in 2007 represented only 19.6% of the amount of funds lent out by banks in that year.

By May 16, the A-share index in Shanghai has already rebounded by 17% from the level on 18 April, the date before the government intervened. It is hovering around 3,800 with a P/E ratio of about 41 times. If the average P/E ratio of the last 10 years, which was about 38, is any guidance, share prices on the Mainland are now more reasonably priced. However, with slowing economic growth and persistently high global commodity prices likely to erode company profits, it may be difficult for Mainland's share prices to rise significantly higher from their present level in the months ahead.



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