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SMALLER ASIAN EQUITY MARKETS TO CONTINUE TO OUTPERFORM

Summary	Investment Conclusions
<p>Market volatility during October can be expected to continue till the Fed clarifies its intentions and gives them a clear time frame. Despite a barrage of warnings over the susceptibility of EMKs to higher UST yields, the truth is startlingly different. The best performing equity markets in Asia are all registering stable to improving macro trends. All Asian interest rates policies are so variable as to make nonsense of the notion that higher Fed rates will automatically mean higher rates in Asia thus impacting equities. The best Asian equity valuations are not extreme compared to G3 equities but outperform them by a long margin. These are facts not expectations!</p>	<p>We have preferred the 3 smaller Asian equity markets of Thailand, Indonesia and Philippines and, more recently, of India. We continue to stay so based on their valuations and outlook for 2015. The longer term decoupling of Asian economies from that of the US economy, let alone from the economies of the EU and of Japan, will continue to allow Asian central banks to exercise monetary policies based primarily on domestic considerations. In most Asian economies monetary policies will remain accommodative even after the Fed starts to hike, except, of course, in Hong Kong.</p>

Monetary policies in Asia: some boring facts

The obsession with the notion that Fed hikes will drag down Asian EMK equity markets disregards the fact that Asian central banks, for a very long time now, run their monetary policies on the basis of domestic considerations and not on some imaginary link to UST yields. Consider:

China last cut rates in July 2012 and since then has used a variety of direct measures to encourage or discourage lending. Its current approach is to inject more liquidity in the money market and to loosen mortgage lending conditions. **Taiwan** has not changed official rates since it hiked them June in 2011, a clear indication of absence of any links with what has been happening in the G3 economies. **India** last hiked rates in January 2014, a move completely driven by CPI inflation trends and likely to be repeated if inflation does not subside. **Indonesia** hiked last in September 2013 while **S.Korea** last cut rates in October 2014 in a countercyclical move, as did **Thailand** in March 2014. However both **Philippines and Malaysia** hiked rates in September and in July 2014 respectively mostly on inflation concerns. **Hong Kong's** rates follow those of the Fed in lock step because of the peg while **Singapore** has no official rates as it drives instead its exchange rate along a policy-determined band.

In last the two to three years while the Fed was following a very loose policy, and since May 2013 a more cautious policy with a tightening bias, Asian central banks, raised, cut and left rates unchanged, especially after the May 2013 "taper tantrum". While a hike in Fed rates will, undoubtedly, impact equities globally and, hence, Asian equities, the impact on Asia will likely be short-lived and leave longer trends unchanged



Source: Bloomberg

Back to the stock markets and macros

As Chart 1 shows the four Asian markets surveyed here have continued to comfortably outperform the S&P 500, itself the best performer of the G3 group. The reasons for this strong performance include the sound underlying macros,(with apparent disregard for politics as in the case of Thailand following the military coup in May this year), the overall supportive monetary and credit policy environment and the long standing decoupling of most Asian economies from the G3 cycles and that of the US in particular. The new president in Indonesia may face difficult policy decisions. The Modi administration in India, after a slow and hesitant start, has kept up at least the rhetoric of more liberal policies, and the markets continue to give it the benefit of the doubt.

FACTBOX: Valuations of big and small markets

Index	P/E 12M	P/B 12M	YTD % USD
S&P 500	15.5	2.5	6.3
Eurostoxx5	13.1	1.4	-10.3
Nikkei	16.6	1.5	-7.7
SENSEX	17.0	2.6	28.0
JCI	15.5	2.8	18.0
SET	12.0	2.1	20.0
PCOMP	19.3	2.8	19.0

Source: Bloomberg, metrics are 12M forward estimates

As the data in the Factbox indicate, the four Asian markets which have been consistently the best performers in Asia in 2014, are not cheap in terms of P/E, Philippines in particular. However the Nikkei and S&P multiples are not cheap either, and especially the Nikkei given its poor performance. Concerns over a steep decline in the indices of these four markets once the adjustments to higher UST starts, can be countered. Even substantial declines between now and yearend will still leave investors who had put their money early in the year in these four Asians with substantial gains in USD terms compared to virtually any other EMK market. The question of a stronger USD, meaning weaker local currencies, is also partially answered by the fact that even after the weakening of these currencies during

Chart 2: GDP,India(red),Indonesia(green),Philippines (violet),Thailand (yellow), 2007-2014



Source: Bloomberg

This October, the returns in USD terms remain strong and, hence, could face some further weakness without forfeiting the gains made so far. It is traditional to end research reports of this type with words of caution when the performance of these markets has been so strong. Chart 2 shows that GDP growth rates in these four economies have been falling but also shows signs of bottoming. This would be particularly encouraging in the case of Thailand whose GDP growth has shown all the signs of the impact of the political uncertainty up to the coup. Indonesia may also benefit from more investment under the new administration. In general these cautions are almost irrelevant unless a strong call is made to sell ahead of expected adverse periods, and this is not the case here. However, reacceleration of inflation in India will postpone for a long time an equities-supporting cut in rates. A deterioration of politics in Thailand or absence of true acceleration of infrastructure investment in Philippines would sour investor’s sentiment. However under current trends there is no reason why an investor who entered these markets in January 2014 will not end the year with an outperformance over all other Asian EMK equity markets and over the G3 markets in particular.

Andrew Freris (writing completed on 28/10/2014)