China stock market: no one said it would be a smooth climb

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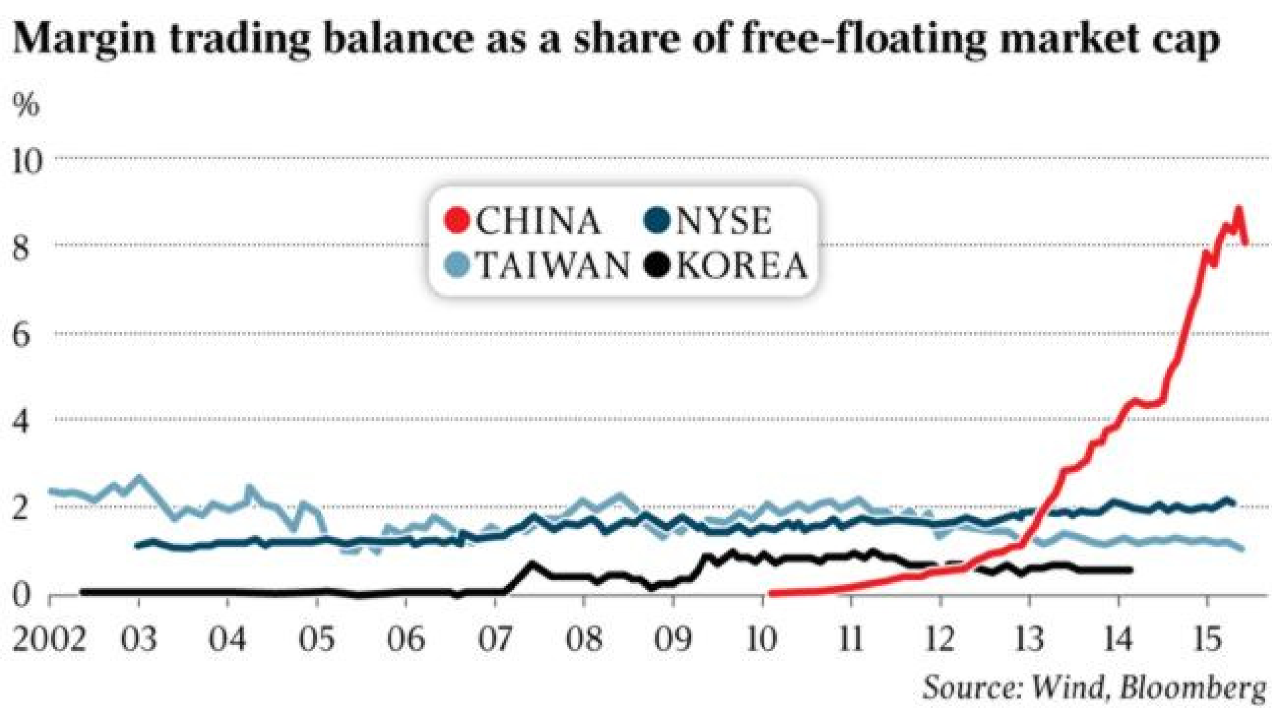

Source: TheAustralian

For too many investors China remains as distant and alien as Pluto had been until we saw NASA's digital images of that faraway planet this week.

Fresh visibility doesn't change the fact that since April 1 — just three months ago — China's volatile CSI300 (combination of Shanghai and Shenzhen stockmarkets) still hovers around the 4000-point level, whereas the ASX 200 has lost 6 per cent over the same period.

The month of July has epitomised the complexity of global investing for Australians in 2015.

Several key investments linked to the performance of China's CSI300 stockmarket are quoted on NYSE boards, which on Wednesday July 8 went offline during several critical trading hours.

Now, it is very doubtful whether Chinese cyber-attacks were responsible for downing a bourse, which was injecting fresh capital support into Chinese stockmarkets especially during a month when fresh foreign liquidity was worth more than its weight in gold.

But the irony of this paradox was that neither Chinese capital controls nor halted underlying shares on the Shanghai and Shenzhen bourses caused market access concerns but rather it was the basic functionality and accessibility on what was supposed to be the world's most sophisticated collection of exchanges found on the NYSE.

This unwanted constraint acutely highlights that the technical age is well upon us and Australian global investors must fully and immediately understand both how their underlying investments are accessed and what the mechanics are behind these globalised markets.

My June 13 column argued a strong case for why the Chinese Communist Party, the CCP, now wants advanced capital market architectures, just like we have in the OECD and what steps the Politburo will take to inflate its bourses, with very specific outcomes in mind for 2017, 2018 and beyond.

Some quarters refer to this as the "Beijing Put" — simply meaning that the government will backstop any serious erosion.

While many others panicked, well-guided sophisticated and ultra high net worth global investors took great reassurance in an important observation that was made during this apparent tumult.

They rightfully took comfort from the observation that between the hammer and the anvil of what appeared to be a significant market correction in China, the CCP stepped in and ensured that the burgeoning market architectures of the Shanghai, Shenzhen and smaller bourses were not damaged.

This was a perfect example, in practice, of a controlled economy ensuring the integrity of its guided market architecture.

Knowing that the Chinese stockmarket story has longer-term legs, sophisticated global investors accept that the CCP decides which gates open and close and where the cattle are permitted to run.

Such actions might be sacrilegious in free-market OECD economies, but this blunt reality must be accepted for those wishing to continue doing business with China: and as almost everybody does business with China, that acceptance must be found quickly.

As the graph unmistakably illustrates, Chinese domestic margin-lending facilities have replaced the former gearing exuberances of Chinese real estate and shadow banking heydays.

Unlike real estate or shadow banking hybrid investments, it should not surprise us that stockmarket gearing corrects itself in a far more public and at a more agile pace.

Appearing as a spectacle to some, the Chinese stockmarket "retracement" of this month is completely different than equivalent market corrections on OECD bourses, simply because China has only begun its listed investment journey.

Having the weakest hands already washed out of the market, subsequent support levels demonstrate that China's listed investment market ascent, albeit volatile, is only beginning.

China's biggest stockmarket rout since 1992 has done nothing to erode the bullish outlook of Goldman Sachs.

Kinger Lau, the bank's China strategist in Hong Kong, predicts the large-cap CSI300 will rally 27 per cent by year end.

The explosion in margin financing behind the recent astonishing run-up in Chinese A-shares is a new twist on Chinese credit concerns nevertheless, the silver lining is that it demonstrates that the political forces at work can successfully, albeit crudely, redirect domestic internal investment away from excessive real estate speculation and towards an entirely new asset class, at the will of the Politburo.

As of the beginning of June, the balance of margin financing outstanding was RMB2.2 trillion, an estimated 12 per cent of the free-float market capitalisation of marginable stocks and 3.5 per cent of GDP; easily the highest in the history of global equity markets.

Of course, even authoritarian state-led authorities make inadvertent mistakes and one potential colossal harbinger is the partial-suspension of CSI300, SSE50 and CSI500 Stock-Index Futures Contracts.

Participants can now only buy or sell, at most 1200 new contracts linked to the CSI500 Index a day, according to the China Financial Futures Exchange. The difference between shares and futures is that, unlike shares, future contracts expire as worthless, if they are not "rolled" forward.

The catch-22 of this CFFE decision, which was taken to limit short-selling, is that it also decimates existing future contracts' "fungible" worth, if this prohibition is not amended to allow existing contracts forward rolling.

They say the first casualty of war is truth and those attacking China this month neglected to mention that Didi Kuaidi, China's largest mobile-based car-booking company, raised $US2 billion ($2.7bn) in Shanghai on July 8, in less than fifteen minutes.

This single round of fundraising exceeded the $US1.5bn Facebook and Airbnb each respectively raised in 2011, during akin nascent ascents.

No one said that the rise of China's listed markets was going to be a smooth climb.

Those who think that this story is now over and who carry disdain towards the return of China may have succumbed to Sun Tzu's omen, which was to pretend inferiority and encourage the adversary's arrogance.

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