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Econotes is a free research publication available on request. It is not a solicitation for business. It is devised and written by Dr. Andrew F. Freris based on 46 years of market experience which included senior positions with GT Capital, Salomon Brothers, Bank of America and BNP Paribas as well as senior academic posts with universities in London and Hong Kong

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SMALL ASIAN EQUITY MARKETS TO CONTINUE TO OUTPERFORM IN 2014

Summary	Investment Conclusions
The smaller equities markets of the Philippines, Indonesia and Thailand (coup notwithstanding for now) have outperformed YTD in USD terms the equities of the G3 economies and are likely to continue to do so for the rest of 2014. India's market has done well but its outlook now is completely linked to the expected policy measures of the Modi administration and, hence, near term disappointments are very likely. All these economies, with the possible exception of India, have been driven by good underlying macros and even Thailand, can rebound. India's macros however remain weak.	Purely in terms of asset allocation, we stay bullish on equities as an asset class for the rest of 2014 as G3 rates and yields will stay low. The US equities will keep outperforming the EU (the latter's macro outlook staying poor) while Japan's impact of "Abenomics" is now coming to a plateau and will require either more monetary ease (likely) or dramatic economic reforms (most unlikely).Continue to invest in the Philippines and Indonesia, keep Thailand steady for now (see coup analysis) but start reducing exposure in India to avoid the end of the Modi honeymoon.

Global and Asian equities outlook

It is hardly surprising to us that **Japanese** equities have been and are continuing to perform poorly as their key driver has been the loose BoJ monetary policy partially offset by tax increases, none of which support longer term earnings growth or improve productivity prospects. The **EU** will continue to suffer from longer term poor growth, with the ugly head of sovereign risk rising again after the anti-EU election results.More easing to come from the ECB. Meanwhile the **US** remains the big economy with reasonable growth prospects but with likelihood of higher rates.

Meanwhile the smaller Asian equities markets (Philippines, Indonesia and Thailand) have been consistently outperforming G3 equities in USD terms. Here are some of the reasons why we think they will continue to do well in 2014.The case of India is examined separately as is the coup in Thailand.

As Chart 1 shows the 12M forward P/E of the three smaller Asian markets are comparatively modest compared to S&P 500 at 15.6, Nikkei 17.0 and Eurostoxx at 14.5. In other words, the rising Asian P/E have not made these markets expensive after their strong performances. Furthermore, their absolute P/E levels are still lower than those they registered just before the January 2014 mini crash in equities .

The basic macro outlook of these economies, and also for Thailand, remain broadly equities-supportive with low inflation, relatively stable forex rates, flat short and longer term rates and rising forex reserves. Thai GDP growth has been hit temporarily, but capital markets took the coup in their stride. Rising USD rates by yearend may impact these markets but via the impact on global equities rather than directly on their economies.

Chart 1: P/E trends in Philippines, Indonesia and Thailand (red,yellow,green) 2013-2014

Source: Bloomberg

India

The election result in India has given rise to extreme hype including calling it the most important election of the century. There is no doubt that drastic economic reforms and deregulation can unleash GDP growth rates for India in excess of 10% over, possibly, a decade or more. But markets are short-sighted and the litany of poor macros plaguing India now is unlikely to be fixed in a year. Hence our concern of a fall in the market, which is expensive (see Factbox) and which is approaching overbought (Relative Strength Indicator, RSI, in Chart 2).

Immediate problems which will continue to affect the macro outlook include persistently high CPI inflation which will hinder the Reserve Bank of India from cutting rates any time soon, poor exports performance and low investment rates. The external balances have improved.

Chart 2: MUMBAI still on overbought territory,2013-14.

Source: Bloomberg

FACTBOX : 12 months forward P/Es, (YTD index %)

In order of P/E size: Philippines 18.5 (14.0), KL 16.3 (2.2), Mumbai 15.7 (19.4), Jakarta 15.5 (19.3), Taipei 14.6 (4.6), Thailand 13.7 (8.6), HSI 11.5 (-3.7), Singapore 11.3 (4.8), S.Korea 10.2 (2.2), Shanghai 7.8 (-6.6).

There is little proportional relationship between high P/E and strong performance, but equally, the two underperformers, HSI and Shanghai, are some of the cheapest in terms of low P/E.

For the sake of completeness here are the YTD % in USD terms numbers for the G3, S&P 500 (2.8), EuroStoxx (3.2), Nikkei 225 (-7.2). The Asians have consistently outperformed the G3 in USD terms

Resolution of these problems is an interconnected process .Keeping the fiscal deficit down to less than 4.5% of GDP means cutting subsidies particularly in the energy sector which will reaccelerate inflation. Even if businesses were willing to invest, the infrastructure investment needs can only be addressed over years and not months. Our concern on equities is not based on a cynical or negative view of the capacity of the Indian government to take unpopular decisions, but the fact that the equity markets are inherently "short-termistic". Any measures taken now by the Modi government are unlikely to impact earnings prospects for the rest of 2014.

What can go wrong (or not !)

Among the many obsessions in the market, but poorly supported by facts, is the notion that the, inevitably, higher US rates will somehow cause domestic rates to rise or will put pressure on the external accounts of Asian economies. The experience of the last 12 months has pointed to the fact that local rates are, and have been for a long time, except for Hong Kong, broadly decoupled from the dynamics of the USD rates and yields. Asian forex rates are not fixed and hence can vary if rate differentials vary. Last but not least higher USD rates can do damage to economies which need to borrow to cover external deficits or fund fiscal deficits, none of which is the case, at last with the three smaller economies covered here.Their forex reserves have been rising over the last 6 months.

Thailand, however, remains of concern. The impact of the 2006 military coup can hardly be detected on the statistics of the capital markets at the time, and he natural catastrophes such as the 2004 tsunami and the 2011-12 floods had but only temporary impacts on GDP growth rates. All this may or may not prove that Thailand is the "Teflon economy" of old where nothing stuck. This is not saying to sell the market, but to keep, for now, a stable position. The difference with India is that the post-honeymoon disappointment in India is more likely to materialize soon, as opposed to making a big negative bet on the far more unpredictable political developments in Thailand. (Completed on 2/6/14)