



Asia ex Japan

Monthly commentary

May, 2010

Market review

MSCI Asia ex Japan fell 8.39% in USD in May. The markets have continued their fall from the peak in mid April as a succession of negative issues continued to plague investors. The primary concern has obviously been the sovereign debt crisis in Europe and its effect on global growth and risk appetite, although other issues such as the oil spill in the Mexican Gulf and the Hon Hai iPhone suicides haven't helped.

The ECB and most European politicians have had to be seen to be more aggressively on the case as the markets obviously feel there has been a delayed response to the substantial deficits faced in particular by the PIIGs countries. The bailout package finally announced this month was very large (Euros 750bn) and initially provided some support. However, continued worries about banks' exposure to Greek and other bonds, downgrades to Spain by the ratings agencies and demonstrations against the 'cuts', in Greece and Spain, needed to reduce the deficits is causing concern to investors globally. Some feel the cuts needed are so severe that growth will slow or even reverse.

In Asia, the worst market was Korea which fell 13.31%, primarily due to the weakness of the Korean won partly caused by North Korean issues. Taiwan fell 9.82% and like Korea, as an exporter, is seen as being effected by any perceived slowdown in global growth. Ironically, the best market was Thailand where domestic politics is so fragile, although at least for now the red shirts have been removed from their zone in central Bangkok.

Market outlook

In the May issue of 'UBS Global Profit Picture' they pointed out that among other measures, 2010 earnings estimates have remained unchanged since their last publication in January, with bottom-up figures still calling for a 30% increase in global earnings growth. This obviously seems at odds with the recent sharp setback in markets. What UBS highlight is that the dramatic cost cutting efforts taken during the downturn have infused companies with a great deal of operating leverage and when combined with the 9% revenue growth expected this year, the result is a strong rebound in earnings, particularly following the poor results of the last two years. As earnings estimates have remained steady, this year's market gyrations have been steered primarily by multiple fluctuations from changes in risk appetite. Currently, the world is trading at 13.0x 2010E earnings and 11.0x 2011E earnings, below historical norms, as investors appear reluctant to pay up for earnings given the prevailing headwinds.

Market gyrations in 2010 reflect the degree to which investors have had to confront the conflicting forces of ongoing cyclical recovery and large structural challenges. Many investors are looking to move to higher quality names with this background. Others are currently looking to move allocations from Europe to the US given the relative strength of the economic recovery.

So where does this leave Asia? Within Asia at the market level, earnings forecasts continued to improve. 12 month forward earnings estimates rose by 9% in the last three months and Taiwan continues to have the best earnings momentum. China and the Philippines also continue to have the poorest earnings momentum. At the sector level, cyclicals continued to see good earnings momentum in the last three months with consumer discretionary and IT showing the best momentum.



However, earnings forecasts aren't likely to drive the markets' direction as worries over European growth will suggest to some that Asian earnings will have to be severely downgraded if European growth is much worse than currently forecast. We believe this is unlikely to materialise currently, but until there is more certainty markets will be weak or volatile. Having said that, given the recent sharp weakness, we would expect to get some kind of bounce in the short term.

Strategy

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

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

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.