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Shanghai Drops 6%, JP Morgan: Bank of China Likely to Ease Further

The increased size of People Bank of China's reverse repo operation could signal that the central bank intends to prevent a spike in onshore interest rates.

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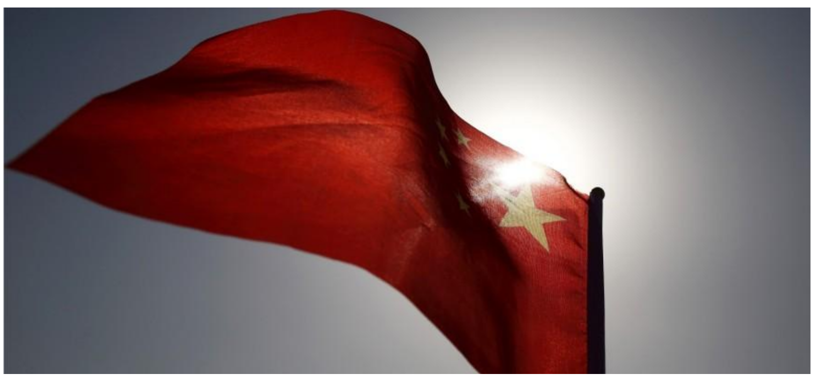

After the Shanghai Composite Index (SCI300) dropped over 6 percent in today's trading, the confidence in the governments various efforts to prop up the stock market is evaporating. Currently the SCI300 is trading lower by 35 per cent after the highs hit in early June, but this may not be the end.

The government has already committed $144 billion from state-owned banks to the market and it was just appearing to stabilize. Today's move could partly be the response to the announcement last Friday that the China Securities Finance Corp, which is a government-backed margin lender will stop its daily interventions into the margin lending market.

Exacerbating the problem, data released by the State Administration of Foreign Exchange (SAFE) has shown that the foreign currency purchases by banks surpassed purchases of the renminbi by $43bn last month, which provides additional rationale for the move of the People's Bank of China to devalue the local currency last week.

JPMorgan easing call

Analysts from JPMorgan have stated in a research note that the likelihood of further easing by the People's Bank of China (PBOC) in the coming months has increased. According to the bank's research team a cut in the reserve requirement ratio (RRR) or an interest rate cut could come as early as next month.

Rating agency Moody's has expressed in a note this morning that the Renminbi reform is credit negative for property developers. Speaking at the release of a new Moody's report on the Chinese property market, Associate Managing Director of the company Simon Wong, said, "we believe that the majority of our rated developers could withstand up to 10 percent depreciation in the Renminbi."

It is possible that other factors could counterbalance the effects of a Renminbi depreciation, including the potential for further declines in domestic interest rates and the ongoing opening up of the domestic bond market," Mr Wong added.

Government intervention explained

The property market data this morning came in better than expected with prices increasing for a third straight month at +0.2 percent, while the annual decline moderated to 3.7 percent. If there is any spillover effect into the real economy from the declining stock market, the property prices could trigger an exacerbated credit crunch.

Speaking to Finance Magnates reporters, the According Chief Investment Officer of First American Trust, Jerry Braakman, explained “Over the long term the valuations on the Shanghai market, the quality of earnings and the reliability of the results of the companies are concerning. Those types of concerns are going to remain in other emerging markets as well. As a result, increased volatility makes sense in the current environment.”

Looking at the Shanghai exchange its much more influenced by government intervention than some of the other Chinese markets. As emerging markets mature they start getting more transparent and the run-up in the Chinese market over the past year and a half was partly due to some substantial retail inflows.

The opening up of a new way to diversify savings for the Chinese population has led to the development of a typical boom and bust cycle where heard mentality instead of analysis of fundamentals led to the run higher on the Shanghai exchange. While the measures taken by the government to arrest the decline in local stocks have worked for a while, curbing insider selling, banning short selling, etc. are not sustainable ways to prop up the stock market.

“Looking at the IMF corruption index, there are a number of countries where financial reporting fraud is widespread. The problems are not isolated to China, but the global investor confidence in China is much less than in the U.S., Europe and Japan,” Mr Braakman said.

More regulation of market activity in China is to be expected. In the short term the insider selling and short selling bans and trading rules might curb speculative activity, but in the long run the market selloff may not make a big difference. The good news is that the average individual is not that heavily invested in the stock market and a downturn will have a more muted impact than in an economy like the U.S.

It is important to note, that the Chinese market is still much higher year-on-year. However some additional caution is advised according to Mr Braakman.

“If you loosen margin requirements like the Chinese government did, the risks are increasing. Using real estate as collateral to fund stock market trades can be dangerous,” he concluded.

Another round of volatility in China will likely result in more demand from clients to trade Chinese indices. While some companies have already taken steps to introduce some Chinese indices, a good proxy is the use of the more widely available Hong Kong Hang Seng index.