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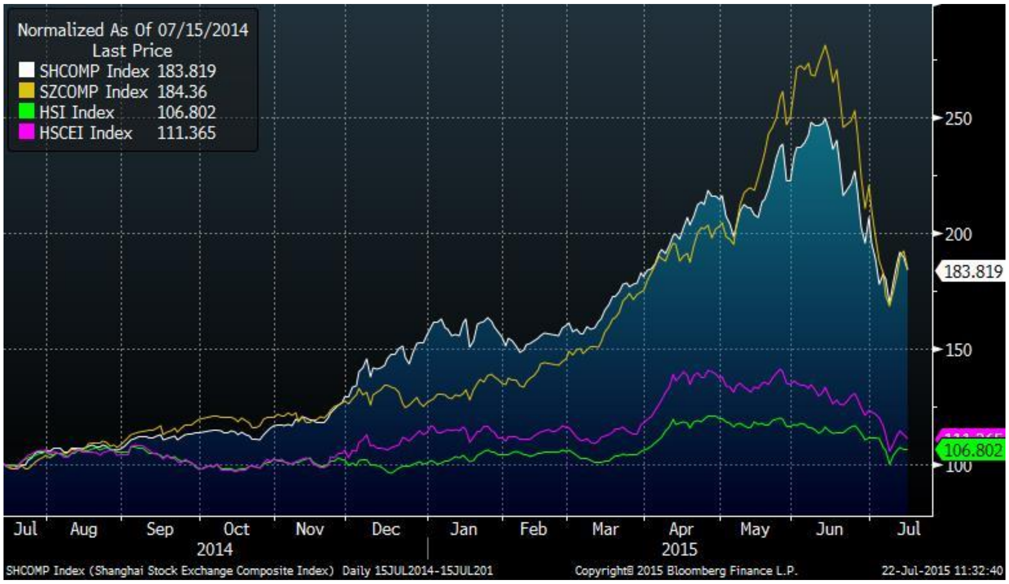
A few thoughts about the present situation related to the Chinese Stock Market

Frenzied, the word best describes the Chinese stock market over the past 12 months. It began when Chinese investors saw stocks as the best way to invest their savings, with returns dwindling from real estate, bonds, wealth management products etc. The mania escalated with the government encouraging investment in stocks and relaxing margin rules, creating the perception of guaranteed positive stock market returns. This happened in conjunction with western brokers' call that the market was undervalued after being neglected for years and in fact being dirt cheap.

And up it went. At its peak, the Shanghai Composite Index, consisting of large-cap companies went up 150% while the Shenzhen Composite Index, which is full of tech companies, almost tripled from mid-2014. ChiNext, a venue for startups is valued at earnings multiple of 147, closely resembles the US NASDAQ situation before the burst of tech bubble. At least 80 listed companies changed names in the first five months of this year, rebranding themselves as high-tech and high-growth companies. They saw share prices quickly increasing few-fold. Even frothier is the Chinese IPOs. Every one of the 29 IPOs in April have risen by the daily limit of 10% and the worst performing IPO earlier this year has doubled in price.

The soar was largely domestic driven. Access to the mainland stock market by foreign investors comes in only two ways, the Qualified Foreign Institutional Investor (QFII) program which permits selected global institutional investors to buy RMB-denominated onshore "A shares" and the Shanghai-Hong Kong Stock Connect which allows investors to trade shares on the other market using their local brokers. China QFII quota was around $75 billion in June while the aggregate northbound quota for the Stock Connect (investors with Hong Kong accounts buying mainland shares) is set around $48 billion. These numbers seem miniscule when compared to the entire Chinese stock market value of $10 trillion.

Then reality sank in. The Chinese stock market corrected more than 30% from its peak in mid-June within a month as retail investors winded down margin investments. The drop wiped out $3.5 trillion in value, more than India's entire stock market. Policymakers, having an interest in a healthy domestic equity market to privatize state owned enterprises, attempted to stem the decline. The leadership cut interest rates, capped short-selling, halted IPOs and enacted share-buying schemes backed by central-bank cash. Major shareholders are prohibited from selling their holdings for 6 months. Companies can ask for the trading in their stock to be suspended for an indefinite time period, more than half have done so. Right now, the measures seem to be working.



While the Shanghai Composite Index is now trading about 20 times P/E which might not seem overly expensive, valuations are much higher in certain market segments. Banks make up a large composition of the index (20%) and are a hated sector due to being heavily overleveraged and little transparent. Stripping out this sector, the index seems slightly overvalued compared to the 10-year average – please see sheet below. The Shenzhen Composite seems still hugely overvalued even after the decline. We are not suggesting that the CN stock market must decline further. Expensive markets may become more expensive or stay expensive for longer, and alternatives are not easily available. Further, the government has signaled that it will do a great deal to avoid a market crash, which might prove to be a major support for the market.

Index	**Weight %**	**Current P/E**	**10YR Avg P/E**	**Current P/B**	**10 YR Avg P/B**
SHCOMP (Shanghai)	100.0	19.5	19.6	2.3	2.5
SHCOMP Banks	20.2	6.4	12.9	1.1	2.1
SHCOMP ex Banks	79.8	22.8	21.3	2.6	2.6
SZCOMP (Shenzhen)		51.4	32.0	4.5	3.1
HSI (Hong Kong)		10.4	12.5	1.4	1.7
HSCEI (H Shares)		8.5	12.9	1.2	2.0

However, when looking at the Hong Kong stock market, this actually looks pretty attractive now, particularly H shares which are Chinese companies listed on Hong Kong exchange, trading at about 35% discount to the long-term average.

We advise investors to cover this market via a few selected funds and ETFs.
Please do not hesitate to contact us for a more in-depth discussion.

Your Helvetic Team YZ/JW

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