



Asia excluding-Japan bank shares – including stocks in China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand – had an unusually strong fourth quarter. The MSCI Asia ex-Japan Financials stock index rose 21 percent the last three months of 2006, extending the bull market run that began in the first half of 2003. The strong performance marked the thirteenth quarter of increase in the index in the last fifteen quarters, and the biggest rise since the third quarter of 2003. Asian bank shares’ relative performance was as notable as their increase in absolute terms. Over the fourth quarter, the Asia ex-Japan Financials stock index outperformed the broader Asia ex-Japan index by 7 percentage points and outperformed the MSCI Global Financial stock index by 15 percentage points.

Bank shares rose in almost every Asian country. Only the Thai bank index fell, and financial stock indexes in seven of the ten countries surveyed posted double-digit gains in the quarter. As in the third quarter, bank stocks in the least developed markets tended to perform

best, as investor risk appetite rose. Banks in China, Philippines, India and Indonesia accounted for four of the top five performers in the fourth quarter, while banks in three of the most developed markets—Korea, Hong Kong and Taiwan—underperformed all other countries save Thailand. The continued strong performance of less developed markets has pushed valuations of banks in some of those countries to levels well above developed market standards.

Banks in China led the surge in share prices for the region. The Xinhua China Financial Stock index increased 71 percent in the fourth quarter alone, putting it at double the level of six months earlier in June and nearly triple the level of the beginning of the year. The 2006 rise left Chinese banks with unusually high price-to-book ratios (PBRs) by Asian standards. Although some of the current high valuation of Chinese banks can be linked to investor optimism about China’s growth prospects, other factors are equally important drivers. The small free float of Chinese shares, the lack of alternative investments and recent market reforms also contribute to Chinese banks’ high PBRs.

## I. PERFORMANCE

### Share Price Performance

Over the quarter and the year, stock performance in the region was impressive. Asia ex-Japan financial stocks rose 21 percent in the fourth quarter, putting them up 41 percent for the full year, the largest annual gain in the current decade (Figure 1). As a result, the index reached a record high and tripled the decade low posted in April 2003. Although no country matched China’s performance, gains were broad-based.

### Asian Financial Stocks Hit Record High

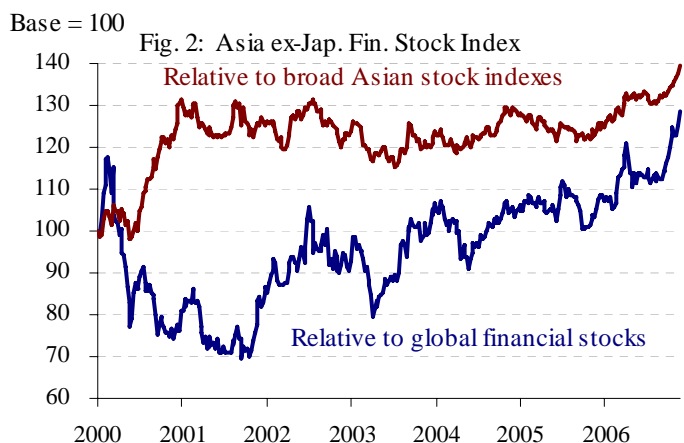


Source: MSCI, Bloomberg

### Relative Performance

Asian financial stocks outperformed their relevant benchmarks over both the quarter and the year. The Asia ex-Japan Financials Index outperformed the MSCI Global Financial Index by 15 percentage points in the fourth quarter and by 26 percentage points for the full year (Figure 2). Similarly, Asian financial stocks outperformed the broader MSCI Asia ex-Japan benchmark by 7 percentage points over the quarter, and 16 percentage points for the year.

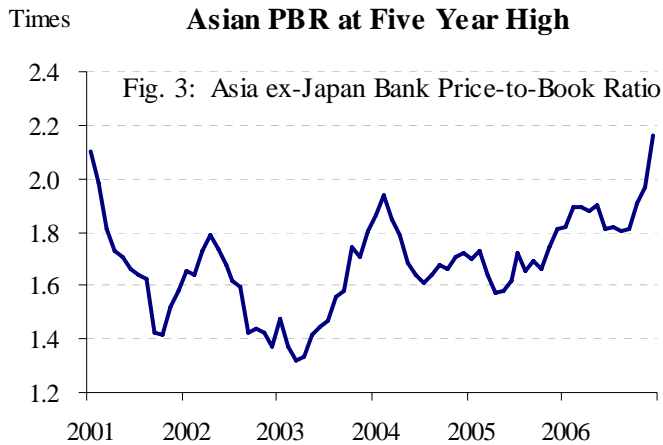
### Outperforming Global Financial Stocks



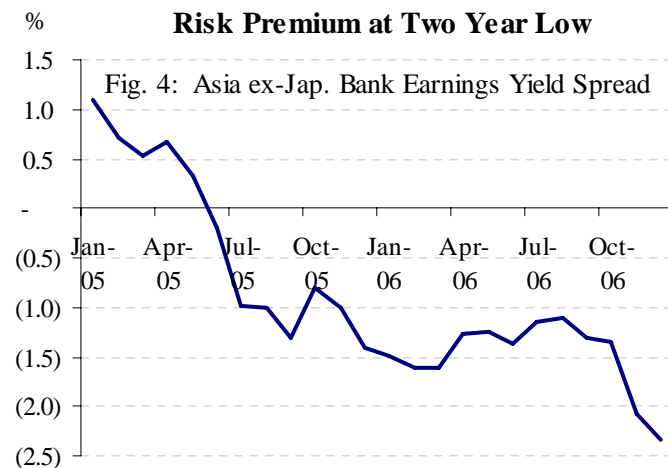
Source: MSCI, Bloomberg, FRBSF calculations

## II. VALUATIONS

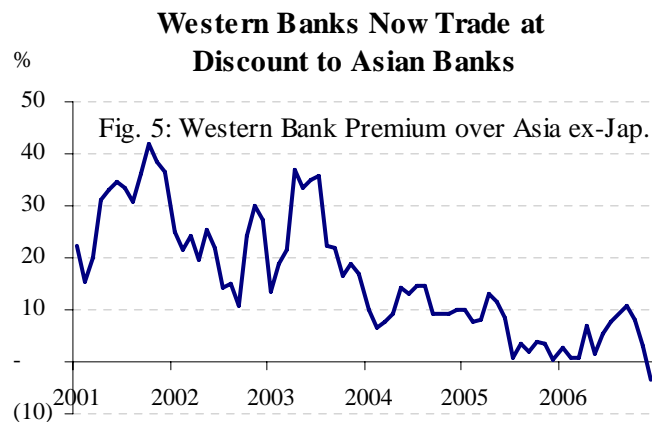
Bank valuations rose rapidly in the fourth quarter and ended the year at decade-high levels. Asian bank stocks in aggregate now trade at valuations significantly above those of top Western banks.



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



Source: Bloomberg, FRBSF calculations



Source: Bloomberg, FRBSF calculations ((Global bank PBR / Asia bank PBR - 1) \* 100)

### Price-to-Book Ratio

In the last three months of 2006, Asian banks' price-to-book value ratio (PBR) rose from 1.8 times to 2.2 times, a large single-quarter increase (Figure 3). Earnings and shareholders equity (i.e., book value) are increasing at healthy paces, but share prices are rising even faster, leading to the PBR expansion. Since the bull market began in April 2003, the PBR has risen 64 percent from 1.3 times. Although the rise in Chinese bank valuations has been the fastest, PBRs increased at double-digit rates in all countries save Thailand and Korea in 2006.

### Earnings Yield Spread

The earnings yield spread\* – a proxy for the risk premium – fell sharply in the fourth quarter. The spread is now well into negative territory and at a two-year low. The negative spread indicates that investors now attach an unusually low risk premium to Asian banks, likely reflecting investors' perceptions of improved health in the Asian financial sector and superior growth prospects (Figure 4).

### Price-to-Book Premium

The price-to-book ratio premium, which measures Asia ex-Japan bank valuations against a low-risk portfolio of ten large Western banks, dropped to negative 3.3 percent in the fourth quarter (Figure 5). The negative PBR premium means that Asian banks, in aggregate, now trade at higher PBRs than the aggregate measure of leading Western banks, which includes HSBC, Citigroup and Bank of America. As with the drop in the earnings yield spread, the decline in the PBR premium appears to reflect investor expectations that Asian banks will see faster earnings growth than Western banks, and that the financial strength of Asian banks has improved.

\* The earnings yield spread is an equity based proxy for a bond yield spread. The earnings yield spread compares the earnings of relatively high-risk Asian bank stocks with the relatively low-risk earnings yield of the top ten U.S. and European banks. The ratio equals annual earnings divided by stock price.

### III. COUNTRIES

The fourth quarter was notable for both the breadth of the bank share rally and the sharp jump in Chinese banks' share prices. The quarter's performance left Chinese banks with valuations far above those of banks in any other country.

#### 4Q06 Performance

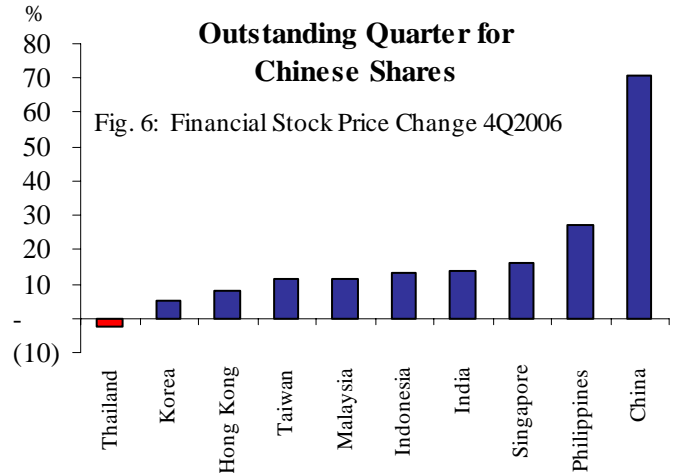
Bank share prices rose strongly in almost every Asian country in the fourth quarter. Only Thai bank shares fell, and only in Thailand, Korea and Hong Kong did banks post less than double-digit gains. As in the third quarter, bank shares in less developed markets tended to outperform in the fourth quarter, likely reflecting increased investor risk appetite. Chinese banks turned in the best performance by far. The Xinhua China Financial stock index's 71 percent increase in the quarter was nearly triple that of the next best performer, the Philippines (Figure 6). Industry consolidation, strong capital inflows and falling NPLs helped drive Philippine bank shares. For the year, only Thai banks fell, with a four percent decline. Thailand's imposition of capital controls in December accounted for the Thai losses.

#### PBR Increase

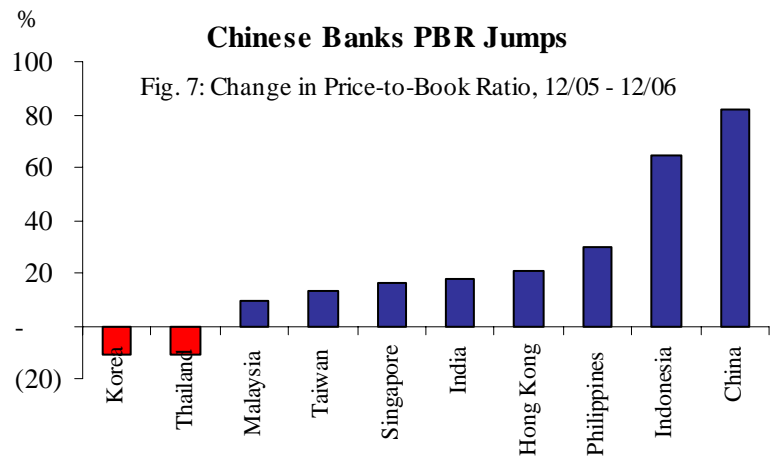
The fourth quarter and the full year saw substantial percentage increases in the aggregate price-to-book ratio of banks in almost every country. Banks in all countries except Thailand and Korea reported double-digit increases in PBR in 2006 (Figure 7). Not surprisingly, China led the way. Chinese banks' PBRs rose a remarkable 82 percent in 2006, followed by Indonesian banks' PBR, which rose 64 percent over the year. Prolonged political instability in Thailand and intense lending competition in Korea likely explain the decline in the Thai and Korean ratios.

#### Price-to-Book Ratios

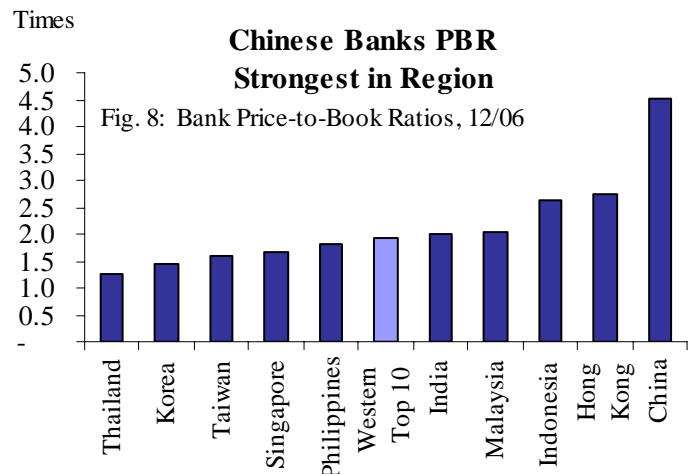
Chinese banks' strong 2006 performance left them with by far the region's highest PBRs. At 4.5 times, the Chinese bank PBR exceeds that of banks in the highly developed Hong Kong market by 65 percent. Chinese banks now carry some of the highest PBRs in the world. Indonesian banks also appear richly valued at a PBR of 2.6 times, just behind Hong Kong. Thai and Korean bank shares now have the lowest PBRs in Asia, 1.2 and 1.5 times, after their significant underperformance in 2006 (Figure 8).



Source: Bloomberg, FRBSF calculations. China only mainland-listed.



Source: Bloomberg, FRBSF calculations



Source: Bloomberg, FRBSF

## IV. CHINA

Investors clearly are bullish on Chinese bank growth prospects, but optimism about Chinese bank operations and finances alone does not fully explain Chinese banks' unusually high PBRs. The scarcity of traded shares, reform of stock market trading restrictions, and the lack of alternative investments are equally important determinants of high Chinese bank valuations.

### Small Free Float

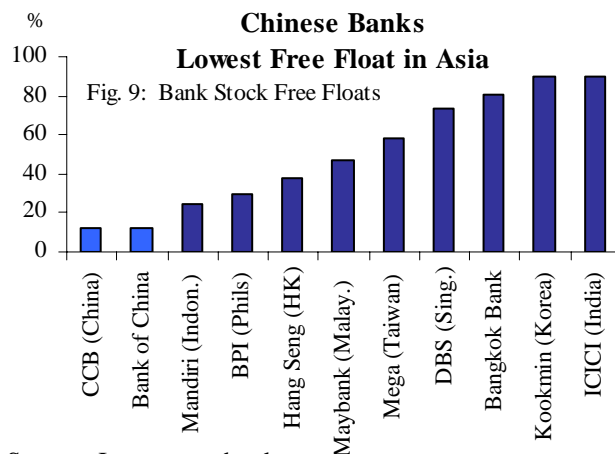
Possibly the most important factor behind the historically high PBR of Chinese banks – and the Chinese equities market in general – is the small free float of Chinese stocks. The free float is the portion of a company's stock not held by long-term shareholders and thus available for trading. Government entities own a majority of almost all listed Chinese banks, leaving relatively few actively traded shares. A comparison of the free float of large banks in the major Asian markets shows that Chinese banks have the lowest proportion of traded shares in the region (Figure 9). Therefore, the supply of Chinese bank shares is low at a time of high demand. As a result, available Chinese bank shares tend to sell at high valuations.

### Reform of Trading Restrictions

While the near tripling of the Chinese Financial index in 2006 is impressive, it is important to note that much of the strength of the Chinese stock market last year is attributed to an ongoing reform of trading restrictions. Since the beginning of stock trading in the early 1990s, a large segment of corporate shares were banned from exchange trading, and a gradual easing of the ban began in mid-2005. Most analysts believe that the lifting of trading restrictions enhanced investor confidence in the Chinese stock market and paved the way for the 2006 bull run (Figure 10).

### Lack of Alternative Investments

High valuations are not a new phenomenon in China. Chinese banks have traded at higher PBRs than banks in the region as a whole throughout the current decade. In fact, the premium was much higher from 2000 to late 2003, before the burden of trading restrictions took their full toll on share prices (Figure 11). With bank deposit rates low and bond markets underdeveloped, Chinese investors have few alternative investments to the stock market. As a result, Chinese willingly buy stocks at valuations that investors in other Asian and global markets would consider excessive.



Source: Investment bank



Source: Bloomberg, FRBSF



Source: Bloomberg, FRBSF