Asia ex Japan

Monthly commentary

April, 2010

Market review

After a positive start to the month which saw the MSCI Asia ex Japan index continuing the upward trend set in March, risk aversion returned on renewed concerns of China's strategy to slow its economic growth and the re-emergence of sovereign debt risks, after Greece's bonds were downgraded to junk status. The Asia ex Japan index ended the month up 2.06%, outperforming developed markets equities (MSCI AC World), which fell 0.2%.

Asian equities were the best performing region in global emerging markets in April after underperforming last month. The region rose 2.06% on stronger economic data. Singapore, the Philippines, Indonesia, Korea and Malaysia all outperformed (all up over 4% in USD) and benefited from strong currency gains. China was down 0.36% and Hong Kong down 2.42%, both due to property tightening, while the worst performer was Thailand which fell 2.66% on ongoing political concerns. The 'red shirts' (anti government) have, post month end, been offered an election later in the year by the 'yellow shirts' (the government). Thailand is still however one of the best markets in Asia this year.

Market outlook

After the sharp recovery in stock markets in the spring and summer of 2009, the pace of improvement has clearly moderated into the spring of 2010. This reflects more complicated questions facing investors about the structural, as well as the cyclical, issues facing the world economy in the aftermath of the financial crisis. Valuation signals are no longer giving as strong a steer. They have been replaced by more nuanced analysis i.e. the state of the earnings, monetary and regulatory cycles.

On a structural basis, investors are still trying to understand the extent of the adjustment that many countries will have to face, making for a complex interaction between economics and politics, which periodically will add to market volatility. One example is the sovereign debt risk pressures facing many OECD economies, exemplified by the crisis in Greece. Beyond the immediate concern about debt refinancing lies two deeper issues. The first is the lack of competitiveness in many European countries. On some measures countries such as Greece, Ireland, Italy, Portugal and Spain now have unit labour costs 20-30% higher than those seen in Germany. Improving their competitiveness will require years of real wage restraint and productivity improvements, negatively affecting end demand. Secondly, to deal with the sizeable public sector debt burdens built up in most OECD economies during the recession, governments will have to implement a tighter fiscal policy in order to limit the impact of onerous debt servicing levels.

This suggests to us two likely outcomes: 1) the need to de-leverage by consumers and governments points to a muted upswing in domestic demand and economic growth outside the emerging markets space; 2) markets' volatility could re-appear at any sign of reform fatigue.

On a cyclical basis, even in a low inflation/low growth environment, there is a positive underpinning from corporate profits. Increased operational leverage reveals itself in the early stages of the cycle and allows profits and cash-flows to grow faster than nominal GDP. The early signs for this cycle are promising and hint at corporate earnings continuing to surprise, in the absence of policy error, and the foundations starting to be put in place for a sustained upswing in the business investment cycle. History suggests that the first year of a business cycle recovery usually sees revenue growth only half the change in GDP, a ratio of 0.5, but this accelerates in year 2 when a ratio of 1.5 is more likely. In other words, although the global recovery began back in 2009, operationally leveraged profits may not fully recover until late 2011. This “empirical” correlation suggests that the earnings momentum will be especially powerful for domestic emerging markets stocks, whose economies are expected to grow at 6.0% in 2010 and accelerate to 6.50% in 2011 (IMF estimates), as compared to +/- 2.0% in both years in the developed world.

Our view continues to emphasise a low growth, low inflation and a low rates world for the OECD economies, contrasting with strong growth and early signs of inflation pressures in selected global emerging market (GEM) economies. China and India all face inflation pressures which are forcing their central banks to consider further monetary policy tightening.

In an environment of low global growth as a result of the low level of activity in the developed world, OECD sovereign debt risk and uncertainties related to the extent of the policy tightening in China, there are clear advantages in keeping our strategy well diversified.

Strategy

The strategy is overweight Singapore and Thailand funded by under weights in Malaysia and Taiwan. We are currently neutral China and India.

The strategy is overweight the consumer discretionary, transport, technology and banking sectors. We are underweight energy, telcos and consumer staples.

In keeping with our core philosophy, we are seeking to maintain a fully invested, fully diversified exposure to the asset class. This does not mean we are looking to take risk out of the strategy, rather that we are trying to diversify that risk by country and sector.