

Philequity Corner (August 24, 2009)
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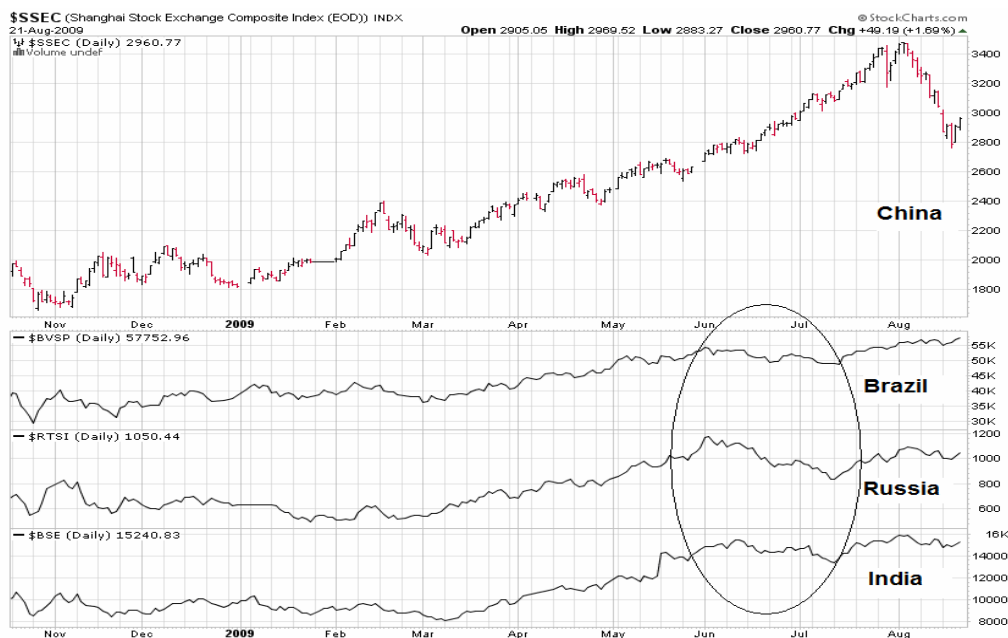
The China Syndrome

Global markets got unnerved the past couple of weeks, not because of a new bout of financial flu emanating from the US, but because of a new strain, the C-H1Na virus (the China syndrome). The Chinese stock market, which was one of the first to turn around and lead the markets on the way up, saw a reversal of fortune and dropped to a nine-week low last Wednesday.

The sharp two-week drop of 20 percent has prompted calls of a resumption of the bear market. Many argue that this could be a foreshadowing of what could occur in the global markets. As China led us out of the downturn, it may lead us back into the bear market.

The bear is back?

Whenever markets drop 20 percent, technicians consider it the start of a bear market cycle. But to put things in perspective, recall that China's benchmark Shanghai index posted the biggest gains among the world's markets from January 1 to August 4. It has gained as much as 109 percent from the low registered in October 28, 2008 to its recent peak in August 4, 2009. Given the strong run-up, it is only natural that there will be corrections or pullbacks along the way.



Source: Stockcharts.com

Note that in June, Russia's RTS index suffered a 30 percent correction but has since stabilized and crept higher. Similarly, in the other BRIC countries, Brazil's BVSP index and India's BSE index, suffered earlier setbacks but had recovered robustly.

In contrast, China has not had any major correction since February. Therefore the sharp decline is not only viewed as normal, but in fact, healthier for Chinese stocks.

Undue speculation

Aside from the fact that it is normal for overbought markets to correct, we enumerate below several reasons for the pullback in the Chinese market:

1) POTENTIAL MONETARY TIGHTENING. The strong surge in Chinese stocks was driven by the stronger-than-expected government stimulus. Early this year, the government unveiled its Rmb4.0 trillion stimulus package (US\$585 billion). In addition, new loans by state-owned commercial banks reached Rmb7.7 trillion (equivalent to US\$ 1.1 trillion) in the first seven months of the year, up 170 percent year-on-year.

However, new loans recorded in July were significantly lower than the prior two months' figure. This deceleration in new loans, together with increasing regulatory attention to the soaring loan growth, has sparked investor concern on potential monetary policy tightening in China.

2) BANK LOANS USED FOR SPECULATION. Many of these new bank loans meant for economic stimulus were being misused. The Chinese monetary authorities found out that a lot of these loans are being used for speculation in the stock market and real estate. They are now devising measures to address this concern.

4) RETAIL INVESTORS DOMINATE. China's stock market is inherently more volatile than most markets because of its large retail investor base. It is estimated that retail investors account for 60 percent of daily turnover on the Shanghai and Shenzhen bourses. And because these Chinese investors cannot invest in any other markets, most of their savings are channelled into the so-called A-shares which foreigners in turn cannot own.

Last week, 550,000 new brokerage accounts were opened. This is a new record since December 2007. Many of these new investors have less than two years experience and tend to buy the more speculative and small-capitalization, low-priced stocks. They also tend to borrow on margin, thereby adding on to the volatility.

Washington Sycip explained, in one of our board meetings, that engaging in speculative activities like the stock market, property speculation and gaming is inherent among the Chinese. It is therefore not surprising to see China's Shanghai index to fall 20 percent after rising 109 percent. In fact, 8 percent of the time, the Chinese market goes up and down more than 5 percent in a day.

5) IPOs SAP LIQUIDITY. Another reason for the plunge in Chinese stocks is because of a flood of new initial public offerings (IPOs) after China lifted its nine-month moratorium. China State Construction Engineering Corp., China's largest homebuilder, raised Rmb50.15 billion in July. This is the largest IPO in China since PetroChina raised Rmb 66.8 billion in October 2007. Similar to what happened in 2007 investors now fear that the new IPOs will drain liquidity from the secondary markets.

Healthy correction

Because of the sharp pullback of stocks in China, global stock markets, especially Asian markets, suffered similar setbacks. In the case of the Philippines, the PSE Index has almost reached our end-2009 target of 2,900 to 3,000. In fact, it reached as high as 2,894 before pulling back 6 percent to 2,720 as of Friday.

We believe that a stock market correction is inevitable. We also believe that corrections may come and go, but we will never know their exact extent and their precise duration. However, we believe that what we are witnessing is a healthy and a much-needed correction.

In the case of the US, after a sharp two-day drop last week, the markets reversed to register new high for the year. The majority of fund managers, technical analysts, and investment gurus have called for a major correction in the market and they have now missed a significant move in the markets.

Long-term trend is up

As we have said, corrections or pullbacks come in many forms. In a previous article, we said that corrections can be a deep or shallow. It can be a nasty or a mild correction. But what is important is that the long-term trend is already up. Our basic thesis is that the low in the US markets was already reached on March 6, 2009. In the Philippines' case, the market bottom was reached in October 2008 and was retested in March 2009.

We believe that stock market corrections will be experienced, but they will no longer reach the lows established in March 2009. Investors should then use this China-triggered correction as an opportunity to get in the market.

Buy on major dips

If you are underinvested in equities, you should buy on dips or use support levels to increase your equity weighting. If you are overleveraged or trading on margin, you should be trimming your positions because this can be a corrective or a consolidation phase. Meanwhile, if you don't have time to monitor the markets or the expertise to invest on your own, you can buy equity mutual funds on a staggered basis (dollar-cost averaging) or use these deep pullbacks to slowly purchase equity funds.

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