

Market Alert

Ad Hoc News Update

HSBC Investments (Singapore)

28 February 2007

No Change In Fundamentals Despite Global Equity Correction

Global equity markets have continued to correct, after a sharp fall in the Chinese equity market yesterday. US stocks had their sharpest decline since September 2001, with European stocks also falling substantially. The Dow Jones and S&P 500 both fell by more than 3%, while European DJ Stoxx 50 and the UK FTSE 100 dropped by more than 2%. Emerging markets, which have rallied strongly since the May 2006 correction, were hardest hit. Chinese equity markets fell the most followed by other emerging markets, such as Brazil (-6.6%), Mexico (-5.8%) and Russia (-3.2%). In addition, the fall in Asian currencies, and a rally in bond prices also suggest a flight to quality, as investors sold off riskier assets.

Potential Triggers For The Correction

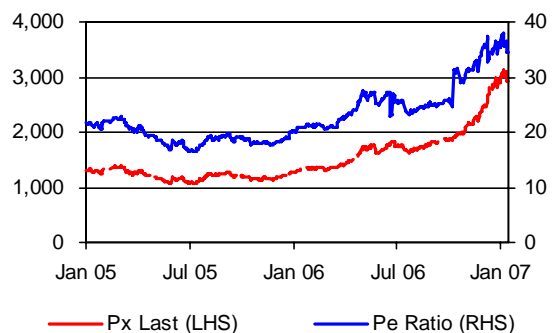
While the fall in China's A-share market has been cited as a key trigger for the global equity correction, other factors may have been at play. In particular, investors have been worried about developments in the certain areas of the US housing sector. Potential defaults in the sub-prime lending segment, which makes loans to households with poor credit ratings, has raised fears of a contagion effect that could infect the financial system. For now, the problems within the sub prime lending segment appear to be contained. The troubled loans were made during a specific period – in the last two years - and to a limited group of borrowers. Going forward investors are likely to pay close attention to housing prices, which though off their highs, have remained relatively stable. They are unlikely to drop drastically if wage growth remains reasonably solid.

In the event the contagion spreads to the rest of the US housing sector, the Fed may look to cut rates. Bond yields have fallen in past weeks, indicating that investors are anticipating potentially lower interest rates. Upcoming data, such as economic or wage growth, inflation readings as well as housing prices, will likely influence the Fed's decision.

Decline In China A-share Market & Other Asian Markets

A-shares accounted for most of yesterday's decline in Chinese equity markets. The correction was broad based across sectors and stocks may have been reacting to rumours that the government could soon hike interest rates again, and may impose a capital gains tax on fund investors. Given the sharp rally in Chinese equities, the decline was not entirely unexpected. After the strong run up in the A-share market, especially at the tail end of 2006, A-share equity performance has turned very volatile. Recently, on the 31st of January, A-shares fell around 5%, but subsequently rose 15%, before the most recent correction. The strong run up in the market has caused valuations to spike. The A-share market currently trades at an estimated price to earnings ratio of around 29 times for the Shanghai A-share index, compared to cheaper valuations for H-shares and red chips, as well as Asian equities in general. As such, investors may have been looking to take profit, especially after the Chinese New Year period.

Performance and Valuations For Shanghai A-share index



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Outside of China, Singapore and Malaysian equity markets also experienced notable falls in the region. The Singapore and Malaysian equity markets have fallen by 3.6% and 4.1% respectively, as interest rate sensitive stocks and China related stocks bore the brunt of the decline. Both markets have performed relatively well year to date, with the Malaysian equity market benefiting from a pick up in soft commodity plays, as well as sector rotation out of other Asian markets and into Malaysian equities. Despite the correction, the Malaysian equity market is still up 8.1% year to date.

Outlook For Markets

We have noted previously that there was a fair deal of investor complacency about the markets, and in some emerging markets there were clear signs of near term overheating. As such, we view a correction at this juncture as healthy. In the short term (i.e. next 4-6 weeks), markets could continue to correct, with emerging markets more volatile than developed equity markets.

Risk perception has certainly increased since the correction, as seen by the recent spike in the Volatility Index or VIX. The index reflects a market estimate of future volatility. Based on history, it peaks at around 25% when markets correct after a bull run (e.g. May/ June 2006 period - see chart). Given the recent rise in the index, markets could be nearing a trough, although investors may still continue to take profit on emerging markets in the near term.

Volatility Index (VIX)



Overall, despite the sharp correction, there has been no significant change in the investment picture. The fundamental environment for equities is supportive in that growth is solid and global monetary policy will be tightened only slowly. Though global equity markets have risen quite steadily since 2003, they have been supported so far by robust earnings growth. As a result, valuations still remain reasonable, and below their historical average. We expect that equities will move higher over the medium term and we would look to accumulate into a correction.

Sources of Data and charts – Bloomberg, HSBC Investments. Local currency terms.

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