China's Stock Markets

By: Jack Perkowski | May 27, 2010

Note to MTD Readers: The following summary overview of China's stock markets was prepared for one of the clients of JFP Holdings. I thought that our readers might also have an interest in the background information that was prepared.

Background

When economic reforms began in China in 1978, the Chinese government first reformed the agricultural economic system and then followed through with reforms in the industrial sector. In 1986, it began allowing some organizations to convert into share holding companies by issuing shares to employees and the public. In 1990, China facilitated the trading of shares by investors by establishing two stock exchanges, one in Shanghai and the other in Shenzhen.

Shanghai Stock Exchange

Established on November 26, 1990, the Shanghai Stock Exchange is China's largest Stock Exchange. Securities traded on the Shanghai Stock Exchange include A shares, B shares, Treasury bonds, corporate bonds, corporate convertible bonds and funds.

Initially, only Chinese investors could purchase A shares, which are priced in Renminbi. After the implementation of stock market reforms in December, 2002, however, certain foreign institutional investors have also been allowed to invest in A shares under the system of QFII (Qualified Foreign Institutional Investor).

Conversely, B shares, which are priced in United States dollars, were initially only meant to be purchased by foreign institutional investors. Chinese were not allowed to buy B shares because Chinese law at the time did not allow domestic investors to freely exchange renminbi into foreign currency. With the subsequent relaxation of these rules, however, domestic investors have also been allowed to invest in B shares since 2001.

The Shanghai Stock Exchange has 1,381 listed securities and 879 listed companies. Shanghai's market capitalization as of May 12, 2010 was RMB 15.2 trillion ($2.2 trillion), resulting in an average price/earnings ratio of 20.16 times. Of the market capitalization on May 12, B shares only accounted for RMB 70.4 billion ($10.4 billion), or less than one-half of one percent of the total. B shares also traded at a lower P/E ratio of 16.07 times on that date.

The most common index measuring the performance of the Shanghai Stock Exchange is the SSE Composite Index which was launched on July 15, 1991. The SSE Composite Index is made up of all stocks (A shares and B shares) listed on the Shanghai Stock Exchange. Other important indices used are the SSE 50 Index and SSE 180 Index.

The Base Day for the SSE Composite Index is December 19, 1990, and the Base Value is 100. The SSE Composite Index was 1,512 at the beginning of 2000, and then traded between 1,000 and 2,200 for the next five years. In June, 2005, the SSE Composite Index began a nearly six-fold increase, hitting an all time high of 5,818 in October 2007. The Index then began a steady decline through the balance of 2007 and into 2008, bottoming at 1,747 in November, 2008. The SSE Composite Index is currently trading at 2,673.

Shenzhen Stock Exchange

The Shenzhen Stock Exchange is headquartered in the city of Shenzhen in the south of China. The companies listed on this exchange are the ones in which the Government of China maintains a controlling stake. Prior to 2005, most (approximately two-third's) of the stocks listed on the Shenzhen Stock Exchange were not allowed to be traded. After stock reforms were implemented in 2005, however, investors were allowed to trade in these shares. There are currently 1,332 securities and 981 stocks listed on the Shenzhen Stock Exchange. On May 26, 2010, the market capitalization was RMB 5.9 trillion ($873 billion), and the average price/earnings ratio was 33.77 times.

ChiNext

Fully independent from the main board of the Shenzhen Stock Exchange, ChiNext, likened to NASDAQ in the United States, was launched on October 30, 2009 to provide capital to China's innovation driven, smaller companies. To date 86 companies have been listed. The total market capitalization of ChiNext listed shares on May 26, 2010 was RMB 366.5 billion ($53.8 billion), and the average price/earnings ratio was 63.7 times.

During the first six months of trading, the 86 companies listed on China's newest exchange have raised $8.5 billion of capital. However, trading has been erratic and valuations remain very high.

Comparison to The World's Top Ten Stock Market Exchanges

In 2009, Shanghai was the sixth largest stock exchange in the world, ranking just below the London Stock Exchange and just above the Hong Kong Exchanges.

Rationale For Higher Valuations in China

The price/earnings ratio for the S&P 500 is currently 17.84 times, below all three of China's stock exchanges. The strength of the China economy and the relatively faster growth of Chinese companies certainly account for part of the difference, but supply and demand for stocks in China is also a factor.

Although the rules governing the ability of Chinese citizens to exchange renminbi for foreign currencies have loosened in recent years, individuals are still limited in the amount of yuan they can convert each year. This restriction, combined with rapid wealth creation in the country, has resulted in a high level of demand for investments in China based assets. Property of all type has been one beneficiary of the imbalance between investment demand and the supply of investments, China's stock markets have been another. With larger and larger pools of capital chasing a relatively limited supply of listed securities, the stage is set for high stock market valuations on the country's stock exchanges.

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