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Worries Surface about a Potential Bubble

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By Geoff Dyer

Two years ago, Shang Fulin, the head of the Chinese stockmarket regulator, came under frequent attack for the uninspiring performance of the market which was languishing at near 1,000 points. Now he is occasionally admonished for not doing more to prevent the market's inexorable rise, with the main index now well over 5,000 points.

"The speculative mood has deepened," Mr Shang admits in an interview. "The rapid rise in the market means that the level of share prices could exceed the growth in companies' earnings." The resurgence of the mainland China stockmarket has been one of the more remarkable investing stories of recent years.

After languishing for half a decade, mainland shares have soared in the past two years as retail money has flooded into the equity market.

The majority of analysts in mainland China are relatively relaxed about the state of the market, even if a few expect short-term corrections, as they feel the rise in share prices is a reflection of China's long-term growth story.

Zhong Hua, analyst at Changjiang Securities in Shanghai, says the mainland market is no longer cheap compared with other markets. "But, in the long term, especially if you compare the size of the market to China's gross domestic product, we still think it is at a reasonable level and can rise further." For many analysts outside of China, however, the market is becoming ever-more dangerous.

"It is a bubble, but it is a bubble that could continue for the next year," says Fraser Howie, co-author of a book on the Chinese stockmarket.* Sceptics point first to valuations.

With the mainland market trading at a price-earnings ratio of about 50 for 2007, the companies that are listed in both Hong Kong and Shanghai are trading at a premium of almost 100 per cent on the mainland market.

A further warning sign has been the importance of rising share prices to company profits. The booming economy has helped corporate earnings increase by 70 per cent in the first half of the year.

However, Jerry Lou at Morgan Stanley in Hong Kong estimates that income from non-core operations - which was mostly from equity investments - accounted for 31 per cent of profits in the first half. As a result, earnings could take a big hit if the market turns down.

Even though corporate governance standards have improved as more Chinese companies have listed overseas, analysts still believe there are serious deficiencies in the way companies treat minority shareholders.

A recent report by New York research firm RateFinancials, which looked at the 10 largest Chinese companies listed on the NYSE, concluded that most of them had low quality earnings, including low allowances for bad debts and insufficient cash flow.

It also criticised the weakness of company boards and the shuffling of executives between different state-owned companies.

While many analysts are worried about the current price levels, they could still go higher.

Economists are concerned that the surge in inflation in China, which has made real interest rates negative, will prompt further flows of bank deposits into the stock market.

“There is a risk that demand for holding money will collapse,” says one influential economist in Beijing who asked not to be named. “That means there is an ever larger amount of money chasing a small amount of shares.” When the market was relatively small, its movements had little impact on the economy.

However, now that it is by some measures the biggest market in Asia and millions of Chinese have opened stock trading accounts this year, the potential fall-out from a sharp drop will be much bigger.

Worried about the growth of a potential bubble, the authorities intervened in May to reduce speculation by tripling the tax on share trading. Yet after the market fell sharply, officials changed tone and began to talk the market up.

Some observers believe the authorities will once again intervene to try to deflate the market - but not through tax measures.

“We expect that over the next month the government will take more policy measures to cool the market,” says Losa Mak, chief investment officer at HSBC Jintrust Fund Management in Shanghai. “But they will likely be market mechanisms aimed at managing liquidity.” Measures could include allowing a series of large IPOs in Shanghai, which are designed to draw some of the liquidity from the market. China Construction Bank and Shenhua Energy, the country's biggest coal-miner, both broke the record in September for the largest mainland IPOs. The authorities could also approve more investment funds which will buy international shares, accelerating the flow of retail savings overseas.

Jing Ulrich, head of China equi t ies at JPMorgan, also believes that officials hope to gradually deflate the market through selling more shares and allowing more money to be invested overseas.

"The authorities expect valuations will decrease over time in the face of rising corporate earnings, increased share supply, widening investment channels for Chinese citizens, and the introduction of index futures," she says. Yet if these efforts to increase the supply of shares do not begin to deflate the market, Mr Shang and other regulators will find themselves in a delicate position.

They will need to find new ways to engineer a drop in share prices without causing a collapse in confidence and a backlash from the millions of new small shareholders. Success also brings its challenges.

* Privatizing China by Carl E Walter and Fraser J T Howie