Daiwa SB Investments

PM'S PERSPECTIVES

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The Reason for the Decline in the Shanghai Composite Index – The Double Leverage of Wealth Management Products

The Shanghai Composite Index has fallen more than 20% since its highs in January, and we have entered a bear market. There is much talk in the media of the trade war between the US and China, but what is actually happening is monetary tightening and an increase in companies going bankrupt. In considering why this has come to pass, we will begin with an anecdote about Chinese real estate from the time I was living in Hong Kong.

30 January 2015 - Having decided to spend the weekend at a beach resort, I left the Hong Kong office on Friday evening and jumped on a flight to Hainan, sometimes called the Hawaii of China. On the plane I struck up a conversation with a female pianist. This woman had been born and bred on Hainan, and her father was coming to meet her at the airport in his car. She offered to drop me off at my hotel. When we arrived at the airport, her father met her in his BMW, and I took them up on their kind offer. When I gave them the address of the foreign-operated luxury hotel where I was to stay, it appeared to be in such a remote location that even the local people had never been there. We had to not only use the car navigation system, but also drive along roads that did not even appear on the map, in order to locate the hotel. Despite the hotel having opened just two months before, the occupancy rate was 10%. Around the hotel, as shown in the photo below, on the upper right, newly built European style houses stretched in all directions, but as the photo on the left shows, these were all empty and derelict. As can be seen in the photo at the bottom right, traffic signs had fallen over and the lights were not working. There was not a single shop anywhere around.

Chinese luxury resort development project after completion (taken by the author at Haikou, the capital city of Hainan Province, 2015)

It was when I encountered this scenario that I became convinced that Chinese real estate was in a bubble. That was because, faced with the sight of a major housing development in a remote location where local people never went, with the houses themselves still empty, it was clear that this would become a non-performing loan at some point in the future. Still, as Chuck Prince, Chief Executive Officer of Citigroup so memorably declared in 2017, that for as long as the music is playing, you have to keep dancing. During the frenzied years of the bubble, residential development proceeded apace, resulting in further increases in real estate prices, and leading to the ranks of non-performing loans such as these spreading all over China.

Then the music stopped. Like a DJ in a club, the People's Bank of China (PBOC) ordered everybody off the dance floor. The declaration at the Central Economic Work Conference to implement tightening measures to control financial risks, such as the suspension of its open market operations, the raising of interest rates, and new regulations on asset management operations. Through such measures, the pleasantly tipsy individuals on the dance floor who had been enjoying the drink, the music, and the spotlight were suddenly brought back to cold reality. Both business conditions and the circulation of money had deteriorated, and there was also talk of an increase in cases where asset management products and corporate bonds that were thought to be safe were not repaid. It was in this environment that investors decided that it was not the right time to invest in stocks, leading to a significant decline in the Shanghai Composite Index.

Figure1: Summary of the Decline in the Shanghai Composite Index (February 1, 2018 to June 30, 2018)

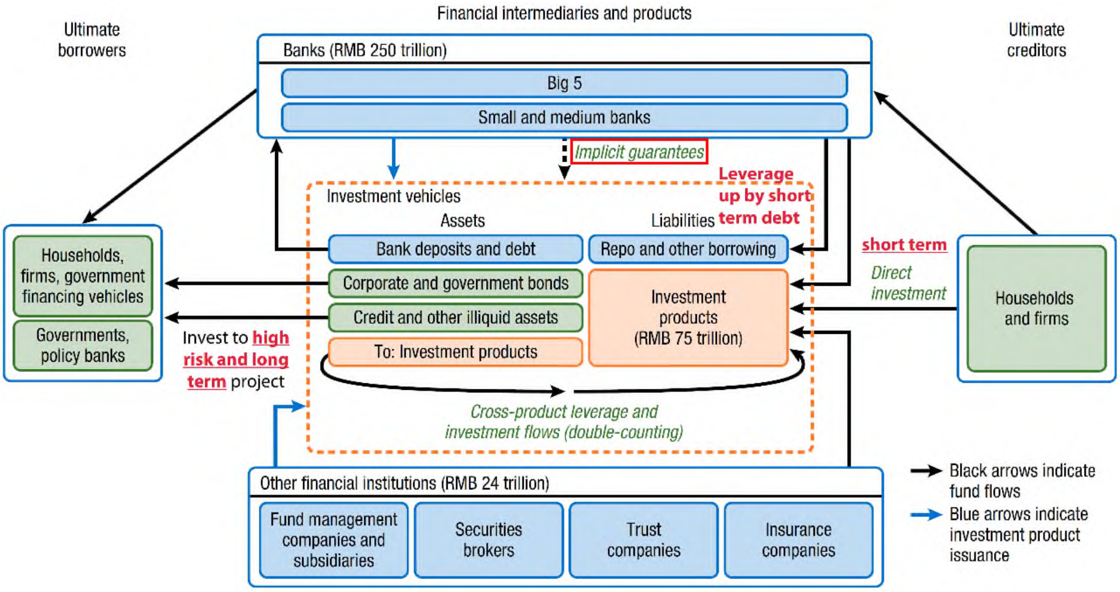
Date	Change	Reason
Feb. 1 Feb. 6	-1.0% -3.4%	People's Bank of China (PBOC) suspends open market operations to provide funds for nine consecutive days. Overseas share prices decline.
Feb. 7 Feb. 8 Feb. 9	-1.8% -1.4% -4.1%	At its annual meeting PBOC announces policies to control financial risks. Predictions that CITIC/HNA real estate trust loan (#2) may call a default. Media reports that some Chinese commercial banks have begun tightening financing to real estate developers.
Feb. 27 Feb. 28	-1.1% -1.0%	Predictions that PBOC will raise the interest rate for open market operations. Chinese manufacturing PMI comes in under expectations.
Mar. 23 Mar. 28	-3.4% -1.4%	Wariness with regard to US-China trade war.
Apr. 16	-1.5%	Financial and trade statistics come in below expectations.
Apr. 17 Apr. 20 Apr. 26	-1.4% -1.5% -1.4%	Wariness with regard to US-China trade war. Reports in the media that the authorities announced new regulations for asset management operations (prohibitions on guaranteed payment of principal, moves to put liabilities on the balance sheet, initiatives to get rid of maturity mismatches, etc.).
May 23	-1.4%	Predictions that the authorities will control the price of thermal coal, leading to declines mainly in coal stocks.
May 30 Jun. 8	-2.5% -1.4%	Wariness with regard to US-China trade war. Defaults on corporate bonds emerge one after the other (from the beginning of the year to May 28, there were 20 defaults with a total value of 17,604 million yuan).
Jun. 13	-1.0%	New yuan-denominated funding decreases more than expected. Predictions that an increase in US interest rates will result in rising Chinese interest rates (when US interest rates increased in March, interest rates for SLF and reverse repo also increased).
Jun. 19 Jun. 21 Jun. 25	-3.8% -1.4% -1.1%	Wariness with regard to US-China trade war. PBOC adjusts the benchmark rate to a weaker yuan versus the US dollar on successive days (on the Shanghai foreign exchange markets, the yuan rate reached its lowest point for around six months).
Jun. 27	-1.1%	Media reports that China's strategic banks are tightening financing for projects aimed at the redevelopment of shanty towns, in order to control the overheated Chinese real estate market.

Source: DSBI (Tokyo) as at 30 June 2018, based on materials from FISCO

There may be people who believe that, because the PBOC also announced monetary easing measures such as the lowering of the deposit reserve rate, this was not a case of monetary tightening. However, the recent policy of PBOC is tantamount to telling those who have been dancing late at night in a fashionable club that they must go to a different, old-fashioned club, during the day, and forgo the alcohol for a healthier approach to dancing. This appears insufficient to prevent people from being caught up again in the maelstrom of frenzied investment.

The figure below shows the Chinese financial system in graphical form. The area enclosed by the blue frame at the top represents banks, and is analogous to the old-fashioned club. These borrow money through deposits and so on, and provide financing to companies and the like, and because there are many regulations related to the deposit reserve rate and capital adequacy ratios, lender returns are low. On the other hand, the area enclosed by the orange line in the middle represents wealth management products (WMP), and is analogous to the fashionable club. If you put your money in WMPs, despite the relatively short term you could obtain high rates of return, and there is also a tacit guarantee of the principal and of investment yields.

Figure2: Stylised map of linkages within China's financial system



Source: Daiwa SB Investments based on IMF Global Financial Stability Report April 2018

The reasons for the high returns were high-risk financing and leverage. Regulation of WMPs was loose, so it was possible to use them to finance long-term, high-risk projects such as real estate finance and infrastructure development. Also, the money raised was then leveraged by putting it into short-term borrowings such as repo agreements. In addition, and this is the frightening part, one WMP would be used to invest in a second WMP, resulting in cross-product leverage. This second WMP would be further leveraged up using short-term borrowings, and used to invest in a third WMP. This is the reason that the circulation of money in China was so strong, and why it was possible to get financing to develop a resort in the middle of nowhere on Hainan Island.

WMPs added multiple layers of leverage to a high-risk financial instrument, and also incorporated a maturity mismatch in that they consist of borrowing short and lending long, resulting in highly risky products. The reason that people invested despite this is because there was a tacit guarantee. Ordinary people believed that they would be compensated by the bank for any losses. The banks were using off-balance-sheet WMPs to provide high-risk financing (indirect financing), because they believed that, if their money was not repaid, the central government would come to their rescue. Whether or not the monies loaned are repaid should ultimately be determined by the profitability of the project being financed, but there were actual cases of losses being compensated, giving them the appearance of having the official seal of approval, and to the misreading of risk. It was not only individuals and financial institutions that invested in WMPs. When I interviewed Chinese companies, I found cases where non-financial private companies with excess cash had formed WMPs, and were using them to finance high-risk companies with stocks and land as collateral.

The PBOC was concerned about the dramatic increase in WMPs, and announced new regulations as well as implementing monetary tightening measures. The specifics included changes such as the prohibition of guarantees for principal and interest rates, a partial prohibition on cross-product leverage, and a prohibition on the use of equity to compensate losses. It is predicted that, as a result of these measures, financing will become difficult for some real estate and infrastructure investment plans that obtained their financing via WMPs. In reality, the momentum of infrastructure investment in China has started to slow recently, and corporate bond defaults are on the increase.

Nobody knows whether or not the Chinese government's attempts to control WMPs will be successful going forward. For that reason, I feel that we need to monitor the following three items.

The first is the direction of the PBOC. The trigger for this monetary tightening and the increase in bankrupt companies was the PBOC, and the fate of WMPs is also up to the PBOC. Points to watch would include how much WMP leverage will be tolerated, how short-term borrowing will be controlled, whether tacit guarantees will continue or not, how much off-balance-sheet, indirect financing by the banks will be brought onto the balance sheet, how the resulting non-performing loans should be evaluated, whether they should be cut away from the balance sheet, and so on.

The second thing to watch is the state of WMP lenders and borrowers. The final determinant of WMP interest rates is the profitability of the borrower's product. If business and real estate conditions deteriorate, it will become impossible to maintain the principal and interest rates for WMPs. According to the IMF, as of 2016, WMPs accounted for 20% of the abundance of deposits, and if the increase in defaults results in a run on the banks, the impact could be enormous. Moreover, small and medium-sized financial institutions have many WMPs on their balance sheet, and it will be important to monitor bankruptcies of such finance institutions.

The third is the direction of the yuan. China's external debt has been rising over the long term. If China as a whole has a high dependence on short-term foreign currency denominated borrowings, not only would then be a maturity mismatch (borrowing short and lending long), but also a currency mismatch (borrowing in dollars and lending in local currency). This would be similar to the situation that existed at the time of the Asian financial crisis, and there is the risk of a negative spiral whereby the yuan weakens, leading to an increase in external debt, leading to an outflow of capital, leading to a further weakening in the yuan. Because China has a current-account surplus and abundant foreign currency reserves, I think the risk of a currency crisis is low, but if the yuan weakens this could affect the global economy, through reduced consumption by Chinese travelers, for example. In addition, there are many listed companies in Hong Kong and Taiwan that post results denominated in yuan, and if the yuan weakens this factor could depress Asian stock markets.

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Mr Kamiishi joined Daiwa SB Investments in 2009 and covered US & European equities as a strategist from 2010 to 2013. He moved to Hong Kong in 2013 as an analyst for the auto & industrials sector in Asia Pacific ex-Japan equity. In 2015, he returned to Japan and covered the IT & services sector as a Japan equity analyst. In 2016, he became a portfolio manager in the Value + Alpha group.

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