

UBS Investment Research

Asian Equity Strategy: Bubblewatch

Is Shanghai finally deflating?

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■ Shanghai Composite down 20% from its high

While investor focus is largely on US sub-prime and the risk of recession, we highlight that an equally important issue for Asian investors (particularly given most are still Overweight China) is the 20% fall in the Shanghai Composite from its 16 Oct high of 6093. The key question is whether this is the start of the Shanghai bubble finally deflating (see our AES of 3 Oct “Bubblewatch”).

Sakthi Siva

Strategist
sakthi.siva@ubs.com
+65-6495 5916

Kin Nang Chik

Associate Strategist
Kin-Nang.Chik@ubs.com
+852-2971 8636

■ Current 20% correction is the biggest correction this year

While there have already been 4 previous corrections this year ranging from 6% in August to 16% in May, we highlight that this 20% correction is the biggest and longest one. More significantly, this correction started from a historic PE of 75x – the level at which 3 of the last 4 bubbles burst. If we average the NASDAQ 100, NASDAQ Composite in 2000, Japan in the late 1980s and Shanghai in 2001, the average was also 75x.

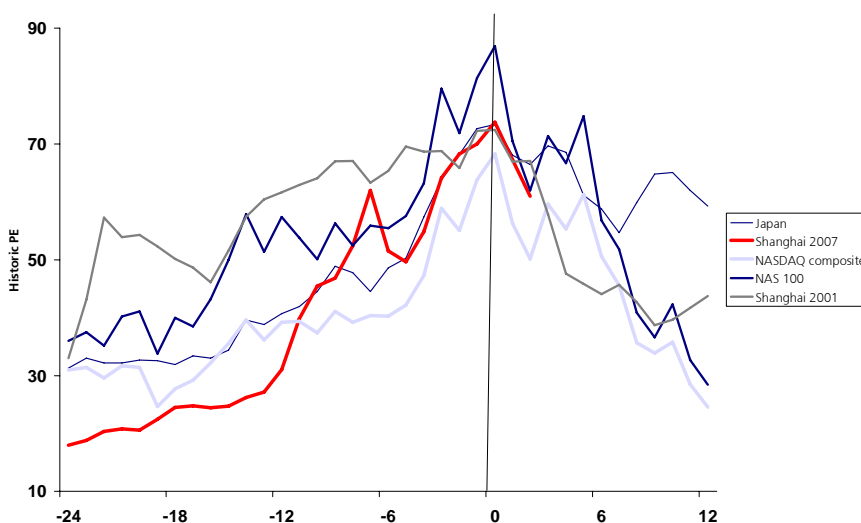
■ Taiwan bubble did get to 105x on historic PE

While the Taiwan bubble did get as high as 105x in 1990, 3 of the last 4 bubbles burst at 75x. If Shanghai follows the path of these bubbles, it could rally 10% near term before the final drop (see chart below).

■ But is Shanghai different because of strong EPS growth?

While some investors are convinced that Shanghai is different from these other bubbles because of strong EPS growth (40%), we highlight that some of this EPS growth is not operational and from stock market gains and also that all the other bubbles also enjoyed strong EPS growth (between 20% to 100% - see charts 3, 4).

Shanghai vs 3 other bubbles (Shanghai in 2001, Japan in 1980s, NASDAQ)



Source: WIND, Datastream, UBS estimates

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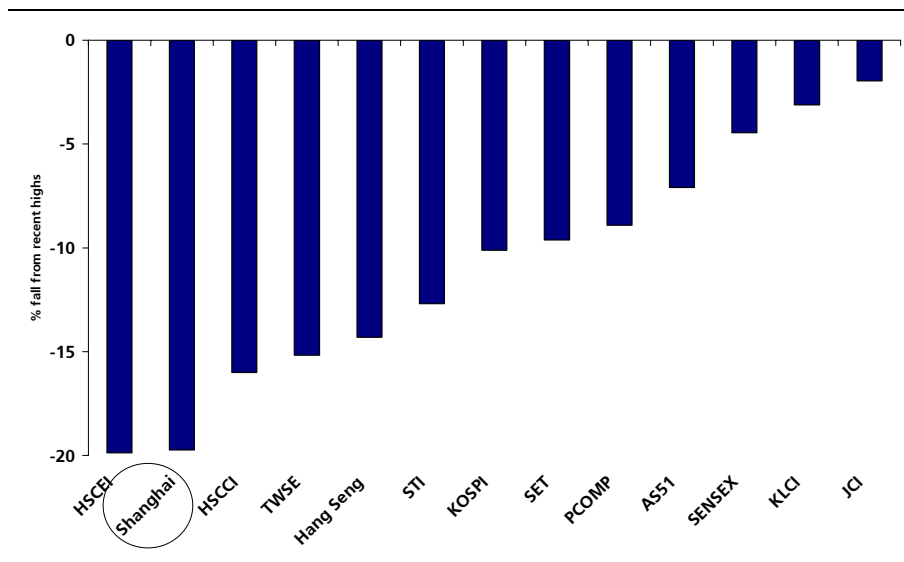
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Is Shanghai finally deflating?

While most investor concerns appear to be over US sub-prime, further bank write-downs and the risk of US recession, we highlight the 20% drop in the Shanghai Composite as another factor that should be equally important to Asian investors. **This is particularly as we believe most Asian investors continue to be overweight China (MSCI China).**

We had previously highlighted our concerns on the Shanghai bubble in our 3 October report *Bubblewatch*. The Shanghai Composite Index has now fallen by 20% from its high of 6093 on 16 October. In fact the current correction has been very different to the one in August as Shanghai on that occasion fell by less than 6%. **While the Shanghai Composite has fallen by between 5.8% (August correction) to 15% (May correction), this correction of 20% has been the sharpest and longest to date.**

Chart 1: Percentage falls from highs



Source: Bloomberg, Datastream, UBS estimates

More significantly, we highlight that 3 of the last 4 bubbles peaked at 75x on historic PE and Shanghai's historic PE did get as high as 75x in mid October (see chart on the front cover and chart 2). We get this 75x average using the following:

- Japan's historic PE peaked at 73.4x in the late 1980s
- NASDAQ Composite's historic PE peaked at 68.3x while the NASDAQ 100 peaked at 86.9x in 2000.
- Shanghai's historic PE peaked at 73x in 2001.

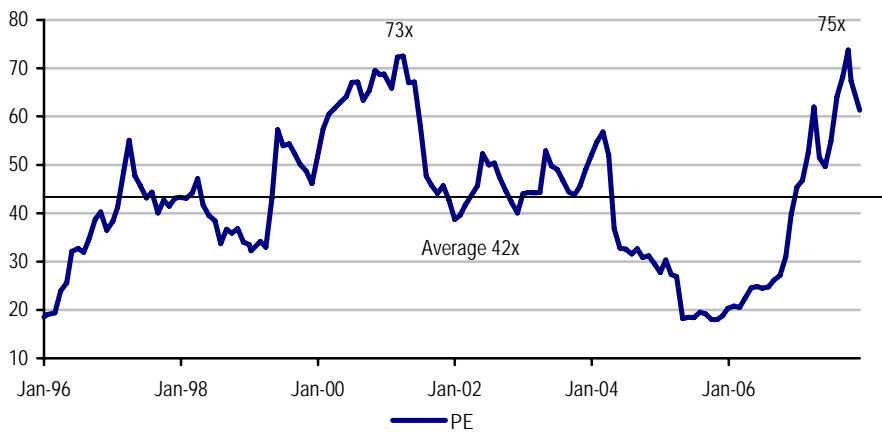
The only major bubble of the last 20 years that peaked at higher levels was Taiwan which peaked at 105x in 1990. But we do highlight that the TAIEX then fell from 10000 to 2000 over the next 6 to 9 months.

Shanghai Composite has fallen 20% from mid October highs

Current 20% correction is the longest and sharpest correction this year

Shanghai's historic PE 75x at Oct highs. 3 of the last 4 bubbles also peaked at 75x on average

Chart 1: Shanghai Historic PE



Only bubble which was much higher was Taiwan at 105x on historic PE

Source: WIND, UBS estimates

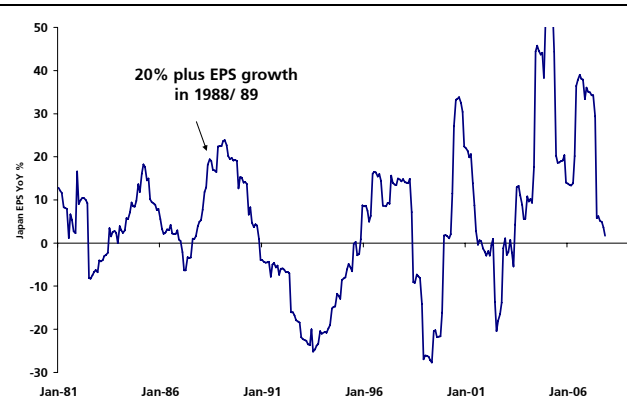
While some investors are convinced that Shanghai is different from these other bubbles as it has strong EPS growth of around 40%, we highlight that some of this is from stock market gains and also that the other bubbles were also associated with strong EPS growth at that time. Chart 4 highlights that Japanese EPS growth was above 20% in the late 1980s. Chart 3 highlights that Taiwan's EPS growth was a strong 100% YoY in 1990 when the TAIEX peaked.

Japan and Taiwan also had strong EPS growth then

Chart 2: Taiwan EPS YoY %



Chart 3: Japan EPS YoY %



Source: Datastream, UBS estimates

Source: Datastream, UBS estimates

As discussed in previous AES of 6 November (see *Can the rest of Asia decouple?*), the correlation coefficients between the Shanghai Composite and most Asian markets have dropped sharply since mid July – for example, just 14% with the KOSPI, 2% with the KLCI. The exceptions are H shares (69%) and the Hang Seng Index (64%).

Correlation coefficients with Shanghai Composite are only high for H shares and Hang Seng Index

■ **Statement of Risk**

There are many risks in investing in Asian equities. Risks include the Shanghai bubble deflating, a US recession and a Chinese hard landing.

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UBS 12-Month Rating	Rating Category	Coverage ¹	IB Services ²
Buy	Buy	55%	40%
Neutral	Hold/Neutral	36%	35%
Sell	Sell	9%	22%
UBS Short-Term Rating	Rating Category	Coverage ³	IB Services ⁴
Buy	Buy	0%	29%
Sell	Sell	0%	0%

1:Percentage of companies under coverage globally within the 12-month rating category.

2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

3:Percentage of companies under coverage globally within the Short-Term rating category.

4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS. Rating allocations are as of 30 September 2007.

UBS Investment Research: Global Equity Rating Definitions

UBS 12-Month Rating	Definition
Buy	FSR is > 6% above the MRA.
Neutral	FSR is between -6% and 6% of the MRA.
Sell	FSR is > 6% below the MRA.
UBS Short-Term Rating	Definition
Buy	Buy: Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.
Sell	Sell: Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.

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Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.

Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium).

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Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

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