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China: implications of the A-share crash

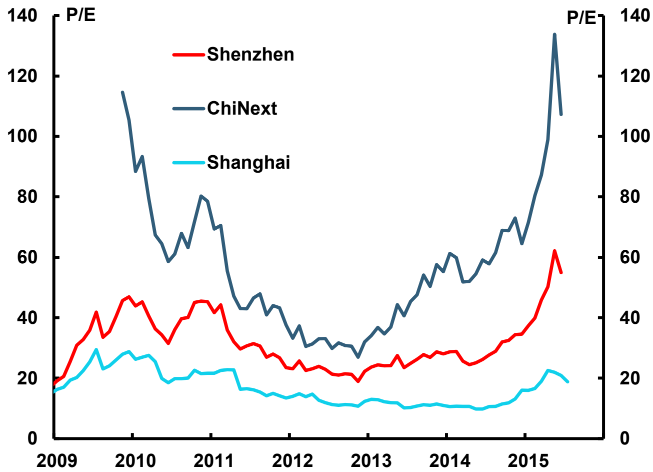
Remain underweight A shares, reduce EM Asia to neutral

Key points

- The recent crash of China's A-share market has led to a significant loss of wealth, albeit on paper. This has started to prompt concerns about potential negative contagion to the real economy.
- We think the direct effect of the crash on the economy is manageable, to the tune of 0.2-0.4%, given the muted wealth effect and limited equity financing in the economy. Additionally, Chinese authorities have plenty of tools to stem contagion and defend the country's growth target.
- What is more concerning for us, are the longer-term implications of the equity market turbulence, and the apparent struggle of the government to manage financial risks in an orderly fashion. The confidence shock to the government's credibility may be a bigger risk and carry greater ramifications.
- We see three scenarios for the market going forward, contingent on how the government's rescue operation is conducted. 1) Bold interventions that help to stabilise the market; 2) continued piecemeal measures that only slow the market slide; and 3) limited actions that lead to a complete collapse of confidence. Even though the first scenario appears to be unfolding, we think further downside for the market is still possible (e.g. 10%-20% from the current level, with a maximum drawdown of 40% from the top). We think the third option is the least likely scenario, given the severe repercussions.
- A spill over to other equity and commodity markets cannot be discarded. The Hang Seng Index took a hard hit last week as offshore investors used it as a proxy to express concerns for mainland China. While further sell-offs and rising market volatility are likely, we think downside risks to other Asian markets are somewhat cushioned by cheap valuations. Yet, the risk of a spill over should not be ignored – we advise taking profits and reducing weighting to neutral.

Chinese stock market: more correction is likely

China: stock market valuations



Source: CEIC and AXA IM Research

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First-round (near-term) effect

As discussed[1] by our Head of Research, Eric Chaney, we think the equity market sell-off will have a limited, but noticeable economic impact in the second half of this year. Assuming that the authorities can avert a total collapse of the market, the following channels are key to assessing the first-round impact:

- **Wealth effect on consumption:** the correlation between consumption and the equity market has been low in China – an observation confirmed by many academic studies. This is partly because households allocate a small portion of their wealth to equities (3%), compared to bank deposits (24%) and property (65%). Additionally, China's equity market has historically exhibited extreme cycles, creating only transitory (as opposed to permanent) wealth creation and destruction. The substantial rally during the first six months of this year, for example, had little impact on consumption and retail sales.
- **Financial sector contribution to GDP:** financial sector activities contributed significantly to first quarter GDP growth (1.2ppts vs. an average of 0.8-0.9ppts in recent years). With trading and leverage-financing activities curtailed by the market crash, this contribution will likely decline in the coming quarters.
- **Equity market as a financing channel**: despite the increasing number of IPOs in the first half of this year, equity-based financing made up only 4% of aggregate financing in the economy (compared to 2.6% in 2014). Bank lending is still the dominant driver of total financing and hence, we do not expect the equity market turmoil to have a material impact on liquidity flows in the economy.

Overall, we think the immediate economic effect from the equity market crash is manageable, amounting to 0.2-0.4% in the second half of 2015, all else being equal. This may seem counter-intuitive, given the severe market drawdown of more than 30% from the peak. There are two factors underpinning our views.

- First, the A-share market has undergone an extreme cycle in a very short space of time. Most investors would not have the time to adjust their spending behaviour in response to the sudden swing in wealth. For them, the severe loss incurred recently represents merely an erosion of paper profit earned in the preceding six to seven months. And since the rally did not have a noticeable economic impact, we do not think the (partial) loss will either.
- Second, the A-share market is dominated by corporate cross-holdings, which account for two thirds of all tradable stocks. We believe these holdings are long-term and strategic in nature, with companies unlikely to change their investment behavior due to a sudden change in the market. This is particularly so, given that the 30% loss came after a much more substantial gain beforehand.

Provided that these assumptions hold, we think the small negative effect on consumption and financial sector activity can be managed by more proactive monetary and fiscal policies. We prefer to keep our below- consensus growth forecast at 6.8% at this stage, and monitor closely the incoming data, along with government policies.

Second-round (medium-term) effect

What is more concerning to us is the medium-term effect of the equity market turmoil, if the current episode is not properly managed. We see the issues below as the key ramifications:

- **Impact on financial/economic stability**: the continued plunge in the equity market could inflict losses on financial institutions, which provide leverage to equity investors, causing contagion in the financial system. If these institutions, particularly banks, start to tighten lending to businesses and households, the second-round effect on the real economy cannot be ignored.
- **Impact on social stability:** even though the total household wealth invested in the equity market is small, some heavily-geared investors could see their entire investment wiped out by market meltdown. This could prompt grievances against the government, which was seen as orchestrating the equity rally in the first place. We think signs of social instability could be a key trigger for additional policy support.
- **Impact on government credibility**: the rollercoaster ride in the A-share market reflects, to some extent, mismanaged polices by the authorities on margin financing, risk control and crisis management. This could lead to a loss of confidence among investors and prompt some to question the government's ability to manage other economic affairs, including capital account liberalisation and renminbi (RMB) internationalisation. The repercussions of this confidence erosion could be severe, potentially triggering capital outflows and currency depreciation.
- **Impact on structural reforms**: if the current crash is not properly contained, the ensuing bear market could significantly affect a number of important economic reforms, including financial liberalisation, debt deleveraging and the restructure of state-owned enterprises. Additionally, the government may slow the pace of capital account opening, given the risk of capital outflows. This could, in turn, delay the launch of the Hong Kong-Shenzhen stock connect, and affect the International Monetary Fund's (IMF) decision on the

[1] AXA IM R&IS team, "Greece/China: limited risks. Overweight equities", July Investment Strategy, 13 July 2015

special drawing rights (SDR) and when the A-shares will be included in the MSCI.

Three scenarios

Looking ahead, we see three broad scenarios for the A-share market:

1. **Further, albeit less aggressive, correction**: even though the most recent policy actions have generated encouraging results, we are still cautious on the A-share market for three reasons: 1) trading on a significant number of stocks remains frozen, and their resumed trading could place downward pressure on the market; 2) leverage is still high, and further deleveraging, which is necessary, will create selling pressure; and 3) valuations, outside the large blue-chips, are still expensive, resulting in a natural tendency for correction. We see a further 10-20% market decline from here, with a max peak-to-trough correction of 40%.
2. **Stabilisation or recovery**: if the government is really concerned about systemic risks arising from the equity fallout, they will likely do "whatever it takes" to prevent further sell-offs in the market. But given the reasons outlined above, we think more supportive actions are needed to cushion additional market declines.
3. **Free-fall resumes**: if the authorities fail to put a floor under the market, a complete collapse of investor confidence could give rise to a systemic crisis. We see this as the worst case scenario, and attach a very low probability to it.

How much further to fall? A-share valuations suggest limited downside risk of another 10-20%

We view 16x to 17x valuation multiple for the Shanghai Composite Index as fair value. But admittedly markets usually overshoot; in which case, we would argue that a 15x multiple, i.e. a tad above broader emerging markets (EMs) valuations, is possible. This means further downside risk of around 10% from the bottom of the market last week (or c20% from the current level). The underlying earnings momentum remains dire. Analysts still expect optimistic earnings growth of around 10% over the coming 12 months. Macroeconomic momentum, as well as margin pressures due to rising salaries, argues otherwise. Regardless of the underlying earnings trend, we would assume that a 15x to 16x multiple would be a decent entry point from a pure valuation perspective. Such a multiple would be well below any industrialised country's valuation (approximately 19x), but would still offer a slight premium vs other EMs (14x) given the structural changes that the government may undertake.

Risk of broad-based contagion to other markets? Risk of 5 - 10%, expect valuation as a shock absorber

Elevated contagion risk: Risk-on and risk-off is not symmetric. While risk-on markets may be an isolated phenomenon and only happen in one country, risk-off markets can easily spread, as neighbouring markets may be considered as a close proxy. This is exactly what happened last week as the Hang Seng Index (and global commodity markets) became the investors' "sell" of choice to reflect concerns on mainland China.

Decent valuation cushion in EM Asia should prevent a substantial rout: Even though a broader contagion cannot be excluded, we think that valuation offers at least a welcome buffer. Currently the EM Asian market (including non-domestic Chinese stocks) trades at a 13.5x multiple, at the higher end of the recent range (11x – 14x, since 2011). Furthermore, the Hang Seng Index trades at 10-11x multiples, while PE of H-shares – stocks of Chinese companies listed in Hong Kong – are only 8.4x. A loss of confidence can easily lead to a further drop; yet valuations at these levels can provide a decent safety net.

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