Channel the Capital to the Real Economy

China Liquidity Analysis – February 2016

Fundamental structural issues in the Chinese economy is a theme we at Bin Yuan have discussed in past quarterly newsletters. One of the key aspects of this which we'd like to devote to this letter, is capital misallocation. The result of this hampers economic development of China, and has contributed to equity market volatility. The problem with misallocation is that the cheapest capital continues to be directed toward the less efficient state owned enterprises -- with unattractive ROEs, while the private companies, who are able to create the most value, have suffered from limited financial resources and the resulting expensive capital. The government has sought to change this situation by encouraging "innovation" in the financial industry. Initiatives have included: lending activities in the stock market, internet finance, Peer to Peer (P2P) Financing and Wealth Management Product (WMP).The intent of these measures was to provide liquidity to the real economy to maintain the targeted growth rate. However, based on our research and observation, while the money multiplier hiked sharply in 2015, loosened monetary policy ceased to be effective. The increased liquidity was largely directed towards the debt restructuring/swap of those industries with redundant capacity, or chased after speculative financial assets.

The real economy as a whole, continues to lack sufficient capital. We believe it is critical to resolve this long lasted overcapacity problem through government sponsored "Supply side reform." Without this, financial resources will continue to be restrained to the innovative & value-added sectors and it will remain difficult to maintain sustainable high economic growth. Without fundamental improvement, the liquidity-driven stock market will continue to be vulnerable to volatile swings. This article aims to discuss the current liquidity situation in China and its implications for the stock market.

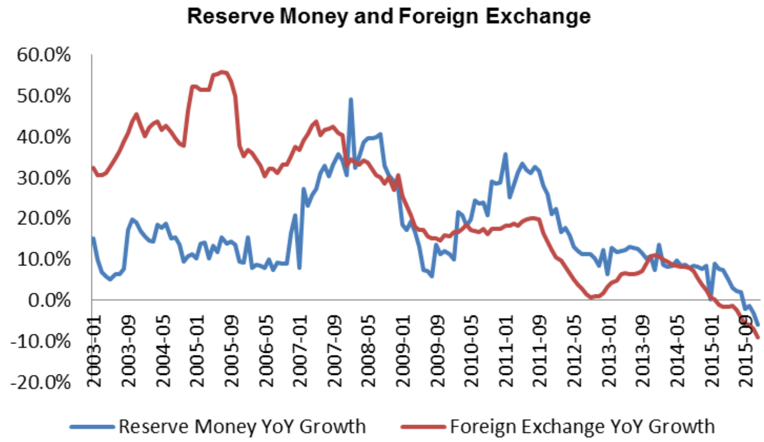
Liquidity situation in China

Liquidity within the financial system is driven by two factors, the reserve money and the money multiplier (Ratio of M2/reserve money). In a normal growing economy, these two factors move in the same direction. Unfortunately for China, they began to diverge in 2014. Reserve money began declining, while the money multiplier expanded to its highest level in the past 10 years. The increasing money multiplier is supposed to drive economic growth; however the economy has been immune to the hiked liquidity.

1. **Reserve money growth has been constrained by the weak foreign exchange rate, which has** negatively impacted liquidity

We indicated RMB overvaluation two years ago. It began to devalue from last August which has caused significant market concerns. At this stage, it is very costly to support the overvalued RMB by digesting foreign reserves. Expected RMB depreciation also accelerated the outflow of liquidity under the capital account. As a result, reserve money growth softened, and even shrank, to negative territory in the recent months (Chart 1).

Chart 1:

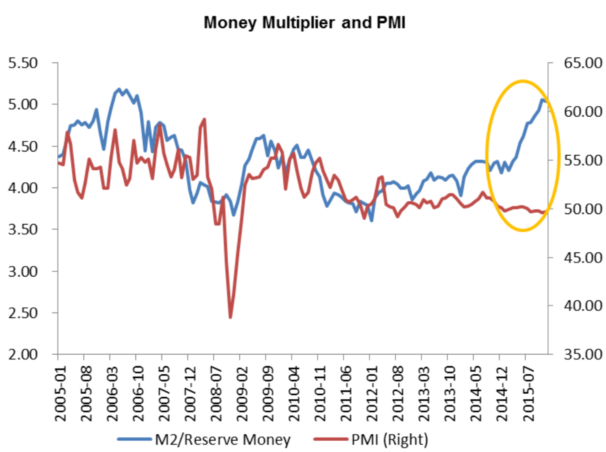


Source: Wind, Bin Yuan Capital

2. <u>Current government expansionary monetary policy has been ineffective -- and is unsustainable.</u>

As shown in Chart 2 below, the money multiplier and economic activities were positively correlated in the past in China; however deviation began in early 2014. The ratio of M2/reserve money, the money multiplier, climbed sharply reaching a high level of 5 and higher. The Purchasing Manager Index (PMI), which indicates the strength or weakness of the economy, continued to decline below 50, which shows the dis-connect between the loosened money supply and the soft economy as a whole in 2015.

Chart 2:



Source: Wind, Bin Yuan Capital

Where did the money go? On one side, household savings have been leaving the banking system to chase higher return financial products. While at the same time, less regulated Wealth Management

Products (WMP) and Peer to Peer (P2P) financing have attracted capital. Both have contributed to the money multiplier yet they have only circulated within financial products rather than to the real economy.

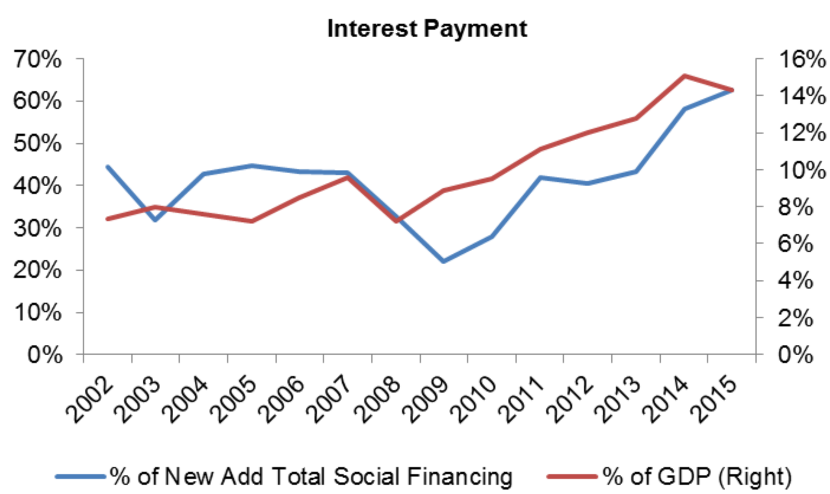
The majority of bank WMP is not principle guaranteed. These are off balance sheet items, and thus not calculated in M2. The outstanding balance of total WMP in China is around 23 trillion RMB.

P2P financing is even less regulated. Some activities are not captured by official statistics at all. Since it is considered a financing activity among households, it does contribute to the money multiplier. From local observation, we estimate that the total size of P2P is around 2-2.5 trillion RMB, including both online and offline.

If we take the size of WMP and P2P into consideration, the real money multiplier might reach 6 in China, or double the current level seen in the US.

The reason of the deviation between the money multiplier and the economy growth is that capital in the WMP and P2Ps are circulating mostly in a closed loop. They are not added to real demand but flow towards the non-needed capacity. These funds come in later and pay part of the earlier money with a higher interest rate. Thus the leverage goes up at an increasingly higher rate of interest. Under such a highly leveraged situation, the financial burden to the whole society is increased. Based on our estimates, Chart 3 illustrates that total interest payment accounts for over 60% of new add total social financing. This costs over 14% of GDP. In other words, room for increasing leverage is limited.

Chart 3:



Source: Wind, Bin Yuan Capital

3. Financial assets are perceived as high return asset class but with mismatched durations

Institutional capital in the financial sector has also played a part. Loosened monetary policy in 2015 did not lead capital to the real economy (due to perceived less attractive returns), rather it went to swap the debt or into financial assets seeking higher returns.

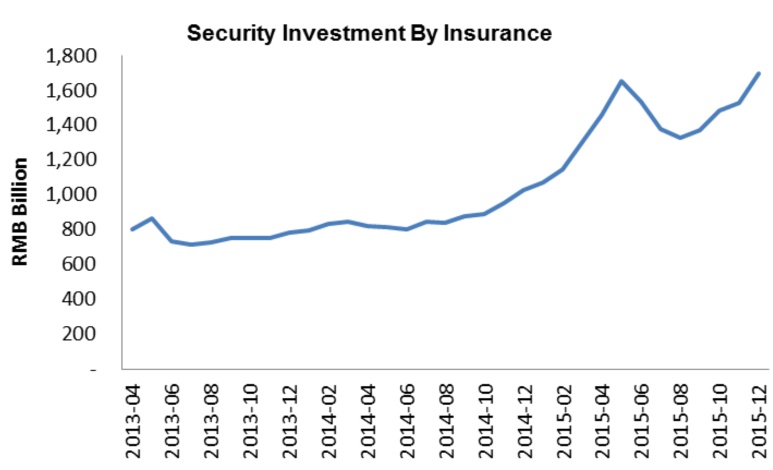
The weak manufacturing sector, combined with the reduction of the return on fixed asset investments has resulted in capital flight from those slowing sectors towards the liquid financial assets with higher expected return. Some insurance companies aggressively allocated cash to the stock market in 2015, as shown in Chart 4. The poorly regulated insurance sector is another cause of concern, as these secondary equity market investments have been funded by short term universal products, which is clearly a mismanagement of assets and liabilities.

There has also been "innovation" created within banking system chasing higher return financial assets without proper regulation. Bill finance is one of them. Instead of using discounted bill financing to fund business credit payments, this capital was channeled to other high risk financing activities. Scandals such as fake-bill-financing-investing-into-the-stock-market were discovered in the Beijing branch of Agriculture bank. A similar case at Citic Bank was reported afterwards. These are not stand-alone cases. Currently, all the banks are required to do a self-examination. Those insider thieves will have to sell the stocks to make up for the loopholes. As of year-end 2015, the balance for discounted bills is around 4.5 trillion RMB, and it is estimated that 10% of that balance may have gone to the stock market. So the amount could reach 500bn RMB.

Funds raised by the newly developed P2P, mentioned above, also have a duration mismatch. We estimate that around 40% of cash was invested in high risk assets including secondary stock market. (Chart 5)

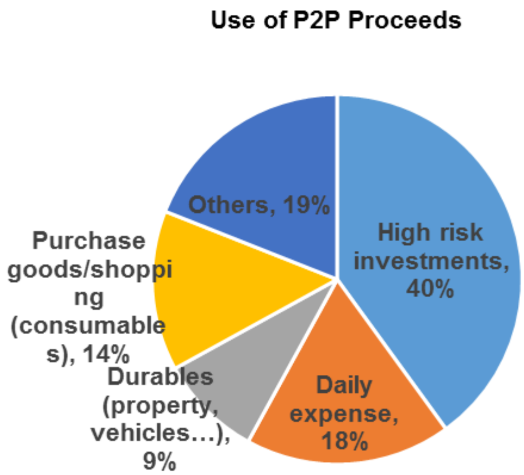
The duration of liquidity to hold those financial assets is short and vulnerable for redemption. Abuse of bill financing, WMP, insurance universal products and P2P, all with a fixed return promise, have to rely on new liquidity to be sustainable. When the marginal incoming money dries up, or payments to higher fixed rates cannot be met, the music will stop.

Chart 4:



Source: Wind

Chart 5:



Source: Bin Yuan Capital

To conclude, liquidity driven asset price inflation within a closed loop is not sustainable without fundamental support. The downside risk of liquidity may come from both reserve money and the money multiplier. Tightened financial industry regulation and structural economic reform are needed to reverse this course.

Stock market implications

With continued deleveraging and tougher regulations, the China stock market kicked off 2016 with dramatic volatility. Concerns about RMB weakness further intensified the sell-off. Capital which came to the equity market early last year seeking higher return has been leaving due to tightened regulations. Those which came in with leverage and gains have been willing to take profits, while others have been forced to sell as a result of margin calls as the market declined.

The intent of this analysis is to identify the worst case scenario, from a liquidity perspective, for the China stock market. The market's bull-run started in the 4^{th} quarter of 2014 followed by big corrections from last June to August, and then in January 2016. These caused panic among investors. The de-leveraging started in May last year after the call by the regulator to control stock purchases using borrowed money. Selling has come from various parties including banks, insurance, margin finance, unlocked shares owned by management, public and private funds, corporates, retail and P2P. The amount of each source has been estimated and the purpose for this analysis is to help to understand the liquidity momentum.

1. Short term downside:

Liquidity Source	**Jan 2016 Selling Pressure**	**Jun-Aug 2015 Selling Pressure**
• Bank bill financing:	500bn RMB.	200bn RMB
• Insurance:	100-200bn RMB	Tiny
• Shares pledge:	100-300bn RMB	100-300bn RMB
• Management selling + unlock shares:	100-200bn RMB	500-600bn RMB
• Margin finance:	900bn RMB	2 trillion RMB
• Illegal leveraging:	Tiny	1.5 trillion RMB
• Fund selling:	600bn RMB	600bnRMB
• Corporate stock investment:	Over 100bn RMB	Over 100bn RMB
• P2P:	400-500bn RMB	200-250bn RMB
• Household allocate assets out of equity	1-2 trillion RMB	500bn RMB
• **Total selling pressure**	**5 trillion RMB**	**6 trillion RMB**

The A share market has four boards: Shanghai main board, Shenzhen main board, Small and Medium Enterprise board (SME), and Growth Enterprise Market board (GEM). The total trading volume and valuation after sell off is shown as below:

Board	Jan 2016 Selling Off		June-Aug 2015 Selling Off		PE TTM Historical Average		Current Valuation (Discount)/Premium to Average Valuation		Performance since 2013
	Trading Volume (Bn RMB)	PE (TTM)	Trading Volume (Bn RMB)	PE (TTM)	Since 2006	Since 2010	Since 2006	Since 2010	
Shanghai Main	4,318.53	13.66	34,786.50	13.58	20.32	13.88	-32.8%	-1.6%	36.02%
Shenzhen Main	1,870.30	28.60	10,558.40	24.06	36.79	28.35	-22.3%	0.9%	60.10%
SME	2,814.35	51.97	10,956.75	42.90	41.28	41.20	25.9%	26.1%	127.10%
GEM	1,737.31	77.78	6,464.96	66.59	61.16	61.16	27.2%	27.2%	247.30%
Total A share	10,773.98	19.09	62,894.69	17.38	23.11	17.08	-17.4%	11.8%	55.98%

The overall selling on the Shanghai & Shenzhen main boards was lower in January than last year and is expected to continue to decline in the future. The factors which triggered the sell-off of larger cap names last year, such as margin finance and some of illegal leverage, are gone this time, and the valuation of the two main boards are at 33% and 22% discounts to the 10 year historical average respectively. Trading volume has been less during the recent sell off as well, which indicates that the selling pressure is mostly released for main boards.

By contrast, the selling pressure related to smaller cap names including bank bill finance, P2P, WMP was elevated this time. SME and GEM boards have outperformed the main boards in the past three years by almost 80% and 200% respectively, and thus have attracted speculative money. The valuation of SME and GEM boards still trade at premium of over 25% to their historical average. Structurally, the downside risk for SME and GEM is higher.

The possible sources of selling pressure:

1. ***Bank bill finance***

As mentioned above, it is estimated that the selling pressure might have been around 500bn RMB in January 2016, compared with around 200bn RMB in June 2015. The balance of discounted bills was lower in the mid of 2015.

2. ***Insurance***

In the fourth quarter of 2015, some insurance companies aggressively allocated cash to the stock market. It is concerning that they buy assets for long term dividends funded by universal products with shorter duration. The termination of selling insurance products that are less than 3 years will pose liquidity risk on these insurance companies and they will consequently need to sell liquid stocks. 1.7 trillion RMB of insurance assets have been invested in the stock market, 10% of which might face this risk due to duration mismanagement.

3. Shares pledged

The shareholders of over 1400 A share listed companies have pledged the shares. Over 400 names have reached the warning line, and almost 300 stocks are at the edge of margin call. If the market goes down another 10% to 20%, the newly added margin call pressure might be above 100bn to 300bn RMB.

4. Unlock of non-floatable shares

The expiration of locked up shares from IPOs & placements totaled 1.3 trillion, 2.2 trillion, 1.8 trillion and 1.4 trillion RMB from 2014-2017, with the peak times in January, June, November and December of 2016. There is a divergence between those listed companies where management of the high quality stocks continues to increase their stake, while the owners of poorly operated names aggressively sell their shares.

5. Margin finance

The balance of margin finance has dropped from a peak of 2 trillion RMB to 900bn RMB currently.

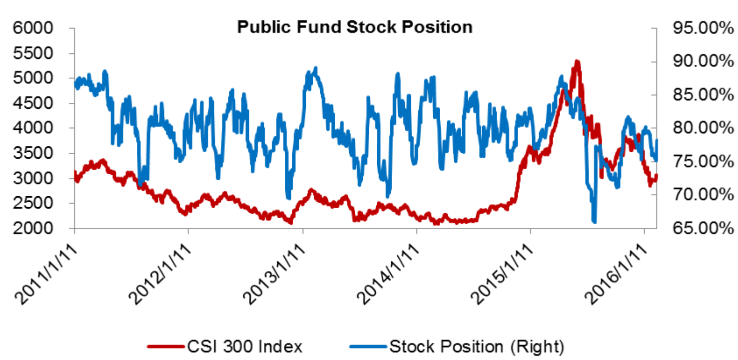
6. Illegal leveraging

The clearance of illegal leveraging was the biggest liquidity risk in the last sell-off last June – August 2015. This clearance is close to its end.

7. Mutual Fund selling

At this stage, the stock positions of most private funds are below 30%, however the level for public funds are as low as 78% (Chart 6). The cash level of public funds was raised to over 35% at peak in the last down market. The total Asset under Management (AUM) of public equity funds is around 3 trillion RMB, and it is estimated the total of another 600bnRMB might be sold.

Chart 6:



Source: SWHY securities

8. Corporate cash balance

The highly liquid financial assets, including stocks with relatively higher expected return, have attracted corporate cash. Cash from State Owned Enterprises and some government public institutions may exit as regulations have been tightened towards cash from public sector.

9. P2P financing

As indicated in chart 5 above, 40% of P2Ps has invested in high risk investment. Assume half of them went to stock market, the amount could be 400-500bn RMB.

10. Household savings and investments

Property sales of higher tier cities soared in the year of 2015. Property has been a good inflationary hedge. Government's strong support of the property market and ongoing concerns about RMB devaluation may encourage some household to allocate capital out of the equity market into real estate and/or US dollar assets.

2. Long term upside:

Pro-market reform is needed to improve the efficiency of real economy. Supply side reform is not only intended to phase out excessive low-end manufacturing capacity, but also aims at allocating resources into the higher value added goods and services from those overcapacity industries. The finance reform of breaking rigid payment and strengthening the supervision system could help to reduce the expected return rate of the whole society, and the liquidity will not be idling or chasing for speculative financial assets any more.

We expect to see plenty of liquidity to support the ongoing development of the stock market if the fundamentals of the economy turn around. Stock holdings as a percent of total financial assets in both households and the social security fund are still at low levels. The inclusion of China A shares into the global index will also be a long run catalyst

Liquidity Source	**Comments**	**Long term Amount**
• Social security fund	Total AUM is around 2 trillion RMB, and 5% of which is invested in equity.	300bn RMB inflow if the equity percentage goes to 20%
• Wealth management products	Total size around 23 trillion RMB and 5% of which is invested in stock market.	1.2 trillion RMB inflow if the stock percentage goes to 10%, which was the case at peak time last June

• Household deposit	Total 45 trillion RMB	7 trillion RMB potential if 15% invested in equity
• MSCI index	If China A fully included into MSCI index, China will account for over 40% of MSCI EM index from currently 25%.	5-10 trillion RMB potential if China A fully included.

Conclusion

Expansionary monetary policy without fundamental economic reform has resulted in liquidity being wasted on the less productive sectors or cause financial bubbles and bust. Fortunately, both the government and business community are mostly aware of the issues discussed in this paper. The challenging issue is how to pilot the restructuring of the economy in the right direction. Supply side and finance reform could help to channel financial resources to the most efficient sectors, and drive economy to grow in a healthy and sustainable way. The stock market is driven by a solid economy and corporate earnings in the long run. Regulators have taken actions to reverse the course of speculative financial leverage, showing their willingness to do their job properly. We are confident that reform is real by this administration and more changes will unfold in the coming years.

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