Chinese Stock Margin Trading

We recently noted that the **Chinese switch from real estate to stocks** has helped fuel a recent boom in the Shanghai stock market. It turns out that Chinese stock margin trading is also part of the equation. *CNN* notes that the **Shanghai Composite** index had its worst day in years when the government discovered and remedied illegal Chinese stock margin trading.

China's benchmark index suffered its worst day of trading in recent memory on Monday after regulators penalized three brokerages for breaking rules that limit risky margin trading.

The Shanghai Composite dropped nearly 8% as investors reacted to the ruling, which will prevent the brokers from opening new margin trading accounts for three months.

Shares of two affected brokerages — Citic Securities and Haitong Securities — quickly lost 10%, the daily limit for stocks trading in Shanghai. Guotai Junan Securities, the third broker, was trading down more than 10% in Hong Kong.

The fallout was limited to stocks trading in China. Japan's Nikkei gained nearly 1%, and most regional indices finished higher.

In our real estate to stocks article we warned about the influx of naïve investors into the Chinese market. Many firmly believed that real estate would make them rich and when the Chinese real estate bubble started to deflate many poured their money into the Shanghai market. The gains over the last few months have been spectacular and probably even better for those trading on excessive margins. The actions of authorities in China is likely to put a damper on investment by new investors but the more likely scenario is that when the available pool of new money is used up the Shanghai market will suffer a large correction.

Plunge in Chinese Equities

Bloomberg also reports the fall in Chinese stocks due to **margin trading** irregularities.

Chinese equities plunged the most in six years, led by brokerages, after regulatory efforts to rein in record margin lending sparked concern that speculative traders will pull back from the world's best-performing stock market.

The Shanghai Composite Index sank 7.7 percent to 3,116.35 at the close, its steepest drop since June 2008. Citic Securities Co. (600030) and Haitong Securities Co., the nation's two biggest listed securities firms, fell by the 10 percent daily limit after they were suspended from loaning money to new equity-trading clients and regulators said brokerages shouldn't lend to investors with assets below 500,000 yuan. About nine stocks dropped for each that rose on the Shanghai gauge, with more than 100 companies retreating by the maximum allowed.

When traders of margin accounts experience excessive losses they are compelled to replenish their margin accounts or the brokerage takes over their account and sells to make up for losses. When traders with inadequate assets trade on margin and the market tanks, the results can be as seen in China, with nine stocks falling in price for every one that rises.

Hidden Loans Hurt in the End

A quarter of a century ago Japan's seemingly unstoppable economy tanked and the result has been deflation. One of the reasons was the large number of hidden loans that masked more debt than investors were aware of. Excessive Chinese stock margin trading and other excessive loans within China to poorly run companies may lead the seemingly unstoppable Chinese miracle to fade rapidly. The Business Record weights in as **China stocks plunge**.

China stocks collapsed in morning trade on Monday, with financials hammered after regulators cracked down on credit products that have been blamed for fuelling excessive market speculation over the past three months.

Brokerage shares tumbled after the securities regulator punished industry heavyweights for illegal operations in their margin trading business while banks were hit after the banking regulator issued draft rules to tighten supervision of entrusted loans, a kind of shadow banking product.

"The entrusted loan regulation and margin trading penalties had combined impacts on market sentiment, adding to volatility and leading investors to turn negative," said Du Changchu, analyst at Northeast Securities in Shanghai.

"These two regulatory moves, in essence, hinder capital inflows, which have been the most significant reason behind the market's recent rally," he said.

It remains to be seen what tomorrow will bring as new investors lick their wounds and try to get out of the market before it falls farther, likely causing a continued rout!

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