



TD Economics

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TAKING STOCK IN CHINA – THE DAY AFTER

Global equity prices took a tumble yesterday, sparked by a 9.2% fall in Chinese renminbi-denominated stocks. While other Asian markets continued to slide overnight, Chinese shares rebounded with a 3.5% gain. This raises two important questions. Is this a sign the Chinese economy is coming unhinged and does it signal economic weakness to follow in the global economy? The answer to both questions is no.

The catalyst of the Chinese equity sell-off was a number of newly announced regulatory changes – and heightened expectations for further changes – which will improve the financial soundness of the domestic Chinese stock market (See box: “Regulatory Changes Drive Chinese Equities”). Chinese equities roared ahead in 2006, as many Chinese investors channeled their savings into the domestic market. The high Chinese savings rate is a reflection of the country’s brisk economic growth coupled with slower de-

Regulatory Changes Drive Chinese Equities

When changes were made last year to increase investor access to Chinese equities, expand the array of financial instruments available, and allow US\$230 billion in non-tradable State-owned shares to be traded, the improved liquidity drove Chinese equities to a 130% gain in 2006. However, this rapid ascent created concern of an asset bubble. Yesterday, the government announced plans to have regulators look to limit liquidity by increasing disclosure requirements, ensuring investors buying on margin are subject to prudential limits, and excluding securities professionals found guilty of repeatedly flaunting the rules from future employment in the financial industry. These improvements strengthen the Chinese market by limiting the potential for speculative bubbles.

HIGHLIGHTS

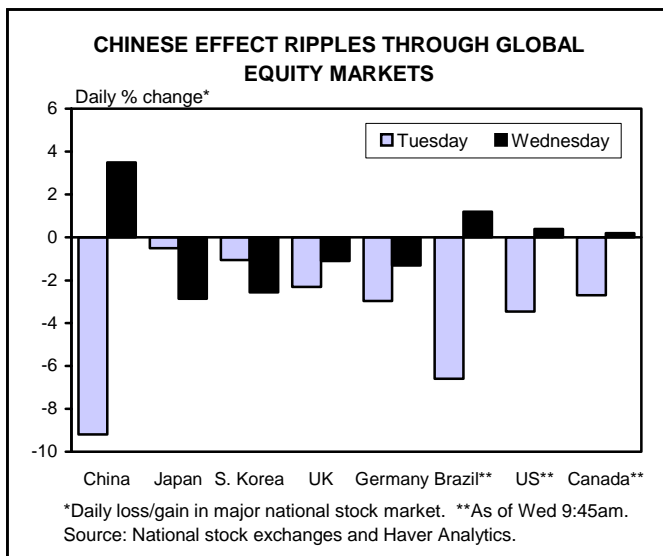
- **Chinese shares fall as a result of regulatory changes.**
- **Corrections in global stock markets not a sign of economic weakness.**

velopments in modernizing the financial system. Chinese individuals simply don’t have enough high-yielding instruments to invest their money in domestically and capital controls limit their ability to invest abroad. This is responsible for driving Chinese P/E ratios higher and fueling the rapid growth in the newly opened stock market. The proposed regulatory changes will limit the inflows of savings, so this set off the stock market correction yesterday and the weakness was likely intensified by profit taking after the huge run up last year. These changes will also likely curtail some prospective equity purchases, but largely to the extent these were being fueled by ill-advised debts and insufficient understanding of the risks inherent in the stock market. Nevertheless, it must be stressed that this week’s pullback was not a reflection of underlying weakness or overheating in the economy, but rather was a result of the Chinese government taking the necessary measures to prevent the economy from just such a fate.

Global equities responded to the Chinese equity correction for two reasons. The Chinese economy serves as a lynchpin in world-wide manufacturing production chains and it has also been driving commodity demand. Disruptions to either of these would have global implications. Since this week’s developments should shore up the Chinese financial system and have little implications for the rest of the economy, these fears should subside. The generally larger declines experienced in emerging markets – which

were coupled with rallies in bond markets – represented a flight to safety seen during any such unexpected shock. Emerging markets by their nature are riskier and more volatile than advanced markets, but that is why they also tend to see higher returns (See box: “The Chinese Roller Coaster”). Moreover, emerging markets tend to be more volatile at this stage of the global economic cycle (For more, see TD Economics special report on global financial volatility here: http://www.td.com/economics/special/rk0806_vol.pdf). Today’s events are a good reminder of the benefits of a well-diversified portfolio.

The real concern would be if any signs were to surface



The Chinese Roller Coaster

Like any emerging market, China’s stock market can see higher returns but is susceptible to greater volatility, as well. The Shanghai Composite Index stood at the same level in November 2005 as it did in November 1997. Between these eight years, the index made no gains for two years, doubled over the next two years, and then lost half its value over the last four years. After that, it proceeded to more than double by the end of 2006. Gains to date this year had been 13% – with an 11% gain just in the last six days. So despite Tuesday’s fall – and even before Wednesday’s recovery – China’s domestic stock market remains in positive territory thus far in 2007.

that this week’s pullback in equities was leaking into other parts of the financial system. There are no signs that investors were overleveraged and will find it difficult to recover from their losses. In fact, the Chinese action was specifically aimed at stemming the tide before any such problem arose. Similarly, there is limited concern these losses will leak into the rest of the economy. We already expected a number of commodity prices – notably base metals – to pull back moderately but to remain high. Yesterday’s pullback in base metal prices by one to two per cent – which is a small move in view of the gains racked up to date – is consistent with our current view.

Developments in China were coupled with downbeat news in the U.S. – weaker than expected durable goods orders and further concerns on sub-prime lending – which served to carry the jitters forward throughout the day. But at the same time, U.S. existing home sales and consumer confidence unexpectedly rose. The Canadian and U.S. economies are in the midst of an economic slowdown, but the extent of the weakness should be limited and economic growth should be strengthening heading into 2008. This will lead to slower corporate profit growth, which might restrain the gains in equities in the near term, but the fact that corporate earnings will continue to rise and will accelerate in 2008 should support moderate returns. As a result, any contagion from the recent Chinese stock correction should prove limited and fleeting.

Richard Kelly, Economist
416-982-2559

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