



In the third quarter, Asia ex-Japan bank shares – including stocks in China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand – recovered strongly from the May-June emerging markets sell-off. The MSCI Asia ex-Japan Financials stock index rose 6 percent in the June-September quarter, sustaining the bull market run begun in the first half of 2003. It was the twelfth quarter of increase in the last fourteen quarters. But in contrast to many earlier quarters, Asian banks were not leaders in the third quarter rally. Asian bank stocks slightly underperformed both broader Asian indexes and the MSCI Global Financials Index.

As in the second quarter, share price performances

varied widely across the ten major Asia ex-Japan markets. Bank stocks in the least developed markets – India, China, Indonesia and Philippines – performed best, as investor risk appetite rose. Bank stocks in two of the most developed markets, Taiwan and Korea, were the worst performers. The strong performance of less developed markets has helped banks in those countries achieve valuations well above developed market standards.

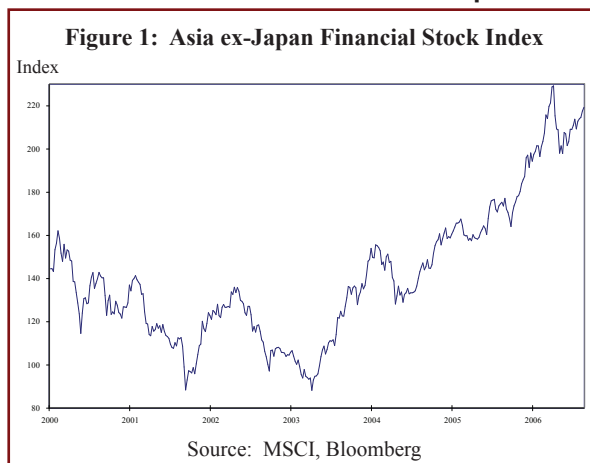
Investors reacted negatively to the September 19 coup in Thailand. Historically, financial markets have reacted little to Thai political upheavals, but Thai bank shares fell after the coup, significantly underperforming banks in the rest of the region.

I. PERFORMANCE

Share Price Performance

Asia ex-Japan financial stocks rose 6 percent in the third quarter, putting them up 10 percent in 2006 and 16 percent for the previous twelve months (Figure 1). They remained 4 percent off the May high, but from the start of the rally in early 2003 to the end of September, the Asian Financial index rose at a compound annual rate of 31 percent.

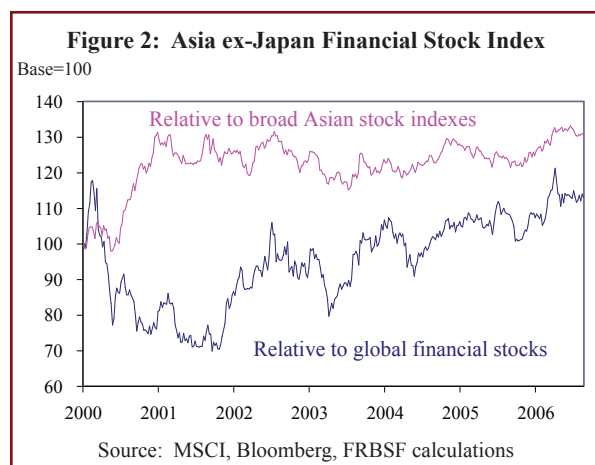
Asian Financial Stocks Resume Rapid Rise



Relative performance

Although Asian financial stocks rose strongly in the quarter, their relative performance was weak. They underperformed both broader Asian indexes and the MSCI Global Financial index by 1 percent (Figure 2). Since early 2001, Asian financials have performed roughly in line with broader indexes, though they have risen much more than global financial stocks since the rally began in early 2003.

But Relative Performance Flat



II. VALUATIONS

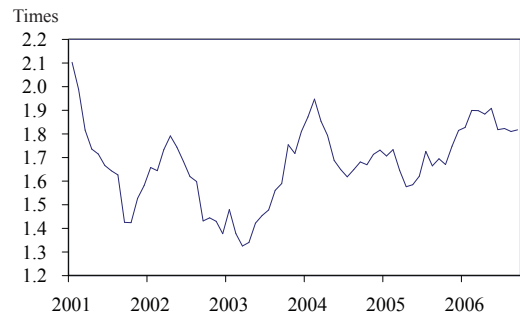
Valuations moved relatively little in the quarter but remained high by historical standards. One valuation metric places Asian banks at higher levels than leading western banks, and another puts them only slightly lower.

Price-to-Book Ratio

Asian banks' price-to-book value ratio (PBR) remained unchanged over the quarter at 1.8 times, and sits at the same point where it started the year (Figure 3). In other words, shareholders equity (i.e., book value) has risen as strongly as share prices. Since the bull market began in early 2003, however, the PBR has expanded nearly 50 percent.

Price-to-Book Ratios Steady

Figure 3: Asia ex-Japan Bank Price-to-Book Ratio



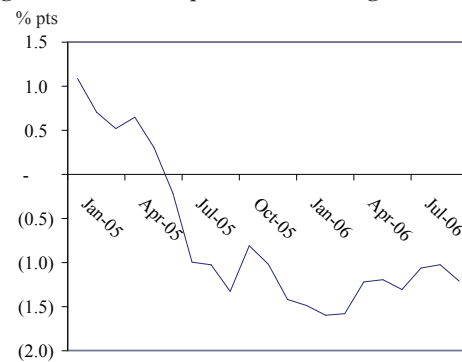
Source: Bloomberg, FRBSF calculations. Calculated as share price divided by 12-month rolling average historical book value per share.

Earnings Yield Spread

An equity-based proxy for a bond yield spread, the earnings yield spread, continues to reflect a low risk premium for Asian banks. A bond yield spread compares the yield of a risky bond (e.g. bank bond) with a risk-free yield of a comparably dated Treasury. In contrast, an earnings yield spread compares the earnings yield of relatively high-risk Asian bank stocks with the relatively low-risk earnings yield of the top ten U.S. and European banks. Whereas a bond yield is roughly the annual coupon divided by bond price, an earnings yield is annual earnings per share divided by stock price. The earnings yield spread – a proxy for the risk premium – fell again in the third quarter, reflecting investors' perceptions of improved health in the Asian financial sector (Fig. 4).

Risk Premium Falls

Figure 4: Asia ex-Japan Bank Earnings Yield Spread



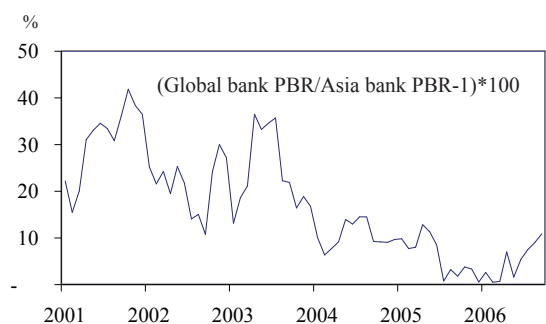
Source: Bloomberg, FRBSF calculations

Price-to-Book Premium

Like the Earnings Yield Spread, the price-to-book ratio premium benchmarks Asia ex-Japan bank valuations against a low-risk portfolio of top ten Western banks. The indicator shows the premium of top ten Western bank PBRs over Asian PBRs. The lower the PBR premium, the lower the risk premium investors have attached to Asian banks relative to Western banks. The measure rose in the quarter due to an increase in Western banks' PBR, but remains very low by historical standards (Fig. 5).

Asian Bank Valuations Still Close to Western Benchmarks

Figure 5: Western Bank Premium over Asia ex-Japan



Source: Bloomberg, FRBSF calculations

III. COUNTRIES

Third quarter saw a partial reversal of the second-quarter patterns. The second quarter's worst performing bank stocks – India's – led Asia in the third quarter, and the second-strongest bank index in the second quarter – Taiwan's – was the only banking sector in Asia to post a significant decline in the third quarter. The strength of stocks in some of the least developed markets – China and Indonesia – has given banks in those countries unusually high valuations.

2Q06 Performance

Banks in the least developed markets performed best in the third quarter (Fig. 6). Indian bank shares jumped 42 percent in the quarter. The gain more than erased the 31 percent drop registered in the May-June sell-off and put the Indian Banks Index at an all-time high the second-to-last day of the quarter, before the index declined slightly the last trading day of September. In contrast to the strong performance of Indian, Chinese and Indonesian bank shares, the Taiwanese and Korea bank indexes fell slightly in the quarter. Increased investor risk appetite likely played an important role in performance patterns.

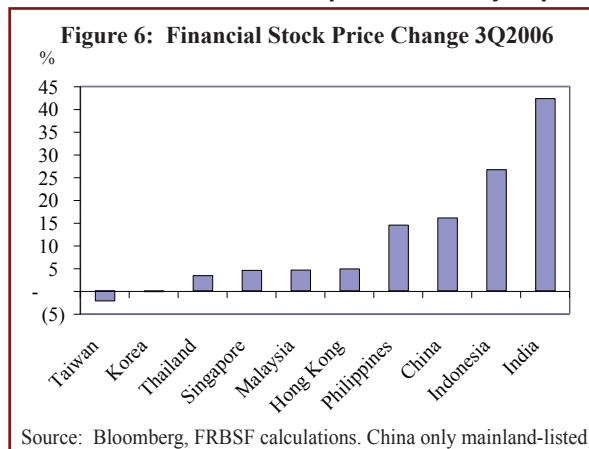
PBR Change

The past twelve months have seen a big expansion in the PBRs of banks in some of the less developed markets, namely Indonesia, China and Philippines (Fig. 7). Banks in those markets have seen healthy growth in earnings and shareholders equity, but share prices have risen much more rapidly.

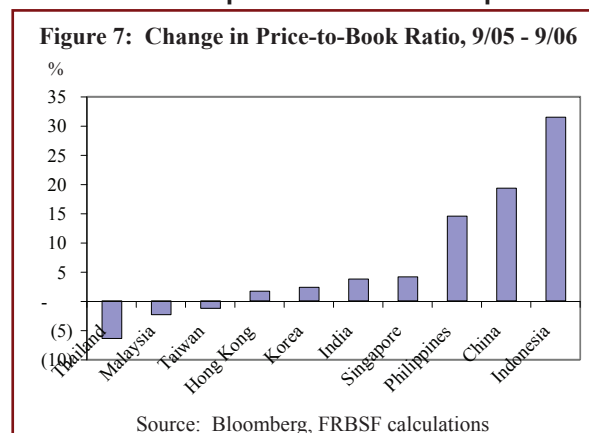
Price-to-Book Ratios

In part due to their strong share price performances the past year, Chinese and Indonesian banks now have the highest price-to-book ratios in Asia (Fig. 8). In general, banks in less developed markets carry higher multiples than those in more developed countries, such as Korea, Taiwan and Singapore. In large part, this surprising pattern reflects restrictions on overseas investment on the part of Asian investors and the lack of cross-border market integration. Lack of integration prevents convergence of valuations and makes cross-border comparisons difficult.

Shares in less developed markets jump



Less developed market PBRs expand



Chinese PBR highest in Asia

