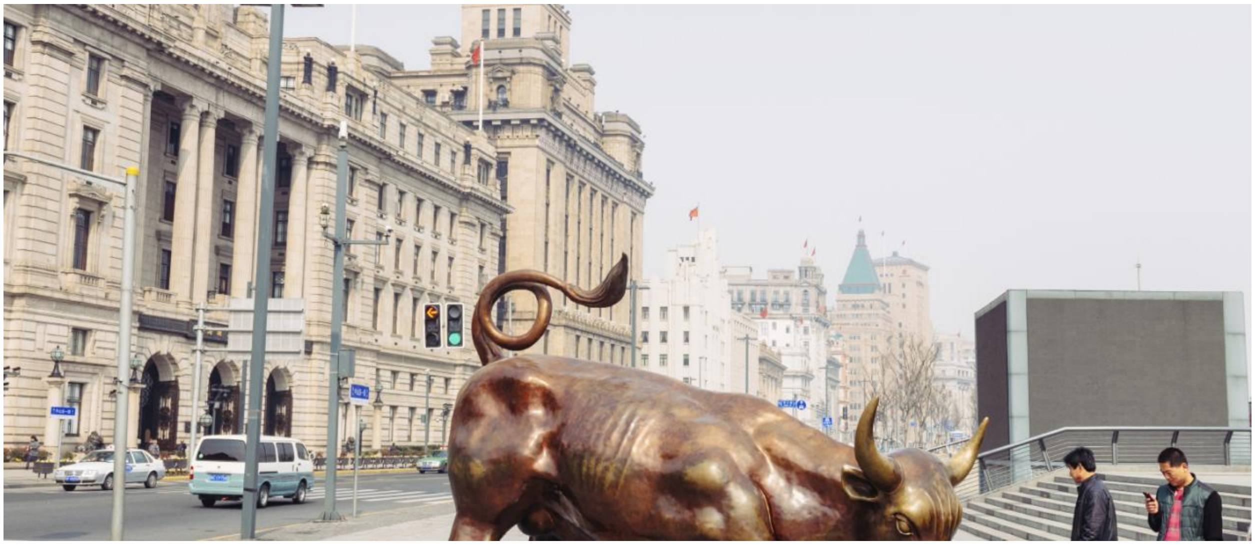
Margin Call on Overleveraged China



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The explosion in margin lending has fuelled a baseless rally in the Shanghai Composite, but the magnitude of leverage in the stock market is still coming to light.

China's stock market has been on a tear. Since the beginning of August 2014, the CSI 300 (China's main A-share index) has gone from 2,329 to a peak of 3,643 on January 7th – a nearly 60 percent run-up. But is it justified? Last week we heard that China's GDP growth was 7.3 percent, the lowest it has been in 24 years. The U.S. economy seems to be recovering well, but Europe is on the edge again. With all the uncertainty, is the optimism in China's market warranted and what is behind it? The answer, as to so many of China's other potential financial problems, is lending.

Unlike other markets, where a large percentage of the investors are institutional investors (for example, banks, insurance companies, investment funds), investors in the Shanghai stock market are predominantly retail. The numbers are a bit hard to come by, but we estimate retail investment activity today accounts for about 50 percent of total turnover in Shanghai as compared to 30 percent in Hong Kong or 20 percent in New York where a larger institutional investor base helps to stabilise the markets. The Chinese government has been introducing measures to push greater institutional involvement, which has shown results. The split 15 years ago was about 95 percent retail and 5 percent institutional and 10 years ago was 70 percent retail and 30 percent institutional.

From 2002-2007, the Shanghai A-Share market went on an unprecedented 500 percent run. It was a special time for China and a heady time for China's economy. The country was investing heavily for the 2008 Beijing Olympics. A number of banks and other state-owned companies were going public. The economy was ticking along at double-digit GDP growth. China was becoming wealthier and there was an entirely new breed of investors who were looking for the next investment opportunity. The stock market was it. Rumours, articles and tips fed the stock bubble as more and more people came into the market.

It was the first time that most of the people in that generation had invested and they had never seen a real economic cycle – the only thing that they knew was growth. Yet, despite all the tips and rumours, a few years later, the bubble popped. By 2009, the Shanghai stock market was in the pits where it stayed for the next five years, nearly always the worst performing stock market globally in annual surveys.

'Borrowing' ideas from other markets

Fastforward to today and China's government and regulators are looking to continue to reform and modernise China's capital markets. Programmes like the Qualified Foreign Institutional Investment (QFII) programme had started off slowly, but the programme, which allows foreign investment into mainland markets, became increasingly popular and is fully subscribed. The original idea of a 'through-train' from the Shanghai Stock Exchange to Hong Kong was floated in 2006-2007, a few years after the QFII programme was set up. Investor demand was fairly tepid – most retail investors we spoke to around the time weren't really interested in anything that wasn't mainland related, and the idea was shelved.

The government brought it up again in April 2014. With the Shanghai Free Trade Zone and margin trading under its belt, and stock options right around the corner, the Mutual Market Access (MMA), or Shanghai-Hong Kong Stock Connect programme, was going to be a crowning achievement and an indication that the Shanghai market was ready for the big time.

That was all the market needed. In the beginning of April, it started moving up. The idea of foreign money flooding the mainland A-share market brought both old and new hands back to the Shanghai market in anticipation of the Shanghai-Hong Kong Stock Connect. This time though, they brought something else with them: lending.

Shanghai investors were having their first taste of something completely new: margin trading. Margin trading had been piloted in 2010 and then fully implemented in October 2011 as another piece in the government's reform puzzle, and was being eagerly embraced by the market as interest grew. Brokerages, sensing more revenue opportunities, were more than happy to provide margin-trading accounts. Investors, who had largely never experienced margin before, lapped it up as margin lending grew.

What are the potential implications?

But major global uncertainties make this a precarious proposition. We are still seeing the fallout right now from Swiss National Bank's move to depeg the Swiss franc from the euro. The immediate 30 percent shift in the exchange rate after the depeg would have given any investor pause, but with some brokerages providing up to 100 times leverage, many investors have been completely wiped out and several brokerages have folded.

Most of the brokerages and investors in the headlines are from mature markets with years of experience in regulation and measurement of risk around margin lending and trading. If they can't handle it, what about Chinese investors and brokers who are fairly new to the space? Although there is a large base of retail f/x investors in China that trade on margin every day, their numbers are dwarfed by the number of potentially inexperienced retail stock investors who have levered up since margin trading became available. In January, **Bloomberg reported** that China's 1.1 trillion yuan of margin loans represent 3.5 percent of the market's overall capitalisation. The New York Stock Exchange's margin debt is about 2.1 percent. Although that is not a huge difference, the NYSE is much larger and has a more experienced pool of institutional traders.

Personal financial and credit history is also scarce in China. There are no companies like Equifax that have a complete picture of a person's financial background and history, so any data is patchy to say the least. China has even **engaged their tech giants** to help better understand personal credit in China. With little available credit information or financial history, it is difficult for brokerages to make decisions on margin limits based on investment history.

If you apply for margin trading in the U.S., you would need to be an accredited investor (certain amount of assets) and verifiable experience in using margin or derivatives trading. The rules for margin trading in Shanghai are not that much different. Investors were meant to have a brokerage account open for at least 18 months at a registered securities company and have cash and stock assets of at least 500,000 yuan in the account. In 2013, the China Securities Regulatory Commission (CSRC) cancelled the minimum account value guidance. One can only assume that brokerages very quickly started to take on investors under that threshold.

The Risk Defined

Although the Shanghai stock market doesn’t move markets as much as the New York Stock Exchange or the NASDAQ might, it is very important domestically. Many of the investors in the Shanghai market are smaller investors who might not be able to afford the price tag of getting into real estate in China. Without a clear understanding of the risk, if the market does move against them, they could be facing difficult times. Keep in mind that there are no stock options available in China, so very little way to hedge positions directly and no intraday trading, so you might be locked into a position for a day if you are looking to trade in and out.

So, if it all falls apart: the stock-market tanks and hundreds if not thousands of investors are margin called, what happens? The end result might be a mixed bag. The economy would certainly not grind to a halt for sure – there’s still enough investment and loose monetary policy to support growth, but we may see another few years of poor stock market returns as those burnt stay away from markets. That would not be great in general, but also not good politically.

The Shanghai-Hong Kong Stock Connect and the current reform programmes are part of the current government’s push to modernise and internationalise China’s markets. If something goes wrong, it would reflect badly on their efforts. They are keenly aware of this.

Responding to the tip of the iceberg

The first response from regulators was a re-iteration of the 500,000 yuan minimum account limit, basically that which was in the original guidance around margin trading. In addition, the CSRC has punished a dozen securities companies for improperly rolling over margin accounts beyond the six-month limits on margin loans. In addition, we have seen a number of brokers in the past week limit their margin lending – presumably under government pressure and likely connected to the punishment for the 12 securities firms.

This won't be the last action we see from the government. It is very unlikely that margin trading would be rolled back, but we will likely see tighter investor requirements and more stringent reporting. Nine other brokerages were cited for serving unqualified clients – that is likely the tip of the iceberg in terms of bad operational practices.

The more worrying aspect is that the markets' growth is based on relatively shaky foundations. Although the Chinese government will likely do whatever it can to inject capital into the system and keep the economy ticking along, there is no strong rationale for the growth in Shanghai's stock market beyond the fact that it may have been undervalued / underperforming for many years. Valuations are higher than they should be. Margin trading is driving investment. It is all a house of cards.

On the other hand, the 7.3 percent growth could be another step in the 'soft landing' that China's economists had been aiming for. Although global growth is slowing, the domestic Chinese economy is rebalancing to be more consumption driven and we're seeing knowledge-driven companies like Xiaomi and Alibaba move beyond manufacturing to design and innovation that is being exported globally. Maybe the valuations are justified.

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