Bianco Research L.L.C.
An Arbor Research & Trading Affiliated Company
Independent · Objective · Original
June 2007 | 1731 North Marcey, Chicago IL 60614 | www.biancoresearch.com

Special Report

June 2007

The View From Shanghai
So Where is the Chinese Market Going?

By Hugh Peyman

This is the second in a weekly series of *Special Reports* about China, its markets and economy.

Mr. Peyman is the founder of Research-Works the leading independent research firm in China. Based in Shanghai for over five years Hugh brings his 30 years of experience in Asia to the phenomenon that is grabbing the headlines, moving global markets and puzzling investors worldwide.

For more information on Mr. Peyman or Research-Works, please email Fritz Handler or call 847.756.3600.

Previously we said that an understanding of the history helps us get a fix on what caused the bubble conditions China now faces. We outlined four major forces – two decades of trade surpluses, pent up savings, gains from property and a growing wealth effect – that drove bubbles in earlier Asian liquidity-fuelled markets.

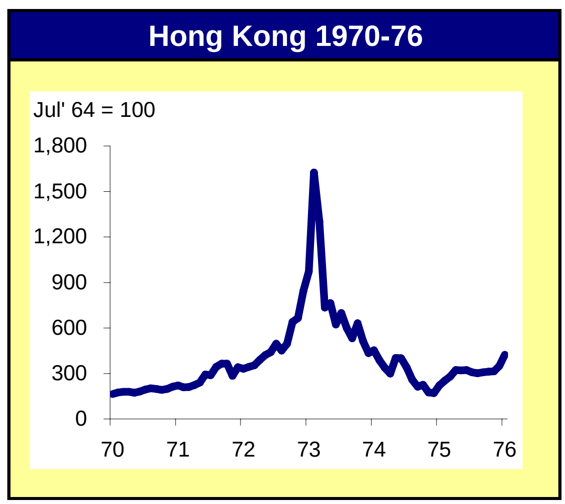
We expect China to be little different. Instead of thinking what would happen in a mature market like the US or UK, investors should think what happens when there is effectively a fixed exchange rate, very little currency convertibility, underdeveloped capital markets and few investment alternatives, especially after the property market has already doubled or trebled.

The answer is simple; most of the liquidity ends up in stocks. The index goes nearly vertical. Not all at once of course and there are corrections along the way but the direction is strongly north.

We have been here before. Just take a look at Japan, Korea Taiwan, Hong Kong and all of Southeast Asia. The pattern is uncannily familiar the first time the stock market takes off with ample liquidity behind it. It is debatable that this is China's first bull run but given the restrictions last time and deformities of the economy it is reasonable to say that this is the first real bull run in which large numbers of people will participate.

Hong Kong

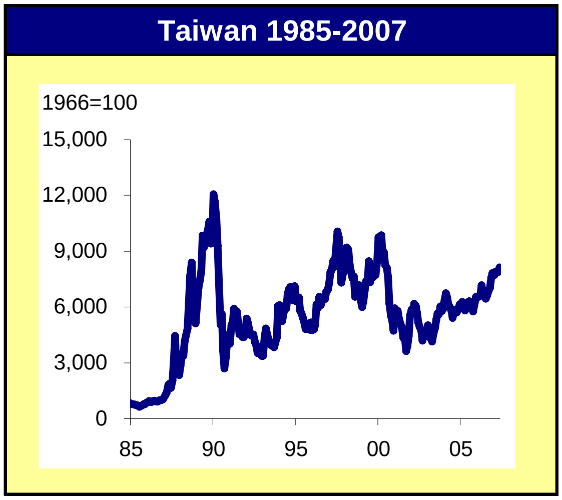
There are several varieties of Asian liquidity-fuelled markets. Some are spectacular peaks and collapses like Hong Kong in 1973. That *rose over 10-fold* in four years, most of it in a climactic six months, and then lost 90% of its peak value in just two years. Again most of the collapse occurred in a mere two months.



Source: CEIC

Taiwan

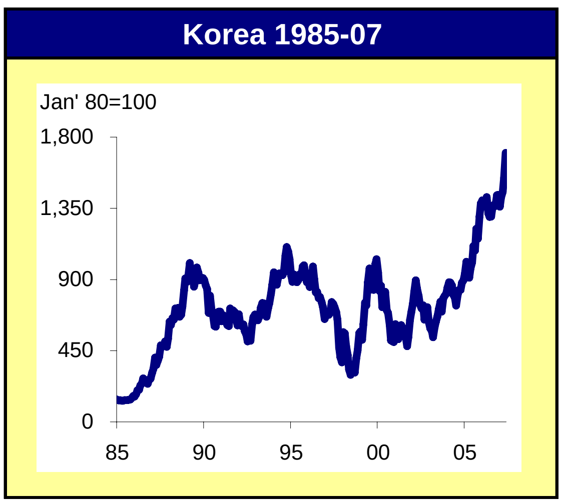
Taiwan rose even further by *over 18 times* in under five years from 1985 to 1990. It then almost emulated Hong Kong's first major boom and bust by collapsing 78% in six months. However not all the liquidity was spent and the market rose again. In fact it rose 260% over the next seven years to make two significant peaks although still below the peak of 1990.



Source: CEIC

South Korea

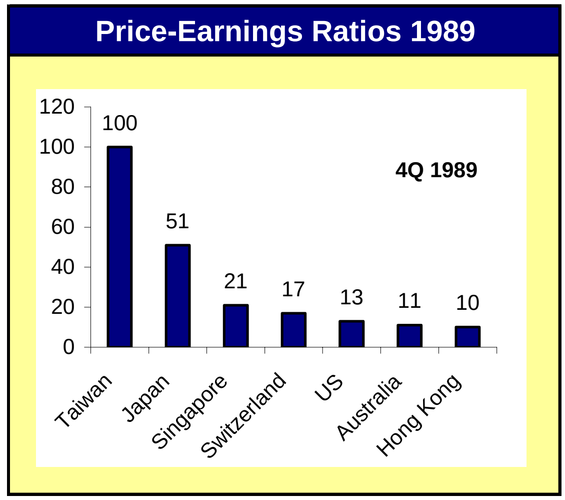
South Korea rose 650% in the four years to April 1989 but collapsed only a mere 49%. Having risen less than other markets in their maiden boom it seemed to collapse less. It then went on to make not two significant peaks, as in Taiwan, but three, before climbing to current highs that are some 54% above the peak in 1994.



Source: CEIC

Valuations

Valuations went into the stratosphere. In Hong Kong even the venerable Hong Kong and Shanghai Banking Corp (HSBC) was selling on 100X in 1973. Tokyo peaked at a similar level in 1989 and so did Taiwan. What does this say about China that is on a PE of about 50X, though there are still plenty of stocks trading a lot lower? Baosteel, very much a manufacturing bellwether stock, trades on only 11X current EPS.

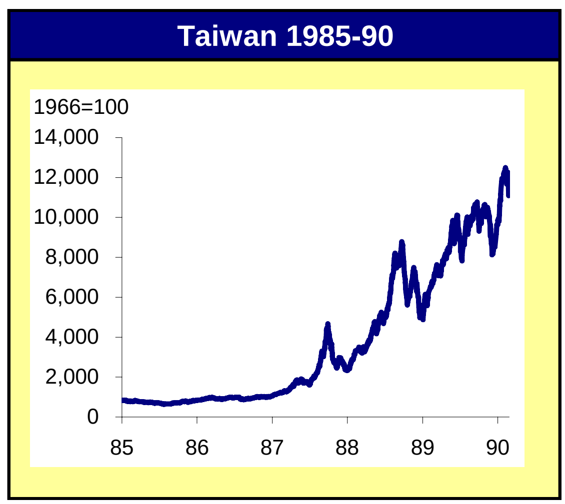


Source: The Great Taiwan Bubble, Steven Champion

Forecast For China

Our sense is that the Shanghai market can double from here, maybe more. It could indeed treble, depending on liquidity and the amount of new equity to mop up the liquidity. Why do we think so after a near vertical rise since late last year and a mere 25% correction? For isn't this the end?

The market looks more like Taiwan in 1987 after the initial peak but before the quadrupling to another peak in 1988 than Hong Kong in 1973. This was followed by the inevitable correction but there was a third surge of liquidity that took the market another 50% higher in 1989. Maybe China will follow this pattern.



Source: Bloomberg

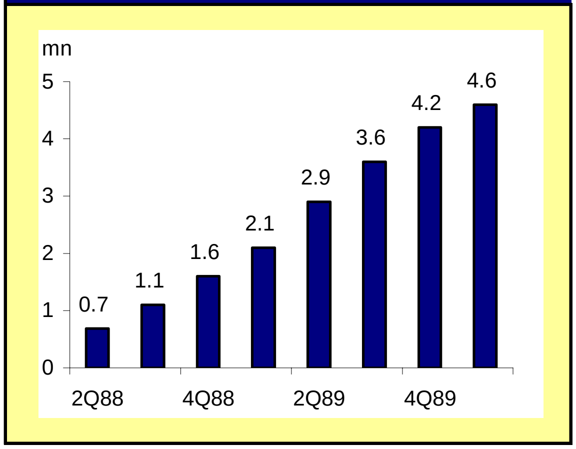
China has barely tapped into its potential liquidity. Not only are household savings high, put at about 40% of income, but many of the features of liquidity in developed equity markets are absent or minimal.

Mutual funds were a mere $110 billion in spite of rising 83% last year.

Insurance companies have very low exposure to equities, barely 5% of total assets.

Brokerage accounts until very recently have been few and far between. Government figures that seek to highlight the problem of an exploding market seem to have exaggerated the numbers. There is no reason why the pace of account openings should be any different from in Taiwan where it took nearly two years to see the number rise seven-fold.

Taiwan Active Brokerage Accounts 1988-90



Source: The Great Taiwan Bubble, Steven Champion

Foreign investors have been severely restricted. Barely $10 billion has been invested

These major forces in developed markets are only just starting to take shape. Therefore the market could well make another couple of new highs. Each time it would retreat, beaten down by government measures to restore some order. However the animal spirits are unlikely to be banished with just a few words and actions from the government.

Investors know that there is a seemingly endless new supply of liquidity that could enter the market, also that there are still many individuals who are not yet in the market. From our own observations, and those of others who travel around the country, few people seem to be stir frying the stocks, as playing the market is called in the colloquial. In a real Asian bull market everyone from the taxi driver to the night club hostess is punting like crazy. China is still far from that in spite of some foreign press reports to the contrary.

From Property To Stocks

The next major source of liquidity will be the property market. Much of China is still in a property bull run, unlike Shanghai whose three to four-fold bull run was over in 2005, for reasons that can be explained another time. That means that some 90% of the country has still not taken its chips off the property table. When they do the surge in liquidity will be far greater than anything seen so far.

For when the Shanghai property investors decided to switch into equities in the middle of 2005, when everyone knew that the Shanghai property bull run was over, they had a major impact. A market that had been sliding for nearly five years suddenly looked less anemic. Since then the market has risen 564% but that is with only 10% of the country's property market turning down.

We anticipate, again it can be explained another time, that the property markets in the rest of China will roll over, just as Shanghai did in 2005, over the next two or three years. When they do there will be substantial sums to be reinvested. Since we don't think that Chinese investors will be allowed to invest in NASDAQ or other foreign markets, that means that much of this liquidity will end up in equities, regardless of valuations.

Conclusion

This might not seem logical to value investors or those familiar with developed markets (but then did the dot com bubble?). However to emerging market investors it is all too logical. And, if we are wrong it does not matter to investors outside China. The reasons why will have to wait until the next *View From Shanghai*

Bianco Research L.L.C.

1731 North Marcey, Suite 510
Chicago IL 60614

Phone: (847) 304-1511
Fax (847) 304-1749
e-mail: research@biancoresearch.com
http://www.biancoresearch.com

For more information about the contents/ opinions contained in these reports:

President (847) 756-3599
James A. Bianco jbianco@biancoresearch.com

Strategist/Analysts (847) 304-1511
Howard L. Simons hsimons@biancoresearch.com
Greg Blaha gblaha@biancoresearch.com
Ryan Spokas rspokas@biancoresearch.com

For subscription/service Information:

Arbor Research & Trading, Inc.
Director of Sales & Marketing (800) 625-1860
Fritz Handler fritz.handler@arborresearch.com
Norma Mytys norma.mytys@arborresearch.com

Arbor Research & Trading, Inc.

1000 Hart Road, Suite 260
Barrington IL 60010

Phone (847) 304-1560 Fax (847) 304-1595

e-mail inforequest@arborresearch.com
http://www.arborresearch.com

Domestic - For more information about Arbor Research & Trading and its services:

Chicago Sales Office

1 North LaSalle Street, 40th Floor
Chicago IL 60602
Daniel Lustig dan.lustig@arborresearch.com
Phone (866) 877-0266 Fax (312) 269-1681

New York Sales Office

The Chrysler Building, 405 Lexington Ave
New York, NY 10174
Edward T. McElwreath ed.mcelwreath@arborresearch.com
Phone (212) 867-5326 Fax (212) 370-1218

International - For more information about Arbor Research & Trading and its services:

London Sales Office

4 Broadgate, 2nd Floor, Room 57
London England EC2M 2QY
Phone 44-207-965-4784 Fax 44-207-965-4787

Neil Tritton neil.tritton@arborresearch.com
Ben Gibson ben.gibson@arborresearch.com

European Sales

James L. Perry james.perry@arborresearch.com
Phone (847) 756-3510 Fax (847) 304-1595
Rich Kleinbauer rich.kleinbauer@arborresearch.com
Phone (41) 22 363-9229

Far East Sales

Robert Reynolds robert.reynolds@arborresearch.com
Phone (847) 756-3680 Fax (435) 647-3073