2020 vs 2014 -15: Four differences in China's market rally

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China's current market rally is taking place against a different macro, monetary and liquidity backdrop, compared to the bull market from late 2014 to 2015. At the same time, internal reforms and external pressures have increased China's resilience, accelerated structural changes and established new growth drivers. As the new China takes shape, more investment opportunities associated with China's new economy will emerge, rewarding active investors who are early to the game.

China's CSI 300 Index is up 10% year to date[1], outperforming regional and global peers. While the market's rally has received much attention, the recent strong performance of the securities companies has been particularly eye-catching, up 17% since the end of June[2]. For some investors, this brings memories of China's spectacular bull market in 2014, which was also accompanied by a sharp rise in the share prices of the securities companies. Since the bull market of 2014 came to a sudden stop in the summer of 2015, should investors treat the current rally with greater caution? We note four key differences between 2014's bull run and today's market rally.

Macro backdrop. China's economy grew at its slowest pace in 24 years in 2014, undershooting the government's target for the first time since 1998. In fact, it was the first time that the economy grew below 7.6% since 1990. With hindsight, 2014 probably signaled the start of the end of China's fast-paced growth path as it transitions towards a more sustainable economic model that is less dependent on fixed asset investments, lower-end manufacturing and credit expansion.

Today, China's economy has rebounded sharply (+3.2% yoy) in the second quarter of 2020, reversing its pandemic-induced contraction (-6.8% yoy) in the first quarter. Not only has the rebound exceeded consensus estimates (1.9% - Bloomberg survey and 2.9% - Wind survey), the economy is expected to recover further in the second half of 2020 as demand and activity normalises.

Monetary policy. To stimulate the economy, the People's Bank of China (PBoC) started cutting

Source: [1]As of 27 July 2020. In USD terms. Bloomberg. [2]As of 27 July 2020. In CNY terms. Wind.

interest rates from the end of 2014. In 1H2015, the central bank had cut interest rates and the reserve requirement ratio three times each. As risk free rates fell, risk appetite rose, and valuation multiples expanded. It was the first interest rate cut in late 2014 that marked the start of a new monetary easing cycle which triggered the rally in the securities companies' shares.

While China too began monetary easing in 2019, it was part of a much larger reform to liberalise interest rates. In August 2019, the PBoC established that new corporate loans had to be priced with reference to a revamped benchmark (Loan Prime Rate or LPR) that tracks the price of credit to banks' best customers. The LPR in turn was linked to the rate the PBoC charged lenders for cash over one year (Medium Lending Facility). By linking the market and official rates, the PBoC hoped to improve the transmission mechanism and lower the cost of borrowing. Not only was the mechanism and nature of monetary easing different between the two periods, the 2014 rally in securities companies' shares was triggered by the first rate cut while the current rally only picked up momentum recently, in the latter stages of China's monetary easing cycle.

Sources of liquidity. In 2014-15, new market inflows came mainly from margin financing, margin lending from online platforms and structured trusts with leverage facilities. In the current rally, guided by the lessons from the past, the Chinese regulators have exercised rigorous control on margin lending facilities. At the same time, we have observed strong inflows from the Stock Connect Scheme and institutional investors, suggesting that the fund flows into the China market this time around may be higher quality and "stickier".

Economic development. China has undergone significant economic transformation since 2015. In the last five years, it has enacted supply-side reforms, attempted financial deleveraging and navigated US-China tensions. These internal reforms and external pressures have increased China's resilience, accelerated structural changes and established new growth drivers. Amid the unprecedented challenges arising from Covid-19, China's new economy has marched ahead.

The uncertainty surrounding potential new waves of Covid-19 infections and persistent US-China tensions could cloud China's macro outlook and create market volatility in the near term. Over the long term however, even as China's economy continue to slow to a more sustainable growth trajectory, we believe that more investment opportunities associated with China's new economy will emerge. In addition, the top tier companies' ability to achieve steady growth even under an uncertain macro environment will become more prominent. Active investors who are able to identify both the emerging trends early in the game as well as quality companies with good fundamentals, are likely to be well rewarded.

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