

Asian Trader

Foreign Investment

China Stocks Look Ready for a Correction

by Leslie P. Norton



IS THE BIG CORRECTION IN CHINA shares starting at last? Late Friday, China boosted its bank-reserve requirements for the fourth time since June, and it could raise interest rates by mid-year to rein in its boom.

In trading later in New York, Chinese shares fell sharply. The iShares FTSE/Xinhua (ticker: FXI) exchange-traded fund was down 6%, while big-caps like PetroChina (PTR), China Life (LFC) and China Mobile (CHL) swooned.

Quite a reversal from last year's enormous gains, which took place as China reformed its share markets, economic growth climbed, the currency snapped higher, and Chinese investors began to part with some of their \$2 trillion in savings.

These conditions created "a long-term sustainable bull market for China," albeit one with "lots of trading rotational opportunities," maintains Lou Gerken of Gerken Capital, whose GCA Greater China Fund was up 24% last year. As the Hang Seng China Enterprises index rose 14% in November and 21% in December, people grew fearful of selling: "You're seeing very limited shorting because you can't bet against the liquidity flow," says Tim McKenna, managing director at CLSA Asia Pacific Markets. "It's very frothy."

Still, investors took profits on financials and real estate, amid fear that China would clamp down on frothy property markets, and rotated into laggard auto companies like Brilliance China Automotive (CBA), and into power companies like Huaneng Power (HNP), whose tax rate may fall as China moves toward a unified tax system.

Despite that rotation, China's big banks, all Hong Kong-listed, are still expensive—"like Nasdaq in late 1999," says Rajiv Jain of Vontobel Asset Management.

"At current levels, we expect a significant correction, particularly in financial stocks," says Shu Yin Lee, the manager of Dalton Greater China, a Shanghai-based hedge fund that rose 28% in 2006. "The state-owned banks are now trading at over three times book value in Hong Kong and four times on the A-share market" dominated by local investors, "and by market capitalization, Industrial & Commercial Bank of China is now larger than HSBC!"

Early last week, Merrill Lynch's emerging-markets strategist, Michael Hartnett, said that Chinese stocks had run up late last year on huge inflows into stock funds that coincided with a December pause in the initial public offering calendar. "The liquidity bubbled straight through to

equity prices," Hartnett wrote clients.

A Bank of Japan rate hike could rein in Japanese enthusiasm for sending capital abroad. China now trades at 17.2 times earnings, with expected earnings growth of 10%, versus 12.5 times for global emerging markets, where profits are expected to rise by 14.4%.

Today's China premium is 38%—more than four times the average since 1994. How far does Hartnett see stocks falling? About 10% in the next four to six weeks. After all, in 2003, Chinese stocks rose 175%. In 2004, as night follows day, they fell.

Pity poor Sanyo Electric, the world's largest maker of rechargeable batteries. Its shares (6764.Tokyo) were halved last year and recently traded at 154 yen after a barrage of bad news: a forecast of its third annual loss amid more job cuts (Sanyo shut

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10% of its business units in the past year to boost returns), a credit-rating cut, a battery recall and slumping sales of mobile phones and digital cameras. Recently, it also disclosed that it would exit LCD-panel production. The company has already considered numerous restructuring measures, sales, spinoffs, and partial strategic alliances.

Many investors hate the stock, but it may yet fall further. Last March, Sanyo issued 429 million convertible preferred shares. "We do not expect holders of the preferred shares to hold them indefinitely," wrote Merrill analyst Hitoshi Kuriyama.

To Mark Hake of Hake Capital, a small-cap value specialist, the best-case scenario is that Sanyo achieves a return on equity of 4.5% by March 2008. Sanyo's shares now trade at 2.25 times book value, "extremely generous for a company that will, at best, make a 4.5% return on equity," says Hake. Sanyo also trades at 15 times cash flow, nearly twice the industry average.

David Benwell of Clocktower Capital remains short Sanyo shares: "The current price doesn't include the potentially large dilution from the convertible, and the business is likely to get more competitive," warns Benwell. "I think even ¥100 would be a full valuation."

The numbers are in: The best Japan fund for 2006 was ProFunds UltraJapan (UJPIX), up 14%; the top Pacific ex-Japan fund was iShares MSCI Singapore (EWS), up 46%; and the No. 1 Pacific fund was Eaton Vance Asia Small Company (EVASX), up 47%. ■

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