Will IPOs make the markets bubble over?

▶ Many experts say 20% drop not linked to new issues

By WENDY QI

SAN FRANCISCO: The Shanghai Stock Exchange has never been a stranger to volatility, and the past couple months have been no exception.

Fueled in part by several successful initial public offerings following the end of a nine-month IPO moratorium, the market fell by more than 20 percent by the beginning of September.

For the global financial community, which often uses Shanghai as a barometer of where the Chinese economy is headed, numbers like these have only spurred suggestions of a bubble environment.

However, not all investors agree.

Rather, fund managers such as Aaron Boesky are optimistic about the future of China's oldest and largest financial exchange. They point out that the mid-term trends portend a much more viable Chinese market.

"Usually a resumption of IPOs is a very healthy indicator that you're at the beginning of a bull market," said Boesky, who runs his China-focused funds through Hong Kong-based Marco Polo Asset Management. "If you remember the bull market of 2007, when the largest IPO in the world (thus far that year) took place on the Shanghai Stock Exchange (SSE), that didn't lower the market performance that month – it increased it."

Boesky helped co-found Marco Polo in 2004, and it remains the only qualified foreign institutional investor (QFII) whose brand and operations are dedicated solely to the mainland capital markets. Today, it manages approximately $125 million in funds.

The China Securities Regulatory Commission (CSRC), the regulatory body which oversees all IPOs issued on mainland stock exchanges, had initially instituted the moratorium last September amid concern that adding new shares on the SSE would drive declining markets down even further.

By the time the CSRC had closed the doors to IPOs, the SSE had suffered a nearly 50 percent loss in value since the first day of trading in 2008. SSE officials declined to comment.

"The regulators control IPOs by allowing more when they feel the market can bear it, and pulling back when they feel that the market is weak," explained Boesky, who attributes the most recent downturn to weak earnings reports by individual companies.

"Short-term fluctuations can be very misleading and can often be contrary to the true medium trend. When the market corrected in August, it was profit-taking after seven months of consecutive gains ... it was a very natural process," said Boesky, referring to a rally that the SSE had experienced since the beginning of the year.

Between January and August, the SSE gained nearly 85 percent, before reaching its peak at 3,644 on Aug 4.

For him, proof of the Chinese market's resilience was written in the way the economy rebounded from its 2008 performance, exhibiting signs of a growing market.

"China showed a leadership economically that was even beyond my expectations, and I had very high expectations," said Boesky. "Through 2008 and through this year, China has proved that it's relatively impervious to US and Eurozone collapses ... the economy is humming on every cylinder."

Jessica Su, an investment banking analyst at one of China's largest domestic banks, agreed that while a resumption in IPOs did not hurt market growth in August, the majority of the increase came from macroeconomic factors such as China's stimulus package and increased liquidity.

"All these measures helped to boost the A-share market in 2009," explained Su. "And the coming out of the first IPO after resuming deal flow coincided with this rebound."

But former Morgan Stanley economist Andy Xie points to these same macroeconomic trends as signs that the Chinese capital markets are indeed encroaching on bubble territory.

In numerous publications, Xie is quoted as saying: "Chinese asset markets have become a giant Ponzi scheme. The prices are supported by appreciation expectation. As more people and liquidity are sucked in, the resulting surging prices validate the expectation, which prompts more people to join the party. This sort of bubble ends when there isn't enough liquidity to feed the beast."

In April, Xie warned that private placement and the end of the IPO moratorium would lead the markets into bearish territory in the second and third quarters of this year.

Since leaving Morgan Stanley in 2006, Xie has worked as an independent economist in China, and is a frequent commentator on market trends.

Despite these strong remarks from Xie, Boesky remains confident that investors will see the return of earnings growth in the third quarter.

He disputed the idea that a return of IPOs means there will be an overrun in supplies and liquidity, and instead focuses on the calculated and gradual steps regulators have taken thus far in expanding the market.

Patrick Yip, a spokesperson for the Hong Kong stock exchange, said he believes that growth of the Shanghai exchange will bring added opportunities for both markets.

He pointed to the successful coexistences of international exchanges in cities such as Chicago and New York in the US, and London and Frankfurt, as prime examples.

"The continued development of the mainland and its markets should be viewed as a chance for all to benefit from the country's growing importance in the global economy," said Yip. "The Hong Kong exchange complements the mainland markets and works with them in providing a venue for mainland companies to attain their full growth potential, while at the same time enabling investors and market participants from all corners of the globe to participate in the opportunities."

Individual investors such as Shanghai resident Ma Tianxiang also sees the return of IPOs as a welcome sign.

Ma shruged off the recent decline and volatility, and said it's just a market correction. Like many investors, Ma sees the resurgence of IPOs as a way to turn a quick profit.

"There's always profit to be made in the short term if you're lucky enough to get some shares on the first round (of an IPO)," said Ma. "It's just like winning the lottery."

While sweeping statements like these are the very reasons why many remain skeptical about the long-term viability of the Shanghai exchange, Boesky sees them it as an opportunity in understanding one of the largest financial stock exchanges in the world.

"Chinese investors are very homogenous. The A-share Shanghai stock market is 99.3 percent owned by Chinese," said Boesky. "When Chinese investors decide to sell, they all decide to sell ... it's not London or New York where you have 42 different cultures and markets with 42 different investment philosophies."

As a long-term investor in China, Boesky does not believe that the growing stock market is a trend waiting to blow over. While he admitted that learning to work with the different policies and interpreting the signs has its challenges, he remained optimistic that China's best days are ahead.

"Not only did China lead the world before the crisis, it was leading after the crisis by almost any economic factor," said Boesky. "They've gotten here through good old-fashioned hard work, and that's to be respected."

Investors trade and monitor stocks at a securities exchange house in Shanghai. Bloomberg News