Presentation

Power of Women in Finance and Investments
12:15 PM – 1:00 PM Wednesday, September 16

Managing Investments in China: The Potential of the Tiger
6:15 PM – 7:15 PM Wednesday, September 16

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July 7, 2015

Chinese Stock Market Meltdown Triggers ADRs Sell-off

Onshore Turmoil Triggers Offshore ADRs Meltdown

We are seeing an indiscriminate selling of China-based US-listed stocks this week. The collapse of the ADR shares appears to be triggered by the meltdown in the A-share market, which reveals the existence of significant overlapping in investor bases among the among ADRs, HK-listed and A-share Chinese stocks, who are selling off their onshore and offshore positions triggered by margin calls. Arbitraging Chinese markets between on and offshore is also possible.

To make decisions on whether long or short, or to forecast the risks in ADR stocks, we suggest that clients think though the incremental risks associated with the onshore market, as well as potential policy responses. Our observation and analysis suggest that the A-share market meltdown was triggered by a cut in the margin requirement in June. The domestic panic and liquidity crunch quickly traveled across the border to the offshore markets.

Margin lending is done differently at individual brokers and banks. Our checks into one of the largest non-state-owned banks reveal the following: They lend to institutional funds (including mutual funds, private equity funds and pension funds) with capital exceeding 50 million RMB to purchase stocks. Margin calls are triggered when a single stock declines by 15% or more from the purchase price, and the broker will force sell the stock and other collateral if the price declines by more than 20%.

The China strategists at Citi issued a report yesterday stating that one quarter of the margin buyers have been squeezed out. The current margin purchase balance is ~5.7% in China vs. 5% peak margin in Taiwan (2000), and <3% peak margin in the US (2013), and ~1% in Japan (2006). If this is correct, the deleverage process still has a few months to go and there will be many more casualties along the way.

As such, we see further and perhaps accelerated downward risks in A, H and Chinese ADR shares.

An Out of Control Financial Market

On Tuesday, July 7 Beijing Time, 217 companies suspended the trading of their stocks. This brings the total amount of stocks suspended to nearly 1000, over a third of the 2,808 companies listed on the Shanghai and Shenzhen exchanges. Trading suspension is to limit the damage to the majority shareholders and to protect their collateral. Such a measure, when implemented excessively, is an enormous blow to Chinese financial development, to the speed and scope of ongoing financial liberalization, and also to the reputation of the CSRC and the other entities (PBOC and CBRC) involved in supervising and regulating the financial markets.

China is using 'macro-prudential' controls asymmetrically: when there is optimism,

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trust, confidence, euphoria, boom and bubble, the authorities let the boom be. When the house of cards crashes, they open the liquidity spouts and cut interest rates, cut margin requirements, ban short-selling, create a rescue fund and stop share trading completely. All of the above are classic examples of out-of-control financial capitalism and show that China's capital market is dysfunctional.

If the stock market continues to tank in China, stronger policy intervention will certainly be on the plate. To prevent the complete collapse of the Chinese stock market (albeit proportionally small relative to the economy), the authorities will use policy tools such as having the Ministry of Finance to purchase stocks despite being funded by the PBOC itself. There is no official buyer of last resort for the onshore stocks yet, as was the case with Hong Kong in 1998.

July 14, 2015

Market Commentary: Chinese Stock Market Selloff Is Not Over

We have spoken with investors on the latest short-lived boom and bust in the Chinese market, the administrative interventions, the global comparison of stabilization funds, and the linkage between onshore and offshore listed Chinese stocks. We have highlighted our findings in the note below.

The key question being asked by clients seems to be whether the administrative intervention will delay market reforms. While we do not think the question has a binary answer, we do, however, think that the recent policy changes may have added uncertainty to the reform outlook, which most investors believe is the next growth driver for the economy. The chances of an early further liberalization of capital flows, let alone a more freely floating exchange rate, have fallen radically. Who in the Politburo Standing Committee will advocate giving the exchange rate a chance to do for China what the stock market just did?

The Onshore Stock Market Not Yet Bottomed

The consequent question is then whether the onshore stock market has bottomed. We think it is unlikely. With the recent short-lived Chinese stock market correction, Shanghai Stock Exchange Composite (000001.SS) and Shenzhen Composite are still up 89.9% and 75.3% respectively for the year, compared to +6.4% and +6.8 for S&P 500 in the U.S. and Heng Seng Index in HK respectively, over the same period of time.

The underlying economy in China is weaker today than it was a year ago measured by new home starts, lingering industrial excess capacity, and sluggish domestic demand. While the stock market was not a very important part of the financial transmission mechanism and the equity issuance accounted for a small part of external corporate funding, therefore, the boom and bust has contained damage to

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an already weakening economy. The true damage is to the reform process. Over the next 6-12 months, we expect to see the onshore stock market converging to the pre rally level (i.e. SHCOMP 2000-2500), as a slew of worse than expected macro data and corporate earnings roll out.

High frequency and Strong Dosage of Policy Stimulus Likely to Delay Reform Process

The broad rally while a wide range of stocks being suspended from trading was triggered by the encouragement of buyback shares with bank credit (see Appendix: Timeline of Administrative Interventions). We were surprised by the government's aggressive, high-frequency intervention to boost short-term confidence at the cost of delaying the long-term reform goal of transitioning into an open and market oriented economy, which is viewed by most investors as the real growth driver for the economy.

We believe that the reform process, and especially the financial reform process, has been seriously impaired. Zhou Xiaochuan, the governor of Chinese central bank PBOC, is a leading proponent of financial liberalization. Therefore his agenda has seen a setback. But the main damage has not been to the PBOC, but to the regulators—especially the CSRC, the CBRC and the China Securities Finance Corporation.

It is ironic that the most damage will be caused by the stock market slump. It should have been caused by the stock market boom and bubble that preceded it. Without the bubble, there would not have been the bust. Somehow, the public believes that the authorities could have stabilized the stock market at its peak value, so they are therefore being blamed for the bust.

Since excessive margin lending was one of the main drivers of the stock market bubble, there is clearly something wrong when authorities relax margin requirements in order to stop stock prices from falling.
Halting IPOs is damaging to the development of financial markets in China and to the greater role for market-driven allocation of capital. SOE dinosaurs will love this development. Suspending the trading of a large number of stocks is a major defeat for the market regulator supervisors. Bullying a number of domestic financial firms and rich individuals into not selling stock and/or purchasing stocks they would not have voluntarily held or bought is a confidence-undermining demonstration that the state will not try to manipulate stock prices. Getting the PBOC to buy stocks outright (through the back door of funding the CSFR) is another example of "heads, you win" (the private speculator) and "tails, I lose" (the tax payer).

People's capitalism is fine (81% of Chinese stocks were owned by retail investors at the peak of the market) on the way up. It is politically very dangerous on the way down. Trust in the government, the state, and even the Communist Party itself has been undermined, and not only in terms of trust in the reform process.

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APPENDIX

Timeline of Administrative Interventions of the Onshore Stock Market (2015)

6.27

- PBOC cuts interest rates and RRR each by 0.25 points during the weekend to prevent market fall on Monday

6.29

- Ministry of Human Resources and Social Security and Ministry of Finance draft a proposal to use no more than 30% of pension funds in stock investment

7.1

- CSRC relaxes collateral rules and allows margin loans to be extended
- CSRC reduces A-share transaction fee by ~30%

7.3

- Futures Exchange suspends 19 accounts from short-selling
- Central Huijin, a state-owned investment fund, starts buying index Exchange Traded Funds (ETFs)
- CSRC slows the pace of A-share IPOs
- Qualified Foreign Institutional Investor (QFII) quota raised from $80 billion to $150 billion

7.4

- 21 Brokers commit to a 120 billion RMB ($20 billion) stabilization fund to purchase ETF
- 25 fund managers pledge not to sell shares until market rallies sharply
- State Council decided to suspend IPO issuance

7.5

- PBOC provides liquidity to China Securities Finance Corp. (CSFC), an organization that makes loans to qualified securities firms for margin on lending to stabilize the market

7.7

- CSFC pledges to buy more small-cap stocks

7.8

- SASAC (a state holding company) orders State Owned Enterprises (SOEs) not to sell shares
- CSFC gives 260 billion RMB ($45 billion) line to brokers
- Cap on qualified insurers investment in a single stock raised from 5% to 10% of assets
- 111 state-owned companies commit not to cut holdings

7.9

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- CSRC bans officers, directors and listed company shareholders with stakes of 5% or more fromselling any shares for six months
- China Banking Regulatory Commission allows bank rollover loans backed by shares

7.10

- Listed companies receive “administrative orders” from CSRCto implement one of five measures: (1) make major shareholders in the company buy more shares, (2) buy back shares of their own stock, (3) make directors, managers and senior executives buy stock, (4) introduce stock-buying incentives for employees, or (5) introduce employee stock ownership plans.

7.12

- CSRC instructs brokeragesto review trades and enforce rules that require the use of real names and national identification numbers

July 15, 2015

A Global Comparison of Stock Market Stabilization Funds

Stock Market Stabilization Funds in Different Regions

China isn’t the only country where the state has intervened in the stock market. In 1998, during the Asian financial crisis, the Hong Kong government bought shares worth $ 15 billion USD to prop up the market. Similarly, the PBOC claimed on July 7th that it would actively assist China Securities Finance Corp. (the agency normally charged with providing funding for margin lending) in purchasing stock outright by providing it with ample funds through channels including loans and bonds. The PBOC would also continue to pay close attention to market movements and would do whatever it could to prevent a stock market bust.

On July 8th, China Securities Finance Corp provided 260 billion RMB ($41.87 billion) in credit to 21 brokerages to buy stocks. However, the stabilization fund established by these brokerages composed less than 1% of total market cap. The scale of China’s stabilization fund in absolute terms is bigger, but as a percentage based on market cap it is much smaller because China’s total market cap is much larger, ranking second in the world. Therefore we believe more money might need to be injected in order to be effective.

In comparison to the clearest example of a successful stabilization fund, Hong Kong, we find that the backdrop of the stock market meltdown in Hong Kong was very different from that of China. The Hong Kong stock market collapsed in 1998 mainly due to short selling activities. The Hong Kong Monetary Authority used the Exchange Fund (US $15 billion, and originally established to support the exchange rate of the Hong Kong dollar) to reverse the market downturn and squeezed out short sellers quickly. The case of China is different. The fall in the Chinese stock market was triggered by margin calls when the CSRC lowered margin

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requirements. Market sentiment was negative in China not just because expectations about the fundamental drivers of stock market valuations had turned negative, but also due to investors' concerns about liquidity in the market. Therefore, in addition to creating and funding a stabilization fund, building up investors' confidence about market liquidity is also important in restoring confidence in the Chinese stock market.

Japan, Korean, Taiwan and Hong Kong are the only countries who have set up stabilization funds previously with the primary purpose of creating a buffer against volatility in the stock market and, more specifically, to prevent a further precipitate fall in the stock market.

Japan: The government has set up stabilization funds (mainly using the financial resources of the (state-owned postal saving systems) three times, the most recent one in 1995. None of these attempts were effective.

Korea: The government launched a 10bn US dollar (~5% of total market cap) stabilization fund to combat its stock market's dramatic fall in 1990. Although it is hard to be confident about what would have happened in Korea without the Fund, the stock market recovered from the second quarter of 1992 and exceeded its pre-1990 high in 1994. The fund exited in 1993.

Taiwan: Ministry of Finance formed a 500bn TWD/16bn US dollar National Stabilization Fund (~8.9% of total market cap) in 2000 as the government's primary tool for managing the stock market collapse and volatility. Many consider this to have been a political move because the stock market became very unstable after former president Lee Teng-hui proposed "nation-to-nation relations" with China. The fund's impact at the time was limited but today it still remains as the government's rescuefund of last resort.

Hong Kong: Hong Kong is the only case where the stabilization fund can be considered successful. However, the situation was different from the others. In 1998, the Hong Kong Monetary Authority set up a 120bn HK dollar/15bn US dollar fund (~6.2% of total market cap) to combat overseas short-selling institutions and to protect the safety of all of Hong Kong's financial markets (including the foreign exchange market) rather than the stock market alone. The establishment of the fund squeezed the short sellers and was considered a success. The government exited by selling the stocks in the ETF which yielded ~83% since its inception.

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August 13, 2015

International and Domestic Response to RMB devaluation

RMB devaluation Surprise and the PBOC response

On August 13th, the Chinese central bank - the PBOC – held a press conference, to discuss this week's RMB devaluation as well as the market's uncertainty regarding its impact and said that the main reasons for the devaluation are to 1) correct the pent-up misalignment of the exchange rate including pressure created by a series monetary expansionary policies and 2) to address the structural transitioning from the de-facto peg to the USD to a managed floating rate system.

We believe that the RMB FX devaluations are aimed to stimulate the export sector after the authorities recently realized that domestic demand alone is unable to stabilize the economy. Additionally, the move also is a concession to the fact that RMB is overvalued against the USD, is largely a result of the rising divergence between the two economies' monetary policies (expansionary in China and tightening in the U.S.) and the growth trajectory (slowdown in China and recovering in the U.S.)

The IMF was the first to conclude this Spring that based on its study, the RMB is no longer undervalued. Although, it did not quiet say that RMB is over-valued this Spring. We also think that the currency devaluation was to strengthen the odds of the RMB's inclusion in the SDR. The SDR decision will be made in Oct/Nov 2015 and its implementation will be in September 2016.

So far, the major suppliers to China including Australia, New Zealand, and Brazil have all announced currency devaluations in reaction to the RMB devaluation. It is also almost certain that the neighboring competitors such as Thailand, Indonesia, Malaysia, South Korea, and Taiwan, (all very concerned by China's unexpected currency move) will have to follow suit to match the new competitiveness of China. Because many of them have floating exchange rates or managed exchange rates, they will be required to take monetary actions, such as rate or liquidity actions, open market operations or cuts of their reserve requirements in an effort to indirectly drive down FX rates, rather than formally devaluing their currency.

For the exporting and import-competing industries, it has been very difficult and even harmful for the RMB to follow the USD on its upward trajectory. However, a single digit of exchange rate depreciation will have little impact on volume, although it improves the exporters' margin due to the inelasticity of the export volume to the change of FX rate. At the moment, ~3pc exchange rate depreciation will likely result in a very limited the effect on Chinese exports, imports and the global economy, in itself is limited.

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