

20 July 2020

China Market Strategy

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The Chinese market surge came to a screeching halt last week, with a one-day plunge of almost 5%. The market run-up was clearly overdone, as shown by the rapid gain compressed into slightly over two weeks. We had warned of the impending correction in our report titled *“Running with the Bull”* last week, while suggesting the secular uptrend has been formed after the historic turning point in April (*“Strong Man of Asia: Markets at a Historic Pivot”* on 2020.04.20). Our market indicators were flashing red last weekend, portending a correction.

The recent surge is reminiscent of the bubble in 2015 in many ways. For one, the market turnover ratio, a measure of how fast stocks are changing hands, soared to a very elevated level that historically suggested significant resistance level (**Figure 1**). Very high turnover ratio in the Hong Kong market also confirms the speculative fervor in the A-share and Hong Kong markets (**Figure 2**). But we note that turnover ratio is a very noisy indicator. One should not take a short surge of turnover ratio as a sign of market top, even though an extreme turnover ratio was one of the key pieces of evidence that we identified the bubble peak on 16 June 2015 (please refer to our report titled *“The Great China Bubble: Lessons from 800 Years of History”*).

A brief period of very high turnover ratio can be a sign of early-stage bull market as well, as it was in early 2006 and in late 2014. At the initial stage of a bull market, expectations will be re-shaped and shares will be handed over from weak hands to strong ones. While such shifts mean near-term resistance, they are setting the initial stage for a bull market.

An uptrend is defined by rising lows. While it has probably been forgotten, but the market arrived at its secular inflection point in early January 2019, when the Shanghai Composite reached its cycle-low of 2,445. We had forecasted this inflection point in our report titled *“Outlook 2019: Turning a Corner”* on 2018.11.19. Turnover ratio was very high in February 2019, but major indices are all higher since then. The Shanghai Composite is up slightly, but the Shenzhen Composite is up more than 70%, the CSI500 small-cap index 50%, and the ChiNext has more than doubled – all despite ongoing and escalating rivalry between China and the US. It would have been a wrong call if one identifies February as the top of the market because of very high turnover ratio then.

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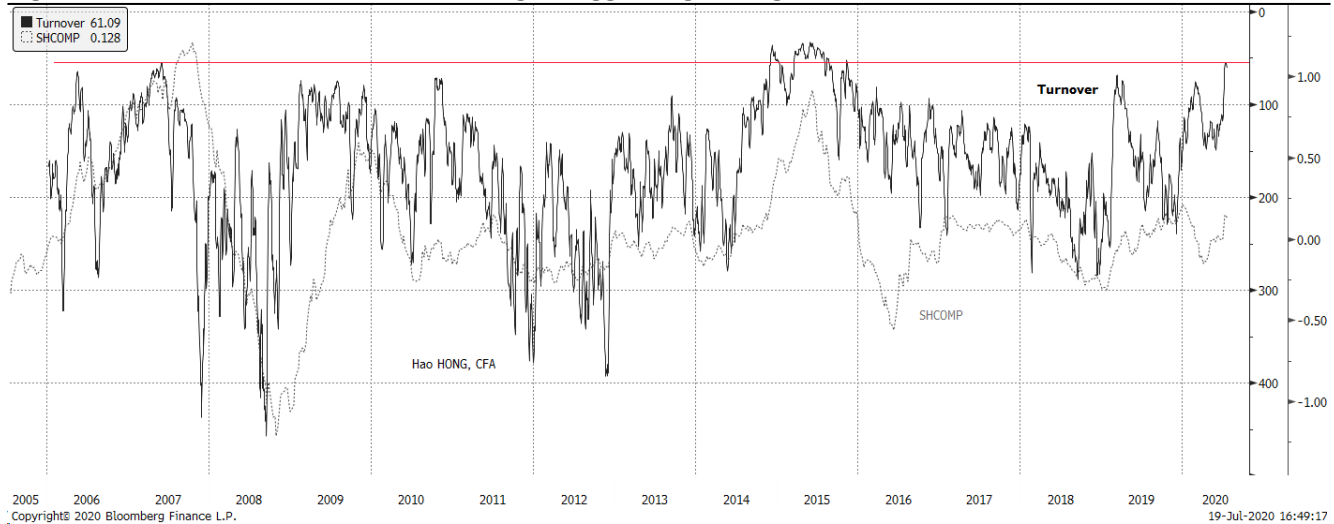
Head of Research

As northbound flows via the connect program retreat, and regulator’s attitude towards margin trades tightens, we are faced with the question of where the additional liquidity will come from to support the market. In my report titled “Market Top: When and Where” on 2013.03.25, I calculated the ratio of free-float market cap of the Shanghai Composite to China’s M2 money supply. My conclusion then was that, whenever this ratio reached 15%, the Shanghai Composite peaked, as Chinese investors would not persistently allocate more than 15% of their liquidity (M2) to stocks. And the composite indeed peaked, and plunged as China suffered its worst-ever liquidity crisis when SHIBOR overnight rate surged to 14%, its highest ever (“*Auguries of Turbulence*” 2013.06.10).

Seven years later, I re-visited this measure, and found that it has lost its sagacity. Indeed, China’s market cap to M2 has been trending lower, in line with the ratio of market cap to GDP that is not far from its historical lows (Figure 3). As M2 expands in tandem with GDP growth, such correlation should not be surprising. It is a sign that China’s market is cheap, and more liquidity can be allocated to stocks when necessary.

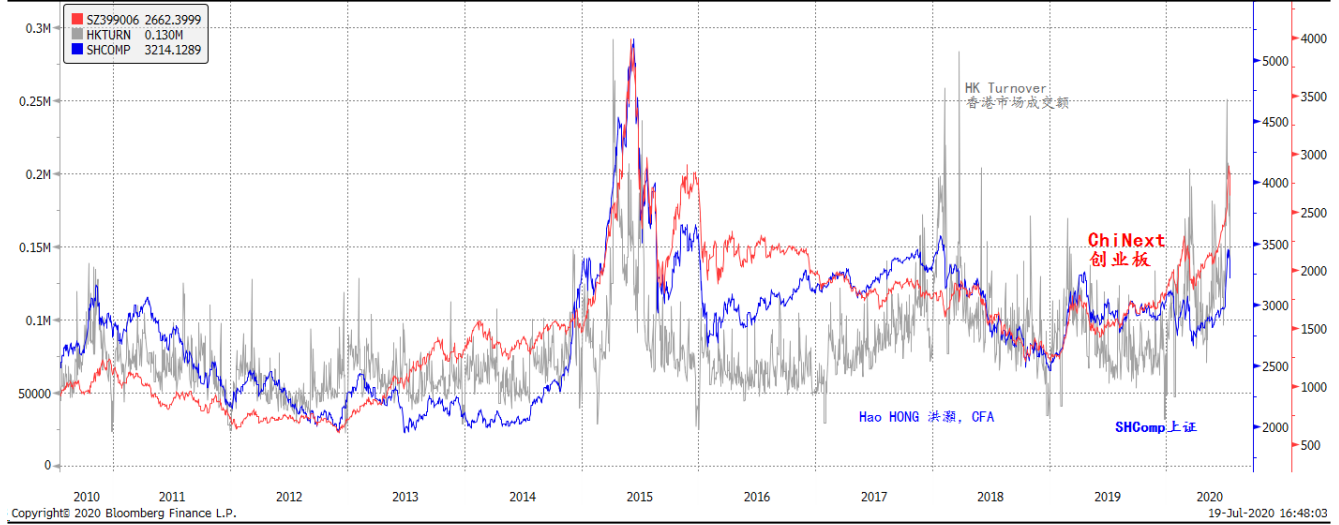
We forecasted the trading range of SHCOMP in the next 12 months to be 2,500-3,500, with 2,700-3,200 being the most likely range (“*Outlook 2020: Going the Distance*” 2019.11.11). SHCOMP’s actual trading range since our forecast has been 2,646–3,456, with being under 2,646-3,200 for around eight months. For now, 3,500 remains a near-term resistance, as expectation needs to be re-shaped, and weak hands need to be cleaned.

Figure 1: Market turnover ratio is too high, suggesting strong resistance



Source: Bloomberg, BOCOM Int'l

Figure 2: HK market turnover ratio is also very fast, suggesting a speculative fervor



Source: Bloomberg, BOCOM Int'l

Figure 3: China's market cap/GDP is low, suggesting cheap market valuation



Source: Bloomberg, BOCOM Int'l

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Broad market benchmark for Hong Kong is the **Hang Seng Composite Index**, for China A-shares is the **MSCI China A Index**, for US-listed Chinese companies is **S&P US Listed China 50 (USD) Index**.

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