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MONDRIAN INVESTMENT PARTNERS LIMITED

The National Team and Co.: China's ¥53 Trillion Experiment

September 2020

"Fostering a "healthy" bull market after the pandemic is now more important to the economy than ever."
China Securities Journal, 6 July 2020

China's authorities manage its stock markets to serve 3 key objectives: 1) Prestige, 2) Support of its middle class wealth and 3) Attracting hard currency inflows. This year and in previous recent crises, a tight team of state or state-controlled actors (the "National Team and Co.") have been used to achieve these goals through:

- Orchestrated buying of Chinese equities
- Media signalling to support the market (control sentiment)
- Controlling margin financing, short selling and rates to support markets

While the authorities are learning from their mistakes, bubbles have emerged, policy errors have been common and moral hazard has crept into Chinese equity markets, affecting the valuations of, mainly, widely held large/mega cap stocks. While we believe China will continue to follow an upward trending "saw-toothed" growth path moving forward, we note that market intervention almost always ends in tears…

"China will continue to follow a "saw-toothed" growth path...but market intervention could cause potentially large short-term market shocks"

Despite being the centre of the Coronavirus pandemic, as of 31 July 2020 the Chinese stock market was up +16% (MSCI China All Share) year to date. In comparison emerging market equities were down -2% over the same time period (MSCI Emerging Markets). On 6 July 2020, supportive signals from Chinese state media led to a sharp increase in the level of the stock market. Similar signals were used in 2014, right before the 2015 Chinese stock market crash.

Since 2015 state or state-controlled actors have used many interventions to try and prop up the stock market. Generally, the more interventions the authorities have made, the more errors have occurred. Errors were made in 2015 and 2018 when trying to stabilise the market. It seems that fewer interventions were used in February 2020 in the midst of the Coronavirus pandemic. Perhaps the Chinese authorities have become better at stabilising the stock market by learning from past mistakes, or perhaps fewer interventions were needed this time around. In any case, we believe moral hazard has crept into the system over the past few years, and by promoting more risk-taking, the risk of bubbles and subsequent crashes greatly increases.

While China will continue to follow a "saw-toothed" growth path over the long-term, we believe market intervention will cause potentially large short-term stock market shocks. As Chinese mainland stock prices are currently exposed to downward adjustments in USD terms, we argue that a measured, cautious approach to investing in China is therefore warranted now more than ever.

In this piece we identify the motivations driving China's stock market intervention and describe the successes and failures of past interventions. We illustrate the numerous levers of intervention available to the Chinese authorities, and describe how these levers and the National Team and Co., who ultimately implement market intervention, all fit together.

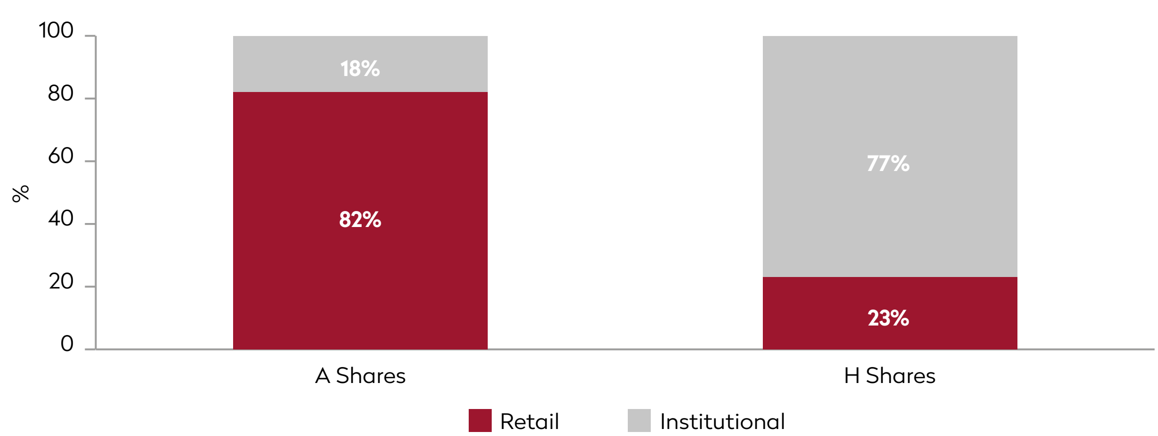
1. The Chinese Stock Market – Incentive to Intervene

The Chinese government underwrites "the compact" with the Chinese people which promises security, stability and steadily rising prosperity. Monetary repression in the Chinese banking system, mainly required to subsidise state owned enterprises (SOEs), has resulted in the stock market, property and shadow banking system becoming a vital store of wealth for a growing middle class. The expansion of the stock market value by 140% over the past 10 years has made stock investment portfolios attractive for private investors who now make up more than 80% of trading volume (see Exhibit 1). Although a success story of sorts, it also means that sell-offs in Chinese stock markets now directly impact "the compact" and give the authorities a strong incentive to manage the stock market. The key vehicle for intervention is known as the "National Team and Co.", which we will unpack later in this piece.

"...sell-offs in Chinese stock markets now directly impact "the compact"

More recently, China is opening its financial sector to more foreign investment. In October 2019, China's State Council, the top governing body, said the country would allow full foreign ownership in a few financial sectors by end-2020, giving another incentive to manage the stock market to attract more hard currency inflows.

Exhibit 1: Proportion of Retail to Institutional Investors – A Shares Vs H Shares Trading Volume



Source: Schroders, Wind and HK Stock Exchange, 18 September 2019.

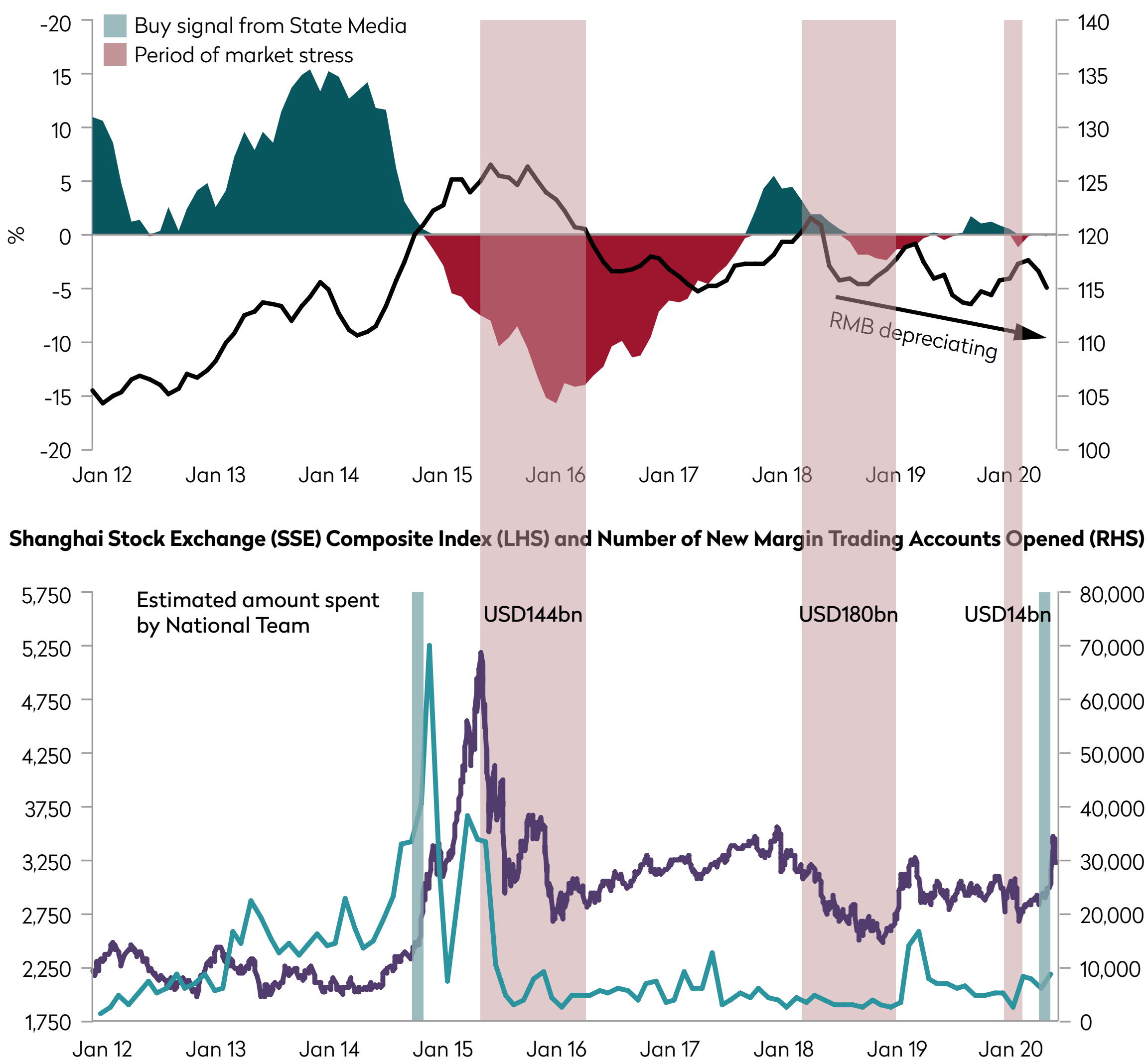
2. Past Interventions – Motivations and Impact

Interventions are typically used in periods of economic weakness, most notably in 2014/2015 (China stock market bubble and subsequent crash), 2018 (US-China trade war) and in 2020 (Coronavirus pandemic). Several effects tend to be evident in these periods: changes in China's FX reserves (see top panel of Exhibit 2), depreciation of the renminbi, changes in the number of margin accounts being opened (see lower panel of Exhibit 2) and the engagement of the authorities to manage markets.

Intervention can be as simple as signalling actions by the authorities. In July 2020, a front-page editorial in the state-owned China Securities Journal was credited with fuelling a strong rally in Chinese markets. Shanghai stocks jumped +6% on Monday 6 July, after the publication suggested investors should look forward to the "wealth effect of the capital markets" and the prospect for a "healthy bull market." Exhibit 2, bottom panel, shows the Shanghai Stock Exchange (SSE) Composite Index price jump right after the announcement. A similar announcement in September 2014 (see first green bar in Exhibit 2, bottom panel) is attributed to starting a margin-fuelled bubble ending in 2015's crash. (It is notable that in 2020 margin trading account openings have remained muted).

Exhibit 2: Chinese Forex Reserves and Exchange Rate (Top Panel), SSE Composite Index and New Margin Trading Accounts Opened (Bottom Panel)

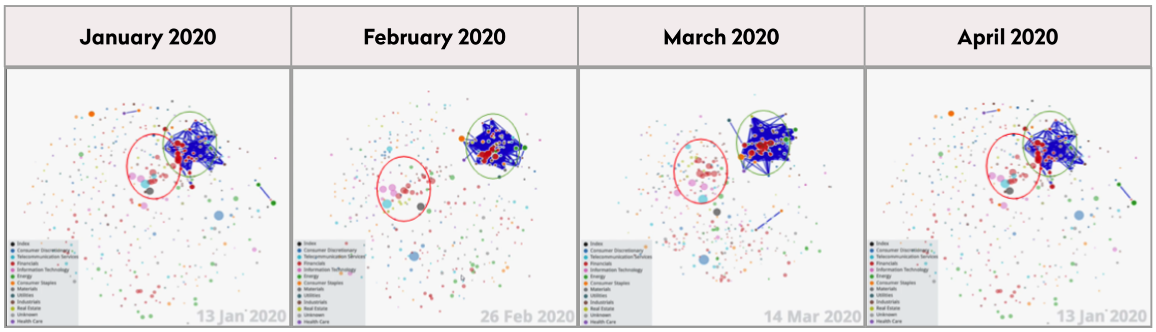
Change in Chinese FX Reserves (YoY) (LHS) and RMB Broad Effective Exchange Rate (RHS)



Sources: China State Administration of Foreign Exchange, Bank of International Settlements, FactSet, China Securities Finance Corporation Limited, Deutsche Bank, Goldman Sachs, Rothko Investment Strategies.

Also in 2020, A-shares and H-shares correlations speak to very different investor behaviour, either directly or indirectly influenced by state intervention. Exhibit 3 illustrates this, with A-shares shown in the green circle and H-shares within the red circle. In January 2020, the green and red circles were in close proximity, implying a high correlation between the two groups of shares. From February 2020 they step apart, implying a change in the behaviour of A versus H shares, before reverting back by the end of April 2020.

Exhibit 3: Correlations Between A Shares and H Shares from January to April 2020



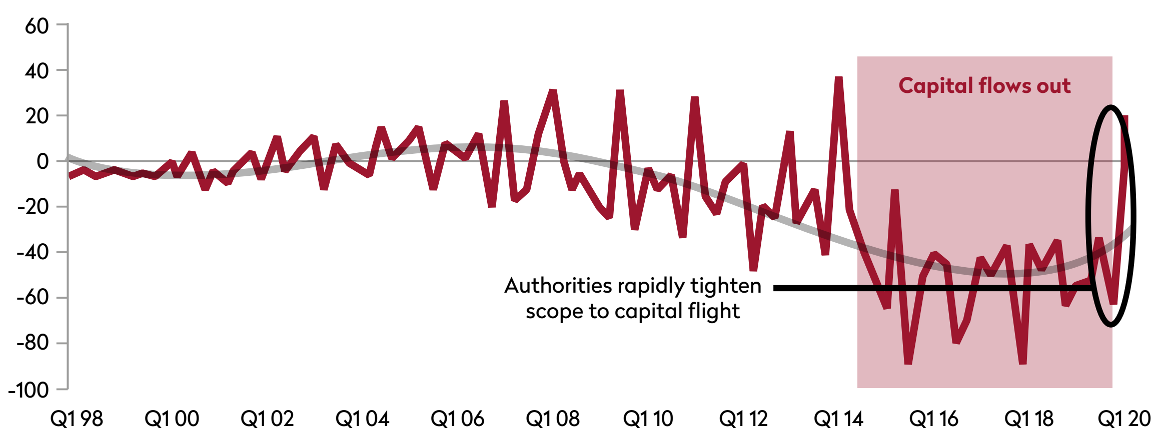
Sources: Scaridae, FactSet, Rothko Investment Strategies.

Much of the impact on correlations (Exhibit 3) and FX reserves (Exhibit 2) is driven by one of the most powerful levers of all: China's capital account. The stock-connect system, a perforation in the capital barrier between China and the rest of the world, is still something of an aberration, and is therefore not a risk free proposition. China's capital account may appear impervious, but not, it would seem, if you know the right tricks. It has been posited by some that stealthy capital withdrawal from China can be proxied by a line item in the Chinese balance of payments accounts; the "Net errors and omissions". This tells an interesting story (see Exhibit 4) of capital flight from China between2014-2019 followed by the rapid tightening of capital controls in Q1 of this year. It seems the authorities have learned lessons from previous asset price sell offs. No chances were being taken with capital flows this year.

"...an interesting story of capital flight from China between 2014-2019 followed by the rapid tightening of capital controls in Q1 of this year"

Exhibit 4: Capital Flight by Stealth?

Quarterly China BOP Net Errors and Omissions



Source: SAFE, Rothko.

3. Methods of Management: The Chinese Authorities' Levers

There are 10 distinct levers the Chinese authorities have used to manage stock markets (see Exhibit 5). These have evolved as a trial and error approach since 2015. The authorities learnt some lessons from 2015 that they seem to have applied this year. Outright buying of securities has been kept to a minimum and only a few other interventions have been introduced such as limiting stock sales and limiting short selling. However, this may simply be down to fewer policy interventions being necessary.

Key intervention levels (see Exhibit 5):

I. **Cut policy rate and provide liquidity to China Securities Finance Corporation** – The first thing that the People's Bank of China (PBOC) did after the initial stock market crash in 2015 was to cut the policy rate by 0.25%. Likewise, in February 2020, the PBOC cut the policy rate by 0.1% to 4.15%. Subsequently in April 2020, it cut the policy rate to 3.85%. By cutting the policy rate, the PBOC can provide more liquidity support to the China Securities Finance Corporation (CSFC). The CSFC is one of the key players in the National Team tasked at buying securities, as we'll see below. Lowering the policy rate would also encourage more margin trading.

II. **Discourage "panic" selling** – Back in 2015 the Chinese state media (Xinhua) and the Asset Management Association of China (AMAC) told investors and fund managers to stay rational and not to panic. Similar media signals were in also used in February 2020.

III. **Loosen margin financing requirements** – Loosening the requirements for margin financing, or the practice of lending to retail investors, was an attempt to encourage margin trading during the sell-off in 2015. However, the number of new margin trading accounts fell steeply between July 2015 and January 2016 (see Exhibit 2, bottom panel).

IV. **Limit short selling and restrict futures trading** – In 2015, the Chinese authorities placed heavy restrictions on short selling to prevent the stock market from falling further. On top of this, the authorities started to investigate "malicious" short selling activities. In 2020, the China Securities Regulatory Commission (CSRC) provided window guidance to brokers telling them to limit stock sales and refrain from betting against the market. The China Financial Futures Exchange also placed restrictions on index futures trading in 2015.

V. **Outright buying of securities** – This is where the National Team and Co. comes in (more on this in the next section). These are institutions tasked with buying securities led by the China Securities Finance Corporation (CSFC). Among all the levers that China used to prevent further falls in the stock market in 2015 and 2018, this is the main lever that stabilised the equity market. The estimated amounts spent in each crisis are shown in Exhibit 2, bottom panel.

VI. **Regulation changes** – Equity holding limits for pension funds and insurance companies are increased to encourage buying of stocks. The China Insurance Regulatory Commission (CIRC) also urged insurers not to net sell equities and demanded daily reports on equity holdings in 2015. In addition, the CSRC can also demand brokers' proprietary trading to maintain net purchase on a daily basis and allow brokers to exceed their risk limits.

VII. **Change friction costs** – Encourage or discourage market participation. For example, the China Securities Depository and Clearing Company Ltd reduced fees to encourage more market participants in 2015. On the other hand, also in 2015, the Shanghai Stock Exchange (SHEX) and Shenzhen Stock Exchange (SZEX) significantly raised commission to discourage program trading because the Chinese authorities deemed that high frequency trading was causing the wild swings in the level of the stock market.

VIII. **Encourage buying** – As described above, the state media plays a pivotal role in encouraging the local investors to buy stocks. This is evidenced in July 2020 where a state media publication said investors should look forward to the "wealth effect of the capital markets" and the prospect for a "healthy bull market." Similar publications in September 2014 also encouraged investors to buy stocks leading to the 2015 bubble.

IX. Take direct control over financial institutions – To exert more control over financial institutions, the National Team and Co. can take direct control of financial companies. In July 2020, the China Banking and Insurance Regulatory Commission and the China Securities Regulatory Commission seized control of nine insurers, trust companies and securities brokers; with a total of $143bn of assets under management. While stock market intervention is more easily managed when entities are directly controlled by the state, it comes with the absorption of liabilities onto the sovereign balance sheet.

X. Capital account – The control of capital flows underpin all asset pricing in mainland China. 2020 has been a case in point, where withdrawals of capital from mainland China were made more difficult for individuals, if not companies.

Exhibit 5: The Interventions Used to Prop up the Stock Market

Chinese authorities' levers	Cut policy rate	Discourage 'panic' selling	Loosen margin financing requirements	Limit short selling and restrict futures trading	Outright buying of securities	Regulation changes – increase equity holding limits and prevent net selling	Change friction costs	Encourage buying	Take direct control over privately run financial institutions
Why?	Provide liquidty to the market	Prevent quick and large market falls	Make it easier for investors to get loans to trade shares	Prevent markets from falling further	Increase share prices to prop up the level of the stock markets	Allow institutional investors to hold more equities - increase demand for stocks	Reduce fees to encourage buying of shares and increase commission to prevent program trading	Prop up the level of the stock market	Exert direct control over financial companies
Who?	People's Bank of China	State media	Brokers	China Securities Regulatory Commission, China Financial Futures Exchange	The National Team, pension funds, insurance companies	State Council, China Banking and Insurance Regulatory Commission	China Securiies Depository and Clearing Co. Ltd	State media	China Banking and Insurance Regulatory Commission

4. The National Team and Co.

The "National Team" is a group of institutional investors, formed after 2015's correction. The team usually steps in to act as a market stabilizer when the stock market experiences a rapid and sharp correction or during politically-sensitive periods.

Since 2015, the National Team has stepped in two more times – in 2018 and more recently in 2020, in the midst of the Coronavirus pandemic.

Team Members

The 5 main members of the National Team follow:

I. China Securities Finance Corporation (CSFC) including mutual funds set up by the CSFC

II. Central Huijin Investment and Central Huijin Asset Management

III. Managed accounts entrusted with asset management companies

IV. Wholly-owned subsidiaries of the State Administration of the Foreign Exchange

V. Insurance companies

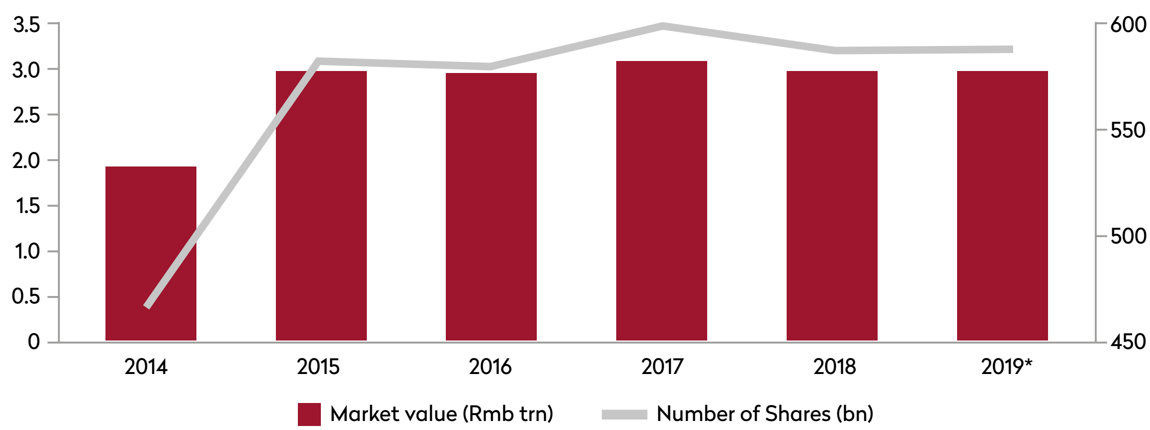
National Team – Score Sheet by Year

2015 — When the stock market fell in 2015 the 20 biggest onshore securities companies — many of them state-owned — were tapped to buy up stocks in an attempt to halt price falls. By some estimates, state financial institutions spent USD144bn, or just under half the war chest the team had at its disposal (*Goldman Sachs, August 2015*).

These securities, of about Rmb2.95 trillion, were subsequently transferred to China Securities Finance Corp, a state-owned margin lender, and Central Huijin, acting as a holding company for shares in state-owned financial institutions. They remained in place on these balance sheets as at the end of 2019, where the combined holding of these two team members was still Rmb3 trillion (see Exhibit 6).

Exhibit 6: National Team Stock Holdings

Stock Holdings of China's 'National Team' of State-Backed Buyers



*As at end of September

National team includes China Securites Finance Corp, Central Huijin, State Foreign Exchange Administration an separately managed accounts under CSF.

Sources: Wind, FT.

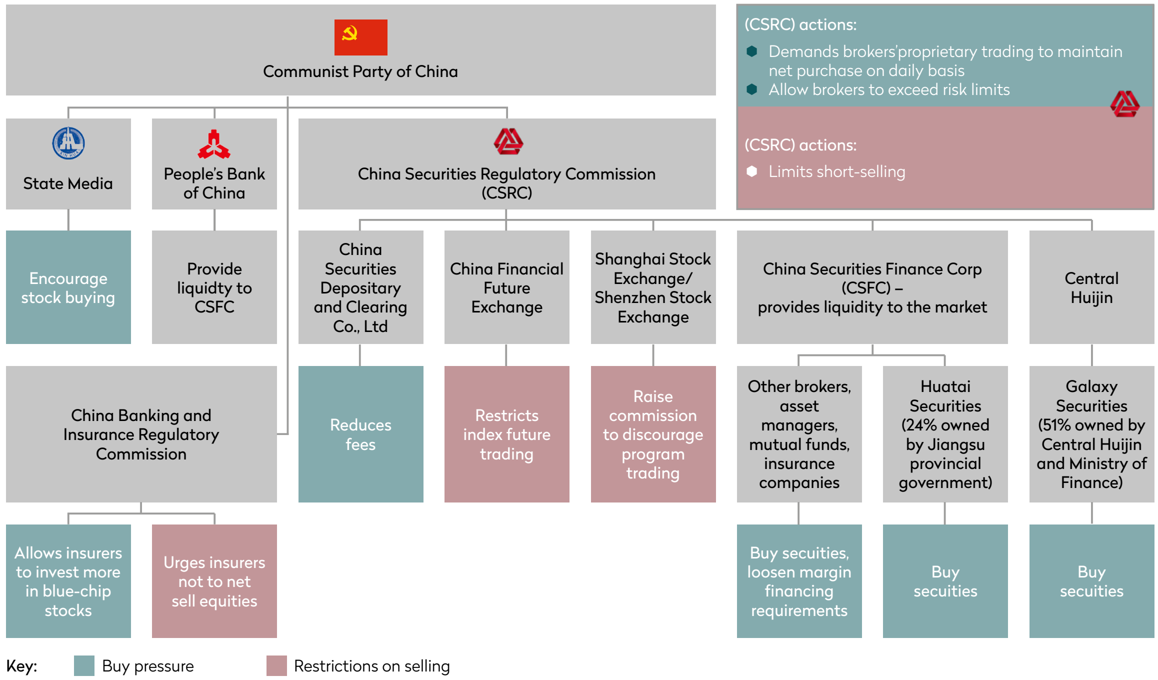
2018 — Amidst the US-China trade war, the National Team bought up holdings in more than 1,100 names that, valued at more than USD180 billion as of June 2018 (*Deutsche Bank*).

2020 — It was not until after market close on Monday 3 February 2020 that state media confirmed the cavalry was prepped and ready — specifically, a group of Chinese insurers with Rmb100bn (USD14.3 billion) ready to plough into the stock market.

5. The National Team and Co. – Connecting the Dots

The National Team is a loose collection of nominally commercial organisations and government departments all ending with the authority of the CCP. Exhibit 7 shows how these bodies fit together, although the actual function of the National Team has been ad-hoc and open to policy errors and mis-steps.

Exhibit 7: The Interventions and Players Responsible for Implementing Them



Market Intervention Almost Always Ends in Tears…"

The Chinese stock market will continue to be an important store of wealth for the people of China, particularly while monetary repression continues to limit alternatives. In this sense, the stock market is front and centre of the "social compact" between the CCP and the people of China and causes a strong motivation for the Chinese authorities to see an appreciating and trouble free stock market. This year and in previous crises, the National Team and Co. has intervened to support these ends.

What is clear is that the more the authorities tinker with the market, the greater the risk of bubbles and crashes becomes. While 2020 has seen a successful operation so far, this may simply be down to fewer policy interventions being necessary. This contrasts with the disastrous tinkering leading up to the 2015 and 2018 stock market routs.

Although China will continue to follow an upward trending "'saw-toothed" growth path in the longer term, market intervention almost always ends poorly in the medium-term. We believe that while Chinese mainland stock prices now have a CCP "put" in place, prices are exposed to downward adjustments in USD terms owing to policy errors in managing this put. To navigate Chinese mainland stocks, a discerning focus on attractive valuations, deep 'economic moats', resilient credit profiles, and high levels of shareholder value is paramount – now more than ever.

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Acknowledgements

Special thanks to Peter Simon (Scaridae) for the correlation swarm analysis shown in Exhibit 3.