Asia Bank Market Monitor

COUNTRY ANALYSIS UNIT FEDERAL RESERVE BANK OF SAN FRANCISCO FIRST QUARTER 2007

The rise of Asia bank shares excluding-Japan[1] stalled in the first quarter of 2007 reflecting a slump in global equities markets in mid-February. After climbing 21 percent the last three months of 2006, the Morgan Stanley Capital International (MSCI) Asia ex-Japan Financials Stock Index inched up just one percent through the first quarter of this year. Although the small increase marked the eighth consecutive quarter of positive returns in the index, it was also the second-weakest quarter in two years. Asian bank shares' relative performance was similarly subdued. In the quarter, the Asia ex-Japan Financials Index outperformed the MSCI Global Financial Index by one percentage point – down from a stronger outperformance of 15 percentage points in the fourth quarter of 2006 – and performed in line with broader Asian indexes.

Country bank indexes posted mixed performances. Malaysian and Philippine bank indexes made strong double-digit gains in the quarter, while Indian banks registered double-digit losses. The index of mainland-listed Chinese banks rose, but the larger Hong Kong-listed bank stocks fell. Excluding the mixed Chinese performance, banks in five countries ended in positive territory, while four fell. Bank stocks in Southeast Asian countries tended to outperform banks in other regions, but no clear patterns emerged from trading. Country-specific factors seem to have played the most important role in determining relative performance. In Malaysia, for instance, government incentives issued in March to the real estate sector and to foreign investors boosted bank shares, while an unexpected tightening in monetary policy by the Reserve Bank of India put downward pressure on Indian bank stocks.

Despite the mixed performance of Chinese banks, the financial sector has emerged as the most important stock market sector for China. As recently as eighteen months ago, financials were only the fourth-largest of the ten sectors in the MSCI China Index and accounted for only 11 percent of index constituents. Now, after two years of share price rises and a series of large bank IPOs, financials are the largest sector in the index – almost double the size of the next-largest – and contribute one-third of the index value. The increase has brought the representation of banks and other financials in the MSCI China index up to the level of Asian countries with similar per capita incomes, marking an important step in the development of China's stock markets.

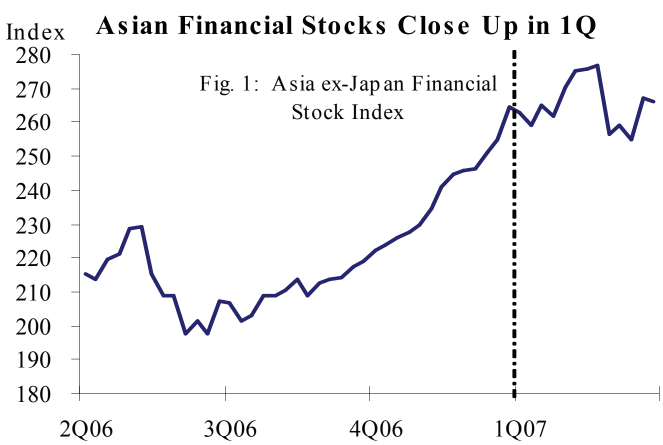
I. PERFORMANCE

Share Price Performance

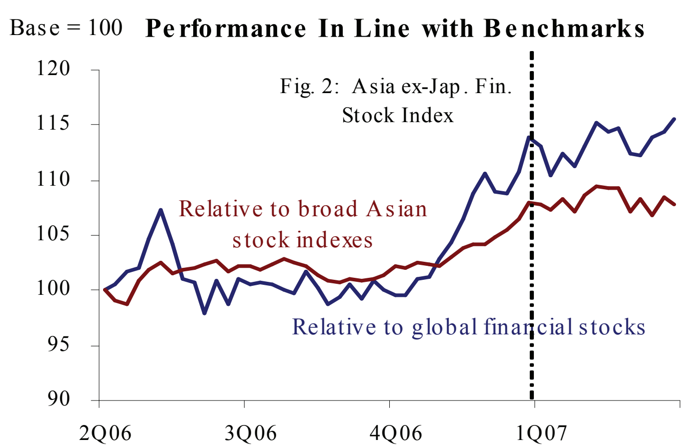
A sharp mid-quarter slump limited Asian financial stock gains over the quarter to one percent. From end-2006 to February 26, 2007, the MSCI Asia ex-Japan Financials Index rose four percent, but the nine percent fall in the Shanghai market on February 27 sent Asian financials – and global markets – into a one-week slide. From the February 26 high point to the end of the quarter, Asian financials fell three percent, resulting in the overall increase of one percent over the quarter (Figure 1).

Relative Performance

Asian financial stock performance over the quarter was generally in line with relevant benchmarks. As the mid-quarter slump was a global phenomenon, Asian financial stocks slightly outperformed the MSCI Global Financials Index by one percent. But Asian financial stock performance was almost exactly in line with that of the broader MSCI Asia ex-Japan Index (Figure 2). This was only the second time in the last six quarters when financials did not outperform the broader Asian index.



Source: MSCI, Bloomberg

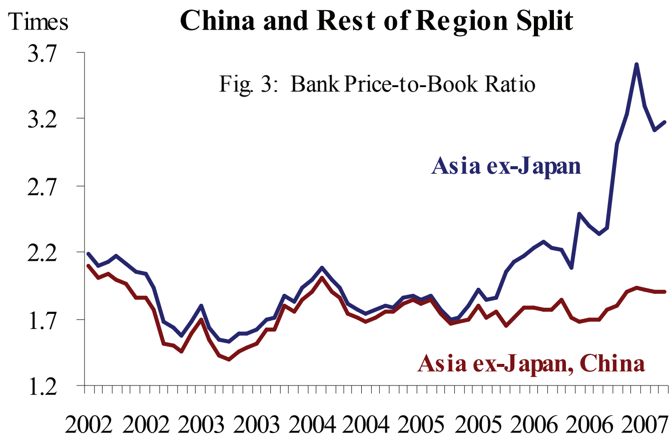


Source: MSCI, Bloomberg, FRBSF calculations

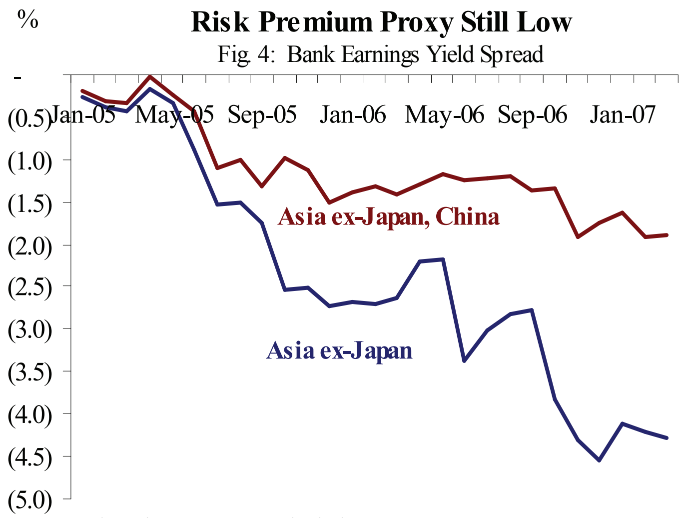
[1]The countries included in the population of Asia bank shares include stocks in China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand.

II. VALUATIONS

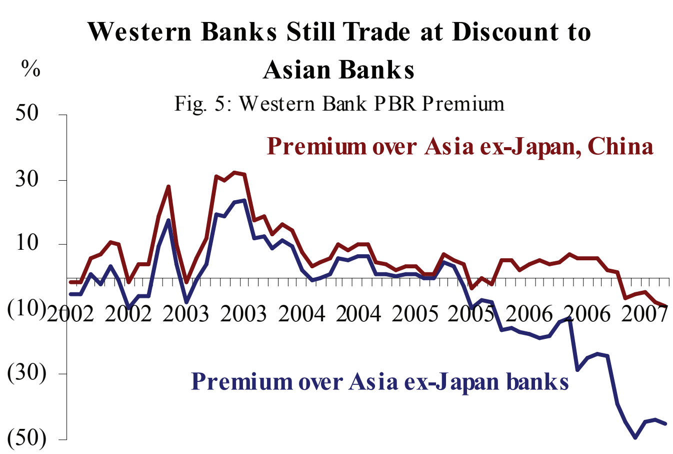
Bank valuations for the region fell in the first quarter of 2007, but Chinese banks were entirely responsible for the drop. Excluding China, bank valuations in Asia remained steady on one measure and rose on two others.



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 first three months of this year, the price-to-book ratio (PBR) of Asian bank stocks fell from 3.6 times to 3.2 times, a drop of 12 percent. The decline ended a two-year period of rising PBRs for the region. Nonetheless, exclusion of Chinese banks provides sharply differing results. Excluding China, Asian bank PBRs were flat in the quarter, and were within the tight range they have remained in since end-2004 (Figure 3). The two-year rise in Asian bank PBRs was driven primarily by China. The Chinese PBR fell in the first quarter due to share price declines of Hong Kong-listed Chinese banks and rising book values. Chinese banks have a large impact on broader Asian measures due to both their size and their extremely high valuations.

Earnings Yield Spread

The earnings yield spread[2] – a proxy for the risk premium – tells a similar story. Including China, the spread rose in the quarter, pointing to a higher risk premium, but excluding China the spread fell (Figure 4). Foreign investors sold large Chinese bank shares in the quarter due to perceptions that valuations had reached excessive levels. In contrast to the PBR, however, the earnings yield spread excluding China has followed the measure including China downwards over the past two years, albeit less so.

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, mirrored the results of the earnings yield spread. Including China, the measure showed a rising risk premium in the quarter, but excluding China, the measure fell by four percent, an indication of a lower risk premium (Figure 5). In absolute terms, Asian bank valuations excluding China were flat in the quarter, but because the PBR of the top ten Western banks fell, the relative PBR of Asia ex-China banks presented in Figure 5 improved over the three-month period.

[2] 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 per share divided by stock price.

III. COUNTRIES

The first quarter of 2007 saw unusually mixed country performances for banks. Southeast Asian bank stocks tended to increase the most, but no clear patterns were evident. Country-specific factors played the most important roles in determining bank share performance over the quarter.

1Q07 Performance

Asian countries turned in widely divergent performances in the first quarter. Malaysian and Philippine banks rose 18 percent, while Indian banks fell 12 percent (Figure 6). Region-wide forces mattered less to performance than country-specific factors. In Malaysia, banks' share performance responded positively to government incentives for property sales and foreign investors, while positive economic news encouraged investors in the Philippines. In India, markets reacted negatively to higher interest rates and tighter interbank liquidity.

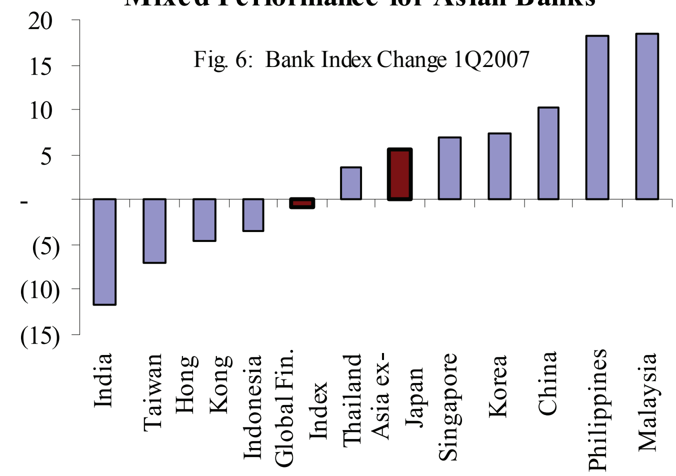
China Bank Stocks Diverge

The stock exchange of listing had a large impact on Chinese bank stocks in the first quarter. Smaller banks are listed on mainland exchanges. The largest banks are listed in Hong Kong exclusively or both the Hong Kong and Shanghai exchanges. No single index measures all bank listings, but comparison of the FTSE-Xinhua Index of mainland-listed banks with the banks having dual or Hong Kong listings shows a sharp divergence in performances. With the exception of Industrial & Commercial Bank (ICBC), mainland listings outperformed Hong Kong listings by large margins (Figure 7). Because of capital controls on the mainland, the two exchanges are not highly correlated, and share prices of a single firm can often differ by large amounts. In the first quarter of this year, Hong Kong-listed banks underperformed mainland-listed lenders due to the greater sensitivity of the Hong Kong market to global equity weakness, and due to the greater importance institutional investors in Hong Kong place on valuations.

Price-to-Book Ratios

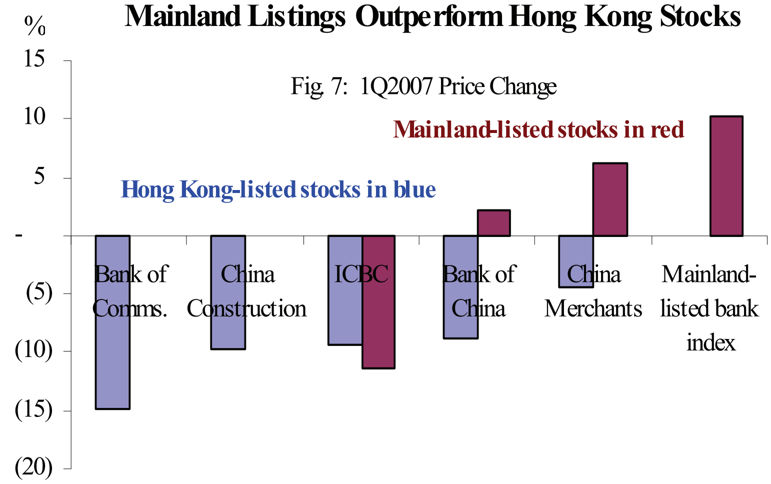
The premium of Chinese bank PBRs over the Asia ex-China average narrowed from 129% percent at end-2006, but remained high at 114% at the end of the first quarter (Figure 8). Mainland-listed banks maintained much higher valuations than Hong Kong-listed Chinese banks. Mainland-listed PBRs ranged from 4.0 to 7.8 times, whereas the top four Hong Kong-listed Chinese banks were in the range of 3.1 to 4.1 times. Even the Hong Kong listings, however, were well above regional averages.

Mixed Performance for Asian Banks



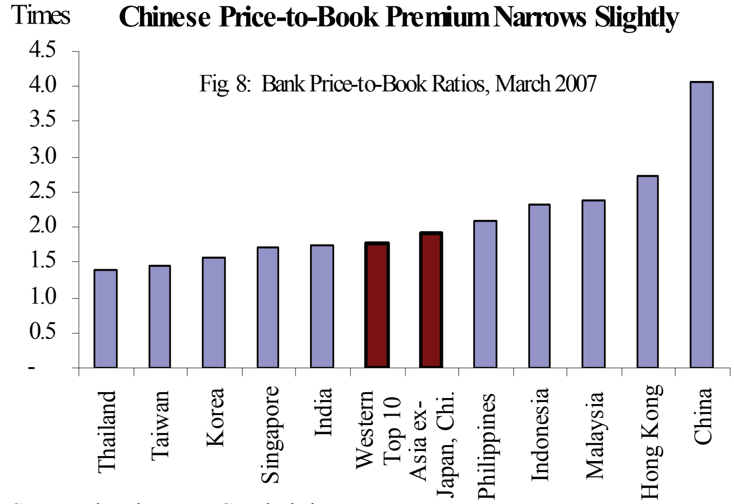
Source: Bloomberg, FRBSF calculations. China only mainland-listed.

Mainland Listings Outperform Hong Kong Stocks



Source: Bloomberg, FRBSF calculations

Chinese Price-to-Book Premium Narrows Slightly



Source: Bloomberg, FRBSF calculations

IV. CHINA

New bank listings are transforming the composition of Chinese stock markets. Previously, banks were a relatively small segment of Chinese stock exchanges, but financials are now by far the most important stock market sector in China. The listings of the past two years have given banks a fairer representation on stock exchanges in keeping with their prominence in the local economy.

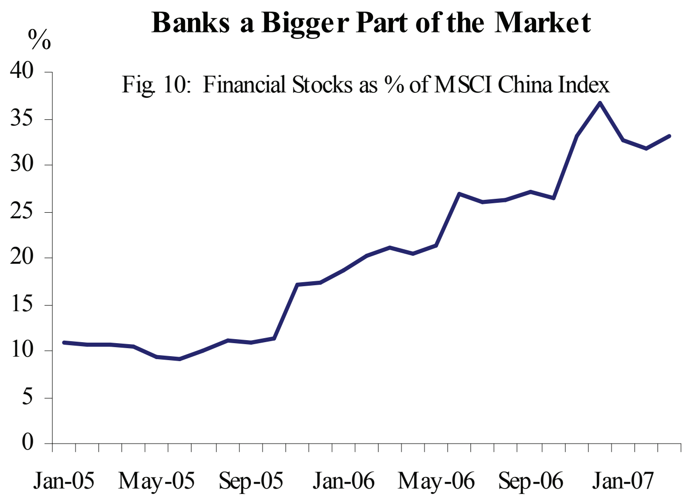
Listings Boost Market Capitalization

Chinese bank share prices have performed strongly over the past two years, but the increase in bank sector market capitalization is even more impressive. Since March 2005, the FTSE-Xinhua Index of mainland-listed banks has roughly quadrupled, but the market capitalization of both mainland- and Hong Kong-listed Chinese banks is up almost 40 times (Figure 9). IPOs at four of the five largest banks in China accounted for most of the gains of bank market capitalization.

Source: Bloomberg, FRBSF calculations. Index for only mainland-listed stocks; market capitalization includes both mainland- and Hong Kong-listed Chinese banks.

Bank Representation Rises

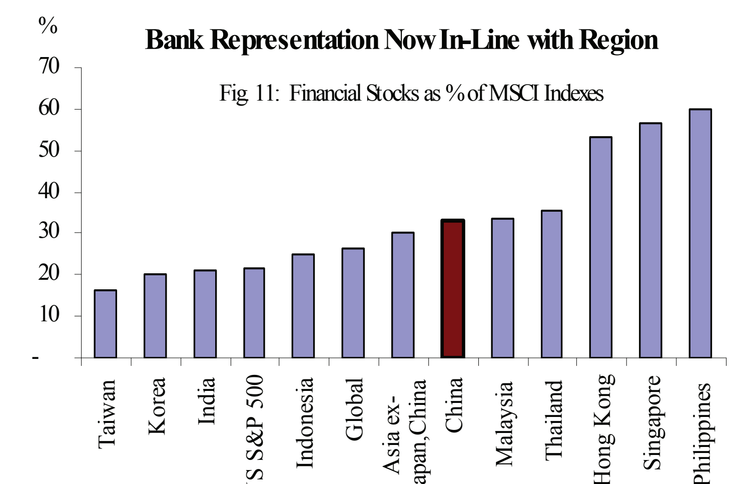
The rise in banks' market capitalization has made the financial sector a much larger share of Chinese markets. At the start of 2005, financial stocks – composed primarily of banks – accounted for only 11 percent of the MSCI China Index, and the ratio fell to 9 percent in May and June of that year. Since then, however, the contribution of financial stocks to the index increased to 33 percent (Figure 10). Over the same period, financials went from being the fourth-largest to the largest sector in the index. The next largest sectors, energy and telecommunications, are a little more than half the size of financials. Although the MSCI China Index comprises mainly Hong Kong listings, the trend of rising bank representation was likely mirrored on the mainland exchanges, where precise data is less readily available.



Source: JP Morgan

Banks No Longer Underrepresented

Although the increase in bank representation has been rapid, it does not appear out of line with regional benchmarks. At the end of the first quarter, the bank representation in the MSCI China Index was roughly in the middle of the Asian range and in line with those countries – Indonesia, Malaysia and Thailand – with the closest per capita incomes. Given the importance of banks to the local economy, the current contribution of financials to Chinese stock indexes is understandable.



Source: JP Morgan, Bloomberg, FRBSF calculations

Asia Bank Market Monitor is a quarterly newsletter issued by the Country Analysis Unit of the Federal Reserve Bank of San Francisco. The information contained in this newsletter is meant to provide useful context and insight into current financial sector developments in the Asia Pacific region. The views expressed in this publication are solely that of the author and do not necessarily represent the position of the Federal Reserve System.

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