Risk Review of the China A Share Market | March 2009

RESEARCH BULLETIN

Introduction

The China A share market has experienced tremendous volatility over the last three years. From the bull market rally that began in early 2006, it rose by over five times until its peak in October 2007. The correction since then has been equally sharp, with a drop back to 1.8 times its value at the start of the rally.[1] More recently, in January of this year, the A share market had shown signs of recovery, rebounding by 11.2 %, while the MSCI All Country World Index declined by 8.5%. Given the backdrop of this volatility, this research bulletin discusses some recent trends in Chinese equities through the lens of the Barra China Equity Model (CHE2).

Performance and Volatility

Figure 1 plots the MSCI China A Index and its cumulative return differential with the MSCI All Country World Index (MSCI ACWI). Chinese stocks had performed relatively well at the final stage of the bull market. The huge bull rally began around 2006 and ended in October 2007, but the return differential with the MSCI ACWI peaked three months later, in January 2008. There has been a noticeable pickup in the relative return since September 2008, during which the China A market has outperformed global equities. Furthermore, in January this year, there was a significant rally in the MSCI China A Index, in both absolute and relative terms.

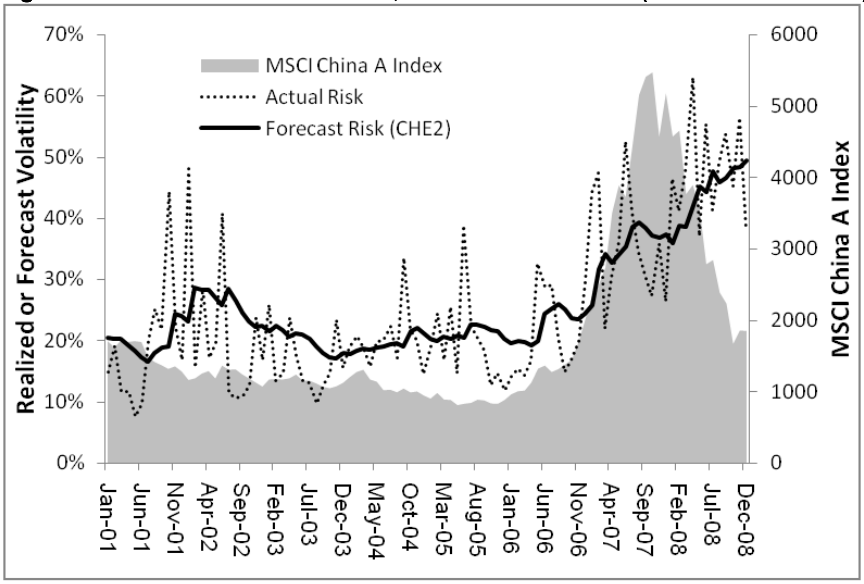
Figure 1: Performance of China A Market (Jan 2000 – Feb 2008)

Source: MSCI Barra.

Next, we consider the evolution in volatility over the recent period. The actual and forecast volatility levels of the MSCI China A Index are displayed in Figure 2, together with the index itself. Risk forecasts are computed using the Barra China Equity Model (CHE2). From 2004 to 2006, volatility rose gradually, although the market was still declining. The upward trend in both the actual and forecast volatilities has become much more apparent since the middle of 2006, when the bull rally in Chinese stocks started. This rise accelerated until stocks peaked in October 2007. Even after the market turned and the decline began in earnest, both forecast and actual volatility continued to climb.

[1] Based on the peak and trough values of the MSCI China A Index.

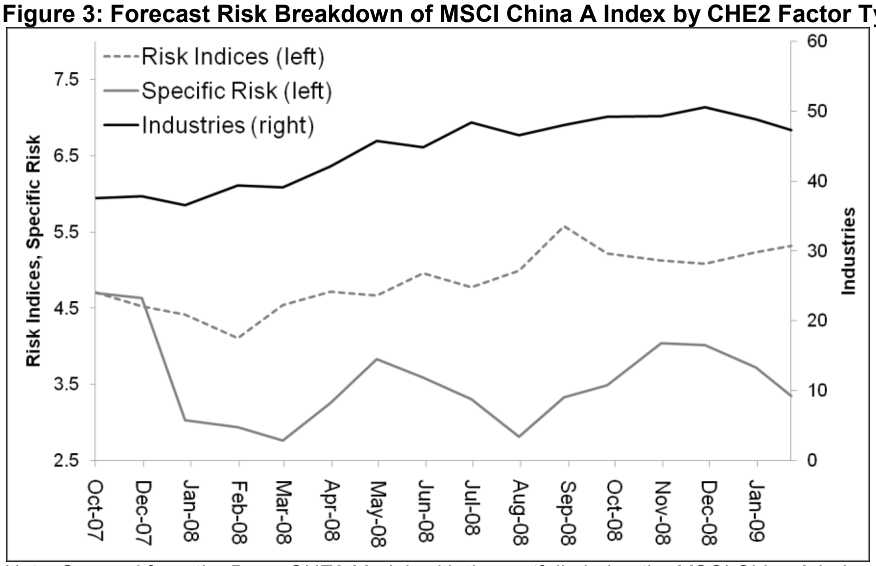
Figure 2: Forecast and Actual Risk, MSCI China A Index (Jan 2001-Dec 2008)



Note: Forecast risk was generated using the Barra CHE2 model, using data up to and including the preceding month. Actual risk is computed using actual daily returns within each month, and it is appropriately annualized and corrected for daily autocorrelation (up to five lags).

Next, we examine changes in the different factor types. Figure 3 shows the forecast risk levels for the MSCI China A Index by risk source — industries, risk indices (or style factors), and specific risk (or asset selection risk). From the start of the bear market in October 2007, total risk has remained dominated by industry factors, which are represented by the uppermost line, and their forecast volatility had been generally on the rise until the end of 2008. Specific risk has fallen significantly since the market went into decline from October 2007. Meanwhile, the forecast risk from risk indices has leveled off in the last quarter of 2008, after rising for most of the year. However, in 2009, risk indices were the only category that showed an increase in forecast risk, which demonstrates the importance of style factors in the rally that started in January this year.

Figure 3: Forecast Risk Breakdown of MSCI China A Index by CHE2 Factor Type



Note: Sourced from the Barra CHE2 Model, with the portfolio being the MSCI China A Index.

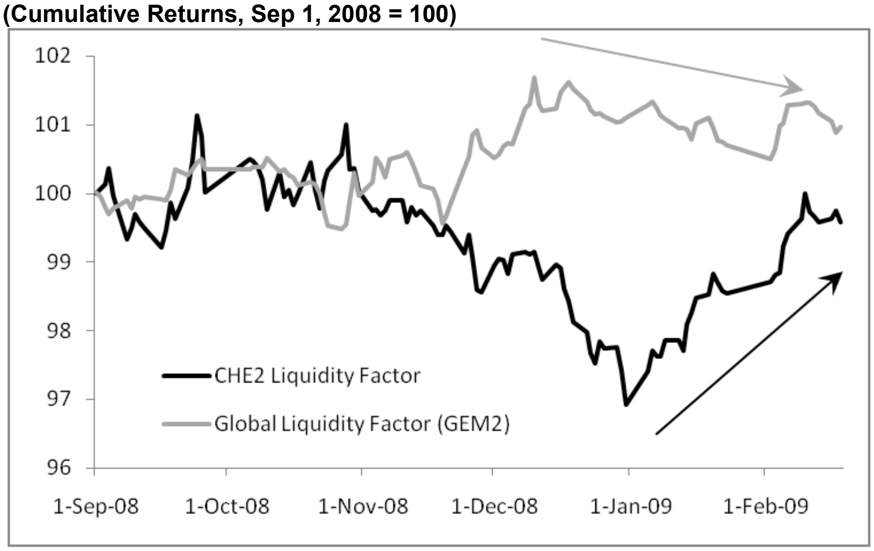
A Liquidity-Driven Rally?

Among the various style factors in the Barra CHE2 model, the best-performing this year is the Trading Activity factor. This factor differentiates between stocks based on their trading volume or liquidity, and its return reflects the relative performance of those stocks that are more actively traded. There are four descriptors used in computing the exposure to trading activity, including the beta of liquidity, as well as the mean turnover over the last 3 months, last 6 months, and last 12 months.

The cumulative return of the Trading Activity factor is shown in Figure 4. A significant rise in this factor since the turn of the year is apparent, indicating that liquid stocks performed better than their less liquid counterparts during this period. This liquidity rally seems to coincide with recent data released by the People's Bank of China, which indicated that China's money supply expanded at the fastest pace in more than a year as the government embarked on a 4 trillion yuan stimulus package.

The corresponding global liquidity factor from the Barra Global Equity Model (GEM2) is also shown in Figure 4. Unlike its Chinese counterpart, the relative performance of liquid stocks in the global universe has not improved in 2009.

Figure 4: Trading Activity Factor in the Barra CHE2 Model (Cumulative Returns, Sep 1, 2008 = 100)



Source: Barra CHE2 and GEM2 Models.

Sector Variations in Chinese Equity Returns

Next, we look into the industry factor returns. Figure 5 shows the industries with the largest declines and gains in the fourth quarter of 2008 and January 2009, respectively. One interesting observation is that a number of the worst-performing industries in the last quarter of 2008 became the biggest gainers in the market rally in January 2009. In the recent rally, the commodity-related industries appear to have benefitted most, with Energy, Metals & Mining, and Steel taking three of the top five spots.

Many of the biggest gainers seem to be beneficiaries of the government's recent stimulus package. For instance, in the energy sector the government started a series of energy projects in association with the package. In commodity-related industries, the Chinese government has emphasized infrastructure construction, which includes public housing, railways, highways, airports, and power grids. For the auto industry the stimulus package earmarked 10 billion yuan for a special fund to support auto companies.

At the other end, consumer and commercial services experienced the smallest rise in January 2009. Hotels and related leisure activities stood out as an industry that was among the worst performers in the fourth quarter of last year and yet one of the smallest gainers in this recent rally.

Figure 5: Barra CHE2 Industry Returns

Q4 2008		January 2009	
Energy	-25.1%	Energy	22.0%
Transport Infrastructure	-24.2%	Metals & mining	17.9%
Transport	-23.0%	Auto & components	16.9%
Hotels	-22.6%	Steel	16.8%
Retailing	-22.0%	Conglomerates	16.7%
Metals & mining	-20.0%	Chemicals	16.5%
Apparel	-18.1%	Capital goods	16.4%
Conglomerates	-18.0%	Transport	15.9%
Steel	-17.9%	Financials	15.6%
Chemicals	-17.8%	Apparel	15.4%
Auto & components	-17.6%	Materials	15.3%
Financials	-16.6%	Transport Infrastructure	13.7%
Media	-14.6%	Health Care	13.6%
IT	-13.4%	IT	13.4%
Capital goods	-12.5%	Utilities	11.9%
Materials	-11.8%	Software & services	11.8%
Consumer Staples	-11.4%	Retailing	10.3%
Utilities	-11.4%	Hotels	9.7%
Real Estate	-9.8%	Media	9.5%
Software & services	-9.4%	Real Estate	9.0%
Household Durables	-8.6%	Telecom	8.6%
Telecom	-7.3%	Commercial Services	8.6%
Commercial Services	-4.9%	Consumer Staples	8.3%
Health Care	2.7%	Household Durables	7.4%

Source: Barra CHE2 Model.

Conclusion

This Research Bulletin considers recent trends in the Chinese stock market. Volatility continued to rise after the bull rally ended and the market went into decline. During the recent rally in January 2009, we have seen liquid stocks outperform. The industries that are associated with the government's stimulus package also appeared to have been some of the better performers.

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