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China Raises Red Flag on Its Stock Markets

Regulator warns investors not to borrow money or sell property to buy shares

By
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China's securities regulator issued its strongest warning yet about the country's soaring stock markets and tightened rules on margin lending while the country's two stock exchanges said they would make it easier to bet against stocks, spurring worries that the world's best-performing markets could tumble.

The announcements late Friday by the China Securities Regulatory Commission, the Shanghai and Shenzhen stock exchanges and two industry associations raised fears of a selloff in China, where the main market has now doubled in the past 12 months and the riskiest index is up 70% this year.

A selloff in China could affect markets around the world, analysts said. "If China is down 5% it's going to weigh on global sentiment," said David Welch, head of equity distribution at brokerage firm Reorient.

The CSRC warned small investors, who have been big drivers of the rally, not borrow money or sell property to buy stocks, ratcheting up its rhetoric about the market. Mainland investors opened stock-trading accounts at the fastest pace ever in the week ended April 10 and margin account balances stood at a record 1.16 trillion yuan ($190 billion) as of April 16, according to the Shanghai Stock Exchange.

The regulator banned a type of financing called umbrella trusts that provided cash for margin trading and placed limits on margin trading for highly risky small stocks that trade over the counter, rather than on exchanges.

The regulator said customer accounts needed to be better classified, potentially a warning that limits will be placed on the type of trading permitted for small investors.

The exchanges issued rules that would make it easier for investors to short, or bet against, stocks. To short a stock, an investor borrows shares and sells them, hoping the price will fall and so allow them to repay with cheaper shares. It has been difficult to short stocks in China even as valuations soared because it has been virtually impossible to borrow shares. The exchanges said they would push for an increase in the supply of shares available for lending and increase the number of stocks whose shares can be borrowed.

"Margin business has been growing rapidly but short-selling business has been developing slowly," a statement from the exchanges said.

The CSRC also said it was considering allowing more cash to flow between Hong Kong and Shanghai, where a trading link has been a big driver of the rally. The Wall Street Journal reported Wednesday that regulators are considering easing rules that have blocked small investors from mainland China from putting their cash in the Hong Kong stock market. The easing could include expanding and eventually scrapping the investment quota.

Currently, mainland investors need to have 500,000 yuan (about $80,000) in a securities account to qualify for the linked trading program. Allowing small investors to buy stocks in the different markets could boost shares.

Even before the regulators stepped in, investors had begun to sell the riskiest Chinese stocks and were shifting their cash to more established, state-owned shares that would benefit from the expected boost in economic stimulus.

The Shanghai Composite Index, home to China's biggest stocks, has surged 6.3% this week and more than 14% this month, on track for its best monthly performance since December. After years of listless trading, it has doubled over the past 12 months.

By contrast, the small-company-rich Chinext Price Index—up 73% for the year when the week began—suffered its first weekly loss since January, dropping 3.5%. Among its components are startups listed on the Shenzhen stock market.

And in Hong Kong, the Hang Seng Index, which gained nearly 8% last week as excitement rose over a flood of mainland cash, slowed to a 1.4% rise this week.

The latest Shanghai gains are fueled by value-seeking fund managers, yanking cash out of smaller companies whose prices they judge frothy in favor of larger companies that have been out of favor. The 50 largest Shanghai listed companies are trading at 15 times earnings, compared with a record 50 times earnings for the CSI Smallcap 500 Index, Reorient Group says.

"The rotation started this month but you're seeing it accelerate this week," said David Welch, head of equity distribution at Reorient. "People are looking for laggards, particularly the guys who have missed the rally."

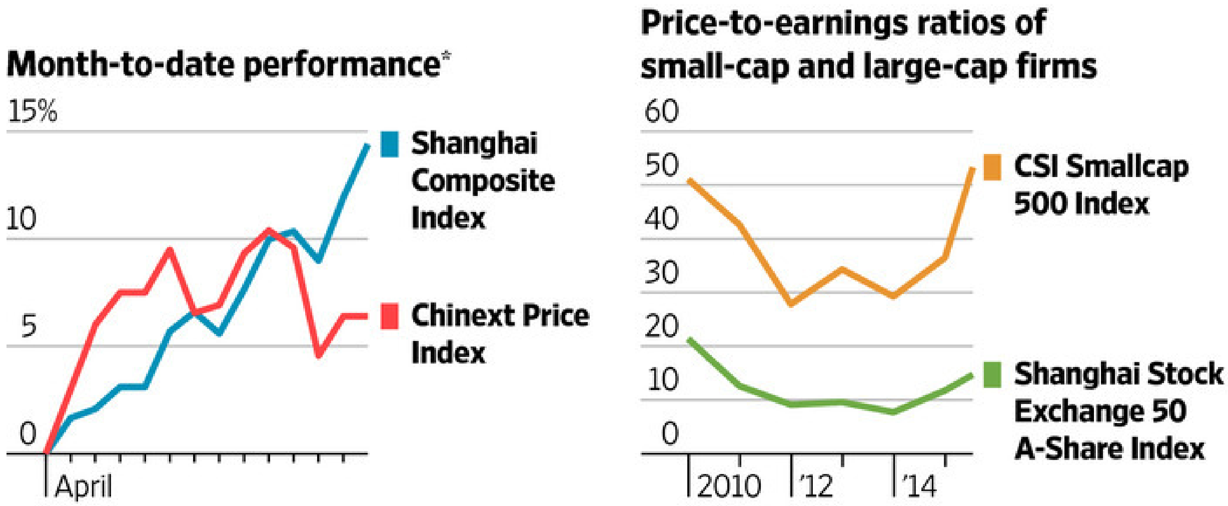
Though up 33% for the year, the ride hasn't necessarily been smooth for the Shanghai Composite. After rallying 53% last year it had a flat January before resuming its climb. Now the launch this week of two new stock-index futures—based on the Shanghai Stock Exchange 50 A-Share Index and the CSI Smallcap 500—helped investors add positions in large caps while shorting small caps for the first time, analysts say.

That was a boost for Shanghai, where the 50 largest companies make up about half the market capitalization. On Thursday, when the new futures contracts started trading, the benchmark index jumped 2.7%, its largest one-day percentage gain since late January; Friday it added more than 2.2% to finish at 4287.30.

Mainland buying of Hong Kong stocks via the Shanghai trading link fell this week, but global investors appear to be jumping on the bandwagon, encouraged by with Hong Kong stocks' having hit a seven-year high last week. In the week ending Wednesday, foreign investors bought Chinese stocks for the first time in nine weeks, according to ANZ Research, which put the inflows to funds at $1.39 billion.

Shanghai Pickup

Investors are growing nervous about how expensive small-cap Chinese firms have gotten, and are rushing to the goliaths in Shanghai instead.



*Includes only trading days

Sources: FactSet (performance); Reorient Group (ratios)

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Still, Chinese businesses listed both in Hong Kong and on the mainland—many of them large state-owned companies—are 30% cheaper, according to FactSet.

"Low valued blue-chips are still appealing," wrote UBS in a note Thursday. "With more than 1,200 A-share companies recording over a 50% YTD share-price rise, mainland hedge funds and high-net-worth individuals do not appear to be concerned about chasing the recent Hong Kong small-cap rally."

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