Philequity Corner (06/11/2007)
By Ignacio B. Gimenez

Correction in Chinese stocks … healthy for global markets

For months the Chinese government has attempted to cool its markets and curb speculation by raising interest rates twice this year and forcing brokerages to make investors sign a declaration acknowledging risks when opening accounts. But despite these measures and government warnings of a possible bubble in stocks, retail investors have continued to pour money into the stock market with retail accounts now numbering above 100 million.

On May 29, the stamp duty on share trades was raised to 0.3 percent from 0.1 percent causing the Shanghai SE Composite Index to fall 6.5 percent the following day and eventually, as much as 21.5 percent before rallying these last four days. Meanwhile, the Shenzen SE Composite Index declined as much as 25.3 percent. In terms of magnitude, the current correction is larger than the February sell-off in Chinese stocks where the Shanghai and Shenzen indices fell as much as 15 percent and 11 percent, respectively. However, unlike the February sell-off where Asian markets fell as much as 10 percent on the average, the recent decline has left most global markets unscathed.

In fact, most Asian markets even hit new highs following May 29. On the average, other Asian markets are just 2.3 percent off their year highs and 13.7 percent up year-to-date. Meanwhile, developed markets such as those in the US, Germany, UK and Japan are just 2.6 percent off their highs and are up 7.2 percent year-to-date.

Global and Regional Market Performance

	Index	Year High	Current	% Chg from High	% Chg YTD
Asia ex-Japan					
China	Shenzen SE Comp	1,292.44	1,145.22	-11.4%	108.0%
China	Shanghai SE Comp	4,335.96	3,913.14	-9.8%	46.3%
Malaysia	KLSE	1,374.54	1,352.39	-1.6%	21.1%
Korea	KOSPI	1,753.24	1,727.28	-1.5%	20.4%
Philippines	PSEi	3,629.82	3,526.73	-2.8%	18.2%
Singapore	STI	3,596.27	3,491.59	-2.9%	16.9%
Indonesia	JCI	2,117.56	2,054.45	-3.0%	13.8%
Thailand	SET	775.41	752.00	-3.0%	10.6%
Taiwan	TWSE	8,376.97	8,300.71	-0.9%	6.1%
Hong Kong	Hang Seng	21,088.90	20,509.15	-2.7%	2.7%
Average				**-4.0%**	**26.4%**
Average ex-China				**-2.3%**	**13.7%**
Developed Markets					
Germany	DAX	8,010.39	7,590.50	-5.2%	15.1%
US	DJIA	13,692.00	13,424.39	-2.0%	7.7%
US	Nasdaq	2,626.40	2,573.54	-2.0%	6.6%
US	S&P 500	1,540.56	1,507.67	-2.1%	6.3%
Japan	Nikkei	18,073.00	17,779.09	-1.6%	3.2%
UK	FTSE	6,686.60	6,505.10	-2.7%	4.6%
Average				**-2.6%**	**7.2%**

Source: Blomberg

While most investors were surprised and caught off guard in February leading to drastic regional sell-offs, this time around the correction in Chinese stocks did not cause such a reaction due to the following reasons:

1) There is still a weak link between the Chinese stock market and the rest of the world. Domestic investors make up the bulk of the Chinese stock market due to the country's closed capital account and heavily regulated markets. Since investment restrictions have put off most foreign funds away, a huge decline in the Chinese market will have little impact on foreign funds' global portfolios.

2) There is little correlation between Chinese economic growth and its stock market. When the market plunged 22 percent in 2001, for example, the Chinese GDP growth remained at 8.3 percent. In 2002, the market fell further by 17 percent while GDP expanded at a faster rate of 9.1 percent. Unlike in the US, there is little correlation between the Chinese stock market and their retail sales, so there is no effect on consumer spending.

3) The long-term bullish trend in Chinese stocks remains intact. The 21.5 percent correction in the Shanghai SE Composite index came after a huge 62 percent run-up from the start of the year. Meanwhile, the 25.3 percent retracement in the Shenzhen SE Composite index came after a 134 percent gain. Therefore, those who invested in the Shanghai market at the start of the year are still up 46.3 percent and those who invested in the Shenzhen market still have profits of 108 percent year to date.

4) The government has now assured investors that it is only trying to curb speculation and not attempting to slow down the economy. Investors have now realized that the Chinese government is just trying to avoid a huge bubble burst and that the recent policy moves are not mean to put a reign on economic expansion. In fact, repeated attempts to quash the bubble seemed to invite for buying as each decline is seen as a healthy correction and a good buying opportunity.

5) Finally, there is no change in long-term fundamentals. Global equity valuations today are reasonably in line with long-term fundamentals and emerging market economies have significant current account surpluses and are in strong financial standing. Absent was the irrational exuberance in US equity price valuation that was experienced in April 2000. Nor was there a loss of confidence in emerging market economies saddled with huge current account deficits experienced during the Asian crisis in 1997.

Has the Chinese stock market bubble burst?

Historically, previous bubbles don't end with just 300% to 400% gains from the bottom. For example, our very own PSE Index (then known as PHISIX) rose from a low of 505 in October 1990 to a high of 3,333 in January 1994 or a 560 percent gain 3 ¼ years. And recently, Saudi Arabia's Tadawul Index rose from 2,362 in November 2002 to 20,634 in February 2006 or a 773 percent gain also in 3 ¼ years.

Meanwhile, the Shanghai SE Composite Index has rocketed from 998 in June 2005 to as high as 4,335 in May 2007 or a gain of 334 percent (see figure below). The Shenzhen SE Composite Index, on the other hand, has zoomed from 235.6 in July 2005 to 1,292.4 in May 2007 or a gain of 448 percent. Therefore, from a historical perspective, the Chinese stock markets still fall short of previous bubbles in terms of magnitude and time frame.

Shanghai SE Composite Index (2005 to present)

Source: Bloomberg

We therefore view this current decline in Chinese stocks as a correction and not the start of a major bubble burst. The correction in Chinese stocks is therefore good not only for the Chinese stock market but for the world stock markets as a whole. A 20 to 30 percent drop is actually healthy after a huge run-up. It avoids an even bigger crash that may affect the Chinese economy and may spill over other markets and economies.

For comments and inquiries, you can email us at info@philequity.net or gime10000@yahoo.com.