



## Asia ex Japan

### Monthly commentary

October, 2009

#### Market review

October proved to be a more volatile month for equity markets as investors began to assess the relative merits of the "reflation trade" in light of the expectations of higher interest rates in 2010 and of a potentially prolonged period of time before any significant earnings recovery emerges.

The MSCI Asia ex Japan index resumed its positive momentum during the first two weeks of October and reached a new 12 month high by mid month (MSCI AEJ index level 414.5, +5.0%) before some profit taking saw the market finish in negative territory. The market has now rallied over 90% from its low in early March 2009, but remains 33.0% off its high in November 2007.

On the corporate front, over 75% of NYSE listed companies reported third quarter results that beat analysts' expectations. On the economic front, the International Monetary Fund upgraded expectations of world economic growth for the first time in two years, to an overall +3.1% rate of expansion. The improvement was heavily biased towards developing economies, which are expected to grow by +5.1% compared with +1.3% in the more mature nations. Chinese GDP estimates certainly supported the suggestion of strong growth in the emerging economies. Third quarter growth was estimated at +8.9%, so strong that it sparked concerns of over-heating and speculation as to when the government might ease back the stimulus programme still in place.

Against this broadly positive backcloth, investors continued to embrace sectors with earnings leverage to an improving economy, although this thematic now appears to be well owned and at risk of fading. The energy, materials and financial sectors outperformed while the information technology, utilities and telecom sectors lagged.

China (+6.44%) outperformed on the back of stronger than expected domestic economic growth figures. Hong Kong also outperformed the region (+2.73%) as employment statistics took a mild turn for the better, and property companies fared well as low interest rates and buoyant Chinese growth are keeping demand for real estate robust. Korea (-6.28%) underperformed as investors grew particularly worried about Korean restraints on appreciation of the won (the currency has appreciated 9% year to date and a whopping 28% since its low in March). Stronger than expected Chinese growth drove commodities prices higher (the Jeffrey Commodity Price Index rose 4.5% during the month), particularly the price of crude which was up 8.5%. As a result, India (large oil importer) underperformed (down 4.01% over the month).

#### Market outlook

After the rises of the past quarter, it is very tempting to take some profits and move to a defensive strategy – markets are, after all, up over 60% so far this year. We are not doing so.

Leading global economic indicators continued to suggest emergence from recession. Central bankers acknowledged the budding improvement, but given weak employment conditions in the developed world and the tentative flow of credit, they reiterated that removal of monetary stimulus likely remains a distant prospect. With liquidity worldwide staying flush and short-term investments offering a dismal return potential, funds continue to flow steadily into equities.



Within the asset class, emerging markets equities (both GEM and Asia ex Japan) are in the “sweet spot” – global interest rates are low, the US fiscal position is taking its toll on the dollar (which supports commodities) and while developed market economies are improving, growth in emerging markets has already recovered and will continue to stay strong and stronger than that of developed markets for many years to come.

Two consecutive quarters of scintillating returns have swiftly reversed the despair that prevailed back in March and have now left equity markets measurably extended to the upside. A bout of profit taking could happen at any time, but even so, we expect any corrective activity to be short lived. Already paltry returns on short-term investments continue to erode, many investors continue to be sceptical about the recovery, short sellers are still abundant and the robust rallies in government and corporate bonds have made fixed income valuations much less competitive. With an average of 20-25% earnings growth to come in 2010 (risks to this consensus estimate are on the upside in our opinion), emerging equity ratings are not extreme and further progress does not require a re-rating.

Risks to watch include military escalation with Iran and an unexpected tilt towards central bank hawkishness, but the major economic trends still point to recovery. The chances for a broad array of earnings disappointments seem limited in the months ahead, and appear unlikely to reach dangerous levels until both expectations and share prices have accounted for recovery more fully.

### Strategy

On a country basis we are overweight China, India and Thailand, and underweight Malaysia, Singapore and Taiwan. However, these under and over weights are now relatively small.

Within sectors, we are overweight materials, primarily cement, real estate, consumer discretionary and technology, and are a little underweight banks, energy, consumer staples and telcom.

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.