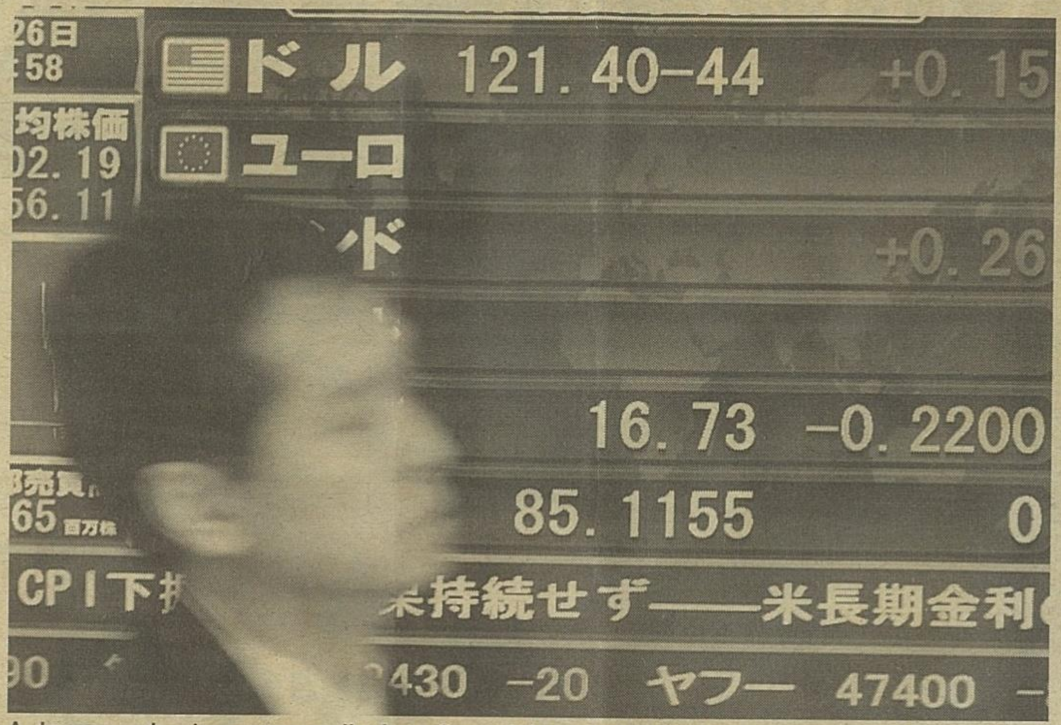
Explaining the market drop

By J VONG

The sharp fall in the equity market this week has caused anxiety to many investors. The events that triggered the downturn globally are explained in this article so that investors can have a more informed view of the situation.



A Japanese businessman walks by a financial market indicator in downtown Tokyo

FEB 27, 2007 must be one of those rare days in the past two decades when markets perform a sort of spectacular "bungee plunge". This time it happened in China when the market plunged almost 8.9%, rebounded 3% on Wednesday and fell again by 2.6% on Thursday. It closed yesterday up 34.34 points or +1.23%.

Markets all over Asia fell in tandem, followed by falls in the US and in Europe.

Markets continued to be weak on Friday's close. A summary of Friday's close in Asia is as follows:

- Nikkei - down 235.58 points, -1.35%
- Taiwan - down 7.90 points, -0.1%
- Shanghai - up 34.34 points, +1.23%
- Hang Seng - up 95.41 points, +0.49%
- STI - down 13.84 points, -0.45%
- KLCI - down 16.23 points, -1.37%

Most analysts are of the opinion that it may take up to two weeks for the markets to stabilise.

Causes & triggers

What were the triggers that caused this turmoil in the global equity markets? A clue to what caused the turmoil was the sharp rise in the yen by almost 3% on Tuesday.

It could be traced to the yen/yuan carry trade. The cause was none other than the economically untutored US politicians' nagging calls for China to rapidly appreciate the yuan.

There has also been a feeling of nervousness among the investment community on China's moves to curb the inflows and to moderate its surging economy after the blunders in Thailand. The markets had also been bullish prior to the events.

The carry trade

Japan's banks have been flush with liquidity for almost a decade now with yields on money deposits as close to zero.

So for the Japanese banks being able to lend at 0.5% is lucrative business and tempting for highly leveraged global equity funds where any return of more than the 0.5% interest per annum will produce highly magnified returns due to the leveraging effect.

This is generally called the "carry trade" in industry terms and thought to be as much as US$1tril outstanding in currency to equity and currency to currency swaps.

During the collapse of the LTCM in the 1990s, leverage funding was to the tune of almost 200 times the funds available. To what extent this is being repeated is not known.

When yen is borrowed, it needs to be converted into other currencies that give higher yields in a variety of investments. Hence, there would have been selling pressure on the yen - thus keeping the exchange low.

Obviously, a sizeable amount of the carry trade was into yuan destined for the Chinese equities.

China moves

The news going around a few days preceding the Chinese plunge was that China was likely to raise interest rates to meet US demand. This would have caused Chinese stock prices to fall and the yuan to appreciate. This was indeed a US demand made on the world's most reserve-rich nation to reverse the US trade deficit.

The perception of an impending interest rate rise or curbs has caused a sudden reversal in the sentiment of the highly leveraged funds position of the Chinese stocks. There was a rush for the exits and simultaneous purchase of the yen to clear or minimise the carry trade positions.

There were also concerns about actions likely to be taken by the Chinese to curb its hot economy, money inflows and worries over a repeat of the Thai debacle.

The Japanese knock-on effect

This raised immediate concern in Japan as the country's manufacturers said the rise in the yen would affect the profitability of the exporters. The US and European funds are heavily invested in Japan. So while the rest of the global markets took a pause on Wednesday, Japanese stocks declined continuously up to yesterday close.

The Nikkei fall had by March 1 triggered the next wave of declines in the US and European markets on Thursday.

Bernanke testimony

Ben Bernanke, the US Fed Governor, in his testimony on Wednesday said sub-prime loans in the US would not be a problem and growth will not slow as previously forecast by Alan Greenspan.

The events of this week have demonstrated that the US political demand for a rapid rise in the value of the yuan is likely to bring untold misery to millions of small time savers and investors - including US citizens.

Global capital allocation

The carry trade and ensuing leverage are not a bad thing - as it is a way to re-allocate capital around the world for the most efficient utilisation. Both lender and investee country will benefit. But what scuttles the arrangement is the rapid movement in the exchange rates as a rapid rise in the yen will have an immediate deleterious effect on investee countries as funds are withdrawn to minimise losses. The effects of this round appear to be almost global.

The extent of this round of reversal will be limited to the scope of the highly leveraged funds' imprudence or the rise in the percentage of the yen.

If leveraged equity funds were looking for just 1% return (which would be magnified on their own funds) on borrowings obtained at 0.5% interest rate, obviously a yen rise of 3% would land them in serious financial woes and they would have to cut losses very quickly in the equity and currency markets.

Such a meltdown in the equity markets is not good for any economy. The pain inflicted on investors can be widespread and assume political implications very quickly.

Central banks

The immediate remedy lies with central banks. Asian central banks have, since the 1997 financial crisis, gained enormous power over forex rates due to a massive build-up in reserves.

In order to minimise the current meltdown, immediate concerted action is required by global central banks to sell down the yen to stem the panic. The Japanese Central Bank can, in consultation with other central banks, increase the supply of 'fiat' yen to restore normalcy. Until and unless the current situation and problems of a world with the US dollar acting as the global reserve currency and export-oriented economies building up massive forex surpluses are better understood, such episodes are likely to recur.

The investor

For the small investor, stick rigidly to very sound fundamentals so as not to get hurt. The highly leveraged funds will need to anticipate currency swings better to minimise forex risks. The current plunge has had only a very minimal effect on sound stocks. Take heart, keep investing!

● *J Vong is the editor of klsetracker.com, an independent equities research portal. For more reports, click on http://klsetracker.com*