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Nikko Asset Management

MARKET COMMENTARY

July 2015

Views on the China equity market selloff – from an Asian Fixed Income perspective

- Nikko AM Asia views the recent market corrections in Chinese equities, particularly in the onshore markets, as healthy given the sharp advance on account of a frenzied retail market intoxicated by the relatively cheap margin financing.

- The sharp equity market correction in recent weeks after a very strong run over the past year will not have a crisis-level impact to the broader economy. The broad economy relies on the banking system more than the equity markets. Banks are the main conduit of financing for the economy and are not directly exposed to the equity market (their exposure to equity investments is only about 1-2% of their total assets[1]) and thus the selloff would not create huge asset impairment. Equity financing plays a relatively smaller role in financing the real economy, and the suspension of IPOs will not choke the real economy. The property market (which is now on a recovery mode) is actually a bigger factor to the broad economy than the equity market.

- It will be the broker and securities houses sector that will be most impacted by the equity selloff. Although, we believe this sector will be supported as it has been reported that the Chinese government will provide liquidity to these firms.

- Would there be a slowdown effect to the economy because of the lower stock prices? Would this impact investor confidence? Equity investment of household wealth is estimated to be about 12-13% of total wealth[1] and most of their wealth is still in property so the wealth effect may still be manageable. Furthermore, equity performance is still actually positive this year despite the selloff.

- The Chinese government has introduced various measures to address the selloff (although it has not been easy for the government to avert the selloff). The government still has macroeconomic tools to stimulate the overall economy. In the last 9 months, the People's Bank of China (PBoC) has been easing monetary policies with 4 interest rate reductions and has lowered banks' reserve requirement ratio (RRR). As at 9 July 2015, the reserve ratio level is still high at around 18.5%.

[1] Source: UBS Research Commentary, as at 7 July 2015

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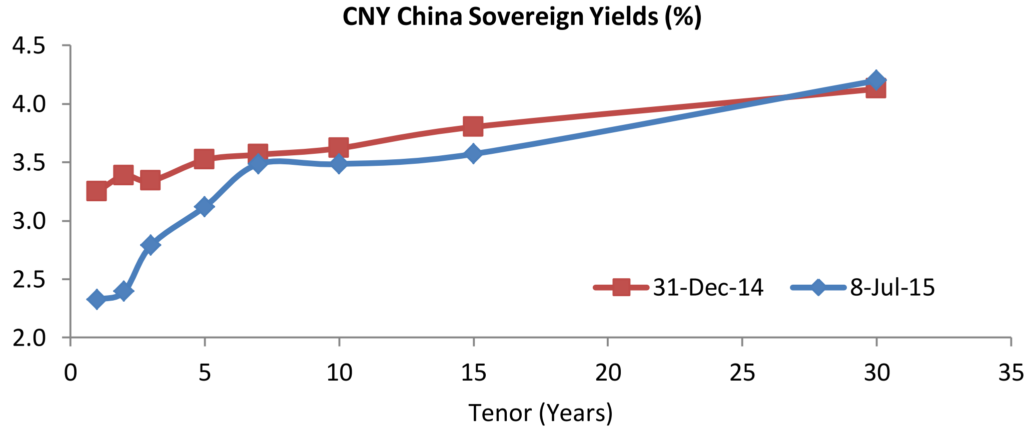
Impact on the Local Currency Bond Market

- The accommodative monetary policy measures that the government have implemented have been supportive of the local currency bond market and we think this policy framework should continue. Bonds have performed well amidst the equity market sell-off with liquidity remaining ample and should provide a less volatile investment option to onshore investors.

- The domestic bond market has hitherto been quite buffered from the equity market selloff. However, if the equity market rout prolongs further, we would start to see sporadic squeeze even in the government bond market as witnessed in the afternoon on 8th of July. This comes mainly from the market agents such as stock brokerage houses and fund management firms looking for ready cash from the more liquid bond market to offset the cash crunch in their equity business. Ultimately, the flows in search of safety will dominate especially if the equity market selloff deepens and worsens the outlook of the Chinese economy.



Source: Bloomberg, 8 July 2015.

- In the minutes of the US Federal Open Market Committee June meeting, the US Federal Reserve (Fed) have highlighted concerns on the pace of economic growth abroad and mentioned "China and other emerging economies," specifically. Along with the Greece turmoil, these volatilities in the global markets could potentially delay the timing of the US Fed lift-off further. Asian local currency bond markets would be supported under this environment.

- On the currency side, the CNY has held up relatively steady, reflecting the fact that the stock market crash is mainly driven by domestic investors, particularly the retail investors who have not leveraged themselves through the FX market. Similar to the offshore credit market, the offshore CNH did feel some pressure because of market agents' attempt to raise ready cash in the most accessible liquid market, namely the FX market and the onshore government bond market. However, the limitation on them to then bring the funds back onshore ultimately buffers the FX market from the domestic equity market fallout.

- More importantly, the stock market crash is seen as a long overdue correction from a bubble that was inflated too fast this year and not from deterioration in China's macroeconomic or political outlook. On the contrary, there are signs of the Chinese economy bottoming up although pockets of deflation pressures still linger at the factory level.

- Also, the stable currency policy should still be in place with the ongoing review of the currency for potential inclusion into the International Monetary Fund's Special Drawing Rights (SDR) basket later this year.

Impact on Asia Credit Market

- Fundamentals of Chinese credits should not be impacted that much by the volatility and selloff in the equity market. With the market correction that started last year, Chinese property names have been focusing on deleveraging and destocking. Supportive measures on both macro-level and property sector-level have been implemented and have supported the physical property market so far.

- Property companies have also been able to raise financing from other alternative sources such as raising equity (although the IPOs suspension might delay this) and through the onshore bond market. The onshore bond market has opened up as a source of financing for property companies. For example, Longfor recently issued a 5-year RMB 2bn bond which was well-received (2.4x covered[2]). This alternative financing source can also reduce financing costs with the lower rates onshore.

- Credit sectors that are most impacted will be the brokers and the security houses. We are currently underweight in this sector. Other credit sectors' fundamentals should not be impacted significantly.

- Measures have been taken to stabilise the market but could have negative impact on the brokers:
  1. The China Securities Regulatory Commission (CSRC) has removed the mandatory level for margin calls (collaterals/margin loans = 150%) and mandatory liquidation (collaterals/margin loans <=130%). The margin calls level will be subject to brokers' discretion. This means that firms have to relax their risk management controls and thus increase risks in the medium to long-term. The large brokers do have better risk control measures and may not lower the margin calls level to a large extent.
  2. 21 brokers pledged no less than RMB 120bn in aggregate to buy blue-chip ETF stocks[3]. Firms setting aside money for this are a deviation from their trading strategies; adding market risk to their overall exposures.
  3. On the other hand, the PBoC says it will provide liquidity to brokerages through the China Securities Finance Corp, a state-controlled industry body. The announcement did not specify the amount or instruments to be used for the liquidity support by PBoC.

[2] Source: CITICS, as at 8 July 2015
[3] Source: Bloomberg, as at 4 July 2015

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