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# China Market Strategy

## The Historic ChiNext Reform: What It Means and How to Trade

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The ChiNext Board, also known as China's NASDAQ, will launch a historic reform on Monday. The IPOs on the ChiNext board will be registration-based, and the daily price change limit will be expanded from 10% to 20% each way. The STAR board had a similar reform last year, and it was a resounding success. Emboldened by this successful precedent, though on a limited scale, the ChiNext is ready to pounce. Already, 20-billion-yuan's worth of IPOs are coming online next week. As the rivalry between China and the US in the technology sector is escalating, China needs this reform to be successful. After all, technological leadership will require funding – and a lot of it.

But concerns about how the ChiNext, as well as the overall market, would react to this reform on the first day, have been rife. Historically, all changes to trading rules had led to a surge in the near-term market volatility. For instance, the change to impose the current 10% limit on daily price change in December 1996 was met with a significant market plunge on the launch day. Given the significance of this reform for China in the global milieu, emotions are understandably stirred.

On the eve of this historic reform, I conducted an online survey on my popular and real-name verified Weibo to gauge market sentiment. The results showed that the market was split, and no conclusion could be drawn. However, given ChiNext's strong performance since early 2019 and comparing that with the split survey, we can see the market is treading with caution, in contrast to the earlier trading fervor.

We believe the market should not be overly fixated on the first-day performance and use it to judge the success of the reform. China's reform is accelerating. The purpose of such reform is to let the market set the price so as to allocate resources more efficiently. The ultimate success of such reform will unlikely to be felt immediately. For instance, when the reform of the STAR board was launched last year, I recommended it against a sea of opposing voices stemming from the board's then expensive valuation. Yet, the STAR board has turned out to be one of the best investments a year later.

Not surprisingly, the ChiNext is driven by liquidity. The PBoC has loosened monetary policy since COVID-19, as seen by falling market repo rates (**Figure 1**). Abundant liquidity has driven up the ChiNext's P/E valuation to about 70 times – essentially the same level as in July 2015 after the bubble burst. After that, an extended downtrend ensued till 2019. At such an elevated valuation level, the ChiNext has ceased to be a price discovery mechanism, and indeed resembles a venue for speculation. If so, a successful market reform is indeed to have the overall valuation corrected to a lower level more in line with the economic fundamentals. That is, instead of rising share prices, falling share prices and valuation should be the evidence of reform's success – quite the contrary to "common sense".

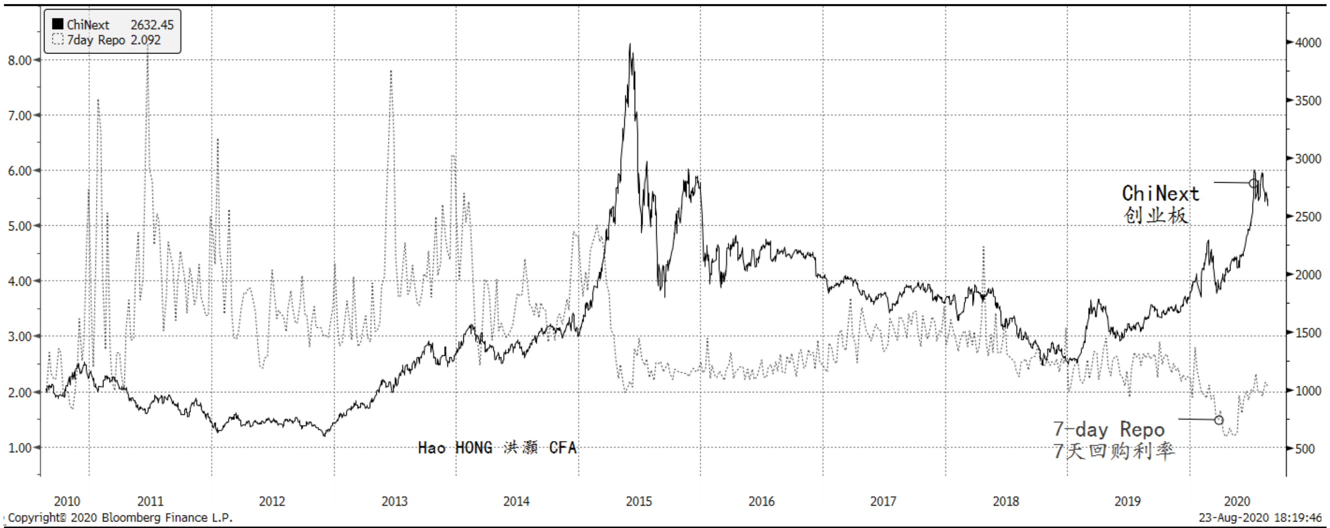
That said, as we have aforementioned, the ChiNext reform will be a significant part in China's grand scheme of technological rivalry with the US. Given that consensus is obsessed with the initial performance as the measure of reform success, a bad first day will not be welcome – even if such obsession is illogical. As such, the "visible hand" will likely intervene, should the situation require. But in an expensive market, how will the "visible hand" do it without distorting the market much further to defeat the original intent of the market reform?

Our quantitative analysis shows that, while the overall valuation of the ChiNext is expensive, the valuation difference between its most expensive and the cheapest stocks is even more glaring. Indeed, this valuation gap has surged to its historical extreme (**Figure 2**). Meanwhile, the median valuation of the index is indeed at its historical average (**Figure 3**). Further, we note that the market value of the most expensive stocks is about one quarter of the overall index market capitalization. In short, there is room for the visible hand to buy the stocks of lower valuation to support the index, should the situation turn out to be undesirable.

In sum, the ChiNext is expensive, and is no longer a price-discovery mechanism but a venue for speculation. Meanwhile, the PBoC's monetary policy will continue to be supportive at the early stage of economic recovery. Amid liquidity, speculation will unlikely dissipate soon. As such, any market reform to set market prices efficiently should in principle adjust stock prices lower. And falling stock prices, instead of rising, should be the sign of whether such market reform is successful. That said, given that the ChiNext reform is a significant part of China's grand competition strategy with the US, conventional wisdom would want to see good initial performance as a boost of national confidence. Given the valuation disparity within the ChiNext, there is room for the "visible hand" to buy those stocks with lower valuation to support the broader index, should the situation require. And if the traders see this rationale, they will likely try to front run the visible hand.

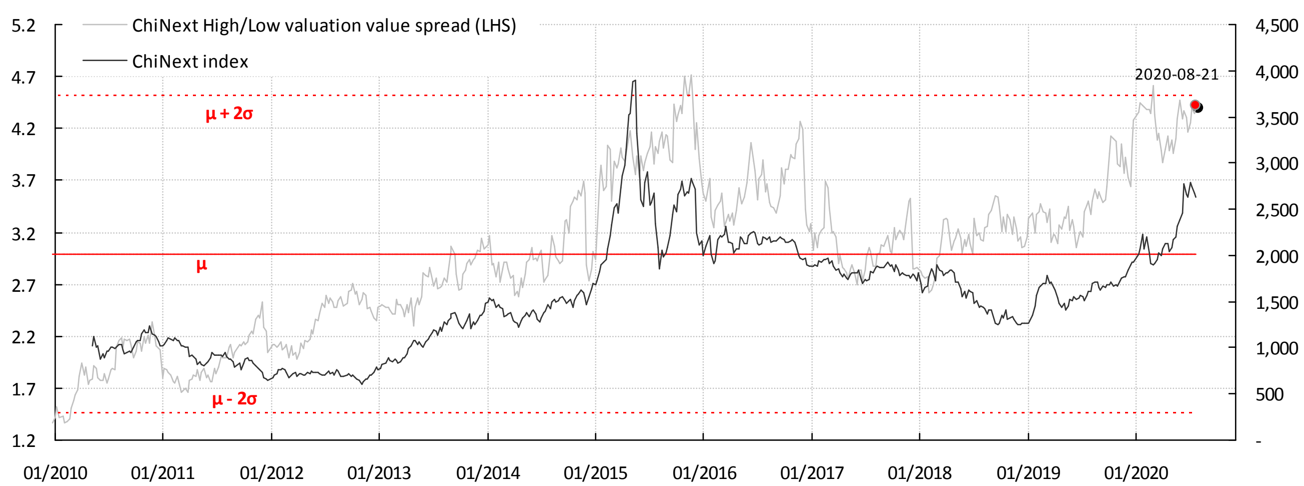
With such awkward logic and with the help from the visible hand, the ChiNext has a good chance to better expectations. And as the hand buys into stocks with lower valuation, the doctrine of value investing that we have been chanting about for some time may be better received by the market.

**Figure 1: ChiNext performance is driven by liquidity**




*Source: Bloomberg, BOCOM Int'l*

**Figure 2: Valuation spread between the most expensive and cheapest ChiNext stocks is at its highest**




*Source: FactSet, BOCOM Int'l*

**Figure 3: Overall, the median valuation of ChiNext stocks is at its historical average**


*Source: FactSet, BOCOM Int'l*

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