GLOBAL MARKETS ANALYSIS
Monetary and Capital Markets

From "Herd" to "Hurt" Mentality? The China September Equity Rally and Lessons From 2015

Prepared by Sally Chen, Hong Xiao, and Jing Zhao

THURSDAY, NOVEMBER 21, 2024

INTRODUCTION AND SUMMARY

The sharp gains and losses in China's equity market in late September recalled a similar episode from the summer of 2015, during which elevated volatility raised financial stability concerns. Following the announcement of the Chinese authorities' stimulus package on September 24th, the CSI 300 index surged 35% in six sessions and subsequently pared one-third of the gains roughly a week later. The closest comparator of such volatility was the summer of 2015. Over six months from late 2014 to the summer of 2015, the Chinese stock market doubled in value before losing 30% of its gains within a month. As the September 2024 rally lost ground, market participants worried that a repeat of the 2015 episode could destabilize fragile market confidence at a time of heightened sensitivity to policy and geopolitical developments.

This note outlines key features that defined the September market rally, compares the current episode with 2015 and highlights potential financial stability risks.

We find that a large retail investor base and the attendant herd behavior have contributed to frequent bouts of volatility in China's equity market. Although regulatory reforms that reduced the size of China's shadow banking sector and investor margin positions have generally curtailed market volatility and possible spillovers, the dominance of retail investors suggest that China's equity market remains vulnerable to sharp increases in volatility that could potentially destabilize the domestic financial market.

CHARACTERISTICS OF THE SEPTEMBER 2024 RALLY:

- **The September rally was driven by a resurgence in animal spirits following the announcement of government stimulus measures.**[1] Some observers compared the authorities' announcement to former ECB President Draghi's "whatever it takes" speech in 2012 and expected a virtuous cycle to unfold between positive asset prices and growth. Sectoral returns in the week following the announcement suggested as much. Commodity prices rebounded. Shares of consumer stables and real estate firms led gains, while foreign, large luxury retail producers also rose. These gains were in stark contrast to broad-based losses before the stimulus announcement (Graph 1).

- **Flows from onshore retail investors dominated market response**. New account openings and market turnovers both jumped in response to the stimulus announcement (Graphs 2 and 3). On the first trading day after the National Day holiday (October 8th), A-share turnover totaled over RMB 1tn in the first 20 minutes after market open, ending the day with a record-high turnover of RMB 3.48 tn; about 60% of the turnovers were attributed to retail investors.[2] Flows from overseas, institutional investors were small by comparison (Graph 3, red line for HKSAR, where overseas, institutional investors dominate). Gross turnover via Northbound Stock Connect (i.e., investors from Hong Kong investing in shares listed onshore) accounted for about 14% in the last week of September, not materially higher compared to 12% for 2023. Market contacts noted that funds looking to make up for their China investment underweight—mostly American and European institutional investors—made up the bulk of flows in Hong Kong. Meanwhile, short covering appeared limited — short sales on Mainland bourses totaled RMB 10 bn, or 0.2 percent of total positions (Graph 4).

- **Housing market losses have heightened retail investors' sensitivity to equity market volatility.** The housing market is traditionally a pillar in household wealth creation. In a PBC survey from 2019, properties made up nearly 70% of households' total assets, and only 20.4% in financial assets. A historic rout in the housing market have

[1] See Annex Table 1 for a list of stimulus measures announced on September 24th. On November 8th, the authorities announced a RMB 6 tr increase in fiscal support, or the equivalent of about 6% of GDP. The package is expected to help close local government financing gaps and support property destocking, though details were not yet available at the time of the writing.

[2] Source: Bloomberg, UBS.

weighed on household wealth and consumer sentiment. The equity market rally thus offered an unusually bright spot for onshore investors (Graph 5).

- **Concerted liquidity support for market stabilization.** Two novel tools for equity market support have helped market liquidity. The PBC will make available RMB 300 bn in loans to corporations for repurchasing their own shares. And, institutional investors will be allowed to pledge stocks, exchange-traded funds (ETFs) and bonds as collateral to the PBC in exchange for up to RMB 500 bn-worth of government bonds and central-bank bills. The proceeds from these must be used exclusively for buying stocks; shares purchased under this program will receive preferential capital treatment. Upon announcement, 20 institutions, or more than RMB 200 bn, have been cleared for participation. The 40% take-up of the quota is a sharp contrast to the take-up of less than 7% seen in PBC's relending facility program.

- **Offshore investors appear to hold less enthusiasm regarding the market outlook.** The share prices of companies listed onshore have historically traded at a premium relative to those listed in Hong Kong SAR (Graph 6). The onshore market is dominated by retail investors, who have held a more favorable view of the September stimulus package. For institutional, foreign investors that dominate flows in Hong Kong SAR, their optimism has been tempered by memories of bumpy reform implementation and unmet promises of past reforms. That said, in the current episode, the wedge between the PE ratios of the two markets is comparatively narrow, suggesting investors' outlook regarding China is becoming more aligned.

THE 2015 MARKET RALLY AND ITS AFTERMATH REVISITED:

China's equity market has experienced frequent bursts of rallies and contractions, a characteristic similar to equity cycles found in other EMs.[3] Still, the sharp gains in late September—35% in 6 days—stood apart. The rally in 2015 is the only comparable analog in recent history (Graph 7).

- **A combination of public relations campaigns that extoled equity market investments and levered, margin account participation fueled the 2015 rally.** Precipitating the 2015 rally was the government's tacit approval of media reports that lauded the capital market's role in reforming state-owned enterprises; the slogans widely used at that time included the "national bull market" (国家牛市) or "bull market reform" ("改革牛"). Leverage rose rapidly in the months that led up to the market peak in June 2015. Funding also came from exchanges' margin lending as well as the shadow banking sector, including umbrella trusts, wealth management products and brokers. The CSI index rallied from mid-2014 until the middle of 2015, more than doubling in value. Once prices fell, even slightly, levered investors were forced to sell, leading to a sharp market correction. By the end of July, the market lost roughly 30 percent of its value from early June.

- **Regulatory initiatives since 2015 have reduced margin positions and the size of the shadow banking sector**. In the years since the 2015 crash, the authorities have rolled out a series of initiatives that contained shadow banking activities, including regulatory guidance[4] that have limited asset management leverage. Since the 2015-episode, speculative fervor appeared have abated somewhat. For example, in the months before the September rally, margin buying was roughly half of the level seen at the market peak in 2015 (recall Graph 4). Investments from NBFIs—proxied by investment collective trusts, which helped fuel the equity market rally in 2015—was also relatively restrained in September (Graph 8).[5]

[3] See, for example, Chen & Svirydzenka (2021). "Financial Cycles – Early Warning Indicators of Banking Crises?" IMF WP 21/116

[4] PBC, "Guiding Opinions on Regulating the Asset Management Business of Financial Institutions".

[5] Usetrust data indicated that stock investment collective trusts represented [about 1%] of portfolio investment collective trust issuance in early October.

SIMILARITIES BETWEEN THE 2015 AND 2024 RALLIES AND ONGOING CONCERNS:

These two episodes, standing nearly a decade apart, underscore some of the key challenges to China's financial market stability:

- **A market dominated by retail investors and characterized by frequent and sharp price swings**. Although retail investors hold an estimated 25% of shares, they contributed to, on average, 80% of trading volume onshore.[6] Currently, there are more than 200 million trading accounts in China's stock market, and virtually all are for individual investors. Studies on retail investor behavior found "a lottery like" preference for winners, short-termism characterized by frequent trading, and a herd-like mentality for investment allocation.[7] Statistics from the Shanghai Stock Exchange found that the average holding period of retail investors was about 40 days over a 3-year period ending in 2019, far shorter than 109 for institutional investors and an average of 90 days for all US investors. Notably, equity market performance in China has had a low correlation with long-term growth: the CSI 300 index peaked in September 2007 while the economy has expanded further since then.

- **Herd mentality could amplify market trends and spillovers.** Small retail investors often engage in momentum trading — buying high and selling low. Their speculative demand tends to reinforce market trends.[8] A proxy of such behavior can be gleamed from social media: the use of the word "stock" on Wechat surged from less than 70mn on September 23rd, one day before the stimulus announcement, to 500mn on October 8th, the first trading day following the Golden Week. Discussions of "open securities account" on the platform surged from less than 0.13 mn to around 2 mn over the same period, corresponding to the record-high level of new A-share account opening, which reached nearly 7 mn. Following market losses on October 9th, mentions of "close securities account" appeared around 56 mn times, compared to 1.6 mn on September 23rd. Around the same time, the size of outstanding money market ETFs declined by more than RMB 600 bn in the week after September 23rd. Inflows into equity ETFs swiftly shifted into outflows as the equity market cooled and the rally lost steam (Graph 9).

CONCLUSION

The dominance of retail investors in China affects its market structure and suggests that China's equity market remains vulnerable to heightened volatility. Anecdotal reports suggest that onshore retail investor interest has remained elevated, despite recent market losses. What is less clear is what would happen if investor confidence were to falter. Although leverage appears subdued and the corresponding risk of margin calls is relatively limited in 2024, a reversal of retail investors' share buying could still destabilize the equity market, especially the small and mid-cap segment where market liquidity is relatively limited. Moreover, given already weak consumer sentiment and the lackluster growth outlook, equity market losses could potentially amplify the wealth effect—already negative due to housing market losses—and jeopardize the effectiveness of the latest stimulus measures through a further reduction on household consumption. Stress in the Chinese equity market could also lead to a broad loss of confidence and potentially trigger selloffs beyond the equity market.

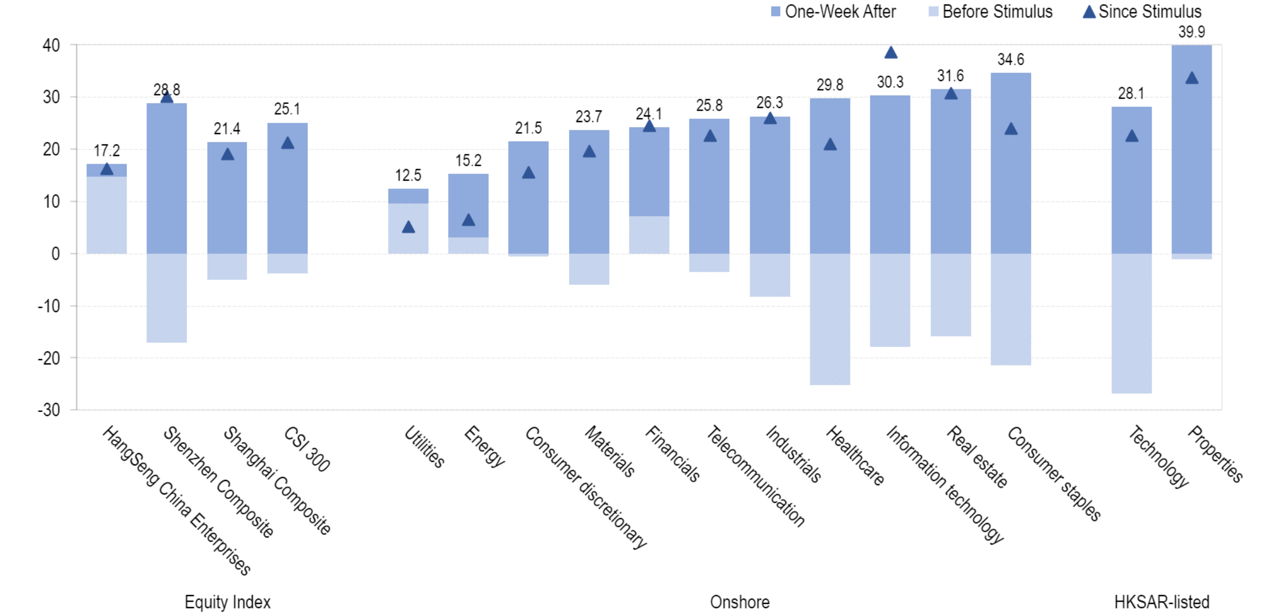
[6] Tan, Lin, Xiaoyan Zhang, and Xinran Zhang. "Retail and Institutional Investor Trading Behaviors: Evidence from China." Annual Review of Financial Economics 16 (2023).

[7] Wu. F. (2022, April). "China's capital market calls for long-term investors", Faculty & Research, *Shanghai Advanced Institute of Finance (SAIF). https://en.saif.sjtu.edu.cn/faculty-perspectives/details/26.html*

[8] Jones, Charles M., et al. "Retail trading and return predictability in China." Journal of Financial and Quantitative Analysis (2023): 1-37.

A rally marked by retail participation

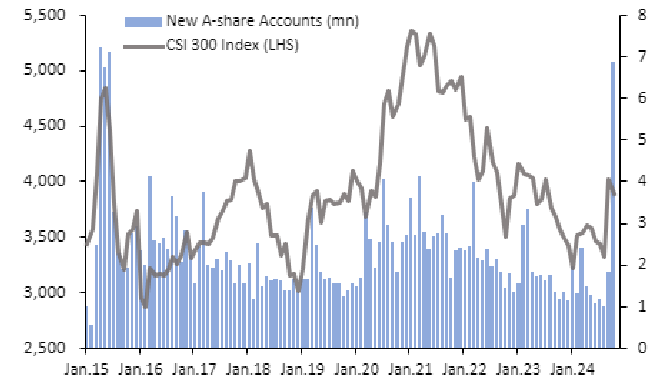
1. Equity return: YTD before and one-week after stimulus announcement



Sources: Bloomberg; and IMF staff calculations.

Retail investors rushed to open accounts

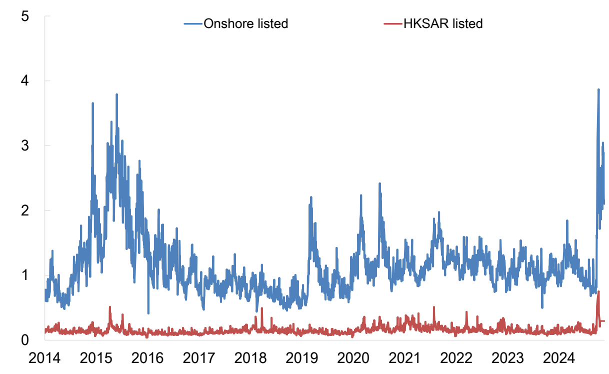
2. New A-share investor account opening
(Number of accounts and index level)



Sources: Bloomberg; and IMF staff calculations.

Market turnover jumped

3. Market turnover relative to total market capitalization *(In percent)*



Sources: Bloomberg; WIND; and IMF staff calculations.

Short positions have declined over the years amid supervisory guidance

4. Margin trading and short sales

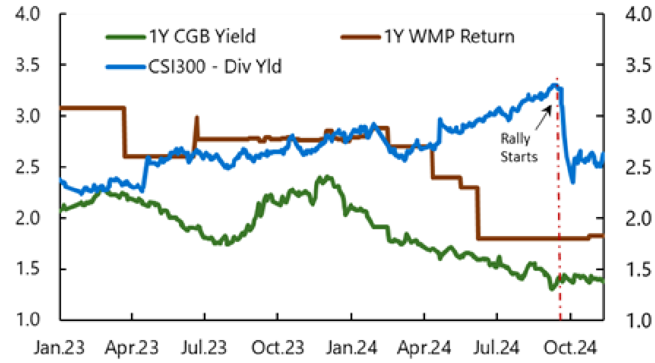
(In percent of total market turnover)

Sources: WIND; and IMF staff calculations.

Equities offer comparatively higher returns relative to wealth management products or CGBs

5. Equity dividend yield vs fixed income

(Percent)

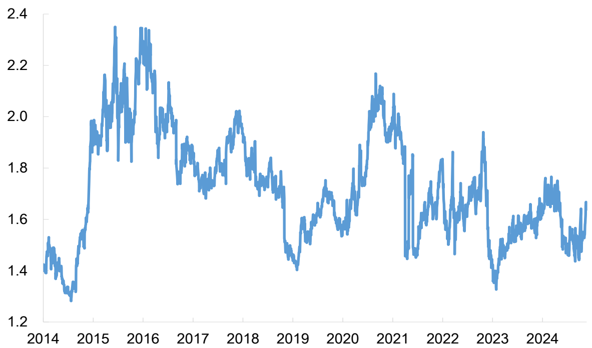


Sources: Bloomberg; and IMF staff calculations.

Onshore PEs higher than offshore counterparts

6. PE ratios of CSI onshore vs HSCEI offshore

(In multiples)

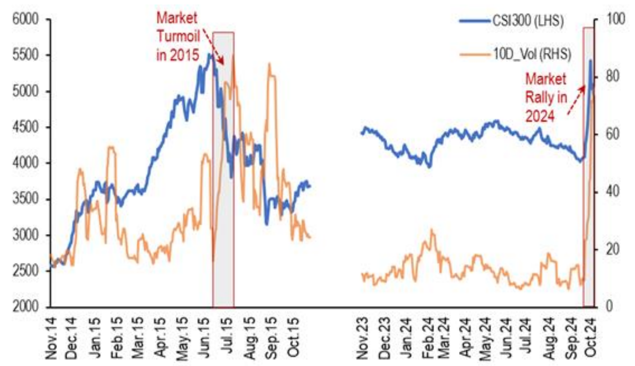


Sources: Bloomberg; and IMF staff calculations.

Rally in 2015 was the last comparable episode

7. Chinese Stock Index Level and 10-Day Volatility

(Index and in percent)

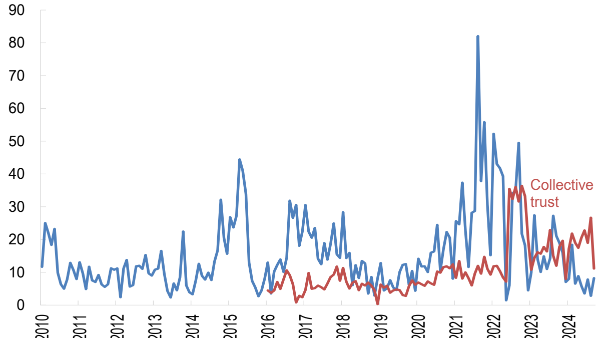


Sources: Bloomberg; and IMF staff calculations.

Share of trust issuance for securities investment has declined

8. Share of securities trust products in trust issuance

(Percent)



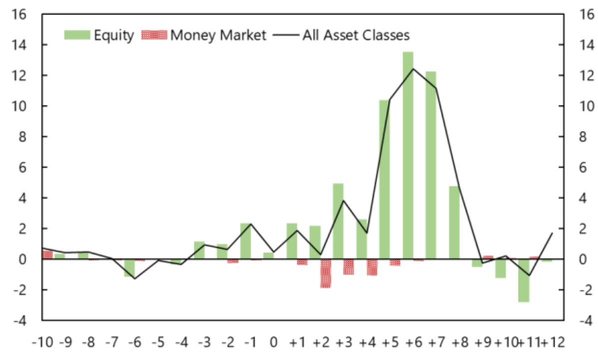
Note: September 2024 data are preliminary and subject to revisions.

Sources: WIND (blue line); Usetrust (red); and IMF staff calculations.

Investors moved money out of ETFs after market rally

9. Daily ETF fund flow before and after September 23

(USD, bn)



Sources: Bloomberg; and IMF staff estimates.

Annex Table 1. China policy stimulus

		Old (YTD)	New (since September 24th)	Media report but no official announcement	Possible new, additional stimulus
PBC					
	Monetary policy rates	10 bps cut in 7day OMO (July 22)	20 bps cut in 7day OMO (Sept. 27)		
	RRR	50 bps cut (release RMB 1 tn in liquidity, Feb 5)	50 bps cut (release RMB 1 tr in liqudity, Sept. 27)		
	Equity market boost		1/ Swap facility - 500 bn RMB (Sept. 24)		
			2/ Relending facility - 300 bn RMB (Sept. 24)		
			3/ Capital injection at 6 SOE banks (Sept. 24)	1 tn RMB funding for capital injection at SOE banks	
Fiscal policy					
	Consumption trade-in	150 bn RMB (July 24)		2 tn RMB over two years to support consumption.	1 tn RMB to support consumption
	Equipment upgrade	150 bn RMB (July 24)			
	Infrastructure	75.2 bn RMB to support national strategic areas (Sept. 27)	Re-emphasize need to accelerate construction of 102 key projects (Sept 29)		
		500 bn RMB from 2023 CGB issuance (Oct 2023)			
		150 bn RMB in PSL for 3 major projects (Jan 2024)			
	LG fiscal transfer		1/ One-off cash handouts for those in extreme poverty (RMB 50-100 bn, Sept. 25)	2 - 4 tn RMB fiscal transfer over two years to LGs.	1 tn RMB to help LG tackle debt
			2/ Consumption vouchers in some cities (eg, Shanghai)		
	Fiscal deficit/LG bond	92.3% of the quotas issued (as of Sept. 26).			
Property policy					
	Purchase restrictions		Homebuying curbs eased in SH, SZ, GZ; Beijing lowered downpayment ratio (Sept. 29/30).		
	Mortgage rate	35bps cut in 5-year LPR (25 bps in Feb., 10 bps in July)	50 bps cut in existing mortgage rate to around 3.45% (effective Nov. 1st).		
	Downpayment ratio	Minimum ratio cut by 5 ppt to 15% for first-time buyers and 25% for second-time buyers.	Lowered ratio for second-home purchases to 15% (Sept. 24).	3 - 5 tr RMB Housing Stabilization Fund to clear inventory	
	Housing invento	300 bn RMB relending program for state-owned firms to buy unsold properties (May 17)	Increase funding support from 60% to 100% (Sept. 24)		
	Whitelisted projects	1.43 tn RMB of financing (as of Sept. 24)	Will increase loans for whitelisted projects (Sept. 26)		

Source: Bloomberg, PBC, MoF, Barclays Research.