



Asia ex Japan

Monthly commentary

May, 2011

Market review

MSCI Asia ex Japan fell 1.34% in May. All Asian countries fell modestly over the month except China, Hong Kong and Indonesia and all 3 of those rose less than 1% in USD terms. In the absence of any major directional lead from developed markets attention concentrated upon the fall in oil and other commodity prices, the rally in the dollar and the prospects for global growth going forward. Within global emerging markets renewed concerns over the peripheral European economies did not have much impact on their emerging counterparts – Europe was weak because of falls in Turkey in reaction to poor inflation numbers and in Russia due to the falling oil price with Asian markets performing slightly better than most. Thailand and India were the worst 2 markets within Asia in May falling over 4% each due partly to internal political concerns.

Market outlook

Nervous markets have a tendency to focus on the next set of data points to provide an illusionary sense of certainty and a signpost for future direction. At the moment those data points in developed economies seem from our perspective to provide plenty of ammunition for the bears: no recovery in the US housing market, lingering consequences of the Japanese earthquake and more problems in “peripheral Europe” to name the most obvious. In Asian economies the situation looks better – not that that will help markets in the short term. Concerns in Asian economies have centred around the consequences of strong growth rather than its lack. We have mentioned many times over the last year our concerns over inflation in Asian economies. We have been enjoying a long period of above-trend growth, combined with historically low real and nominal interest rates. The inevitable consequence has been a pick up in inflation. Central banks and finance ministries have of course been well aware of the problem, but their room for manoeuvre has been constrained by the knowledge that any rise in interest rates will attract yet more “hot money” from yield seekers around the world. Base effects, recent stability in food prices and continued currency appreciation all suggest that we are getting close to the peak. The weighted average CPI inflation for emerging markets has risen from 2% to 6% in the last eighteen months. Given secular trends around the world we do not expect this average to fall much, but we do think we are approaching a peak. Markets will soon have to acknowledge that most emerging economies have achieved the fabled “soft landing”. In the absence of major market dislocations from developments in the developed world, a realisation that inflation is under control should be positive for emerging markets. Note: Chinese inflation numbers due after this report was written (14th June) will go some way to confirming or denying this hypothesis.

Strategy

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

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.