Asia ex Japan

Quarterly commentary

Quarter 2, 2009

The MSCI Asia ex Japan second quarter index performance (+34.89 in USD) was the best quarter since 1993. Emerging market equities had their best quarterly gain (+33.6% in USD) since the 1988 inception of the MSCI EM index. The main drivers of this rally have been the bank recapitalisations and quantitative easing within the G7 and possible ending of the US recession, while China appears to be recovering strongly. During the quarter, US equities rose 15% while the USD fell 6%, EMBI spreads tightened and oil prices and the Baltic Freight index surged. Thus during the quarter Asia and emerging markets outperformed developed, small cap beat large cap, financials and cyclicals beat defensives.

India was the best market rising by 59.84% after the unexpectedly positive election result in May, while Indonesia also rose 54.51% as risk levels fell globally. Thailand (+53.48%) similarly did spectacularly well after the political problems of the last 6 months, while Singapore rose 45.99% as growth and property expectations were deemed overly pessimistic. China and Hong Kong only rose a little over 35% while the export driven cyclical markets of Korea and Taiwan were the worst performers, but both still rose just over 25%.

We feel that after the substantial second quarter rally, we have now had, perhaps, the price earnings ratio expansion phase of a recovery. What happens now depends on real demand and there have been some tentative signs of that. For example, in China, strength in household spending has broadened beyond auto and housing related items and exports show encouraging signs of improvement (well less bad admittedly). Additionally, inventory reduction is amplifying the recovery in production. For example, the latest electricity output data in China and manufacturing PMI numbers suggest that strong momentum in overall industrial activity continued in June.

More interestingly perhaps, consensus EPS numbers for Asia ex Japan have been revised up for the third month in a row. EPS growth is now forecast at -2.6% for 2009 and 30% for 2010 across Asia ex Japan with the greatest recoveries in cyclical technology and Taiwan and Korea. Overall, Asia ex Japan markets trade at 17.8x 2009 and 13.6x 2010 and are on Price to Book valuations of 1.8 currently, compared to a 5 year average of 2.0 (according to Credit Suisse/IBES estimates). This suggests fair value.

If there is to be a surprise catalyst upwards, it seems most likely to come from an unexpectedly strong recovery in the US and Europe (where most forecasters have weak growth in 2010) thus leading to a much stronger export recovery than currently forecast. This would give more credence to an asset bubble in Asia ex Japan which has been suggested, particularly in China.

On a country basis we are still overweight China, India and Thailand, and underweight Singapore, Taiwan and Korea. Within sectors, we are overweight materials, primarily cement, real estate and telcom. We are underweight banks (although overweight other financials), consumer staples and utilities. We are neutrally positioned in technology, consumer discretionary and capital goods.

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.