



Asia ex Japan

Monthly commentary

July, 2011

Market review

MSCI Asia ex Japan rose 1.15% during July, but this was the calm before the storm in August. Our markets continued to take their cue from developed markets, namely Congress' impasse over the extension of the US debt ceiling and the debacle in Europe spreading to Italy and Spain. It is not surprising therefore that the outperformers were once again the smaller, more insulated Asean markets of Thailand (11.6% buoyed by a decisive election outcome), Indonesia (7.2%) and the Philippines (6.7%).

India was the worst performing market (-2.3%) weighed down by a larger than expected rate hike. China continues to under perform (-0.8%) as concerns over a hard landing and systemic banking risks fail to wane.

Market outlook

When looking at the problems of developed economies the only thing that we can be sure of now is that there is no magic wand that can be waved to make the problems disappear – we are in for a prolonged period of uncertainty. For the time being the direction of emerging markets will be determined by developments in peripheral Europe and on Wall Street. For most of the last two years our central scenario has been that the West will “muddle through”, thus providing a background of low interest rates and low growth from developed economies. The risks of a worst case outcome – namely a second credit crunch, a double dip in the United States and the possible disintegration of the Euro have clearly risen.

We have not changed our medium-term view – we continue to expect solid growth in emerging economies, driven by China, and slower growth in the West. As before, we believe that the Chinese authorities will succeed in a “soft landing” of the economy (we define this as a higher than 7% GDP growth rate). Its worth noting that China is finding it tricky to slow an economy with a lot of growth momentum – any worry about a hard landing would likely see the authorities willing and able lift their foot off the brakes a little. Compare and contrast with the West, where growth is going through a soft patch despite extreme monetary stimulation such as the aforementioned Quantitative Easing programmes.

Given that outlook it is tempting to take advantage of recent declines to increase the risk profile of the strategy – if we are right about the durability of growth in Asian and other emerging economies, it is probably right to buy now. However, we have to acknowledge the growing risks of a much worse than expected outcome in developed economies. Asian markets would not be insulated from such problems and history tells us that in the early stages of a crisis, risk assets such as Asian equities could underperform.

Strategy

The strategy is overweight China, Hong Kong, Singapore and Thailand, funded by an underweight in Taiwan and to a much lesser extent Indonesia and Korea. At the sector level the strategy is overweight the capital goods, materials, utilities and consumer discretionary sectors, slightly over in technology and consumer staples whilst underweight telecoms, real estate, banks, and energy.

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.