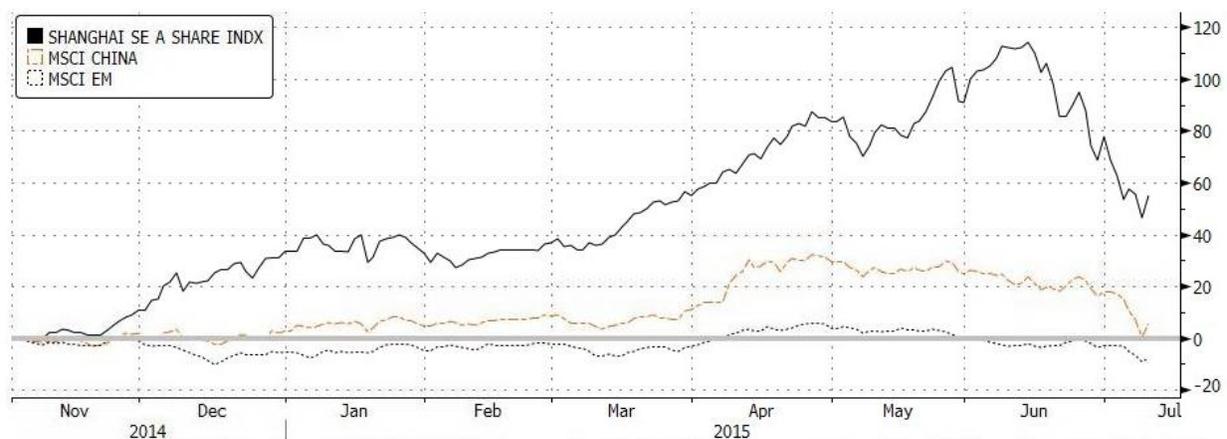


## Update on the recent volatility in China from the AGF Global Equity Team

The volatility of the Chinese equity markets over the past few months has been significant. From November 1, 2014 to its peak on June 12, 2015 the A-Share market rose 111% compared to the H-Share market, which climbed 31% and the MSCI Emerging Markets Index, which fell 2.4%. The A-Share market, comprised of the Shanghai Stock Exchange Composite Index and the Shenzhen Composite Index, is mainly traded by Chinese domestic based fund and retail investors. However, foreign institutional investors such as AGF, typically invest in the Hang Seng China Enterprises Index, an index of Chinese companies traded in Hong Kong, commonly referred to as H-shares.

The rally in Shanghai commenced in November, 2014 with the opening of the Hong Kong-Shanghai stock connect, which allowed funds to move between Shanghai and Hong Kong. The rise in markets accelerated on March 27, 2015 (Figure 1) after China's securities regulator said it would do more to open mainland financial markets.

**Figure 1: Shanghai SE A-Share Index rally**



Source: Bloomberg

We believe the extraordinary rally of A-shares was not driven by fundamentals but rather as a result of the following five factors:

### 1. HIGH MARGIN LEVELS

Substantial margin financing became prevalent as low margin requirements accelerated retail investors' ability to use leverage to purchase stocks. As a percentage of GDP and market cap, the amount of margin in China has grown to a larger portion than in the U.S. Strikingly, the path that the U.S. has taken to reach this level has been gradual – taking a few decades – whereas China has taken only four years,

from the time it formed a standard program, in October 2011 (Figure 2). Margin debt at its peak reached 9.6% of the A-share free float and is still high at 8.1%.

**Figure 2: U.S. vs. China margin debt as a share of GDP**



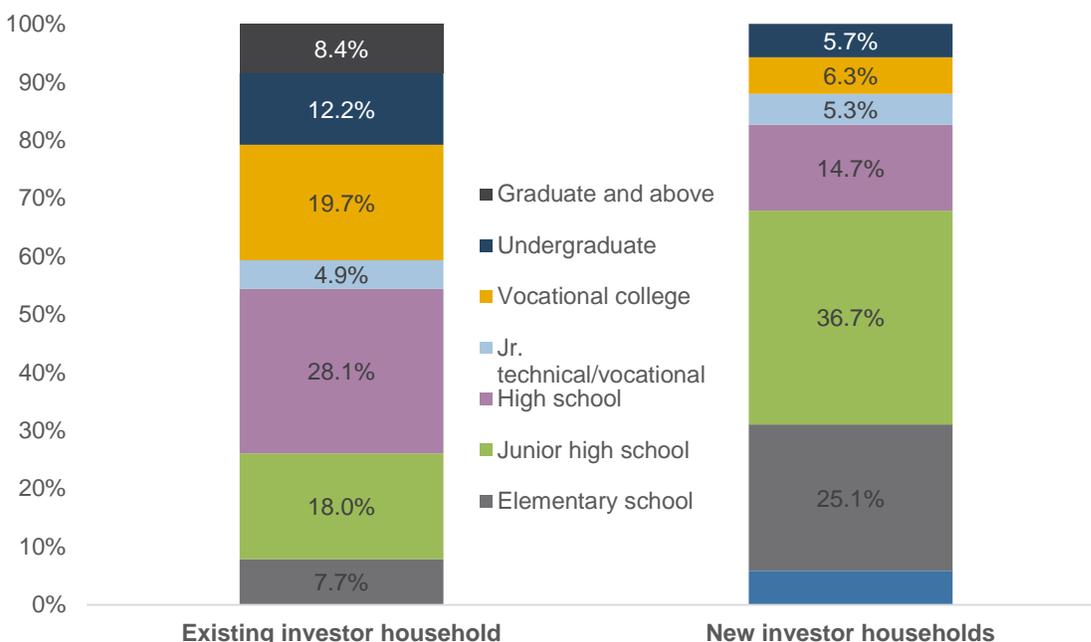
Source: Ned Davis Research, July, 2015.

## 2. RETAIL INVESTOR OPTIMISM

As share prices moved higher, more investors invested in the market, exhibiting the herd mentality. Given 85% of trading volume in the A-share market comes from retail investors, the impact was significant. Other important factors that exacerbated the trading frenzy was that retail investors in China typically trade at a significantly higher frequency with typically less assets and a lower level of education relative to their U.S. counterparts. In fact, 81% of Chinese retail investors trade at least once a month, compared with 53% in the U.S. and many of these Chinese investors have not graduated from high school<sup>1</sup> (Figure 3).

<sup>1</sup> Bloomberg, SWUFE China Household Finance Survey

**Figure 3: China: Highest level of education attained (%)**



Source: Bloomberg, SWUFE China Household Finance Survey, Fortune, April 1, 2015.

### 3. LIQUIDITY

Liquidity has played a significant role as interest rate cuts by the People’s Bank of China (PBoC) helped to stimulate equity purchases. The PBoC cut interest rates four times since November 2014, cutting 115 basis points to 4.85%. Cuts were also made to the one-year deposit rate and the reserve requirement ratio, which was lowered 175 basis points, in an effort to increase the number of loans made by commercial banks, and stimulate the domestic economy.

### 4. GOVERNMENT POLICY

An agreement between the China Securities Regulatory Commission (CSRC) and the Hong Kong Securities & Futures Commission (SFC) to mutually recognize funds between the mainland and Hong Kong resulted in increased trading volumes. The initiative allowed eligible Hong Kong–domiciled funds to be sold to retail investors in China under a streamlined procedure with qualifying Chinese funds receiving the same treatment in Hong Kong, allowing investors to access mainland equities directly, without the need for an investment license.

### 5. POTENTIAL INCLUSION OF A-SHARES IN THE MSCI INDICES

MSCI also announced in early June that it was reviewing inclusion of China A-shares in its emerging markets index after a number of issues were resolved, which helped to spur buying. At the time of the

announcement, MSCI forecasted that global funds could potentially add around US\$20 billion to the Shanghai and Shenzhen markets. MSCI later announced that it would put the decision on hold until China further liberalizes its capital markets and addresses other matters, including quota and ownership issues. Still, China could be close to addressing these issues, perhaps two years away, which could pave the way for significant inflows into China's domestic markets by asset management firms, pension funds and insurance companies over time.

## ECONOMIC FUNDAMENTALS – DISJOINTED FROM EQUITY MARKETS

The crux of the issue was that the sharp rally was juxtaposed against a weakening economic backdrop, not an improving one. Real GDP for the first quarter of 2015 grew at 7%, its slowest rate since 2008, while nominal GDP is growing at its slowest pace in over two decades. The May PMI Services and Manufacturing Employment reading came in at 47.9% steadily declining since its peak in 2010 of close to 54% and import volumes were weak<sup>2</sup>. Additionally, leverage throughout the country is high with debt to GDP almost doubling since 2007 to 282% and corporate debt to GDP rising from 72% to 125%<sup>34</sup>. With economic data continuing to weaken, market participants increased their expectations for additional stimulus by the central bank, believing that further stimulus would fuel further risk taking and drive equities higher.

## BEAR MARKET – TOOLS USED BY PBOC TO STABILIZE THE MARKET

Since its peak on June 12, 2015, the A-Share market has declined 26% while the H-Share market has declined 14% as of July 15, 2015 (Figure 4). Initial efforts by Beijing to stem the downturn were unsuccessful. However, the PBoC announced a number of other measures that helped stabilize the A-share markets including the following:

- The China Securities Regulatory Commission (CSRC) announced on July 3<sup>rd</sup> that it will increase the registered capital of China Securities Finance Corporation (CSFC) to Rmb 100 billion from the RMB 24 billion limit to provide more funds for CSFC's market stabilization activities;
- On July 5<sup>th</sup>, CSRC announced that the PBoC will provide further liquidity support to the CSFC to expand its market support operations. The CSRC also announced a pause in new IPOs on July 4<sup>th</sup>;
- China's Central Huijin Investment announced that it had increased its holdings of China ETFs and would continue to expand its holdings. China Insurance Regulatory Commission also required insurance companies to maintain net equity purchase positions on a daily basis;
- Trading was suspended on more than 1,300 companies freezing US\$2.6 trillion of shares, or about 40% of the country's market value;
- Chinese regulators banned corporate executives from selling stock for six months;
- China Security Ministry launched probe into "malicious" short selling of blue chip shares in an effort to crack down on activities that could destabilize the market; and
- China provided access to as much as US\$483 billion (3 trillion yuan) for the China Securities Finance Corp. to use to buy shares and provide liquidity to brokerages.

<sup>2</sup> Cornerstone Macro, June 4, 2015

<sup>3</sup> McKinsey Global Institute

<sup>4</sup> BCA Research, May 27, 2015

**Figure 4: Shanghai Composite (A-shares) versus Hang Seng China Enterprises Index (H-shares)**



Source: Bloomberg, July 15, 2015.

## HOW THE AGF EMERGING MARKETS STRATEGY IS POSITIONED

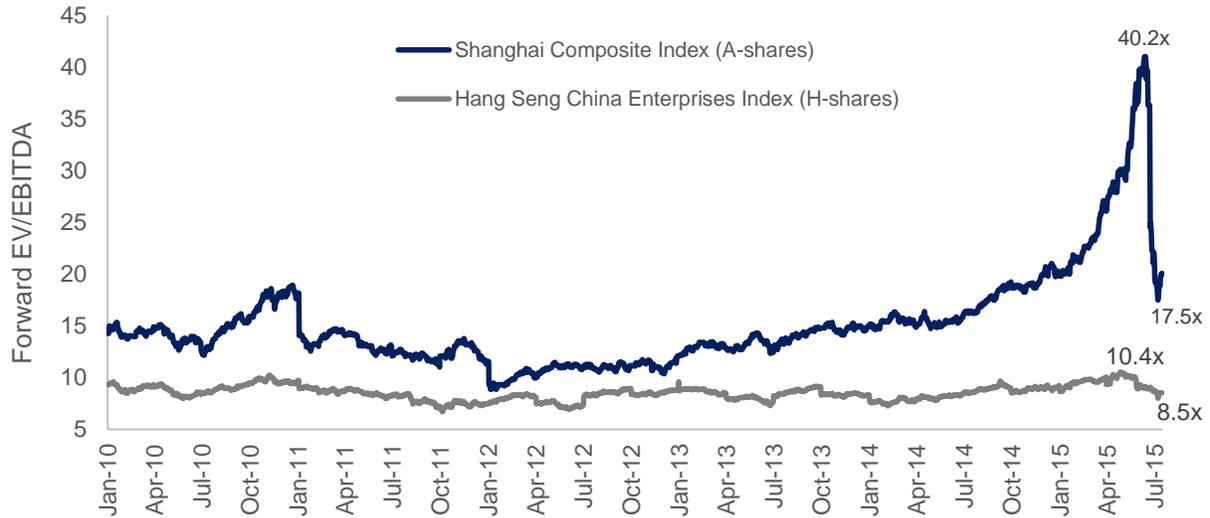
Our underweight to China is driven by a lack of bottom-up investment opportunities. We aim to construct a diversified portfolio of quality companies supported by attractive valuations. Our investment screens continue to identify a diverse range of opportunities throughout the EM universe. Within China, however, these screens are dominated by the financial services sector, where concerns of high debt levels and deteriorating growth prospects have led us to adopt a more cautious view. We see better risk-reward opportunities in countries such as Mexico, Czech Republic, Thailand and Indonesia, where we have better visibility on the outlook for growth and profitability. Within China, bottom-up fundamental analysis continues to identify excess capacity and deflationary pricing trends in a number of other industries, which could lead to deteriorating margins and asset turns, thereby hurting future EVA creation.

## OUTLOOK

We currently see the outlook for A-shares as even more unpredictable given the numerous interventions made by the government over the last few weeks and as 1,387 stocks or around 50% of the index remains suspended. Also, retail investors continue to constitute the bulk of the A-share market and, unlike institutional investors, may be more prone to base investment decisions on short term sentiment and emotion rather than fundamental analysis.

Currently, we believe H-shares are more attractively valued relative to A-shares. H-shares are currently trading at a forward EV/EBITDA of 8.5x, while A-shares are trading at a forward EV/EBITDA of 17.5x (Figure 5).

**Figure 5: Shanghai Composite (A-shares) versus Hang Seng China Enterprises Index (H-shares) Valuation**



Source: Bloomberg, July 15, 2015

China is seeking to re-engineer an economy that has relied for years on investment in heavy industry and infrastructure. Now China wants growth to be driven by domestic consumption and services. Although the current macro environment makes it challenging for companies to drive profitability, we do expect the overall potential for companies to generate earnings and profitability will be positive over the long term.

Ultimately, we believe markets that are driven by factors other than fundamentals typically are short lived. As long term investors, we focus on companies that can generate strong EVA (Economic Value Added) characteristics and are priced at attractive valuations.

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