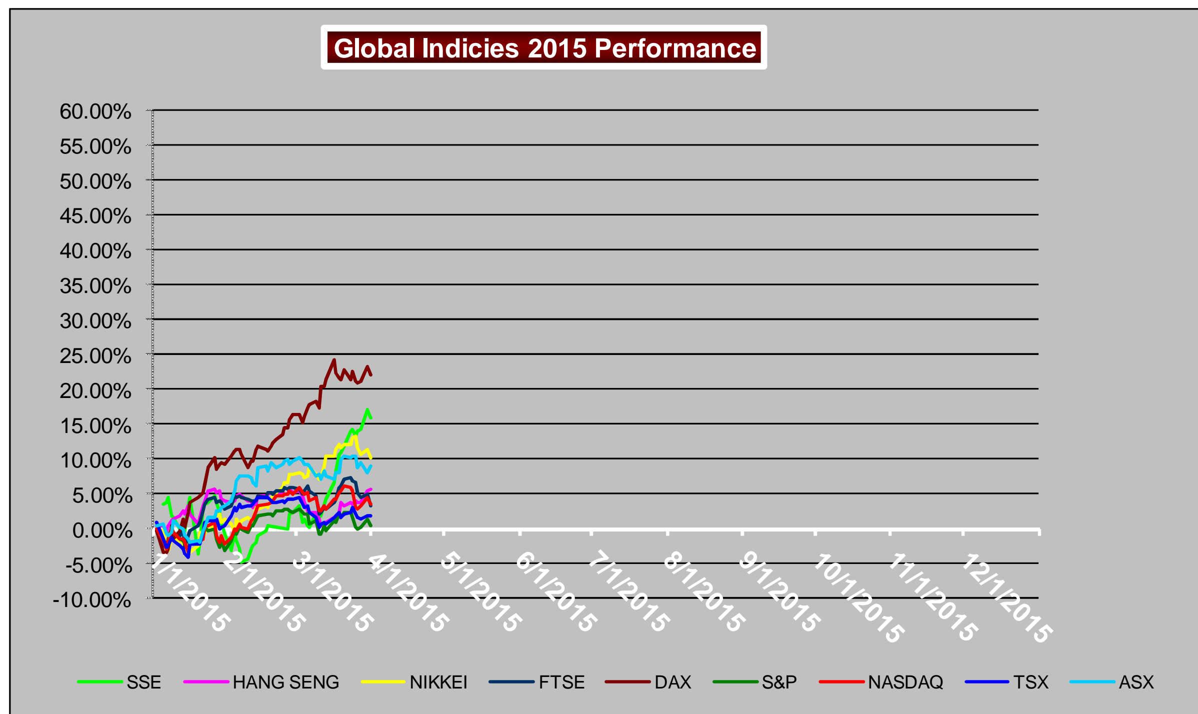
# GDB April 2015 Newsletter

## Monthly Market Summary:

| 2015 March Market Activity | | |
|---|---|---|
| SSE COMPOSITE | ***3,747.90*** | +437.60 (+13.22%) |
| HANG SENG | ***24,900.89*** | +77.60 (+0.31%) |
| NIKKEI 225 | ***19,206.99*** | +409.05 (+2.18%) |
| FTSE 100 | ***6,773.00*** | -173.70 (-2.50%) |
| DAX | ***11,966.17*** | +564.51 (+4.95%) |
| DOW | ***17,776,12*** | -356.58 (-1.97%) |
| S&P 500 | ***2,067.89*** | -36.61 (-1.74%) |
| NASDAQ COMPOSITE | ***4,900.88*** | -62.65 (-1.26%) |
| ASX 200 | ***5,891.50*** | -37.30 (-0.63%) |
| TSX COMPOSITE | ***14,902.40*** | -331.90 (-2.18%) |



## Investment Themes:

In our Newsletter in August 2014, we highlighted the potential opportunities in the Chinese equity market fueled by the liquidity injection from the launch of the Hong Kong – Shanghai Stock Connect project. Since then, the SSE Composite Index has almost doubled in value from 2,235.51 on September 1 to 4,393.69 on April 24. Back then, the Shanghai A-shares had a valuation of 10x P/E, the lowest of all major global markets. Today, the average P/E has soared to 22x.

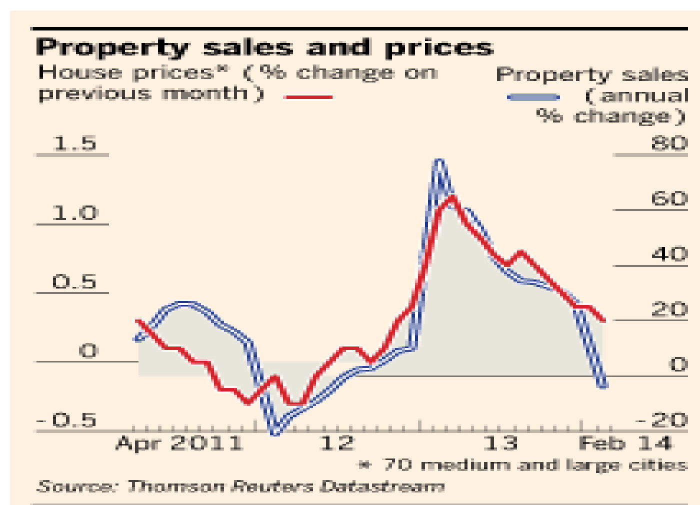
So is the Chinese stock market rising too much too quickly? We would caution it is. Is there an opportunity to bet against the current sentiment? No. Well, at least not indiscriminately.

China is a very unique market compared to other developed markets. The government still has a firm grip on the capital flows within the second largest economy in the world. The combination of a cooling property market, POBC's efforts to stimulate the slowing economy, and the limited investment options for domestic investors are channeling a liquidity tsunami into the domestic stock market. Throw out all traditional models that are used to provide rationale to the market. The Chinese stock market is now riding on momentum and herd mentality (evident also in the surge in daily trading volume observed in the chart above). As long as the government maintains its support for the rally and keeps borrowing costs low, the capital will flow into equities and continue to prop up Mainland stocks. And from the looks of it, China will need a strong stock market to replace the much relied upon credit market to drive expansion in the future, especially when the nation is burdened with a mountain of debt and hopes to transition to a more consumer driven

economy, away from investment in fixed assets such as properties and infrastructures.

While the Chinese stock market has been surging relentlessly, the Chinese economy seems to deviate in the other direction. Chinese GDP in the first quarter came in at 7%, the worst since the last financial crisis. Other recent economic pulses from export figures, to industrial production, to retail sales, to capital flows were all weaker than expected. The data seem to support that the slow down in China's is real, and it is further confirmed by the actions from the country's central bank. The PBOC has opted to cut the reserve requirement ratio for all banks by 100 bps to 18.5% in April, the deepest single reduction since the depth of the global financial crisis in 2008. And this comes after two rounds of interest rate cuts since November in a bid to spur lending.

What goes up must come down. Eventually, the disconnect between the stock market and the economic fundamentals will converge. As the central government tries to rebalance economic activities from property developments to consumer spending, an obvious investment strategy would be to shed exposures to Chinese property developers. Chinese property developers are facing a perfect storm. From the demand side, both domestic property sales and prices have been declining month over month in its 70 largest cities. But focusing the data on the big cities may not show the whole picture. The outlook is more abysmal in smaller cities where the markets are oversupplied. According to Nomura, the smaller cities actually account for as much as two-thirds of China's property under construction. This is where sales plunge is hurting property developers large or small.



Not only are the Chinese property developers feeling the pressure from softening sales, the sector may also be facing a credit crunch. On April 20, Kaisa Group became the first Chinese property developer to default on its dollar denominated debt, missing an interest payment of $52 million dollars. Other developer such as Glorious Property Holdings Ltd. is expected to follow suite in the coming months. The Chinese home builders have borrowed heavily in the offshore bond market, and with generous funding costs. Since 2010, foreign inventors have poured $78.8 billion into the offshore bond and equity markets to finance Chinese property developers, making this sector the largest issuer of non-financial dollar bonds sold by companies across Asia ex-Japan. The default by Kaisa will raise alarm on the financial health of companies in this sector. Once doubts start to set in, investors may withdraw liquidity. If everyone starts to exit, then contagion takes place. It may quickly spread to the entire sector and beyond. Timing is also not favorable for the Chinese homebuilders. The property developers are restricted in their means to refinance onshore as domestic banks have cut back lending and government's attempt to crack down on shadow banking have choked off alternative lending channels.

The shadow casted by Chinese developer's offshore bond troubles have been so far masqueraded by the overall bullish sentiment in the Chinese stock market. YTD, the SSE Real Estate Index is up 25.19%, near its 52 week high.

While we are not ready to bet against the white hot Chinese stock market overall, the opportunity to establish a position against the Chinese real estate companies may present itself as an opportune trade. To

hedge against the probability of this trade going against us, we could hedge with a long position in the overall Chinese index.