

# MARKET INSIGHTS

January 2012

## Asia-Pacific markets in the Year of the Dragon



**Edward Pulling**  
Managing Director,  
Head of the Pacific Regional  
Group, Hong Kong

### An interview with Ted Pulling

*As we move into the Chinese New Year, Ted Pulling, the new head of our Pacific Regional Group, takes a look back at 2011 and gives his views on what may lie ahead for investors in the Year of the Dragon.*

#### What were your thoughts on markets in 2011?

2011 was a tough year for investors in Asia. Investors had to contend with a number of key issues, most notably, fuller valuations after a strong performance in 2010, earnings downgrades, rising inflation across the region and worries over a potential hard landing in China, Asia's largest economy. Alongside this there were the headwinds from global markets that led investors to reduce risk in portfolios.

The ASEAN markets were the strongest in Asia in relative terms in 2011 (**Exhibit 1**). The more domestic oriented countries in the ASEAN region performed better than their counterparts in north Asia. Indonesia and the Philippines were supported by strong corporate earnings, which were insulated from global issues, while Malaysia's low foreign ownership and defensive qualities were an attraction for investors. Positive election results in Thailand, coupled with lower valuations than other countries in the region, led to relative outperformance from the Thai market.

In contrast, concerns over the global slowdown weighed heavily on Taiwan and Singapore, while concerns over inflation, politics, fuller valuations and the 15% fall in the rupee led India to lag the Asia region. The biggest disappointment for us was the underperformance of China, which had already underperformed in 2009 and 2010. Given that valuations were reasonable (**Exhibit 2**), we expected China to perform well in 2011, but stubborn inflation, worries over local government and banking debt and the threat of a hard landing kept investors on the sidelines.

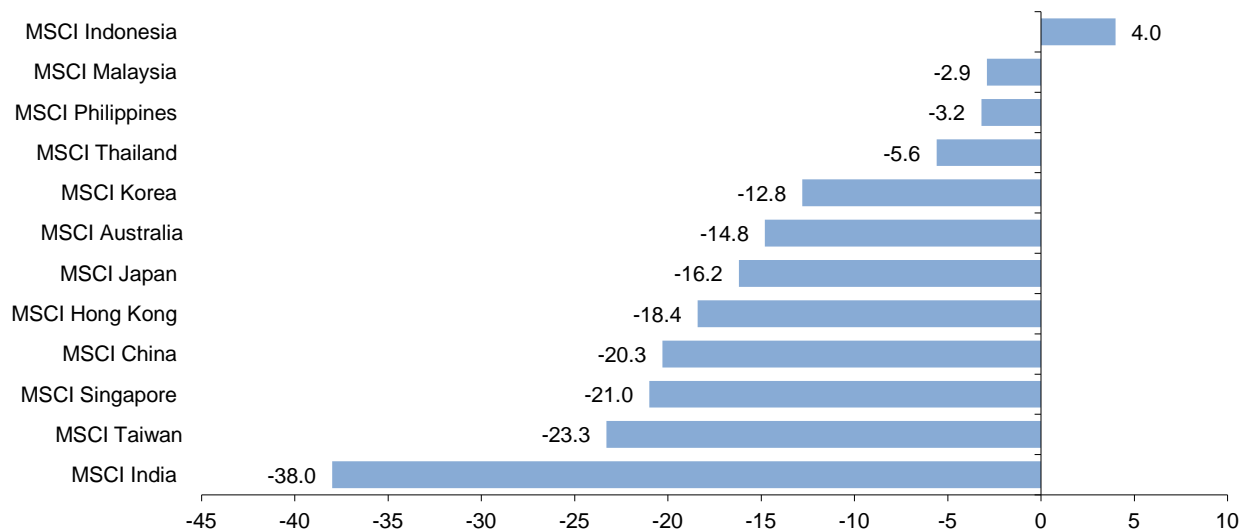
In the first few weeks in 2012 we have seen Chinese A shares resume their march northwards. We have highlighted this Index as a real time and prescient indicator of government policy change. There is a sizable short base in H shares that needs to be moderated. Our recent company visits indicate that credit is flowing better and that policy is adjusting satisfactorily. So China could be the tide that floats the region. Within the rally, there is an element of January mean reversion. That will probably manifest itself in weaker ASEAN performance, which we can accept tactically, especially if Malaysia is the main laggard.

1

\*'Professional Investor' means the definition ascribed to it within the European Union Directive 2004/39/EU on Markets in Financial Instruments (MiFID).

**Exhibit 1 – Performance of Asian markets in 2011**

**USD price index (%)**



Source: Credit Suisse. Data as of 30 December 2011.

**Exhibit 2 – Asian market valuations**

30 Dec 11	Mkt Cap USD bil	P/E (X)			EPS Growth (%)			Yield (%)	PBV (x)	ROE (%)		
		2011	2012	2013	2011	2012	2013	2012	2012	2011	2012	2013
<b>MSCI Asia Pacific</b>	<b>5217.4</b>	<b>12.4</b>	<b>10.9</b>	<b>9.4</b>	<b>9.3</b>	<b>14.0</b>	<b>15.1</b>	<b>3.5</b>	<b>1.1</b>	<b>9.6</b>	<b>10.3</b>	<b>11.0</b>
<b>MSCI Asia ex Japan</b>	<b>2339.4</b>	<b>11.3</b>	<b>10.3</b>	<b>8.9</b>	<b>8.9</b>	<b>9.8</b>	<b>14.2</b>	<b>3.4</b>	<b>1.4</b>	<b>13.3</b>	<b>13.4</b>	<b>13.9</b>
Australia	817.1	11.3	10.4	9.5	11.0	9.0	9.2	5.7	1.5	13.9	14.4	14.6
China	577.4	9.2	8.3	7.3	12.4	10.6	13.7	3.9	1.3	16.5	16.2	16.2
Hong Kong	265.4	11.9	13.2	11.7	20.0	-9.6	12.1	3.4	1.1	9.7	8.4	8.7
India	200.1	13.2	11.5	10.0	10.5	14.5	15.4	1.8	1.8	15.9	16.0	16.2
Indonesia	96.7	14.7	12.8	11.1	20.1	14.9	15.5	3.0	3.1	24.5	24.0	23.6
Japan	2049.7	14.4	11.8	9.9	9.1	22.3	19.0	2.8	0.9	6.3	7.3	8.2
Korea	485.8	9.3	8.2	7.2	21.3	12.6	13.4	1.8	1.0	12.7	12.8	12.9
Malaysia	115.0	16.1	14.4	13.0	8.2	12.0	10.6	3.6	2.0	13.2	13.9	14.2
New Zealand	11.2	13.8	13.2	11.7	0.8	4.5	13.2	5.8	1.5	10.5	11.1	12.1
Philippines	23.9	15.5	13.9	12.6	8.2	11.8	10.7	2.8	2.3	16.0	16.2	15.9
Singapore	157.6	12.4	11.8	10.6	-0.7	5.1	10.8	4.2	1.2	10.6	10.5	11.0
Taiwan	354.4	15.6	13.0	10.8	-20.7	19.6	20.6	4.6	1.6	10.6	12.1	14.2
Thailand	83.1	11.4	10.2	9.0	22.3	11.7	12.9	4.1	1.8	17.5	17.4	17.6
<b>MSCI AC World</b>	<b>25751.7</b>	<b>11.9</b>	<b>10.8</b>	<b>9.7</b>	<b>10.4</b>	<b>10.2</b>	<b>11.7</b>	<b>3.4</b>	<b>1.4</b>	<b>13.0</b>	<b>13.3</b>	<b>13.7</b>
<b>MSCI Europe</b>	<b>6129.3</b>	<b>10.4</b>	<b>9.6</b>	<b>8.7</b>	<b>1.6</b>	<b>8.1</b>	<b>10.4</b>	<b>4.6</b>	<b>1.3</b>	<b>13.0</b>	<b>13.1</b>	<b>13.4</b>
<b>MSCI EM Emerging Markets</b>	<b>3240.7</b>	<b>10.1</b>	<b>9.2</b>	<b>8.2</b>	<b>12.6</b>	<b>9.9</b>	<b>10.8</b>	<b>5.6</b>	<b>1.3</b>	<b>14.7</b>	<b>14.6</b>	<b>14.7</b>
<b>MSCI United States</b>	<b>11854.5</b>	<b>13.1</b>	<b>11.8</b>	<b>10.6</b>	<b>15.0</b>	<b>10.2</b>	<b>12.0</b>	<b>2.3</b>	<b>1.8</b>	<b>15.2</b>	<b>15.4</b>	<b>15.7</b>

Note: The above data are compiled based on the MSCI AC Asia Pacific universe of stocks with which IBES forecasts are available. 2012 and 2013 data are forecasts as of end-December 2011. The fiscal year of each company uses December as the year-end. The market capitalisation for countries, sectors and the region are free-float adjusted.

Source: IBES Consensus, MSCI, FactSet, Citi Investment Research & Analysis

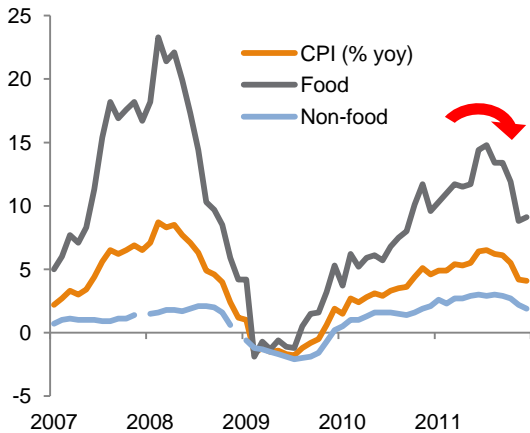
2011 was a disappointing year for us. In terms of country allocation we were relatively flat, with an overweight in Korea and underweight in India in the first half of the year proving the right choice. We also held an overweight in Thailand throughout the year, which was positive. However, an overweight in China and an underweight in Malaysia were negative through the year.

Our positioning in China was the biggest issue. Moving into 2011 China looked to have good defensive qualities, having underperformed for three consecutive years, which had left the market very attractively valued on a price-to-earnings (P/E) and price-to-book (P/B) basis (**Exhibit 3**). Corporate earnings were still growing and the market was still seeing upgrades during the first half of 2011.

Within China, banks and property were the two sectors that offered the best value. Both sectors had been negatively affected by the government's ongoing tightening measures. At that time, we also took the view that inflationary pressures would ease and believed that China would start to outperform as long as investors were convinced that the tightening cycle had ended. When inflation figures showed signs of weakening in August, we would have expected banks and property stocks to have received a boost, but concerns over European debt caused risk aversion to rise and these stocks instead continued to struggle.

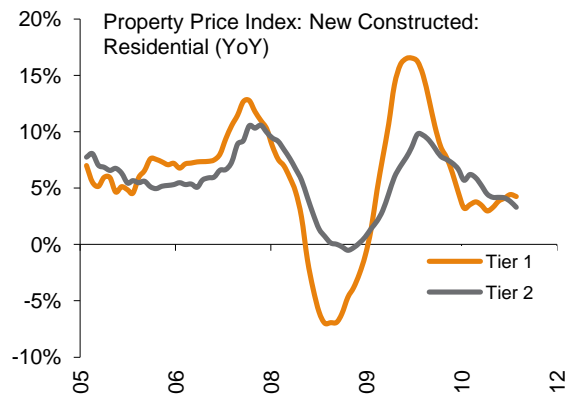
**Exhibit 3 – Chinese inflation, property prices and P/E valuations**

**Inflation is easing, led by food prices**



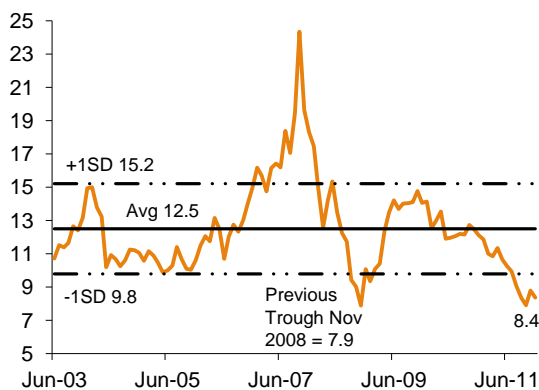
Source: Bloomberg, data as of end December 2011.

**Property prices declined**



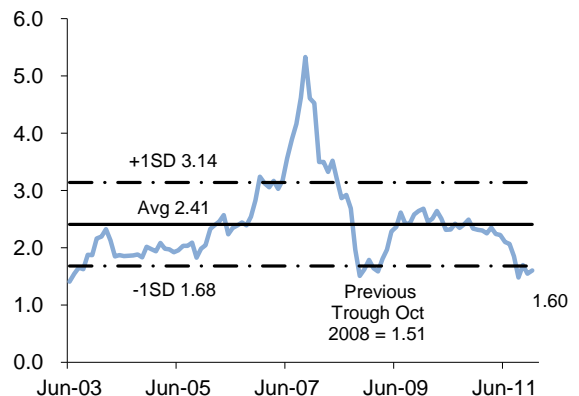
Source: Morgan Stanley Research, 25 Oct 2011

**MSCI China 12-Month Forward P/E**



Source: IBES, Morgan Stanley Research, 31 Dec 2011

**MSCI China Trailing P/B**



Source: MSCI, Morgan Stanley Research, 31 Dec 2011

Asia underperformed in 2011. Do you think Asia will perform better in 2012?

I think the first half of 2012 will be very tricky as investors await greater clarity on the larger global macro issues. As long as uncertainty persists, we will continue to see volatility in all risk markets. The challenge as we move into 2012 is finding a solution to the European sovereign debt problems that also supports Europe's banks without severely hampering the broader European economy. We must assume that a solution will be found – at some stage – but even then growth in the world's developed economies may remain subdued for several years to come. The US economy is showing signs of improving marginally and is likely to muddle through to the November presidential election. After that, budget deficits and government spending have to be tackled head-on. Global risk appetite is likely to be the biggest driver of Asian markets in 2012.

The three key things that may provide support to Asian markets are: waning inflation, an improvement in earnings, and supportive valuations. We are coming to the end of the tightening cycle in Asia. Rising inflation was one of 2011's biggest drags on the Asian economies and we are seeing inflation begin to subside. Rates have already been cut in a number of countries including Indonesia, Thailand and Australia, and China has signalled the start of easing by reducing its reserve rate requirement.

As inflation figures begin to fall Asian governments will have plenty of room to stimulate growth through monetary policy. While the outlook for earnings is not clear across Asia, we are starting to see some positive trends. The earnings outlook for Asia has begun to improve. The rate of earnings downgrades regionally has started to slow and Asia is relatively advanced in the earnings downgrade cycle. Finally, valuations are moving into the attractive zone in Asia. We haven't quite hit the bargain basement levels of 2008, but we are not too far off them. Asia is now trading at 10.3x P/E (FY2012) and 1.4x P/B, which is over one standard deviation below historical averages.

Within Asia, what countries should investors be focusing on?

Top down decision making in this sort of environment will be challenging. The most important thing we can do is focus on getting the stock calls right, and letting our bottom-up fundamental analysis drive our country weightings and investment decisions. What our research clearly shows is that the best opportunities lie within countries and sectors where earnings are driven domestically, rather than outside Asia. We are currently finding the strongest ideas within China, India, Indonesia and Thailand, while unsurprisingly concerns over a slowdown in the major western economies are weighing heavily on markets like Taiwan. From a sector standpoint the most attractive sectors are those that are geared to the Asian consumer.

Even in the countries where we find good ideas there are concerns at the moment, with China suffering from worries over the slowdown in growth and a possible hard landing, while India faces a number of issues around governance and economic paralysis caused by the political landscape. That said, both of these markets have very sound long-term structural stories to support them, while in the short term they are benefiting from falling inflation and compelling valuations.

Indonesia shares the same positive structural long-term trends and is one of the most exciting opportunities in the region. The market has outperformed over the last two years and now trades above the region at 13x P/E. We believe this premium is well justified given its high return on equity.

In general, we remain cautiously optimistic over the first half of the year. We have increased our weightings in higher quality, higher yielding stocks, but still remain positioned for a bounce in Asian markets. If risk appetite is largely determined by events in the West, then we think that risk appetite is improving, at least tactically. That, combined with cheap enough Asian valuations, compels us to believe that markets could enjoy a rally in the shorter term.

How do you see Japan at the moment – is there a case for investors to re-visit this unloved market?

Historically, many investors, including ourselves, have tended to look at Japan independently from the rest of Asia. There were many reasons for this, but most obviously Japan's size dominated most regional indices and investors wanted to separate the two decisions. This has changed in the last few years and we now look at Japan more within a broader Asia-Pacific context, in the same way we would look at Korea or Taiwan.

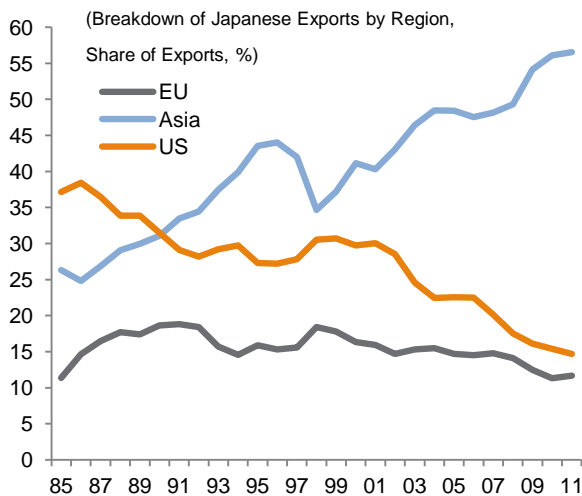
From this standpoint Japan struggles to compete with the dynamism and strong levels of growth from other parts of the region. We all know the structural issues the Japanese economy faces, so it's difficult to get too bullish on Japan from a country perspective over the long term. However, from a bottom up perspective Japan has some very high quality companies with a number of good investment opportunities.

Our strategy in Japan continues to focus on companies with solid bottom up earnings trends and strong balance sheets. Despite the global economy slowing, there are some very exciting trends developing. For example, Japanese companies are market leaders in areas such as factory automation, where they are seeing strong growth from the emerging markets. As discussed in one of the earlier questions, one of our favoured plays is consumption growth in the ASEAN region. If you look at Japanese car manufacturers (**Exhibit 4**), they have a strong foothold in the ASEAN market and will be beneficiaries of the expected strong growth in demand.

We believe the market is undervalued trading on 12x P/E based on 2012 earnings forecasts, and below 1x P/B. So, while we aren't overly positive on the longer-term fortunes for Japan, we are managing to find many well managed Japanese companies that are available on attractive valuations.

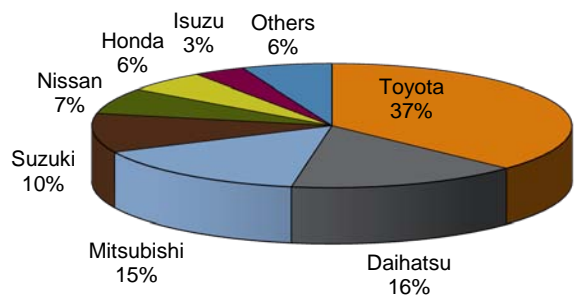
**Exhibit 4 – Japanese exporters are benefiting from Asian demand**

**Exports to Asia Exceed the US And EU Combined**



Note: calendar year basis. As of September 2011. Source: MoF, Goldman Sachs

**Japanese Auto companies dominate market share in Indonesia**



Source: Citi. As of 31 December 2011.

## 2012: The Year of the Dragon

Legends and mythology are a big part of Chinese culture, especially in relation to the Chinese zodiac. The 12 animals that appear on the Chinese zodiac calendar are a rat, buffalo (ox), tiger, rabbit, dragon, snake, horse, goat, monkey, rooster, dog and pig.

2012 is the Year of the Dragon. Occupying the fifth position in the Chinese zodiac, the dragon is the mightiest of the signs. Dragons symbolise character traits such as dominance and ambition. Dragons prefer to live by their own rules and if left on their own, are usually successful. They are driven, unafraid of challenges and willing to take risks. They are passionate in all they do and they do things in grand fashion. Unfortunately, this passion and enthusiasm can leave dragons feeling exhausted and interestingly, unfulfilled.

While dragons frequently help others, rarely will they ask for help. Others are attracted to dragons, especially their colourful personalities, but deep down, dragons prefer to be alone. Perhaps that is because they're most successful when working alone. Their preference to be alone can come across as arrogance or conceitedness, but these qualities aren't applicable. Dragons have tempers that can flare fast!

### Gong Xi Fa Cai – Happy New Year!

**Edward Pulling**, *managing director*, is head of the Pacific Regional Group (PRG), based in Hong Kong. He joined the firm in 1995 as an investment manager and was appointed head of the PRG in January 2012. Immediately prior to joining the firm, Ted spent a year as vice president of institutional sales with Goldman Sachs in Singapore, focusing on the Thai, Indonesian and Indian markets. Before joining Goldman Sachs he spent five years at W.I. Carr, first as research analyst in Hong Kong, then research manager in Thailand and later as head of Asian emerging market sales in Singapore. Ted obtained a B.A. in history from Princeton University.

Follow @JPMAM\_UKAdviser on 

Visit [jpmorganassetmanagement.co.uk](http://jpmorganassetmanagement.co.uk)

FOR PROFESSIONAL INVESTORS ONLY. NOT FOR RETAIL USE OR PUBLIC DISTRIBUTION. 'Professional Investor' means the definition ascribed to it within the European Union Directive 2004/39/EU on Markets in Financial Instruments (MiFID).

Any forecasts, figures, opinions or investment techniques and strategies set out, unless otherwise stated, are J.P. Morgan Asset Management's own at date of publication. They are considered to be accurate at the time of writing, but no warranty of accuracy is given and no liability in respect of any error or omission is accepted. They may be subject to change without reference or notification to you. The views contained herein are not to be taken as an advice or recommendation to buy or sell any investment and the material should not be relied upon as containing sufficient information to support an investment decision. It should be noted that the value of investments and the income from them may fluctuate in accordance with market conditions and taxation agreements and investors may not get back the full amount invested. Both past performance and yield may not be a reliable guide to future performance. You should also note that if you contact J.P. Morgan Asset Management by telephone those lines could be recorded and may be monitored for security and training purposes. J.P. Morgan Asset Management is the brand name for the asset management business of JPMorgan Chase & Co and its affiliates worldwide.

Issued by JPMorgan Asset Management (Europe) Société à responsabilité limitée, European Bank & Business Centre, 6 route de Trèves, L-2633 Senningerberg, Grand Duchy of Luxembourg, R.C.S.Luxembourg B27900, corporate capital EUR 10.000.000. Issued in the United Kingdom by JPMorgan Asset Management (UK) which is authorised and regulated by the Financial Services Authority. Registered in England No. 01161446. Registered address: 125 London Wall, London EC2Y 5AJ.