

ANALYSIS

Prick it

By Eric NG PING CHEUN

It is taboo to talk down the Port Louis Stock Exchange. While international indices are enduring a painful but welcome correction, our broad-based index, the Semdex, closes at new highs every week, having gained 27% since the beginning of the year. The market price earnings ratio is hovering around 14.4.

The money market is awash with excess liquidities as demand for Treasury Bills largely exceeds supply. The Bank of Mauritius is thus in a position not to adjust its accepted bid yields according to the recent increase of 75 basis points in the Repo Rate. Bulls are taking heart from the ease with which people are channelling the surplus in demand money to the stock market despite a very low dividend yield of 3%. Investors are feeling sufficiently flush with cash to inflate the Stock Exchange.

True, share prices are being pushed higher by companies' fat profits, which may lead people to think that shares are still undervalued, especially relative to government bonds. Indeed, profits of blue chips have risen faster and for longer than anyone expected a few years ago. Some listed companies have so much cash that they have used it to buy back shares, thereby supporting the stock market.

A fast-rising and highly valued stock market does not, in itself, imply a bubble. However, we are in an unusual bull market where the volume of transactions is low, the number of sellers is limited, and investors are buying stocks, not because they believe shares are good value, but simply because their prices are rising. This can be rational behaviour if investors think that everyone else will do the same. But the fact remains that we are dealing with a financial bubble: the value of assets has moved out of line with their fundamental worth.

In two years (2004 to 2006), the Semdex grew by 70% whereas the share of corporate profits in gross domestic product (GDP) expanded by 22%. Yet, Gross Operating Surplus is historically high, accounting for 59% of GDP. Analysts are blithely assuming companies' earnings can keep rising to the detriment of compensation of employees. Perhaps globalisation has shifted the balance of power firmly in favour of the corporate sector and away from labour. But workers

have votes and may demand the balance be shifted back, either through taxes or... economic democratisation!

A convenient way to prick the bubble is to supply more shares to meet demand. In the 2007-2008 Budget, the Finance Minister has announced that the government will encourage the official listing of Mauritius Telecom and State Insurance Company of Mauritius, and that it will sell some of its shares in other state owned companies. But the process may drag on for several months. What can be done at once is to increase public floating from 25% to 50% of total shares. It would be a concrete step towards real economic democratisation, especially in the hotel industry!

Another way to burst the bubble is to continually raise interest rates. But we do not expect a further Repo Rate hike when the Monetary Policy Committee will meet on 21 August. This time, the risks to investment and to economic growth will outweigh the oil price effect and the current account deficit. Credit conditions have become sufficiently tight for households and businesses.

Nevertheless, the Bank of Mauritius cannot lie back and relax. Sooner or later, asset inflation will cause harm to the real economy. A stock market bubble can engender an economic bubble as the surge in share prices and inflated expectations about future prospects encourage over-investment, over-borrowing and a fall in savings. If that happened, it would take longer to unwind those economic excesses. It should be a matter of months before the central bank errs a little more on the hawkish side.