MARKET VIEWS

Franklin Templeton Investments

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China Q&A

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China tripled the stamp duty on securities transactions and China stock market tumbled. Do you expect a further correction in the A share market? What do you expect will be the percentage of decline in Shanghai and Shenzhen A share market?

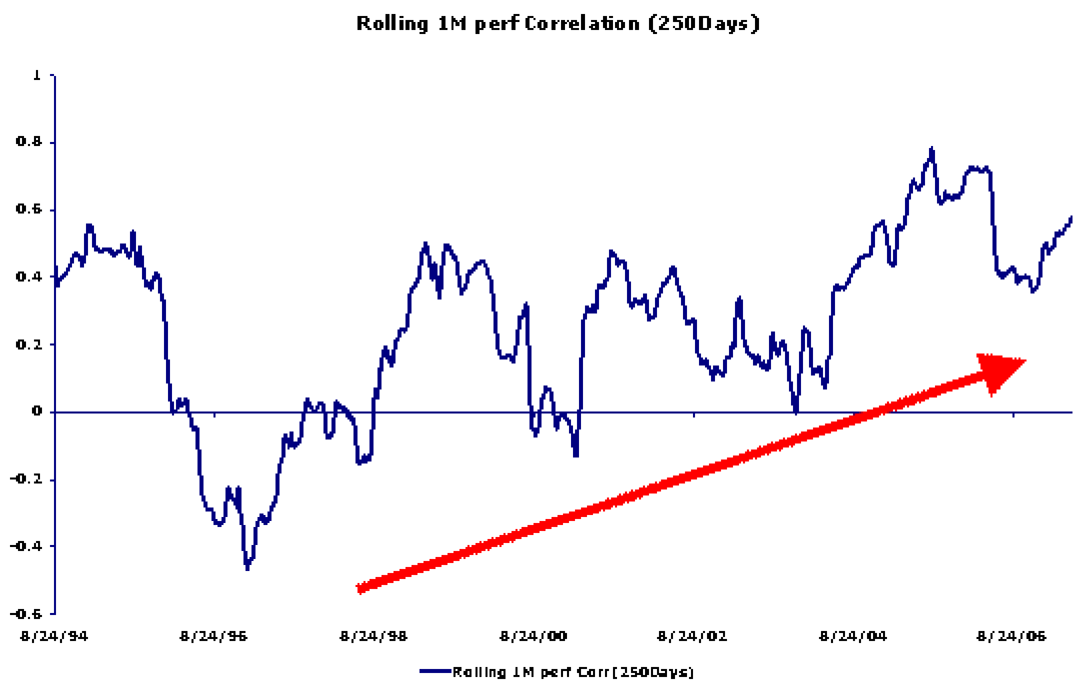
We can't make any short-term predictions but if you look at the performance of the Shanghai A share Index, which had gone up 61% this year before the government hiked the stamp duty, the correction over the past few days is mild and I would not be surprised to see a market, after sharp rise of over 60%, to give back 20% to 30% of its gains. This is natural in stocks markets and the Chinese A-share markets are no different.

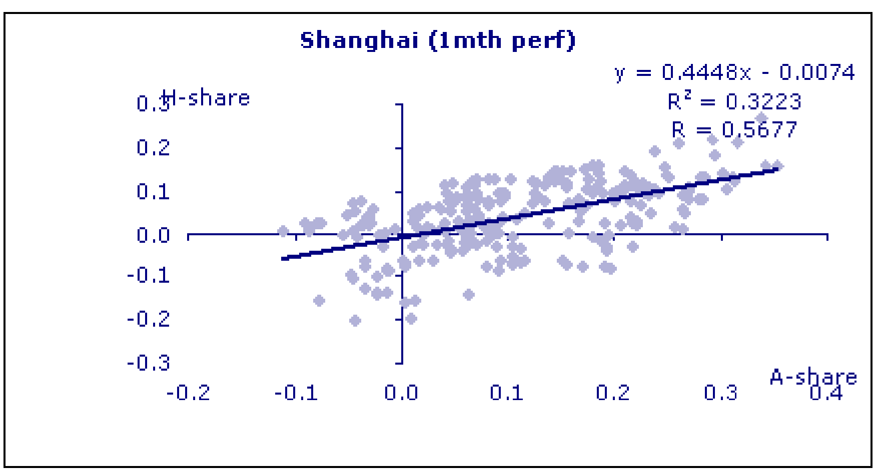
Do you foresee further aggressive measures be introduced, e.g. Introducing capital gain tax, selling off stated-controlled stakes in listed companies?

I don't think the Chinese government would like to see the market crash and so they would be very cautious in introducing new cooling measures. The experience of introducing a capital gain tax had an adverse impact in Taiwan while a simple flat rate could be a disadvantage to small investors. I think the government is well aware of this and so it's unlikely that this will be introduced in hastily. The government may sell shares in the market as the lock-up period for most tradable reform shares are due to expire. But I believe that a massive sale will not be easy in practice. We have to remember that not all shares are centrally controlled by the government. Many are held under different ministries, municipalities and entities. All of them incurred significant loss of shares in the tradable share reform and I don't believe that they would want to give up more control by selling the shares and handing the proceeds back to the central government.

What will be the impact on H share market if the A share market slumps? What do you expect will be the percentage of decline in H share market?

We did a little study and found that the correlation between H and A shares has been getting higher. Below is a chart showing the correlation coefficient over time between the one-month performance of Shanghai A against the corresponding 1 month performance of the Hong Kong H shares. The latest reading is +0.57 and it seems to be heading higher. Moreover, if we use the data over the last 250 days to do a regression analysis, we can find that statistically, for an every 10% move in the Shanghai A market, H shares will move by about 4.4% in the same direction.





Will you decrease your holding in the A share and H share market?
We don't have any exposure to the A shares. However, taking a long-term view, we are still finding many stocks in the H market attractive.

Which sectors or stocks are you most pessimistic about?

There are no specific sectors that we are particularly pessimistic about but relatively speaking, we have higher weightings in energy, financials and consumers, more because of their relatively attractive valuations.

China Insights

China recently tripled the stamp duty on share trades in a bid to cool the red-hot yuan-denominated domestic share market in Shanghai and Shenzhen. This market is quite different from the 'H' share market for Chinese companies listed in Hong Kong in which the Templeton Emerging Markets group invests and which is now trading at a substantial discount to the 'A' share market. Apart from 'H' shares, the group invests in "red chips" (which, like 'H' shares, are listed in Hong Kong). Franklin Resources also has a joint venture in China that has about US$1 billion invested in 'A' shares.

Of course, the A share market has become highly speculative as small Chinese investors try to achieve returns beyond those available from bank deposits given that interest rates have been kept deliberately low in China. But the experience of Japan in the 1980s and early 1990s suggests that markets can benefit from investors' bullishness for much longer than outside observers believe possible.

One obvious question concerns the impact elsewhere of a potential crash in the Chinese market. The impact need not be huge, in our view. True, the abrupt fall in the domestic share market in late February this year did have a ripple effect throughout emerging markets, but it proved short lived. Now that markets are attuned to what is happening in China, we don't think there will necessarily be a repeat.

However, there is a risk if the effects of a bursting of the 'A' share market were to spill over unto the Chinese economy, especially as China has become an engine for growth in the rest of Asia – and, indeed, for much of the world.