Box B

Recent Developments in Chinese Equity Prices

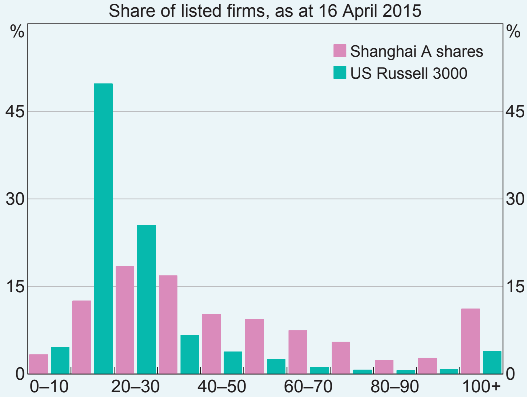
Equity prices in mainland China have more than doubled since mid 2014, with both the Shanghai and Shenzhen exchanges rallying sharply over this time (Graph B1).[1] This rally has been broad based across sectors, and has occurred despite slowing economic growth. It has, however, coincided with rapid growth of debt-financed retail investment in the stock market.

Graph B1
Chinese Share Prices
1 January 2014 = 100

Source: Bloomberg

With analysts' earnings forecasts for Chinese companies actually being lowered since mid 2014, the forward price-earnings (PE) ratio has increased a little more sharply than overall share prices to around 20. This follows a prolonged period in which the PE ratio was low, largely reflecting scepticism about the outlook for earnings at Chinese banks (which account for around 15 per cent of market capitalisation), such that it is now only moderately above its average since 2007. However, half of the companies listed in Shanghai have a PE ratio greater than 40, with over 10 per cent having a ratio greater than 100 (Graph B2).[2] By comparison, only 4 per cent of companies included in the broad US Russell 3000 Index have a ratio greater than 100.[3] Moreover, the premium paid by investors to own mainland-listed shares of companies that are listed in both Shanghai and Hong Kong increased sharply in late 2014, meaning the same companies now command an average 30 per cent premium in Shanghai, compared with Hong Kong.

Graph B2
Distribution of 12-month Forward PE Ratios
Share of listed firms, as at 16 April 2015



Source: Bloomberg

Leverage has played an increasingly large role in this rally, in contrast to the previous upswing in 2005–07 when margin financing was prohibited. (Chinese authorities only allowed margin financing from March 2010, predominantly for institutional and wealthy investors, but have since relaxed restrictions to extend its availability to retail investors.)

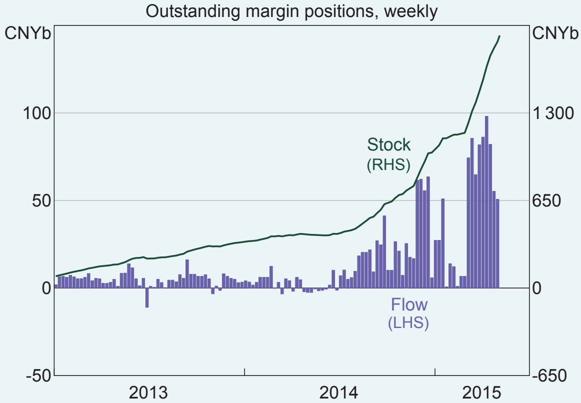
1 The Shanghai Stock Exchange mainly comprises larger companies including state-owned banks, and the Shenzhen Stock Exchange mainly comprises small- to medium-sized companies.

2 Forward estimates of earnings are not available for many companies listed in Shenzhen.

3 Such comparisons are influenced by differences in accounting standards, but any difference is likely to result in Chinese ratios being understated relative to the United States.

Outstanding margin positions in Chinese equities have more than quadrupled since early July 2014 to CNY1.9 trillion (Graph B3), equating to almost 9 per cent of the free float market capitalisation in China (compared with 2½ per cent for the United States and 1 per cent for Australia).[4] Daily purchases using margin financing have increased tenfold over this time, and currently account for almost 15 per cent of turnover. Margin account balances may also be underestimating leveraged purchases of equities, as some investors are reportedly funding equity purchases with money borrowed from other sources. The increase in leverage has been mainly driven by retail investors opening new accounts, though little else is known about the distribution of margin debt.

Graph B3
Chinese Margin Financing
Outstanding margin positions, weekly



Source: WIND Information

Chinese authorities have introduced regulations in response to this rapid rise in leverage. These include temporarily prohibiting some brokers that breached lending regulations from opening new accounts and banning a source of margin financing (not captured by the data above) known as umbrella trusts. The Shanghai and Shenzhen stock exchanges also issued rules designed to make short selling of stocks easier and the authorities allowed foreign investors to short-sell stocks via the Shanghai-Hong Kong Stock Connect (though this is yet to be used due to tight limitations). In addition, Chinese mutual funds were granted access to the Stock Connect at the end of March, giving retail investors an avenue to purchase dual-listed companies in Hong Kong at the substantial discount prevailing on these companies' Hong Kong-listed shares. This led to a surge in buying of Hong Kong-listed shares by Chinese investors and a rapid increase in the Hong Kong price of dual-listed companies. ✠

4 Free float market capitalisation refers to the value of shares that are readily available in the market. Free float market capitalisation in China is considerably less than total market capitalisation due to the large number of state-owned enterprises listed on the stock market.