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GLOBAL MARKET COMMENT

CHINESE EQUITIES: ENVISIONING THE ENDGAME

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Chinese Equities
Envisioning the Endgame

Juiced by a massive credit boom, China is simmering, just a few degrees shy of boiling over. Its economy grew 9.1% in 2003, the fastest rate since 1997—and that is according to official estimates: many private observers believe growth has actually reached around 20% (see Table A). With the money supply expanding at a 19.6% clip in 2003, outstanding loans grew 21.4% in 2003, nearly double the 11.9% average annual rate from 1997-2002. In the real economy, this has translated into a capital expenditure boom, some have called it a "bubble," with fixed asset investment reaching 46% of GDP in 2003, after 41% in 2002.

Much of this stimulus is attributable to the government's resolve to maintain its currency peg with the US$. In order to keep the *yuan* within a tight range around 8.277 to the US$, the People's Bank of China (PBOC) sells its domestic currency and buys US$ (or U.S. Treasury securities). Without "sterilizing" its intervention by selling bonds in the Chinese domestic market, the central bank has accumulated an enormous amount of foreign exchange reserves, much of which has been circulated back into the economy. In addition, China is absorbing substantial capital inflows from business people, investors, and punters from Japan, Taiwan, and Southeast Asia, who are building factories, as well as investing (and speculating) in property, currency markets, and a myriad of other assets.

The Clash of Policy Levers and Market Forces

The Chinese government appears to be trying to cool the economy, though its policy response has thus far been relatively measured. It has begun applying regulatory pressure to reduce lending and investment in the hottest sectors — property, steel, cement, and autos. It has also moderately expanded the issuance of central bank bills in order to sterilize the impact of its currency market intervention.

However, should pricing pressures pick up steam, the PBOC may move more aggressively. Inflation rose 3.9% in 2003, a figure that appears fairly benign (Table A, middle panel). However, it represents a marked jump from its mere 1.8% uptick for the year ending in the third quarter 2003, and it stands in stark contrast to the deflationary pressures endured throughout the late 1990s and as recently as 2002. Relative to China's two other growth spurts since the early 1980s—1982-85 and 1991-93—inflation in the current cycle has thus remained quite subdued; both of those periods were brought to an abrupt end after the PBOC hiked rates to stave off rising pricing pressures.

Can China Avoid Another Bust?

Many pundits believe that fears of triggering an investment bust and precipitous economic slowdown will discourage a substantial rate hike until inflation rises above 5%. However, the economy is so highly leveraged that even small moves in interest rates could result in a hard landing. Others believe that China's ongoing economic transformation has reduced the potency of raising rates to brake the economy since many borrowers now have access to non-bank sources of financing; according to official estimates, bank loans financed only 24% of the economy's investment in 2003, with 48% provided by "internal funds" (current income and retained earnings). Since the central bank's customary administrative measures may not successfully defuse the investment boom, it may *eventually* increase nominal interest rates and widen the band of its US$ peg. Many commentators, however, do not foresee an imminent rise in interest rates, largely because the current foreign exchange rate benefits Chinese exporters (as well as U.S. consumers).

Equity Investors—Coping With the Volatility

Consistent with this economic backdrop, Chinese equities have become quite overvalued, though the degree depends on the particular index and sector. The relative performance among indices has varied considerably, not only from their recent lows, but also over their ten-year histories (Tables B-D, and summarized in the table on the following page).

Several valuation metrics suggest Chinese equity indices *in the aggregate* are currently quite expensive. Shanghai A shares carry a trailing P/E ratio of 35.8, and P/B ratio of 3.0, while the respective ratios for Shanghai B shares are 31.6 and 2.0. The P/E of the Red Chip Index is currently 16.3, while H shares seem the most reasonably priced, with a 15.7 P/E and 2.0 P/B (oil and energy sectors, which make up nearly 50% of the H shares index have been underperforming as of late). In a larger context, during the equity boom in 1997, the P/E ratios of H shares and the Red Chip Index reached 30 and 55, respectively, suggesting that there may be a final blow-off phase before the (probable) bust. MSCI China, the index with the most thorough historical valuation data, appears fairly valued-to-slightly overpriced, relative to its own historical averages and to the other indices (see Table E).

Not only are Chinese equities quite expensive, but it is also far from clear that investors have been adequately compensated for incurring their risk (Table F). From January 1994 through January 2004, on *average*, the six Chinese equity indices posted an average annual compound return (AACR) of 0.1% with a 49.7 annualized standard deviation. From January 1994 to present, Shenzhen A shares have provided the best rate of return in relation to risk: over the last ten years (and one month), investors in Shenzhen A shares would have earned a 5.5% AACR with an annualized standard deviation of 43.9, while investors in the other indices would have incurred either a slightly higher return with considerably more volatility, or a smaller return with only slightly lower (or higher) volatility.

It is doubtful, however, that many investors could have endured such volatility while earning such paltry returns; Shenzhen B shares, for example—the relatively best-performing index since 1994—posted an AACR of only 7.4% with an annualized standard deviation of 61.3. At the other end of the spectrum, MSCI China posted an AACR of -15.2% with an annualized standard deviation of "only" 41.0.

Characteristics of Chinese Equity Indices

	Price/Earnings	Price/Book	AACR (%) (since 1994)	Annualized σ (since 1994)	Performance since Recent Lows (%)
H-Shares[1]	15.7	2	-5.3	48.3	152.3 (since 10/02)
Shanghai A[2]	35.8	3	6.9	55.3	18.1 (since 10/03)
Shenzhen A[2]	39.5	3	5.5	43.9	10.9 (since 10/03)
Shanghai B[2]	31.6	2	1.1	48.1	15.6 (since 9/03)
Shenzhen B[2]	16.8	3.1	7.4	61.3	55.2 (since 12/02)
Red-Chips[1]	16.3	2.4	13.3*	45.7*	89 (since 4/03)
MSCI China[3]	17.7	2.2	-15.2	41	84.7 (since 4/03)

[1] As of February 2004
[2] As of November 2003
[3] As of January 31, 2004
* From February 1995

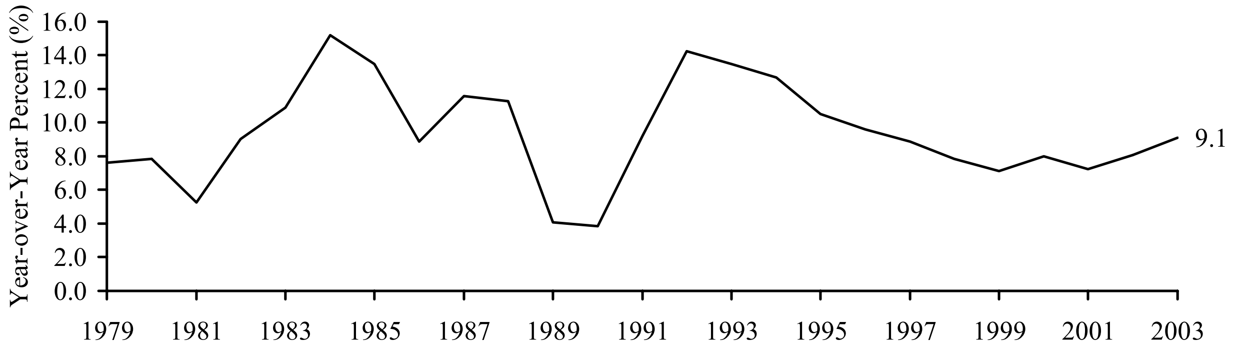
The Cyclical-Secular Interplay

The current excitement for Chinese equities has not approached levels that marked their prior speculative extremes, and sentiment could well grow even more frothy before the endgame finally plays out. That said, we remain positive about China's longer-term secular story. While Chinese equities are clearly not for the faint hearted, we continue to recommend that investors begin analyzing the various managers and hedge funds that specialize in the region. Value-sensitive managers who invest from a bottom-up perspective will almost certainly outperform managers who are loath to assume benchmark risk.

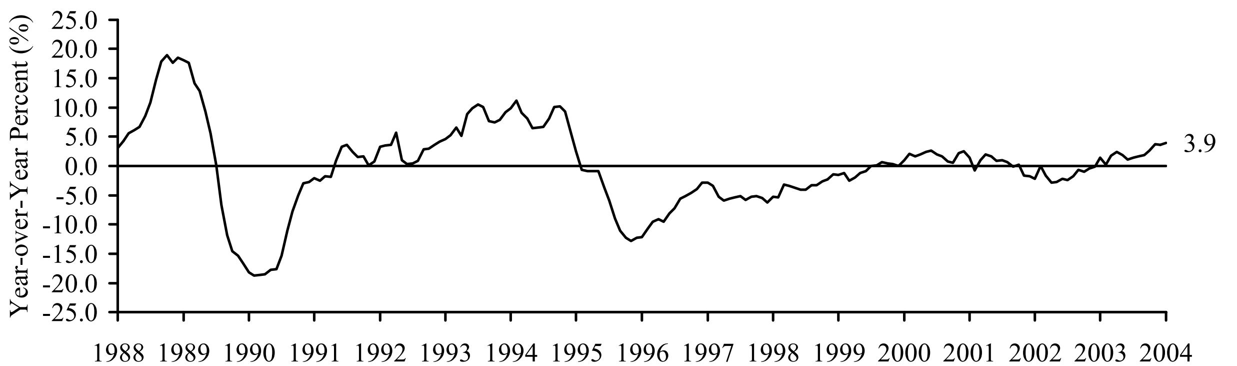
Table A

GROWTH OF ECONOMIC INDICATORS

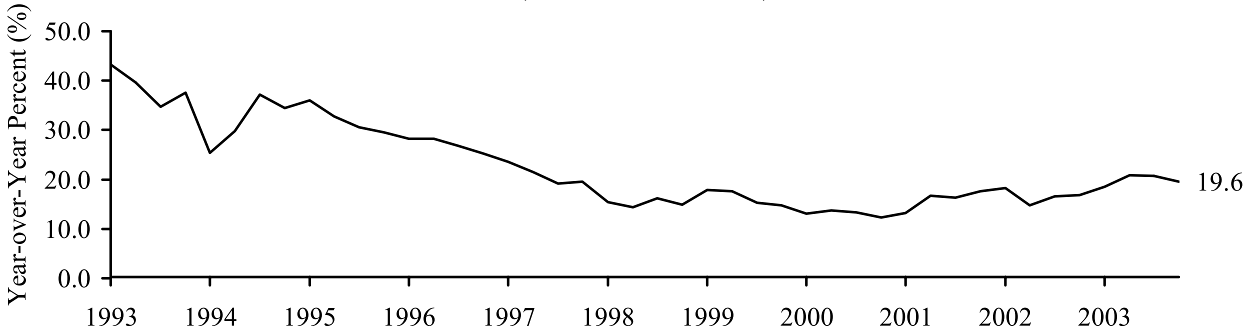
Nominal Gross Domestic Product
1979-2003



Consumer Price Index: China
January 31, 1987 - January 31, 2004



Chinese Money Supply: M2
March 31, 1993 - December 31, 2003



Source: Thomson Datastream.

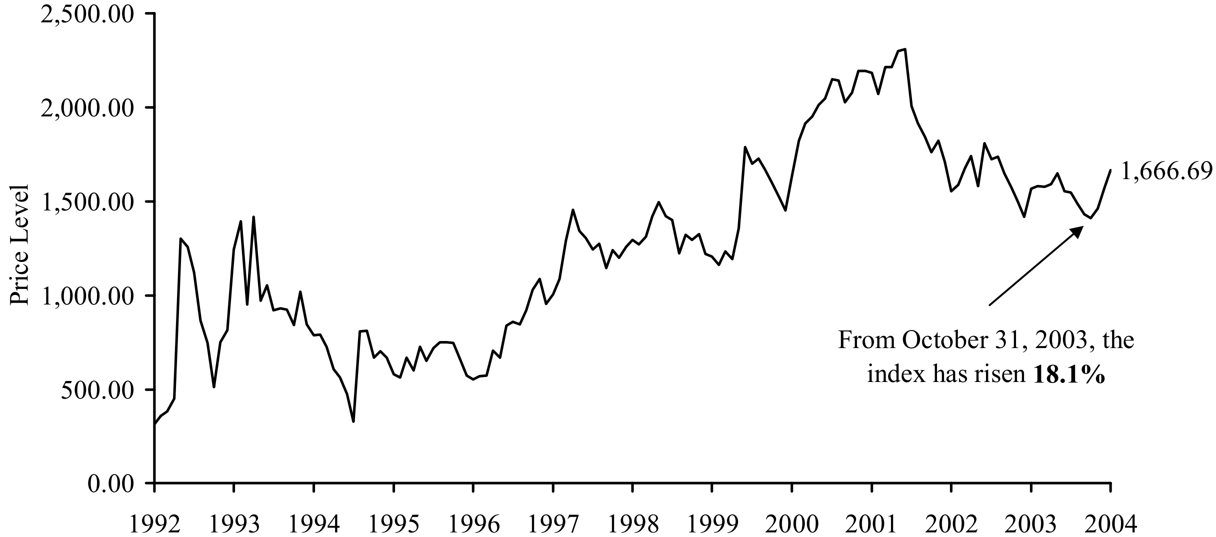
Notes: Gross domestic product data are annual. Consumer Price Index data are rolling on a monthly basis and money supply data are rolling on a quarterly basis. All data are in local currency.

Table B

MAJOR CHINA INDICES

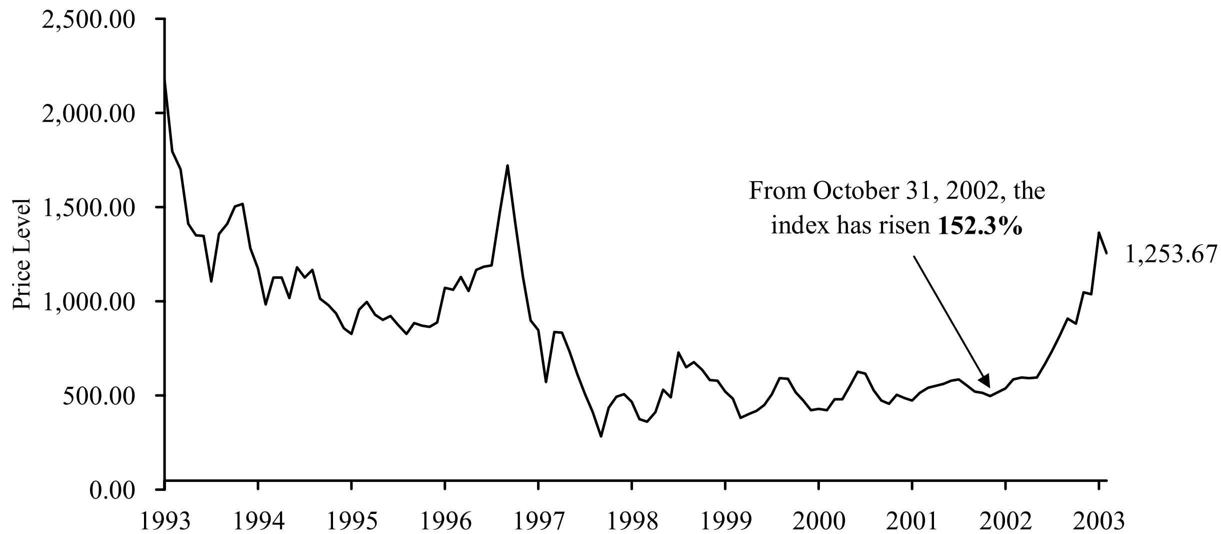
Shanghai Stock Exchange A Share Index

January 31, 1992 - January 31, 2004



Hong Kong H Share Index

January 31, 1994 - January 31, 2004



Source: Thomson Datastream.

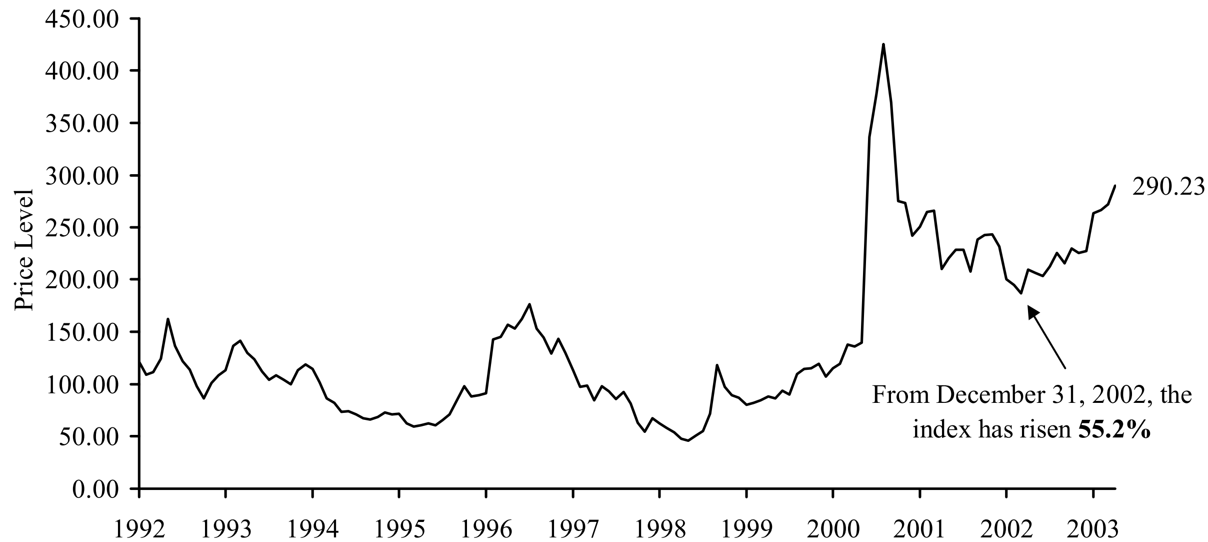
Notes: A shares are shares held by Chinese public and only traded in local currency (yuan), while H shares are shares listed on the Hong Kong Stock Exchange, the best rated of which are called Red Chips. Data for the H share index are represented in Hong Kong dollars and are represented by the Credit Lyonnais Securities (Asia) Limited Hong Kong H Share Index.

Table C

MAJOR CHINA INDICES

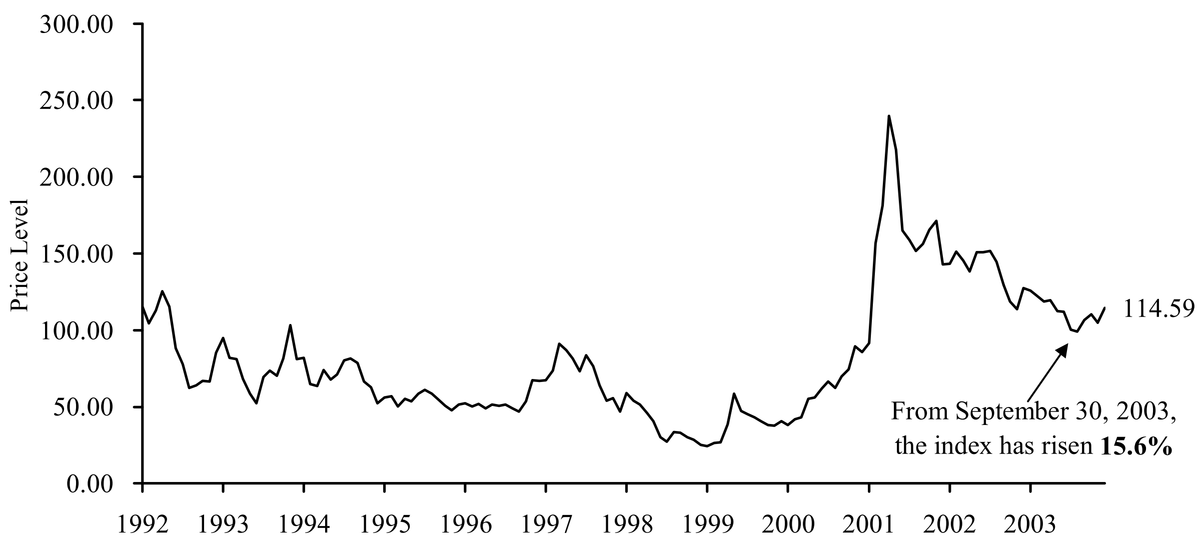
Shenzhen Stock Exchange B Share Index

October 31, 1992 - January 31, 2004



Shanghai Stock Exchange B Share Index

February 28, 1992 - January 31, 2004



Source: Thomson Datastream.

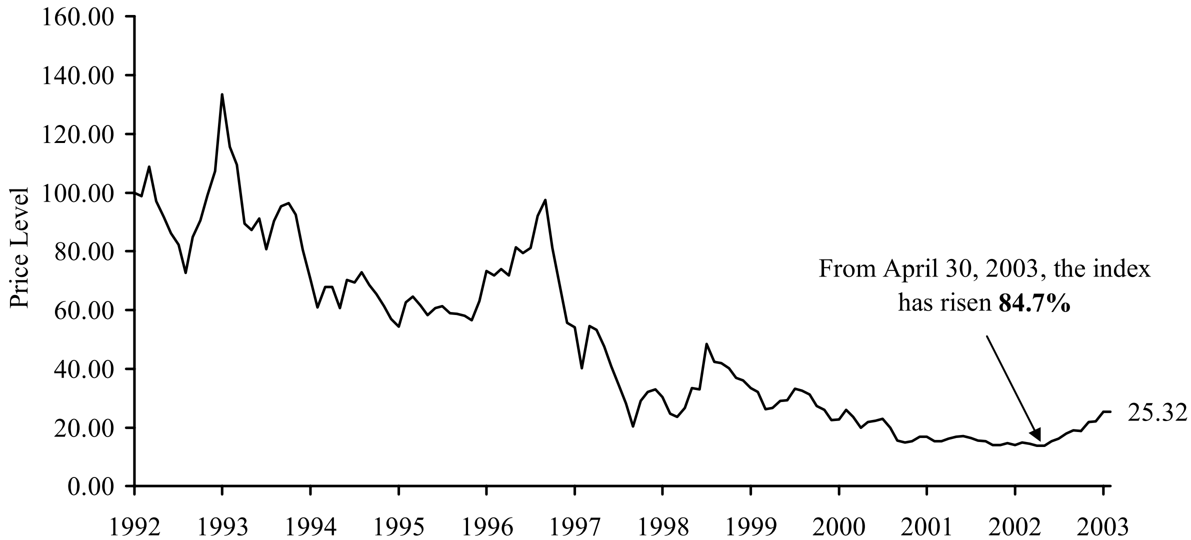
Notes: B shares are shares designated for foreign investors and payable in foreign currency. Data for the Shenzhen SE B Share Index are in Hong Kong dollars, while those for the Shanghai SE B Share Index are represented in U.S. dollars.

Table D

CHINA EQUITY PERFORMANCE

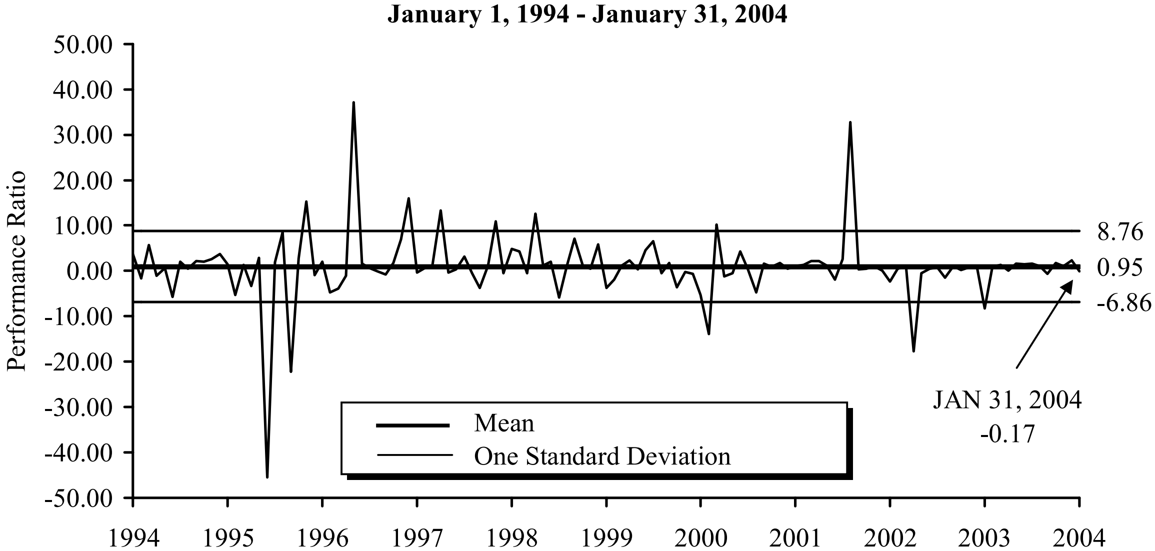
MSCI China Index

December 31, 1992 - January 31, 2004



Relative Performance of MSCI China to MSCI Emerging Markets

January 1, 1994 - January 31, 2004



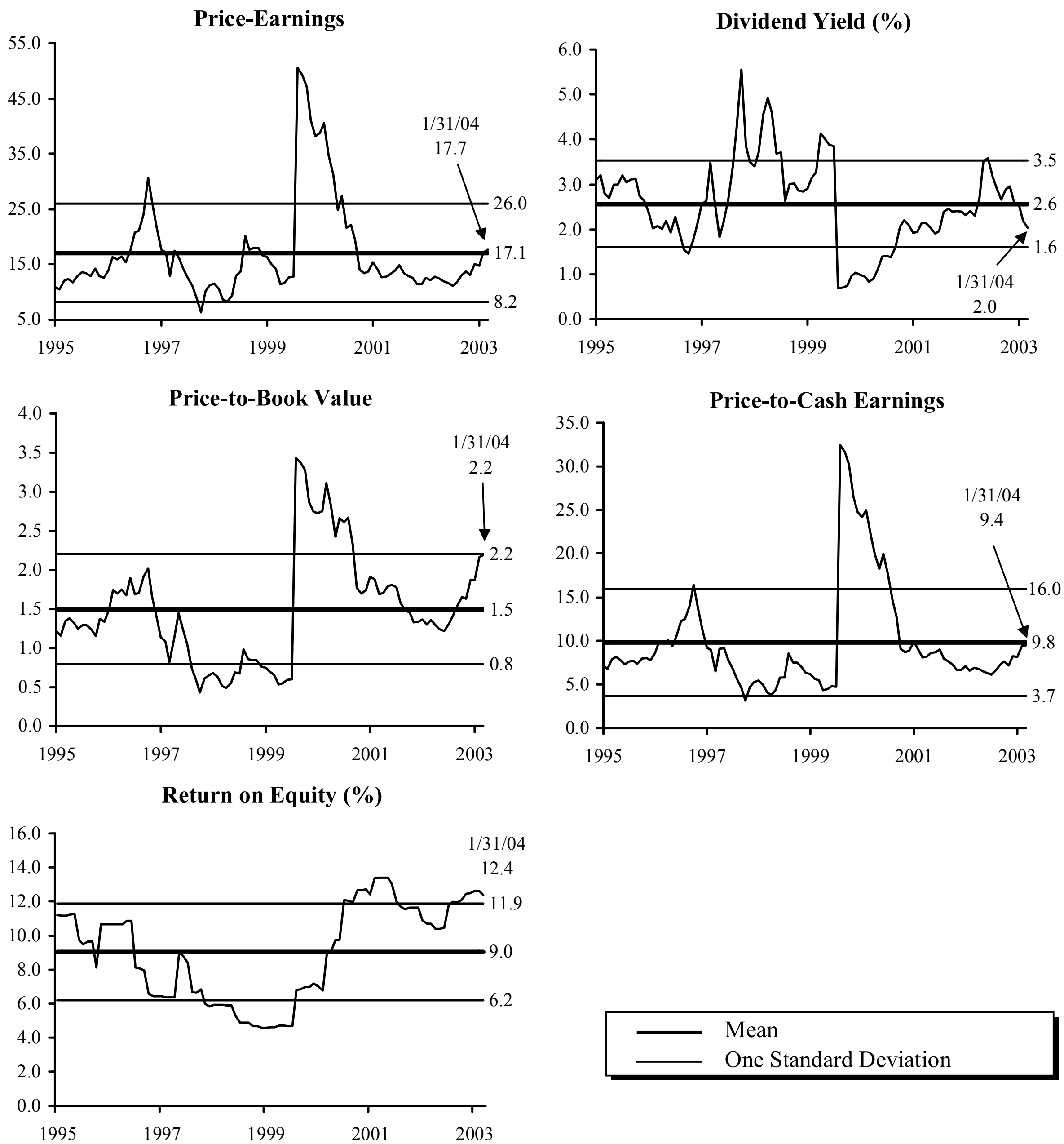
Source: Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: The MSCI China Index includes equities issued by companies incorporated in the People's Republic of China (PRC), and listed in the form of B shares on the Shanghai Stock Exchange (in US$) or Shenzhen Stock Exchange (in HK$), H shares in Hong Kong (in HK$), or N shares in New York (in US$). In addition, MSCI China also includes companies not incorporated in the PRC or the Hong Kong Special Administrative Region, effective May 31, 2000. These companies must be listed on the Stock Exchange of Hong Kong and the companies' major shareholders must be organizations owned by the state, provinces, or municipalities of the PRC or companies incorporated in the PRC. Data for MSCI China Index are in Chinese yuan, while those for MSCI Emerging Markets Index are in local currency.

Table E

MSCI CHINA VALUATIONS

November 30, 1995 - January 31, 2004

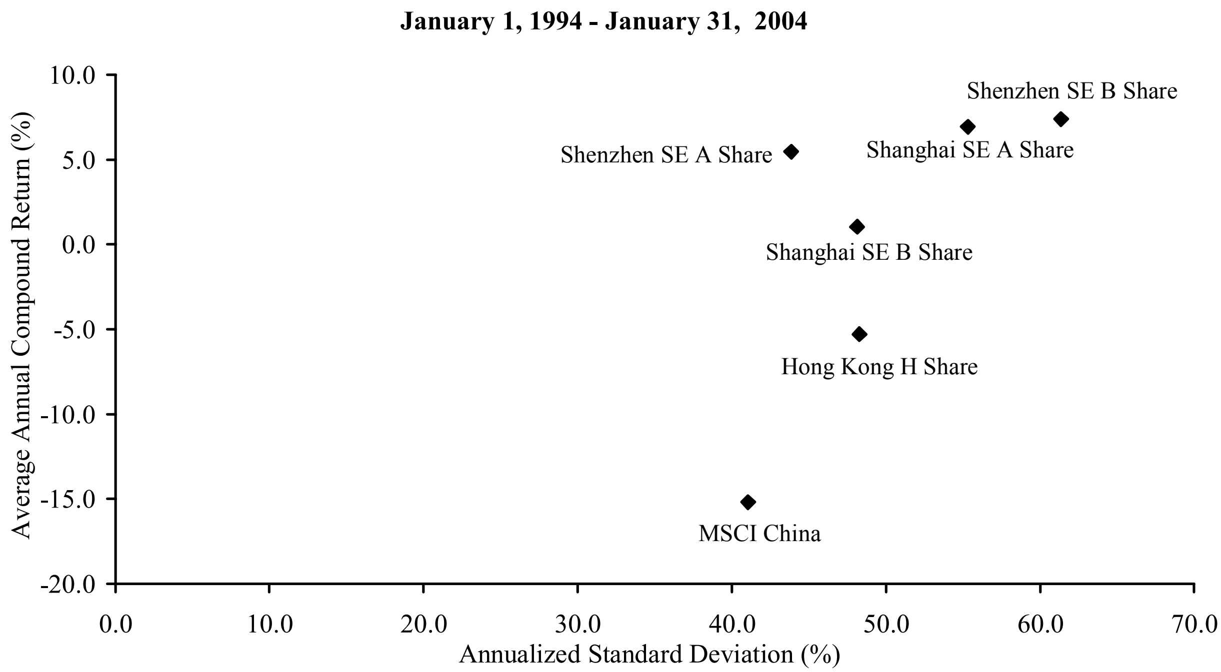


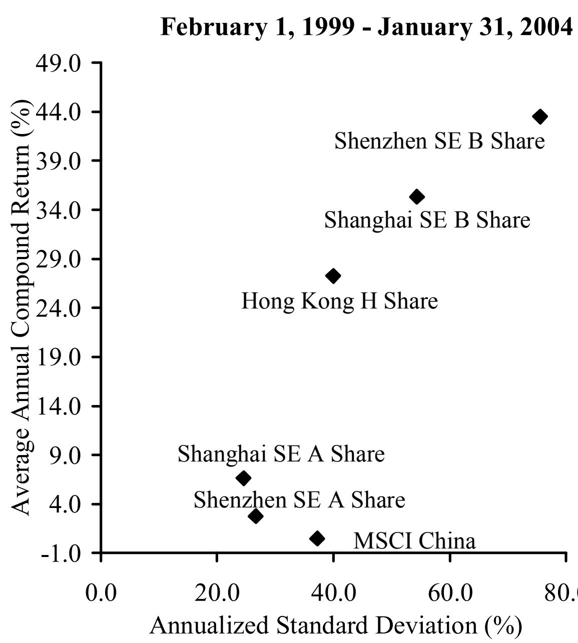
Source: Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

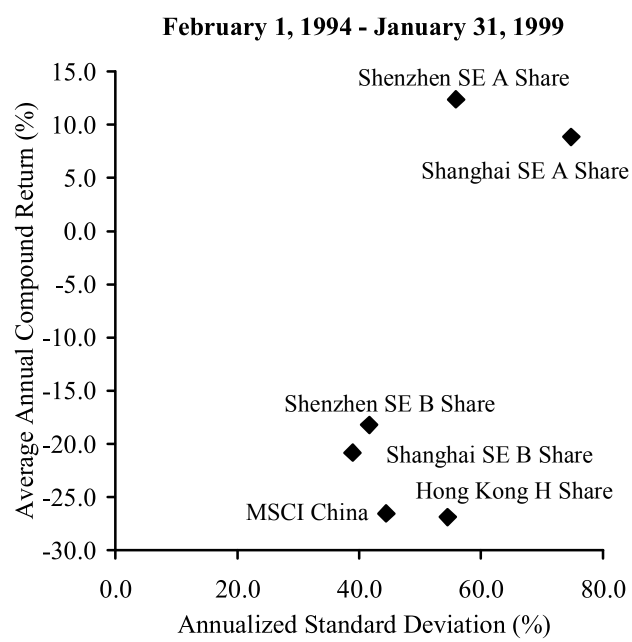
Notes: ROE is calculated by dividing the earnings per share by the book value per share. Book value per share is calculated by dividing the index price by its price-book ratio. Earnings per share is calculated by dividing the price index by its price-earnings ratio. All data are in local currency. The MSCI China Index includes equities issued by companies incorporated in the People's Republic of China (PRC), and listed in the form of B shares on the Shanghai Stock Exchange (in US$) or Shenzhen Stock Exchange (in HK$), H shares in Hong Kong (in HK$), or N shares in New York (in US$). In addition, MSCI China also includes companies not incorporated in the PRC or the Hong Kong Special Administrative Region, effective May 31, 2000. These companies must be listed on the Stock Exchange of Hong Kong and the companies' major shareholders must be organizations owned by the state, provinces, or municipalities of the PRC or companies incorporated in the PRC.

Table F

RISK AND RETURN COMPARISON







Source: Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: The H Share Index is represented by the Credit Lyonnais Securities (Asia) Ltd. Hong Kong H Share Index. The CLSA Hong Kong H Share and the Shenzhen SE B share indices are in Hong Kong Dollars, the Shanghai SE A Share, Shenzhen SE A Share, and MSCI China indices are in Chinese yuan. The Shanghai SE B Share Index data are in U.S. dollars. Average annual compound returns are calculated from price returns.