Asia ex Japan

Quarterly commentary

June, 2010

Market review

The MSCI Asia ex Japan index fell 4.91% in the second quarter of 2010. The strongest market was Indonesia which rose 4.22% while Taiwan (-9.31%) and Korea (-7.59%) were the weakest.

Given the weakness has been caused by concerns over a double dip due primarily to Europe and China slowing, we thought it appropriate to focus the quarterly on global macro forecasts. Thus, after contracting by 1.9% in 2009, global real GDP is forecast to expand by 3.8% in 2010 and 3.4% in 2011 according to Citibank. Within this, they expect further significant differentials between developed and emerging economies. Developed economies are expected to grow by 2.4% in 2010, compared to 6.8% in emerging. In 2011, they expect developed economy growth of 2.1% compared to 6.0% for emerging markets. The key message from these forecasts is that the overall global economy should slow, but not double-dip, in 2011.

Amongst the major developed countries, Japan is now expected to grow fastest (+3.5%) in 2010. This is the first time that Japan has topped these growth rankings for almost 20 years. The US is expected to generate healthy, if unspectacular, growth over the next 18 months (+3.2% in 2010, +2.8% in 2011). Citibank forecast Eurozone GDP growth of 1.1% in 2010 and 1.0% in 2011. So they expect the region to lag, but not drop back into recession, as fiscal austerity policies bite. Within the Eurozone, both Spain and Greece are expected to see GDP contract in 2010 and 2011. But this is countered by decent growth forecasts for Germany, where a weak euro should help to boost exports. UK real GDP growth (+1.4% in 2010 and +2.4% in 2011) is expected to outperform the Eurozone, but underperform the US and Japan over the next 2 years.

Chinese economic growth is moderating as fixed asset investment flattens and industrial output softens. We do not expect the change in China's FX policy to lead to rapid near-term currency appreciation, and by cutting risks of greater US-imposed tariffs – the move probably reduces downside risks to China's growth. Fears of a major economic slow-down look overdone to us. Citibank forecast China GDP growth of 10.5% in 2010 and 9.3% in 2011. Indian real GDP growth is forecast at 8.4% in 2010 and 8.6% in 2011. Thus, Asia ex Japan economies will generate about 40% of global GDP growth in 2010.

Market outlook

Markets have plenty to worry about. Globally, the travails of Greece and the consequent health of European banks continues to provide a negative backdrop. Recent disappointing data out of the United States meanwhile raises again the possibility of a "double-dip". Clearly if the Euro broke up or if the Western economies moved back into recession markets would indeed fall – and emerging markets would suffer more than most as befits their status as "high risk" assets. We just do not believe either of those events is likely – we are working on the assumption that central banks and governments will "do what it takes" to head off such cataclysms. More parochially, the slowdown in China has impacted confidence, especially in commodity dominated markets. Again, we are in the bullish camp. China is indeed slowing – but from 11-12% to 8-9%. The slowdown marks a return to trend and a renewal of the re-balancing of the Chinese economy away from infrastructure spending towards consumption led growth. This change does have negative consequences for commodities, but it is nevertheless good news, not bad – the last thing China or the rest of the world needs now is an unsustainable binge in one of the world's largest growth locomotives – to be followed by a painful crash.

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So, we are relatively relaxed about all the big worries facing markets. On the more positive side, we are assuming developed economy interest rates will stay very low for the foreseeable future and, importantly, we are assuming corporate profits in emerging stocks will continue to benefit from the growth in their domestic economies despite a slow-growth environment in developed economies. It is worth quoting some numbers here: consensus earnings growth for emerging markets show a rise of 43% for this year (after a fall of 11% last year) and 20% for next year (source: Morgan Stanley, IBES, all numbers in USD). The actual numbers will of course differ from this consensus, but the trend and the general magnitude will not alter if we are right on the macro-economic environment. Using consensus numbers emerging markets trade on under 10x next year's earnings – a discount to both their own history and to developed markets. Given continued low bond yields these valuations look too low.

Strategy

The strategy is overweight China, Singapore and Thailand funded by underweights in Korea, Malaysia and Taiwan.

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

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