

MARKET INSIGHTS

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Is Asia decoupling from the west?

Introduction

An escalation in the eurozone sovereign debt crisis and a string of weak economic reports from the US has caused increased volatility in markets in recent weeks. Although markets have been affected globally, our Asian investment team believes investors should be encouraged to see indications that Asia's economy is decoupling from the west.

Double-dip fears causing market volatility

Under pressure from huge amounts of public sector debt, governments in the US and Europe have been forced to enact austerity measures. Such measures have the potential to restrain growth and recent data releases indicate this may already be the case. Leading economists and analysts have therefore begun to downgrade the economic outlook for the west. Fears of a double-dip recession have increased recently, causing intense market volatility.

Rather than reacting solely on newsflow, we strongly follow the principles of long-term investing, looking at corporate fundamentals, political stability and economic trends. These indicators lead us to believe in the long-term strength of the Asian markets, supported by the robust balance sheets of Asian corporations and governments. Asia's apparent long-term strength suggests it might be decoupling from the west – a very exciting development for equity investors in the region.

Asia's growing intra-regional demand

Asian exporters typically suffer from market-moving events in Europe and the US, but increasing domestic consumption in Asia has begun to lessen dependence on western consumers. The most recent purchasing managers' indices (PMIs) for countries across Asia are encouraging in this regard.

The new export orders component of the PMIs fell sharply – a clear consequence of weakness in the west. For example, Taiwan, perhaps the most exposed Asian market to western demand, saw its new export orders reading fall to 44.7 in July from 50.2 in June. However, the new orders and employment components saw mostly solid increases, suggesting strong domestic demand for Asian-made products is offsetting weakness abroad.

Industrial production growth also points to domestic strength, with data readings currently hovering around their ten-year average. With extraordinary weakness in the west, average industrial production numbers based on trade figures mean above-average demand from Asia itself. For example, July's trade figures for Korea showed a 4% growth in exports to developed markets, but an impressive 30% growth in exports to emerging markets, mostly in Asia.

Exhibit 1 – Intra-Asian trade accounts for a large percentage of total exports, suggesting less dependence on the west.

Trailing four quarters, % of total exports			
	To China	To developing Asia	To developed Asia
Australia	26.0	41.9	35.9
China	n/a	10.5	29.7
Hong Kong	53.0	61.4	8.0
India	8.4	19.8	13.5
Indonesia	10.1	30.7	37.6
Korea	24.2	36.8	18.2
Malaysia	19.4	33.4	33.1
Philippines	21.0	30.2	40.7
Singapore	10.3	46.4	22.1
Taiwan	27.9	40.9	28.4
Thailand	10.9	32.4	26.1

Developing Asia: Composed of 27 countries: Republic of Afghanistan, Bangladesh, Bhutan, Brunei Darussalam, Cambodia, China, Fiji, India, Indonesia, Kiribati, Lao People's Democratic Republic, Malaysia, Maldives, Myanmar, Nepal, Pakistan, Papua New Guinea, Philippines, Samoa, Solomon Islands, Sri Lanka, Thailand, Democratic Republic of Timor-Leste, Tonga, Tuvalu, Vanuatu, and Vietnam. Developed Asia: Composed of South Korea, Singapore, Hong Kong, Taiwan and Japan. Source: CLSA Asia Pacific Markets

In China, export growth unexpectedly accelerated to 20.4% year on year in July from 17.9% in June, despite western demand weakness.

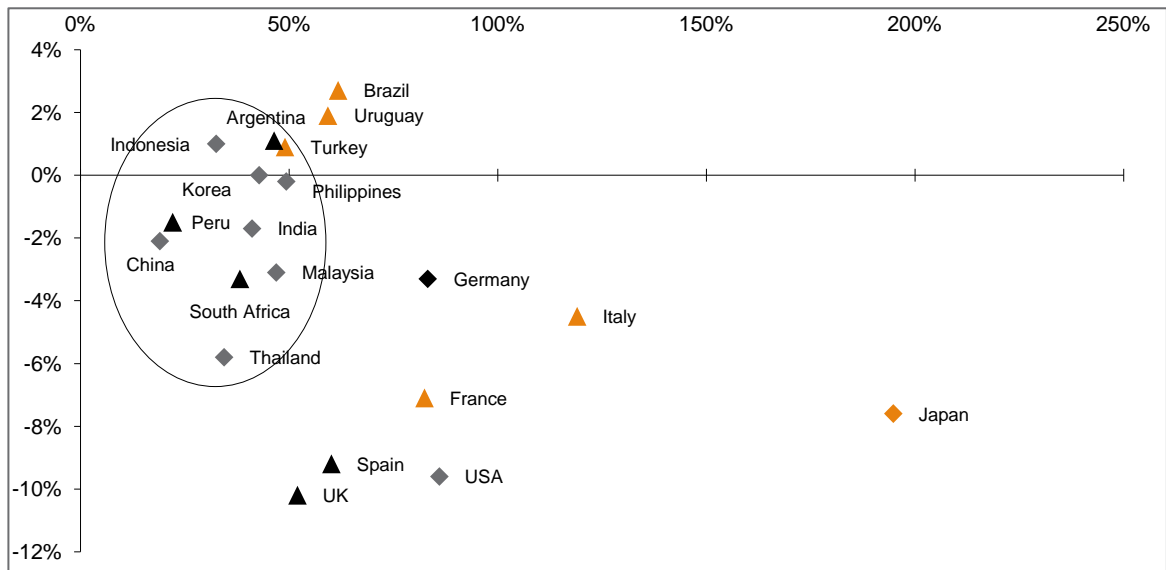
Even more importantly for other Asian economies, China's imports grew by a very strong 22.9% in July as the government's efforts to transform the economy into a domestic consumption-driven model begin to take hold.

In contrast to the common notion that the region is simply a workshop for the west, the recent data points to Asia being a workshop for itself. Data from the key trading countries of Taiwan, Korea, Singapore and Hong Kong, shown in **Exhibit 1**, illustrates that intra-Asian trade has reached between 54% and about 70% of total exports, while China has even pushed its intra-Asian trade to 40% of total exports. Although depressed demand from the west will affect Asia's marginal export growth figures, it is not implausible that government fiscal stimulus from within the region or simply organic demand growth could provide a cushion for Asian exporters.

Asian fiscal policy supportive of growth

Asia's long-term fiscal outlook also remain strong, underpinning economic growth. Unlike in the west, most Asian economies have public debt-to-GDP ratios of well under 50% and are running strong budget surpluses. **Exhibit 2** highlights Asia's fiscal strength compared to the rest of the world.

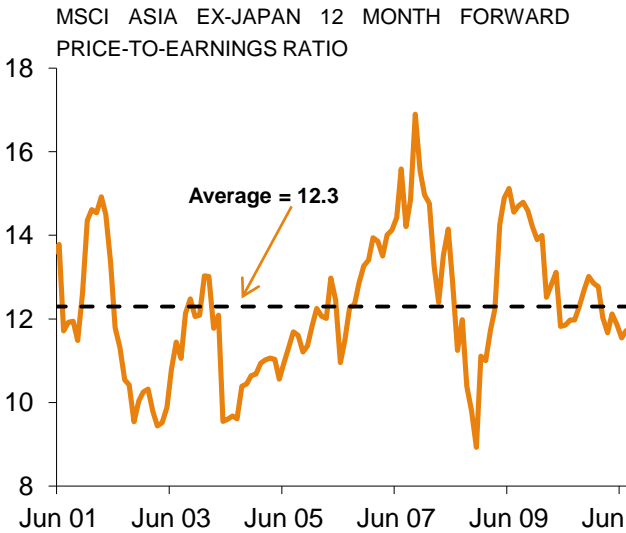
Exhibit 2 – Asia maintains strong fiscal positions in a world of rising public debts



Source: J.P. Morgan Securities; IMF Fiscal Monitor. Data as of Oct 2010. For illustrative purposes only.



Exhibit 3 – Asia’s valuations are nearing historic lows but fundamentals remain very strong



Source: I/B/E/S, J.P. Morgan Asset Management, FactSet.



The stable fiscal situation in Asia has led to the re-consideration of regional sovereign debt, with countries that used to have fiscal problems, such as Indonesia and the Philippines, steadily being upgraded to near-investment grade status. We think that this re-rating of sovereign debt is a consequence of strong growth and prudent economic management, and will lead to an eventual re-rating of equities in many Asian markets.

Asian equities look cheap

The recent volatility in global markets affected Asia but there is a silver lining to the market correction – it has led to some excellent buying opportunities. Despite stronger fundamentals, net foreign buying of Asian equities has been below trend since the Global Financial Crisis of 2008/09. This year is no exception as inflows and outflows have remained roughly in balance year-to-date. Considering the percentage of global corporate profits earned by emerging Asia we believe global equity flows are currently out of balance, which should benefit the region in the long run.

Meanwhile, valuations have been pushed down to near-historic lows as shown in **Exhibit 3**. The current forward price-to-earnings ratio for the MSCI Asia ex Japan index has fallen to 11.6x, below the long-term average of 12.3x. Furthermore, Asia ex Japan’s price-to-book ratio is at 1.9x, edging towards the 1.1x trough seen during the Global Financial Crisis.

However, the cheap valuations are not a reflection of poor fundamentals. Asian markets are supported by strong economic growth, solid balance sheets and improving return on equity. As such, we strongly believe that current market weakness may provide an excellent entry point for Asian investors.

A slowdown in the west could spark a pickup in Asian markets

Investors react not only to valuations but also to catalysts. We think that the slowdown in the west will lead to just such a catalyst. Monetary tightening due to inflationary pressures has held back equities across the region; however, most of that inflation is due to the global factors, particularly high food and energy prices.

With a slowdown in the west, we will see commodity prices fall and a likely end to the current round of monetary tightening in Asia. History has shown that easier monetary policy almost always leads to a strong stock market rally in Asia as investors are pushed to seek higher returns and valuations revert to the mean.



Conclusion

Many Asian investors have been worried about developments in the west and how they might affect their Asian holdings. There is an increasing amount of evidence that Asia is decoupling in an economic sense from the west. We therefore believe the region may survive any global growth slowdown better than in the past, including the sharp post-Lehman contraction in world trade. As a result of this decoupling, our portfolios are heavily invested in companies that are geared to domestic consumption growth. We think that, to a certain degree, Asian markets have acted irrationally in the face of western fiscal woes, but in the mid- to long-term the true fundamentals of the region will reward patient investors.

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