

Is It the 2006 Correction All Over Again?

Alvin Liew

 (65) 6539 3923
 Alvin.LiewTS@UOBgroup.com

Thomas Lam

 (65) 6538 2169
 Thomas.LamTL@UOBgroup.com

Suan Teck Kin

 (65) 6539 3922
 Suan.TeckKin@UOBgroup.com

Jimmy Koh

 (65) 6539 3545
 Jimmy.KohCT@UOBgroup.com

Although some semblance of stability returned to the stock markets in Asia today (06 Mar 07), it was nonetheless a nerve-wrecking week after the bourses around the world went on a tailspin as investors fled the markets and sold down on equities. Using the weekly MSCI All Country Far East Ex Japan (MSFExJ), Asian markets declined by nearly 5.7% with trading volume at a record high of 36.6bn (volume averaged around 25.9bn in the past 6 months), as the index receded to 414.72 last week (ending 2 Mar) from a record high of 439.64 in the previous week. While markets in Asia have broadly stabilized today, it is still not entirely clear if the worst is behind us. What is certain is that one cannot draw parallel conclusions from the last time and apply it to our current situation.

While on the surface, this may seem reminiscent of the correction in May-June last year. But on closer inspection, there are quite a few differences. Again looking at the weekly MSFExJ, the index declined by a similar 5.5% in the first week of the 2006 May-June correction (for the week ending 19 May 06) with volume markedly up as well at 29.7bn. However, when we measured the declines suffered by the top 5 Asian equity markets (which are all incidentally included as constituents in the MSFExJ), we found that the declines are much more pronounced this time round compared to that in the first trading week of the 2006 correction and also more widespread. In particular, the Chinese stocks were actually trading higher during the 2006 correction, while this time round it has fallen by nearly 7%, more of less in line with the declines in the regional stock bourses. Indeed, the broad market sell-down in Asia was attributed to the initial plunge in the Chinese stocks as a trigger point. As for the international indices, the degree of the sell-down was also much sharper this time round, possibly caused by a confluence of distinctively different triggers from the 2006 episode.

Comparison of Equity Performances 2006 vs 2007

<u>% Change During The Period</u>	<u>(Trading week 8-15 May 06)</u>	<u>(Trading week 26 Feb- 5 Mar 07)</u>
MSFExJ	-5.5%	-5.7%
<u>Stock markets</u>		
China	11.2	-6.9
Hong Kong	-4.7	-5.2
Korea	-2.6	-3.8
Singapore	-4.6	-6.9
Taiwan	-4.0	-2.9
<u>International Indices</u>		
DJIA – Industrial	-1.3	-4.6
NASDAQ	-4.5	-6.5
S&P 500	-2.3	-5.2
NIKKEI 225	-4.7	-8.6
UK FTSE 100	-3.7	-5.8

Source: Bloomberg

Chinese Trigger

Part of the blame for the current global market sell-off was attributed to China, which saw the Shanghai Composite index plunging 8.8% on 27 Feb, on "Black Tuesday". The SHCOMP has fallen 6.9% between 26 Feb and 5 Mar. The sharp drop was due to rumoured anti-speculative measures such as capital gains tax, but officials later clarified that no such measures were being considered. Note that the Chinese equity market was due for correction given its valuation, and ran with it when such rumours surfaced. On the back of speculative activity and without substantial change in underlying fundamentals, valuation on the Shanghai A share has risen substantially in recent months to a high of 40x historical PE by February, compared to 18x just a year ago, and Chinese officials have warned

against such 'bubble' as late as in January this year. Shanghai Composite Index has risen 130% in 2006, one of the largest gains in Asian markets. As such, the recent sell-off in China was due to profit taking on rich valuations. In terms of fundamental outlook, nothing has changed significantly. We continue to see liquidity tightening winding down, with just 60% probability of another interest rate hike and perhaps two more increases in reserve requirement ratio. We see China's GDP growth decelerating to 9.5% in 2007 from 10.7% in 2006, while China's official growth projection of 8% for 2007 could prove to be too conservative as it was in 2006. In sum, the turmoil on the Chinese market was likely to be sentiment driven, and not reflective of economic fundamentals.

From the US Vantage Point: Relevant Factors and On-Going Risks?

As the financial community attempts to comprehend the on-going pullback in financial markets, the financial press continues to churn-out a slew of reports that supposedly identify the likely factors that triggered the initial wave of selling. On the US front, at least, some of these possible factors include the weaker than expected economic data, continued uncertainties in the sub-prime mortgage market and the recession-rhetoric from former Fed Chairman Greenspan. Although there is some scant evidence that several of the foregoing factors might have exacerbated the down-move in the major US equity indexes to some degree, there is limited evidence to suggest that the magnitude of the sell-off was a direct response to these factors.

The Weaker than Expected US Economic Data?

While the US data release schedule last week initiated with the weaker than expected January durable goods report on Tuesday (Feb. 27) morning, the subsequent better than anticipated February consumer confidence index and the January existing home sales data should have offered some solace. In fact, the overall tone of the US data releases from Tuesday (Feb. 27) through Friday (Mar. 2) was only mildly negative, with around 60% of the releases having surprised on the downside. Essentially, the recent indicators have not altered our view that US economic growth is forecasted to come-in between 2.0% and 2.5% in the first-half of this year. The major US equity indexes, however, shed more than 3% on Tuesday. They stabilized somewhat on Wednesday, and subsequently resumed their decline of more than 1% in total over the next two days.

Sub-Prime Mortgage Woes

The negative sub-prime mortgage news surfaced a couple of weeks back. The initial response from the equity market was mainly concentrated on the respective firms that were directly involved with the credit quality deterioration in the sub-prime segment. Indeed, while the sub-prime delinquency rate rose to more than 12%, the delinquency rate in the prime segment was still in the neighborhood of less than 2.5%. In fact, upon the release of the negative sub-prime news, the different measures of credit spreads and default risk spreads barely budged (though the reaction was more pronounced in the MBS market, whereby spreads did widen). Although we suspect that the credit quality deterioration in the sub-prime segment would likely persist--with room to intensify further--it is still too early to ascertain if the situation might spillover into the prime segment. It is not entirely clear why some might have attributed the recent week's retreat in the broader equity market to the sub-prime news, despite the concentrated response in the earlier weeks.

The "Greenspan-Rhetoric"

The former Fed Chairman, Greenspan, spoke at a business conference on Monday (Feb. 26). During his question and answer session, Greenspan indicated that it "while, yes, it is possible we can get a recession in the latter months of 2007, most forecasters are not making that judgment and indeed are projecting forward into 2008...with some slowdown". Although the US equity indexes on that day did end lower--with the DJIA and S&P 500 down by about 0.1%, and the NASDAQ Composite fell by around 0.4%--there were other influences in the market, which stemmed from the US-Iran tension that evidently pushed the front-month NYMEX crude oil contract to an intra-session high of \$61.75/bbl. In actuality, we are inclined to believe that Greenspan was merely emphasizing that the US business cycle is not dead, and that the duration of a typical US business cycle expansion is on average about five years (though the recent two business cycle expansions did stretch roughly twice the historical average). Although some degree of caution is warranted, the likelihood of a recession over the next six months or so--based on the recent indicators--remains well below the alert threshold.

In Summary

All in all, we have underscored in our daily publications that the recent retreat in US equity prices was likely related to an abrupt shift in investor sentiment, which appeared to have been triggered by a sharp decline in the overseas markets, as fundamental indicators continue to evolve unevenly. To be sure, shifts in investor psychology are highly unpredictable, especially when investors en masse rush for the exits. Similarly, the tendency for financial markets to overshoot suggests that the eventual magnitude of the down-move is anyone's guess. If the negative market sentiment stabilizes, then the recent correction could be viewed as a healthy development. But if the pullback in asset prices is reinforced by weaker than expected evidence on the economy, the recent episode could become self-fulfilling and ugly.

While markets in Asia have broadly stabilized today, recovering somewhat from the plunge on Monday (5 Mar), it is still not entirely clear if the worst is behind us. What is certain is that one cannot draw parallel conclusions from the last time and apply it to our current situation.

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