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Increasing Volatility in Chinese Market: How Can India Capital Markets Cope With It?

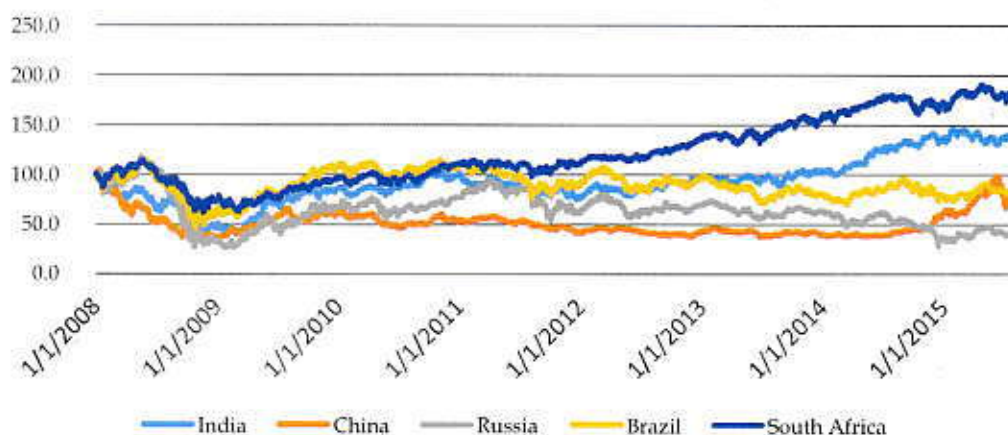
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The three months period between June to August, 2015 would be remembered in Capital Market history for wrong reasons where the value of stocks listed on Shanghai Stock Exchange lost by over one third of the value. Major after-shocks occurred globally. It is estimated that global companies who relied mainly in Chinese Market suffered over US \$4 trillion because of loss of business. May be it were, alcoholic beverage Remy Cointreau, Luxury Brands Burberry or Yumt Brands? The tsunami even engulfed commodities, base metals, steel, iron ore, etc. Initially, though it was felt that India would be affected minimally yet India

The chart below show a comparison between China and India's Stock Index i.e. Shanghai vs. Sensex, during the post financial crisis period.

Comparing Indian and Chinese stock indices over the period 2008 to 2015, Indian Sensex has steadily grown by more than 70 per cent over the last 7 years. Whereas China's growth has been more or less stagnant in the post financial crisis period. It has only picked up in the last year. Growth has not been uniform for Shanghai Composite. A steep rise since 2014 and a fall in 2015 indicate high volatility in the index.

Chart: Percentage Movement in Indices of BRICS nations during 2008-2015 (with April 1, 2008=100)



could not isolate itself from these shocks. Therefore, the question arises whether the volatility in China is ephemeral or long term. How it is going to affect its peers and more importantly how India can cope with it?

Performance of China's benchmark Index Shanghai Composite has been a mixed bag in 2015. Compared with other BRICS nations, the SHCOMP index has given one of the worst performances for last 1 month/3months period. However, the Chinese

Returns of Indices in BRICS countries over different time periods

	Brazil	Russia	China	South Africa	India
1 month	-5.22	-7.18	-6.51	-0.77	-0.30
3 months	-9.18	-16.98	-15.36	-5.40	1.24
6 months	5.20	14.71	16.15	1.28	-7.14
9 months	-8.02	-24.51	60.71	4.51	3.63
1 year	-12.03	-28.79	73.56	-1.23	6.05
Since January	0.48	8.81	17.14	3.67	0.20
2 years	2.10	-36.51	91.73	26.41	40.68
3 Years	-11.15	-40.59	78.00	48.82	63.69
5 Years	-24.96	-44.39	43.09	80.73	53.20
7 Years	-13.43	-56.47	32.94	89.95	99.86
10 Years	92.94	1.37	249.87	240.73	260.99

benchmark index has been doing pretty well for last 10 years. It has outperformed India's sensex in 1 year, 2 years and 3 years returns.

Various theories has come out for such large scale corrections or even re-rating of Chinese economy which created low returns and low capacity utilization on investments made in infrastructural projects. There returns were not adequate to service the large mounting debts. Sharp Corrections in real estate, a buildup of excess capacity, and decelerating export growth were affecting industrial activity. Growth in industrial output slowed from 7.6 percent (year on year) in the Q4 of 2014 to 6.4 percent in Q1 of 2015. Similarly, Growth in credit, decelerated from 19.4 percent (year on year) in the Q3 of 2014 to 14.3 percent in the fourth quarter and 16.8 percent in the Q1 of 2015, driven by moderating growth of credit products linked to China's shadow-banking sector. Even with policy efforts to redirect credit, banks are reluctant to lend to priority sectors. Credit allocation to priority sectors, including micro and small

enterprises and households, has not seen huge change over recent years. Among the 36.1 percent of households that borrowed any money in 2014, only 9.6 percent had access to formal loans from a financial institution, while 26.2 percent relied on family, friends, or informal lenders.

Although, the contribution of net exports in the first quarter was positive, largely due to slowing imports, yet data pointed to decelerating export growth



momentum. Export growth for the first quarter moderated to 4.6 percent from 8.6 percent in the previous quarter. China's exports to the European Union (EU) contracted by 19 percent, Japan 24 percent, Russia 50 percent, and the United States 8 percent. Import growth contracted by 17.6 percent in the first quarter of 2015, down from a decline of 1.8 percent in the previous quarter (figure 1.13). Lower oil prices are pushing down nominal import growth. In Q1 of 2015, investment growth decelerated further to 13.5 percent. Some of the factors – overcapacity in key heavy industries, policy tightening in energy-intensive sectors, a slump in real estate sales and construction, and regulatory curbs on shadow banking – have held back private investment.



Market became over-heated as appears from some key ratios. Ratio of securities bought on margin to Total Market Capitalization of china was around 3.4% in July 2015 as compared to 2% in July 2014. Ratio of Value of collateral offered on margin to Total Market Capitalization of china was about 12.1% in July 2015 as compared to 5.3% in July 2014. PE ratio of shanghai composite Index was 18.7 at the end of July 2015 compared to 10.4 at the end of July 2014. Total market cap of China was USD 6.7 trillion at the end of July 2015 compared to \$ 3.6 trillion in July 2014. Price earning ratio of Shanghai composite index increased to 25 in June, 2015 from 9.6 in 2014.(almost 7 year high). PE of Shenzhen index reached to 75 (almost 5 times of MSCI).Capitalization increased by over 5 times. Market Capitalization ratio to GDP was increased to 118% reaching almost figure of 10US \$ trillion.

The Chinese Economy benefitted due to large scale export based growth based on low cost paradigm. The low income group workers could not share the benefits of buoyancy in the economy and ultimately started going back to their home towns from industries. This reverse migration process affected the local consumption badly and there was no sizable middle income group who could have supported the demand. The problem also got aggravated because of large scale liquidity infusion in capital market. Margin Funding provided to investors coupled with IPO at

The Chinese Capital Market suffered not only because of Economic factors but also because structural issues of the Capital Markets like volatility, Margin Trading, Easy Liquidity etc. Just to recap, 30D volatility of Shanghai composite Index (annualized) was 62.2 in July 2015 compared to 10.8 in July 2014. On June 12 2015, China's Shanghai composite reached 7 years high of 5,166 (yielding 152% YOY and 60% YTD returns, surpassing peers by huge margin). During next one month, Shanghai Composite Index dropped more than 30% (highest monthly fall since 2007). On July 27, 2015, Shanghai Composite Index plummeted by 8.5% (making it the biggest daily fall Since Feb 2007) Similarly, Total Outstanding balance of margin transactions (both long and short) combined for both the exchanges (Shanghai & Shenzhen) stands at USD 225 billion at the end of July 2015 compared to USD 73 billion in July 2014. Out of this 225 billion margin outstanding, 224.1 billion was used for long positions where as only 0.5 billion was used for short selling. This shows there was huge build up of long positions in Chinese market. USD 808 billion amount of securities were kept as collateral as against USD 190 billion worth of securities pledged in July 2014. Stock

heavy discounted prices created a rush for new investors to the market. These new entrants came without proper understanding of market in search of easy money. They also used peer to peer money raised from private sources and acted mainly in tune with market swings which increase the volatility. The upsurge in Stock Market during last one year was hardly commensurate with the growth of economy or industry and became flat at slightest feeling of discomfort.

Whereas, India remained among the most favoured destinations for overseas funds even in July 2015 with equity markets receiving second highest inflows globally despite the rout in Chinese equities and crisis in Greece. However, the problems in Chinese markets will affect India. There will be downside pressure on exports to China from India like Iron Ore or on Chinese FDI in Indian industries. Many Indian Companies have set up manufacturing bases across China. Viability and Profitability of such companies would remain under pressure at least in short term. However, overall Indian economy and Capital Market both are in sound shape not only to withstand this pressure but also to turn this calamity into an opportunity. Post 2008 melt down, Indian Capital Market is growing steadily whereas China Market recorded sharpest increase of over 150% during last one year alone. This skewed jumps in the index forced the investors to book profit. The GDP growth of 1st quarter of current year in China at 7% was the lowest since global crisis in 2008 whereas the 1st quarter Indian GDP was almost highest during this period. Though India do not have capital account convertibility on currency yet the exchange rate of rupee is determined by free market forces which has automatic check and balances for depreciation or revaluation. However, in case of Yuan free market pricing is not available though the Central Bank has

changed the range within which Yuan can move. Money in Chinese market came mainly from retail investors who used borrowed money/peer to peer funding/excessive margin funding. The new investment did not come through domestic or foreign institutions who have a long term view of the market. This again created a short term view of the market which created wild swings.

Measures taken by the China to arrest the volatility acted on two pivotals. On one hand, short sales were banned, restriction or halts in trading in select shares were imposed. Large investors were restrained from selling their holdings. On the other hand, large institutional liquidity was introduced in the system to absorb the selling. However, these curbs and measures only created more uncertainties amongst participants which created this volatility. India did not resort to short selling even in 2008 crisis. Moreover, Indian Markets have active sectoral index, futures and option segment which helps in curtailing of volatility by providing a hedging mechanism to the investors.

To conclude, the structural advantage to India thanks to its regulators, policy makers will ensure that India will remain the most attractive market in peer countries.

