



Bank shares in Asia excluding-Japan¹ continued their bull run in the second quarter of 2007, ending the quarter at a record-high. The Morgan Stanley Capital International (MSCI) Index for Asia ex-Japan Financial Stocks climbed 11 percent in the quarter, the seventh double-digit quarterly gain since the four-year rally began in the second quarter of 2003. Enthusiasm for Asia, more than a special interest in Asian banks, propelled financial stocks in the region. Although the Asian financial index outperformed the MSCI Global Financial Stock Index by 11 percentage points, it underperformed the broader index of all Asian stock sectors. Over a longer time horizon, since March 2003, the MSCI Asia ex-Japan Financial Stocks index is up 226 percent and has posted only two quarterly losses.

Country financial indexes in Asia rose across the board with only one exception: Hong Kong financial stocks were flat. China and India – two of the strongest performers since the rally began in 2003 – led the gains, with increases of 27 percent and 17 percent, respectively, over the quarter. Taiwan, Malaysia and Singapore lagged along with Hong Kong, but even those three markets posted increases in the six to seven percent range. In gen-

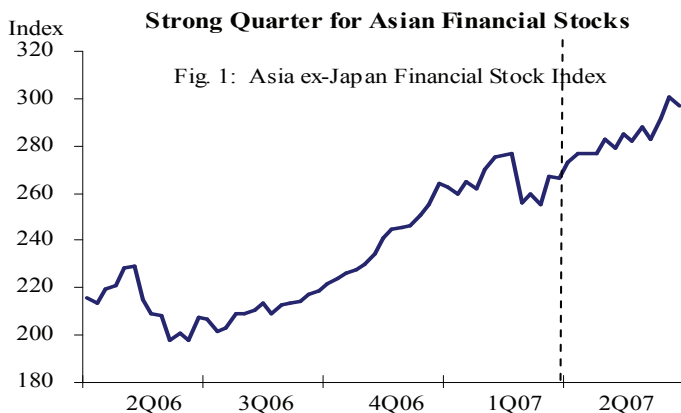
eral, traders returned to the pattern of more risk-tolerant investing which has been predominant since 2003. As a result, riskier, less developed markets such as China and India performed best. Price-to-book ratio data also reveals that investors are assigning the richest valuations to markets with the highest growth rather than those with the lowest risk.

In the smaller market of Indonesia, banks posted another strong quarter. Although Chinese and Indian banks have seen more spectacular growth, the Indonesian bank index has outperformed the broader Asia ex-Japan Financials Index by 155 percent since March 2003. An important issue for Indonesian banks over the coming years will be industry consolidation. Although takeover targets in other countries often trade at premiums relative to acquirers, in Indonesia the nature of the consolidation process appears to give the pricing advantage to larger banks. The central bank is forcing consolidation with increased capital requirements obliging small banks to seek outside capital, opening potentially valuable opportunities for large banks. Valuations reflect the advantage that large banks enjoy, with the biggest banks having much larger price-to-book values than smaller banks.

I. PERFORMANCE

Share Price Performance

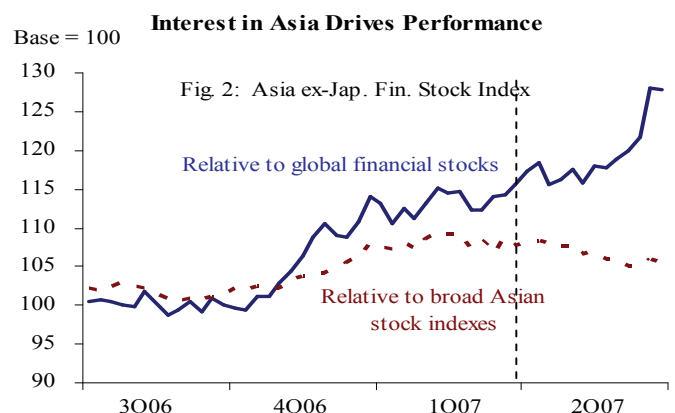
The gains of the Asian Financial Stock Index in the second quarter were consistent and strong, in contrast to the first quarter, when a sharp mid-quarter downturn, related to fall-out from the nine percent drop in the Shanghai market on February 9, limited the overall quarterly increase in the index to one percent (Figure 1). The index fared much better in the second quarter, posting an 11 percent gain and ending the quarter at a record high. The increase marked the second-best performance for the index since the fourth quarter of 2004 and the ninth-straight quarter of positive returns.



Source: MSCI, Bloomberg

Relative Performance

Asian financial stock performance compared to relevant benchmarks was mixed. Asian financial stocks outperformed the MSCI Global Financials Index by 11 percentage points, but underperformed the broader MSCI Asia ex-Japan Index by two percentage points (Figure 2). The divergence indicates that the strong absolute gains of Asian financials in the second quarter resulted less from enthusiasm for Asia's banks in particular and more from interest in Asia in general.



Source: MSCI, Bloomberg, FRBSF calculations

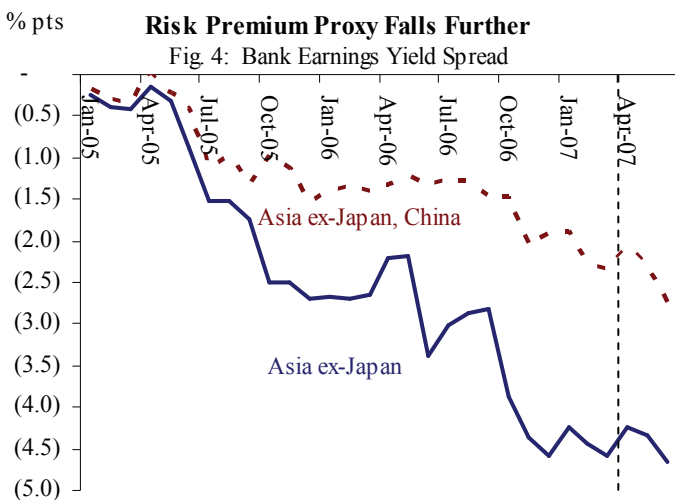
¹The countries included in the population of Asia bank shares include stocks in China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand.

II. VALUATIONS

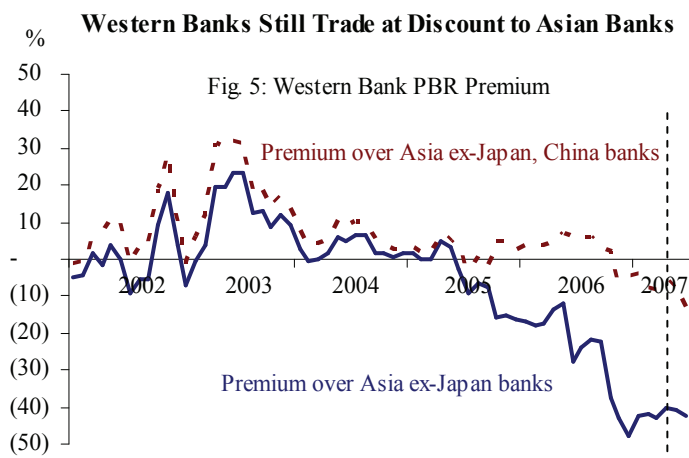
Bank valuations remained high in the second quarter of 2007 and by some measures rose. Measures comparing Asian and top Western bank valuations reached historic peaks, indicating increasing investor preference for Asian banks, probably due to enthusiasm for Asia in general.



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 $((\text{Global bank PBR} / \text{Asia bank PBR}) - 1) * 100$

Price-to-Book Ratio

In the second quarter of this year, the price-to-book ratio (PBR) of Asian bank stocks excluding China rose slightly from 1.9 times to 2.0 times. Including China, the PBR fell from 3.0 times to 2.9 times. Despite strong share price increases, the Chinese PBR fell due to expanding book values driven by strong profits and capital increases. The decline represented the second consecutive quarter of falling PBR after two years of increases (Figure 3). Chinese banks continue to have a large impact on the measure due to their size and rich valuations.

Earnings Yield Spread

The earnings yield spread² – a proxy for the risk premium – showed an even stronger increase in Asian bank valuations. Including China, the negative spread between Asian and top Western bank earnings yields widened in the quarter by eight basis points to -4.65 percent. Excluding China, the negative spread increased by over 40 basis points to -2.76 percent (Figure 4). Both measures are at their widest levels since January 2005. The wide negative spreads indicate that investors are highly optimistic about Asian bank prospects, and also may be less positive on U.S. banks in light of widening spreads in U.S. credit markets.

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, tells a similar story. Including China, the measure was relatively flat in the quarter, but excluding China, the negative spread widened five percentage points to 13 percent (Figure 5). The measure including China remains well off its widest level posted in December 2006, but the PBR premium excluding China is at its biggest negative spread of the past five and one-half years. As with the earnings yield spread, these measures indicate that investors are currently valuing Asian banks more highly than leading Western banks, partly due to problems in U.S. credit markets, and partly due to optimism regarding Asia.

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

Bank stocks in almost all Asian markets rose by large margins in the second quarter of 2007. The strong performances in the least developed markets point to lower risk aversion by investors. Average price-to-book valuations of banks in less-developed Asian countries also suggest that investors are placing a higher premium on growth over stability.

2Q07 Performance

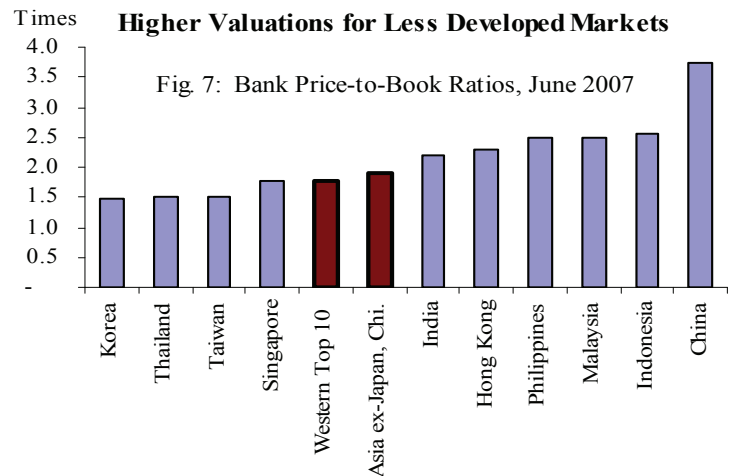
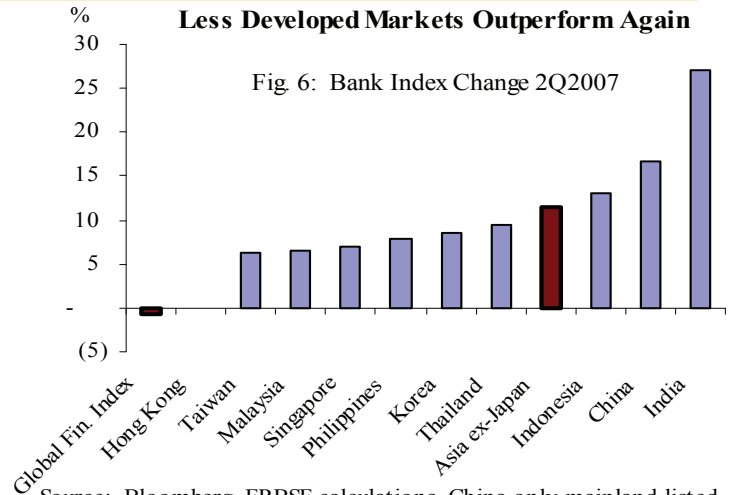
With the exception of Hong Kong, which posted flat returns, financial stock indexes in every Asian market recorded returns in excess of six percent in the second quarter (Figure 6). The least developed markets – India, China and Indonesia – performed best, while most of the more developed markets – Hong Kong, Taiwan, Malaysia and Singapore – lagged. In India, investors are hoping that the potential end of local interest rate hikes will boost lending, which resulted in the best performance of all countries in the region.

Bank Price-to-Book Valuations

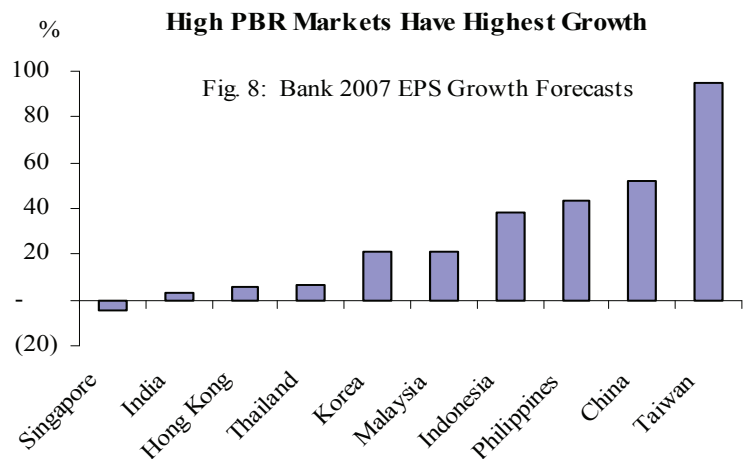
Bank price-to-book valuations also display a bias favoring less developed markets. Banks in two of the least developed markets – China and Indonesia – have the highest PBRs, while a third – the Philippines – has the fourth-highest PBR. Banks in the more developed markets of Korea, Taiwan and Singapore have three of the four lowest PBRs (Figure 7).

EPS growth

Growth expectations explain much of the valuation pattern. UBS Securities expects the four countries with the highest bank PBRs – China, Indonesia, Malaysia and the Philippines – to have four of the five highest bank earnings per share (EPS) growth in 2007 (Figure 8). The one low-PBR country with a high EPS forecast – Taiwan – is actually not a high-growth market for core earnings. Taiwanese banks are expected to have strong earnings growth this year due to the low 2006 base resulting from heavy credit and cash card write-offs, not due to bright long-term growth prospects. Overall, investors appear to be valuing banks in countries with higher growth opportunities much more highly than banks in more mature markets. Since banks in the least developed countries are seeing the fastest growth, those banks carry some of the highest valuations.



Source: Bloomberg, FRBSF calculations



Source: UBS, FRBSF calculations.

IV. INDONESIA

Indonesian bank stocks rose 13 percent in the second quarter of 2007, capping a four-year period of significant outperformance over bank stocks elsewhere in the region. A much-improved macroeconomic and political environment, in addition to healthy profitability, have boosted the sector. Investors are assigning widely divergent valuations, however, to individual stocks and there is a strong bias in favor of size.

Outpacing the region

Indonesian bank stocks have outperformed regional counterparts fairly consistently over the past four years. In the second quarter, the Indonesian bank index outperformed the Asian financial stock benchmark by a modest 1.6 percent, but since the regional rally began in the second quarter of 2003, total outperformance has reached 155 percentage points (Figure 9). An improving macroeconomic and political environment is the most important factor explaining the outperformance. The accession of Susilo Bambang Yudhoyono as president in 2004 stabilized the political scene tremendously, and rising consumption helped to accelerate economic growth. At the same time, Indonesian banks have earned healthy, low-risk profits from their large investment in high-yielding government bonds.

Bank valuations

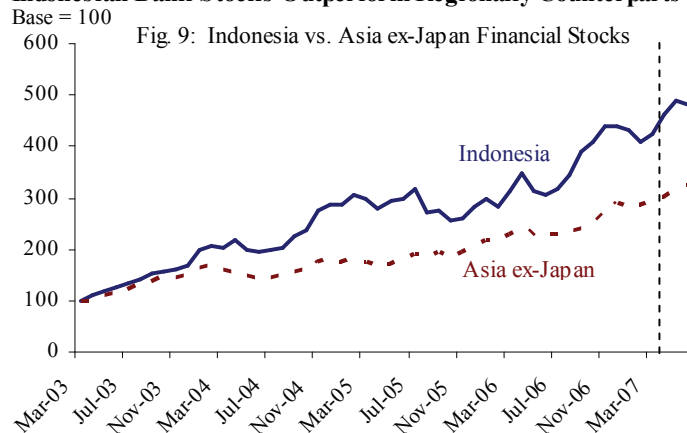
Although macroeconomic and political factors have driven much of the Indonesian sector's outperformance, individual bank stocks trade at divergent valuation levels. PBRs of the most highly valued stocks, at 3.5 times, are more than double those of the low-PBR stocks, at 1.5 times (Figure 10). In India and China, similar valuation disparities exist between banks owned by the central governments versus those that are either private (in India) or owned by local governments and state-owned enterprises (in China), with central government bank stocks trading at much cheaper prices. In Indonesia, however, no such pattern is evident. A mix of state and private banks is present in both the high and low PBR groups.

Large banks favored

Size is the most important factor determining the relative valuations of Indonesian banks. The four high-PBR banks are also the four largest banks in the group analyzed here both by market capitalization and assets.³ In large part, liquidity explains the higher ratings for large banks. Only the largest Indonesian stocks have sufficient liquidity for institutional investors to buy, leading foreigners to favor investments in these institutions. As well, industry restructuring explains the size bias. The central bank is promoting sector consolidation through more stringent capital requirements that are forcing smaller banks to seek capital injections from or mergers with bigger banks. In other countries, potential acquisition targets often trade at premiums to acquirers, but because the smaller Indonesian banks are under regulatory pressure to accept takeover bids, they trade at a discount to potential acquirers.

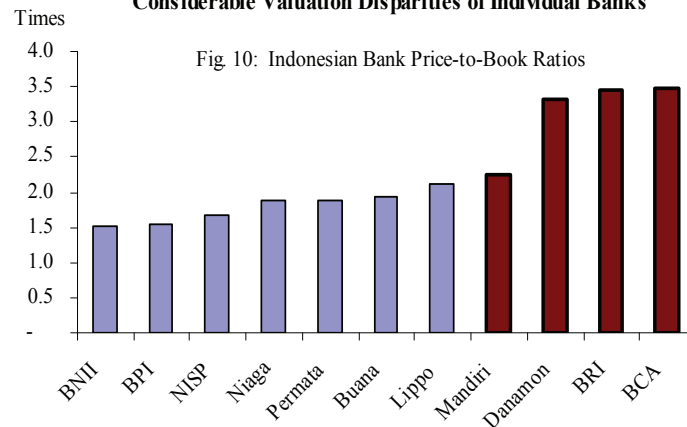
³ The third-largest bank by assets and fifth-largest by market capitalization, Bank Negara Indonesia (BNI), is excluded from the calculations. BNI receives limited analyst coverage, and consensus earnings forecasts are unavailable. Without consensus forecasts, a PBR consistent with those of other banks analyzed cannot be calculated. BNI's large government holding and limited number of tradable shares limits investors interest in the stock.

Indonesian Bank Stocks Outperform Regionally Counterparts



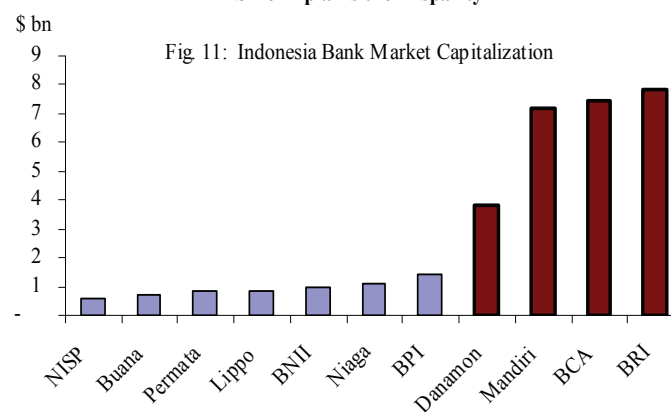
Source: Bloomberg, FRBSF calculations

Considerable Valuation Disparities of Individual Banks



Source: Bloomberg, FRBSF calculations

Size Explains the Disparity



Source: Bloomberg, FRBSF calculations