

Derek Holt 416.863.7707
derek.holt@scotiabank.com

Frances Donald 416.862.3080
frances.donald@scotiabank.com

China's Equity Market Is Not A Bubble —Yet

Whether or not China is in a stock market bubble that is at risk of popping clearly matters to the world economy given mainland China's market capitalization of almost US\$7 trillion and a 10% share of global stock markets. It could impair Chinese and thus global growth, risk financial instability, and further damage the commodities complex while eroding China's external financial strengths.

Such risks clearly bear monitoring in light of the nearly 100% rise in the Shanghai and Shenzhen equity composites since last June. However, **at this juncture we view the rapid rise of China's equity market as a positive development on balance.** While constant monitoring is required and volatility should be expected, the rapid rise since last summer takes Chinese stocks from being among the cheapest and most neglected asset class in the world to now being closer to fair value in a process that is being aided by long-awaited regulatory reforms via financial liberalization and concomitant knock-on effects that have brought equity valuations more in line with underlying fundamentals. We therefore think that risks to financial stability in China and abroad stemming from domestic equity market developments are overstated and remain manageable in the context of China's still-sparkling measures of external country finances.

This article first presents **multiple equity valuation metrics** given that no single metric should ever be fully relied upon while assessing the attractiveness of an asset class. Then we explain how **regulatory changes have changed the nature of the game** in ways that have unlocked value in Chinese companies. Following that, we argue that **the rise of new account openings and margin debt are overstated influences** in the equity rally. Finally, we attempt to put stock market developments in the bigger picture context of the country's finances. At the end of the day, large Chinese foreign reserves offer a big safety buffer against potential domestic financial imbalances in contrast to other countries with inflated stock markets alongside fewer reserves and more external debt. The more recent small declines in Chinese foreign reserves are something to celebrate rather than malign.

Valuations: From Cheap To Fair

While it's true that the levels of the Shanghai and Shenzhen equity composites stand at their highest since early 2008, this serves as scant evidence of a bubble even ignoring the fact that the Shanghai composite remains 35% below the bubble peak in 2007. That's because in economics, price levels like stock market indices tell us little if anything by themselves. Economics is about ratios and most variables only carry meaning when expressed relative to something else — and that something else also grows over time.

In the case of equity valuations, this can mean expressing stock values relative to a variety of metrics. The **price-to-trailing-earnings (P/E) ratio** for the Shanghai composite is shown in **chart 1** over about the past twenty years. Last summer's reading of ten times earnings made Chinese stocks rather cheap by comparison to a variety of other global stock exchanges (**chart 2**). Today's Shanghai price-earnings ratio has come up quite a lot but remains below a long-run average and at or below p/e ratios across exchanges in more mature and slower-growing markets (**chart 3**). At presently 20 times earnings versus 70 times in 2007's stock market bubble, it's difficult to argue that valuations are enormously stretched. That's not true for the smaller Shenzhen equity

Chart 1

Shanghai Composite: Price to 12m Trailing Earnings



Scotiabank Economics

Scotia Plaza 40 King Street West, 63rd Floor
 Toronto, Ontario Canada M5H 1H1
 Tel: 416.866.6253 Fax: 416.866.2829
 Email: scotia.economics@scotiabank.com

This report has been prepared by Scotiabank Economics as a resource for the clients of Scotiabank. Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made as to their accuracy or completeness. Neither Scotiabank nor its affiliates accepts any liability whatsoever for any loss arising from any use of this report or its contents.

™ Trademark of The Bank of Nova Scotia. Used under license, where applicable.

index with its vastly higher p/e ratio that has usually been higher as shown on both charts. More of our focus in this article is weighted toward the Shanghai index because it accounts for about two-thirds of mainland Chinese equity market capitalization. Also note that Shenzhen is typically comprised of smaller, younger, privately owned companies versus the greater presence of State Owned Enterprises (SOEs) on Shanghai and so — to a point at least — Shenzhen may be expected to trade at a higher multiple.

While the focus of this paper is upon mainland China's equity market, **an offset to elevated valuations in the smaller Shenzhen market is that valuations in Hong Kong remain cheap in our view.**

The Hang Seng's p/e ratio stands at 11 times and is among the world's most under-valued markets while the dividend yield stands at 3.35% and is among the highest. The recent rally in the Hang Seng may have legs as that market has replaced Shanghai's status last summer as being the cheapest exchange in mainland China and Hong Kong combined.

A broader macro measure that looks at the aggregate Chinese stock market instead of being susceptible to whether we are considering the dominant exchange (Shanghai) or the smaller developing exchange (Shenzhen) entails examination of China's **equity market capitalization to GDP ratio** over time (**chart 4**). Today's ratio is the highest since early 2011 but hardly high. At 60%, it is a full one hundred points below where it peaked in early 2008 and still far below the US's market cap to GDP ratio which is more than double China's.

The **price-to-forward-earnings ratio** is another valuation alternative (**chart 5**). Using one-period forward earnings estimates on the Shanghai composite yields a valuation metric that is the highest since 2010 but in line with the historical average and well below prior periods of stretched valuations.

Another approach is to consider **dividend yields** (**chart 6**). Again, Shanghai went from being cheap last summer with a yield of over 3% to more in line with long-run fairer value averages at just over 1.5% now but well above true bubble periods.

Chart 2
China Was Cheap Last Summer...

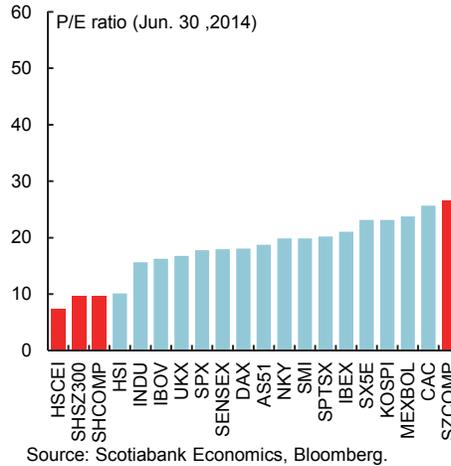


Chart 3
...And Could Still Be Now

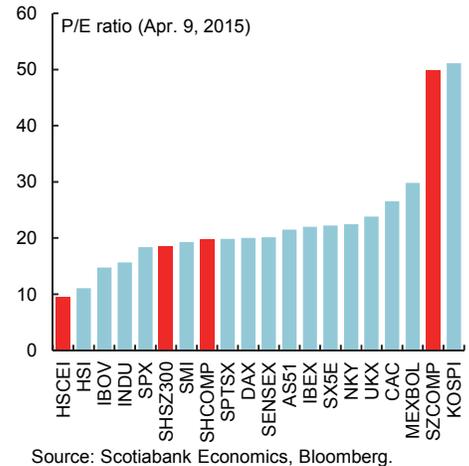


Chart 4
Mainland Equities: Market Cap to GDP

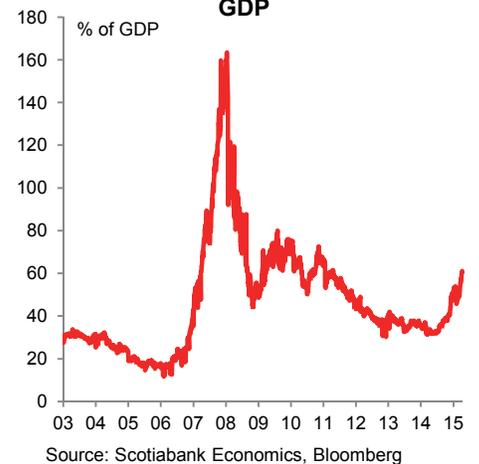


Chart 5
Shanghai Composite: Price to 12m Forward Earnings



Chart 6
Shanghai Comp: Dividend Yield

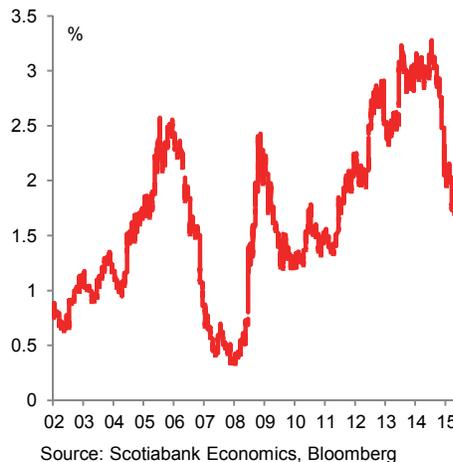
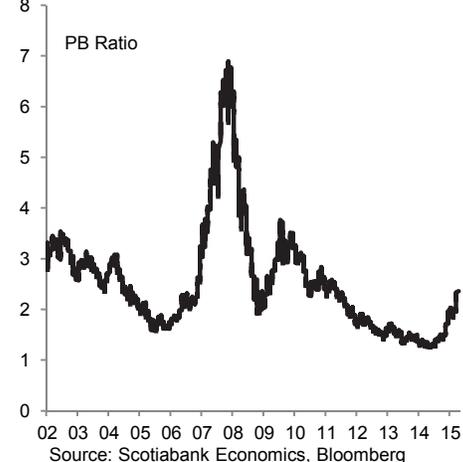


Chart 7
Shanghai Comp: P/BV Ratio



A fourth approach is to look at **price-to-book** valuations (chart 7). Here too, the Shanghai composite went from among its cheapest valuations over the past two decades last year to something trending more in line with long-run averages.

Financial Liberalization Is The “Fundamentals” Part Of The Story

Since taking office in March 2013, Premier Li has championed financial liberalization as a major pillar of China’s “new normal”. It is a difficult task that ultimately involves three major regulatory changes: the deregulation of interest rates, the opening up of the capital account, and the free-float of the RMB. Our view is that the equity rally has corresponded fairly closely with the acceleration in several key policy steps towards, and communication in support of, this financial liberalization — in particular, the widening of the RMB trading band, the establishment of the Shanghai-Hong Kong Stock Market Connect, the gradual [lifting](#) of the deposit ceiling, the introduction of deposit insurance, and comments from both Governor Zhou and Premier Li that FX rules would be reformed “relatively radically” this year (see **Table** for other key policy moves/communication).

In our view, **while the recent rally has not necessarily corresponded with improved economic data, it started from a point of extreme under-valuation and has most likely been heavily influenced by the long-term benefits associated with all aspects of financial liberalization**, but particularly the potential for both mainland financial markets and companies themselves should China become a mainstream investment opportunity for global investors. In this sense, the rally *is* a fundamentals story. **The overarching risk, then, is that policymakers aggressively back away from liberalization** or that investors lose faith in the process, but that is a scenario on which we put a low probability in the near-term.

Chart 8 demonstrates the already rising role of foreign market participation in Chinese stocks as policymakers begin to slowly open up the capital account. At less than US\$400 billion, it remains a still very small share of China’s US\$7 trillion equity market capitalization, but the figure is rising and will likely continue to do so as test pilots like the Shanghai-Hong Kong Stock Connect initiative (and reported intention to develop a Shenzhen-Hong Kong Stock Connect) open the doors to investors.

Why The Focus On New Account Openings May Be Misleading

Over 12 million new A-share investor accounts on the Shanghai Composite have been opened since the PBOC first cut interest rates and raised the deposit rate ceiling on November 21st, and 4.4 million of them were opened in the last three weeks alone (chart 9). As we first wrote on pp.14-15 [here](#), about 80% of investors in the Shanghai Composite are retail investors, and our sense is that the new appetite for equities is primarily the result of asset reallocation driven by lower returns in more traditional investments. The catalyst, however, has been Beijing’s moves toward financial liberalization discussed above.

Policymakers Accelerating Financial Liberalization Reforms	
2014	
March 15	PBOC widens RMB trading band from 1% to 2%
March 20	Foreign investors on Shanghai Comp allowed to invest in more products and up to 30% in a single company (vs. 20%)
April 10	Shanghai-Hong Kong Stock Connect announced
November 17	Shanghai-Hong Kong Stock Connect goes live
November 21	PBOC cuts deposit and lending rates; raises deposit ceiling from 1.1x to 1.2x for first time
November 30	PBOC unveils plans to institute deposit insurance
December 12	Beijing announces that the pilot free trade zone in Shanghai, which has an open capital account for companies and banks, will
December 28	PBOC effectively expands the deposit base in banks’ loan-to-deposit ratios
2015	
January 5	Premier Li is quoted as saying the Hong Kong Shenzhen Stock Connect is the next goal
January 16	China Securities Regulatory Commission (CSRC) bans 12 brokerages from opening new margin trading accounts for three
January 19	CSCRC issues subsequent comment that brokerage ban was not designed to curb equities and instead will help support “healthy
January 29	Beijing releases guidelines for the expansion of China’s free trade zones
February 4	PBOC cuts banks’ Reserve Requirement Ratio (RRR) by 50 bps
February 11	PBOC expands availability of its Short-term Liquidity Facility (SLF) to allow more banks to tap 1-3 month liquidity
February 28	PBOC cuts deposit and lending rates again; deposit ceiling raised from 1.2x to 1.3x
March 3	Interest rate on SLF lowered
March 12	Governor Zhou says probability of full interest rate liberalization by end of this year is “very high”.
March 23	Premier Li says that “China will speed up the basic convertibility of yuan on the capital account”.
March 27	Mutual funds granted access to Shanghai-Hong Kong Connect
March 29	Governor Zhou promises to reform FX rules “relatively radically” this year.
March 30	Governor Zhou implies further easing ahead “China can have room to act”
March 31	PBOC announces that deposit insurance will be introduced on May 1st
April 2	IMF announces that the RMB will be included in the Special Drawing Right basket,
April 8	Mainland Chinese buying of Hong Kong shares via Shanghai-HK Connect reaches daily quota for first time.

Chart 8 Ownership of Equities

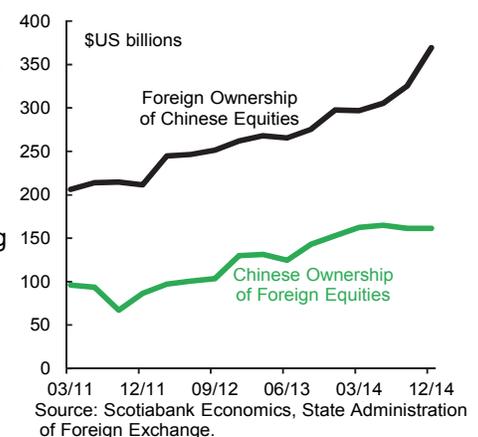


Chart 9 Are New Accounts Fuelling Or Following The Rally?

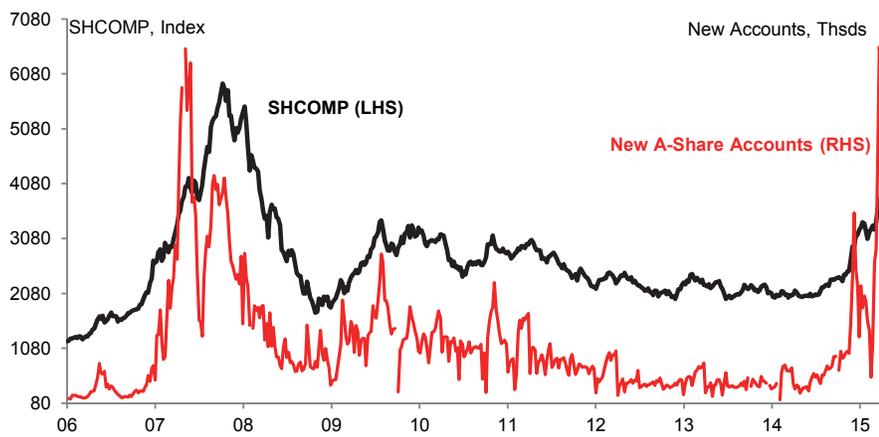
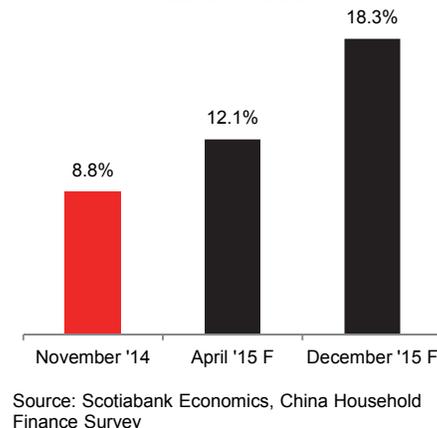


Chart 10 % of Chinese Households With Stock Accounts



Yet, despite the exponential increase in new accounts, equity ownership remains low. In November, the China Household Finance Survey found that 8.84% of Chinese households (or approximately 33 million) held stock market accounts. Since November 21, 12.19 million additional A-share accounts have been opened. If we assume that there is one new stock market account per household, new accounts would have lifted the share of households invested in stocks to 12.1% by this week, a 3.3 percentage point move but still a systemically low share of households. If more than one new account is being opened per household then the ownership rate per household obviously would have risen by less. Assuming accounts grow at the same average weekly rate that they have since end-November (an aggressive assumption), 18% of households will own stocks by the end of 2015 (chart 10).

While it's tempting to say that the surge in new accounts is the driver behind the stock market rally, we hesitate to make that claim. A widely circulated Bloomberg [article](#) reported on a survey that found new investors' total household wealth is, on average, RMB1.56 million vs. the average RMB2.87 million of wealth held by existing investors. Assuming that all new investors have contributed 8% of their total household wealth to equities which is on the upper end of recent average estimates for all investors (or alternatively about double that to err on the side of being conservative in making a point), new accounts would have added RMB1.5tn (or RMB2.9tn) to the RMB12.6tn increase in market capitalization over the past several months. In other words, new accounts could account for 12% (23%) growth in market cap since November. Note that this is probably already an aggressive assumption given that new investors are likely to start off with smaller contributions and grow their contributions over time. It is also probable that, in some cases, more than one account was opened per household. Taken together, **the flows generated by new accounts are not insignificant, but they are unlikely to be single-handedly fuelling the rally as opposed to more likely chasing it.** In other words, a deceleration in new accounts should not, by itself, imply a correction in the equity run.

Are new account openings likely to continue? Chinese households have faced declining returns across almost every other available asset class: property prices are falling (-5.7% y/y in February) and faith in prolonged secular real estate strength is dwindling; regulatory changes and the introduction of risk aversion (e.g. allowed defaults) have reduced the demand *and return* on risky wealth-management and trust products; deposit rate cuts and the expectation of further cuts are suppressing already low returns on bank deposits; the precious metals outlook is uncertain. With few other investment options, households are left with equities to generate savings returns. Looking ahead, we do not expect any of the above asset classes to experience a material trend change that would encourage sharp flows out of equities, though the greatest risks are a cyclical property revival later in 2015 or an aggressive move higher in offered deposit rates should the deposit ceiling be eliminated. That said, the pace is likely to moderate somewhat as the most willing and able new accounts have probably front-loaded into the index (another reason our assumptions above are conservative and probably overstate long-run participation increases).

Leverage Is An Overstated Concern (for now)

Headlines also continue to emphasize the spike in margin lending that has coincided with the equity rally: **total outstanding margin loans in China have nearly doubled from RMB 0.58tn (USD94bn) to RMB 1.13tn (USD180bn)** between February 2014 and February 2015, though we'd point out that margin loans began increasing as early as September '14. It would be a mistake to completely ignore this element of the rally, particularly given the speed of the run-up: new leverage adds to volatility

and works against the ultimate policy goal of deleveraging. Plus, the high share of retail investors in China is generally suggestive of less experience with the challenges of margin borrowing, particularly since regulatory changes in 2013 increased access to margin borrowing. It's also likely that additional borrowing via shadow banking products exceeds the official margin lending figures produced by China Securities Finance Corporation. Yet, even when taking the above into consideration, our sense is that concerns over China's increased margin lending are overdone.

First, **the ratio of outstanding margin loans to combined Shanghai and Shenzhen index market cap peaked at 3% in October and has since fallen back to 2.4%**, which is roughly the same as the ratio on the New York Stock Exchange (chart 11).

Second, the existing margin lending is relatively healthy: the collateral ratio has remained fairly stable at around 25% and the ratio of cash vs. securities as collateral has actually grown from 48% to 73% over the past year, according to data from the China Securities Finance Corporation. It's also clear that **regulators are keeping a close eye on the growth in margin lending**: the Shanghai Composite lost 7.7% in January when the China Securities Regulatory Commission banned 12 brokerages from opening new margin trading accounts for three months because of failure to comply with regulatory standards. However, the Commission stressed that the measures were not designed to curb equities but instead to support the "healthy growth" of margin financing (indeed, the Shanghai Composite is more than 25% higher since the move).

Finally, we'd point out that margin financing only became a standard program in October 2011 and at the time, required investors to have held an open account with at least RMB 500,000 (USD80,600) for a minimum of 18 months. In 2013, that requirement was lowered to 6 months and the guidance on minimum account levels was cancelled, coinciding with the first surge in margin lending. In other words, **a 'ramp-up' period in margin lending to around global standards should be expected**, particularly because this is the first bull market in which margin financing has been available. In January, regulators re-instituted the RMB 500,000 account minimum, which could help control excessive growth moving forward, though the risk is that margin financing as a share of the market meaningfully accelerates from current levels and/or collateral ratios worsen. As of now, however, activity is in line with global norms.

External Finances Offer Insulating Advantages

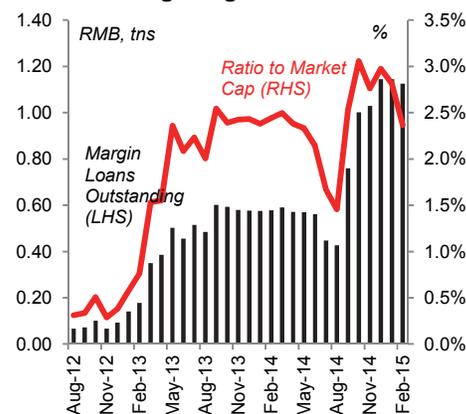
Apart from casting doubt on bubble fears and questioning popular perceptions of the drivers of Chinese equity market gains, we conclude with a final point that places domestic financial stability risks in the important context of enormous strengths in external measures of country finances. A country with a reserves war chest of nearly US\$4 trillion (chart 12) would usually not be at the top of the list of countries to worry about while monitoring potential stock market bubbles. A country with a bloated stock market that is also heavily indebted to foreigners and with few reserves would be higher on the list of worries, and that does not describe China. In the past, for example just over a decade ago, China has used its reserves to paper over challenges in the financial sector by 'gifting' them toward bank recapitalization and pulling more bad loans into off-balance-sheet structures. While Premier Li and the PBOC have indicated they wish to pull back on these measures in order to reduce moral hazard, creative measures like the local government debt swap announced last month are still being utilized and have the potential to provide a backstop to crisis scenarios (go [here](#) for more).

While China's reserves have recently slipped modestly, they remain very high and **the fact that reserves are declining somewhat is something we view as a positive if it continues to occur at a controlled pace**. For years, China has been accused of stock piling excessive saving. **It would be consistent if its critics acknowledged evidence that falling reserves might reflect a greater move toward global rebalancing of saving and investment flows with deeper, more liquid and more open Chinese capital markets being a vital part of this development.**

The authors wish to thank Juan Manuel Herrera and Andrew Gorsky for their research assistance in crafting this article.

Chart 11

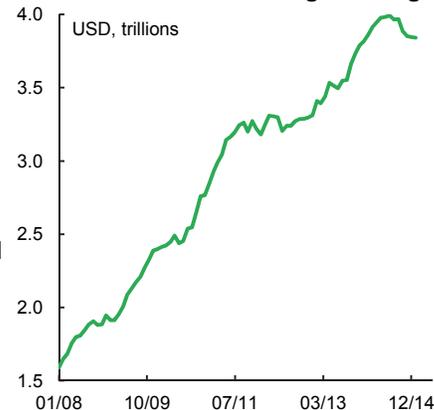
Outstanding Margin Loans in China



Source: Scotiabank Economics, China Securities Finance Corporation Limited

Chart 12

Reserves Are No Longer Rising



Source: Scotiabank Economics, State Administration of Foreign Exchange