

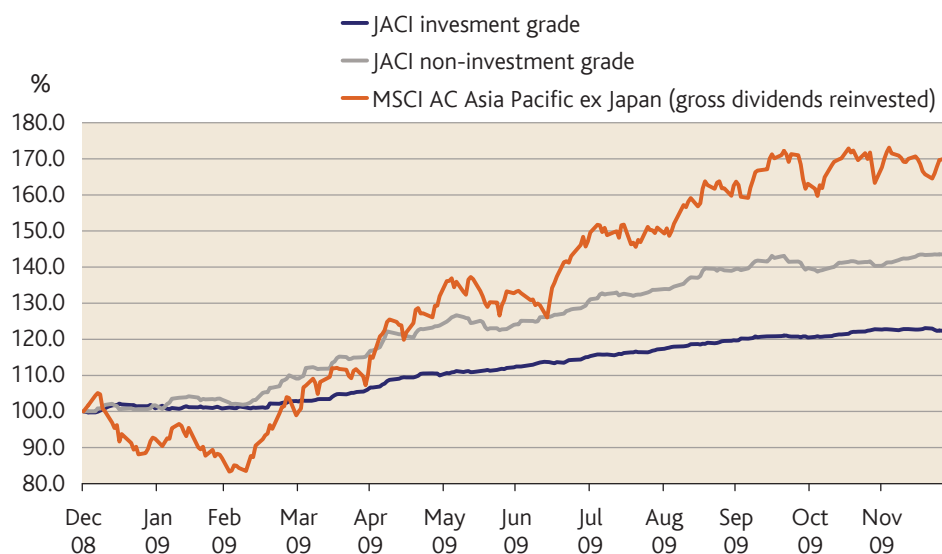


Asia review and outlook 2010

Summary

2009 saw Asian bonds and equities rally sharply, following huge losses in 2008. Equities, as measured by the MSCI AC Asia Pacific ex Japan index, returned 70% in US dollar terms, while investment grade and non-investment grade Asian bonds, as measured by the JP Morgan indices, returned 22% and 43% respectively.

2009 Asian bond and equity performance



Source: Bloomberg, 28 Dec '09

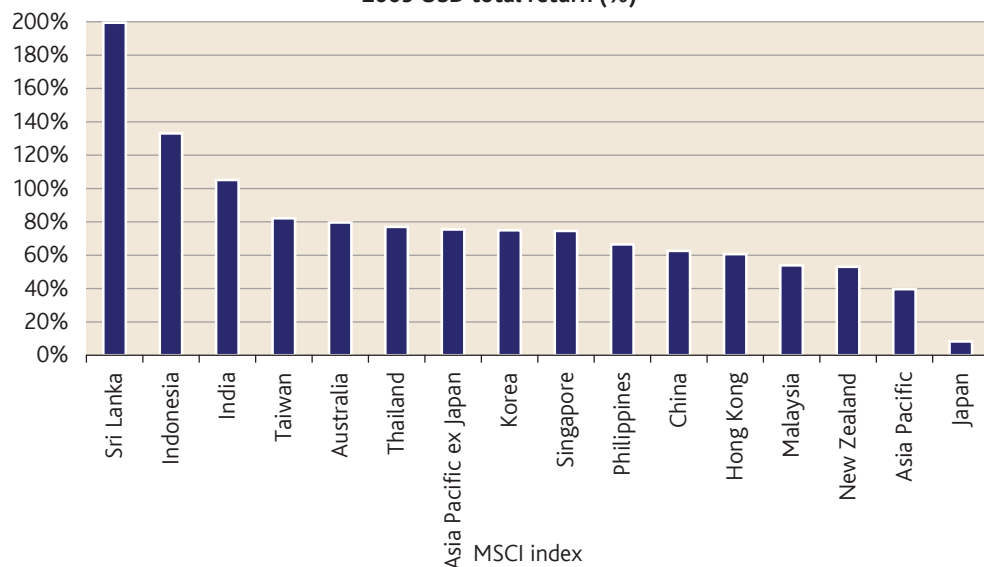
In January and February, equity markets extended their 2008 losses. Despite governments' unprecedented responses to the deflationary forces that were causing economies to contract very sharply, investors were not convinced, fearing a prolonged downward spiral. In addition to the extraordinary measures to loosen monetary policy and, at least in certain developed countries, prop up banking systems, governments everywhere announced massive fiscal stimulus.

Investor pessimism reached extreme levels in early March, allowing markets to rise sharply. Although it was not clear early on, strong equity market performance around the world since March reflected the collective realisation that a 1930's-style depression would be avoided. Having underperformed their developed counterparts in 2008, Asian equity markets significantly outperformed in 2009. Asian bonds also performed well as the fall in spreads from above 700 late in 2008 to 250 basis points currently more than offset the sharp rise in US longer-dated treasury yields.

Although key economic measures such as industrial production and retail sales continued to fall during the second and third quarters, they did so at a lesser rate. Towards the end of the year countries began to post positive growth, confirming hopes and expectations that had earlier driven equity markets. In fact, equity markets during the fourth quarter essentially moved sideways, finding it hard to improve upon the sharp gains of the previous two quarters.

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2009 USD total return (%)



Source: Bloomberg, 5 Jan '10

Looking at individual markets, there was a wide range of performances. At one extreme, Sri Lanka posted a total US dollar return of 200% following the ending of the civil war, while at the other, Japan's poor returns reflected difficulties in the corporate sector due to the strong yen and crowding out of the private sector by massive government borrowing. Elsewhere, the large domestically-driven markets of India and Indonesia outperformed, as investors perceived them to be relatively immune to the global recession. On the whole, other regional markets performed similarly, posting returns in the 60-80% range.

Outlook for 2010

The immediate outlook may turn on today's low interest rate policies. In the short term, we think these could drive markets higher; equally they may cause, along with massive increases in government borrowing, new and dangerous risks to build. That being borrowing will have to be paid for through higher taxes yet private consumption and investment in developed countries continue to be very weak. Meanwhile, low interest rates designed to get people spending again have only had the effect of forcing investors to seek yield, driving up equity and credit markets in an unsustainable and unhealthy fashion.

Despite remaining cautious on developed countries, the picture in Asia is more positive. In fact Asia will probably lead global growth for the foreseeable future, pulling other emerging markets along with it. If the West experiences a relapse, Asia will be affected. Regional economies still depend to a degree on demand from the West for their manufactured exports as well as portfolio investment.

That dependence is best reflected in the import of very loose US monetary policy through fixed exchange rates. US-China trade relations have become frayed in the face of protectionism, with the exchange rate a lightning rod. Pressure is growing for the yuan to be revalued. For countries that do not have capital controls, our expectation is that consumer price inflation will lead to monetary tightening anyway. Should prices rise because of stronger domestic demand (rather than supply-side price changes), such developments will however be positive.

Indeed, we are firm believers in the concept of 'decoupling', meaning that increased domestic demand (in Asia) will be able to compensate for weakness in developed economies, and can become a driver of growth in the next decade. Countries do not export goods and services for the sake of it but in order to pay for imports, such as commodities and capital goods that are needed to grow domestic economies. As countries such as China, Taiwan and Korea have increasingly been able to manufacture their own capital goods, their need to export has decreased.

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Furthermore, while economic growth across Asia was certainly dented by the collapse in demand from the West, Asia's banking systems remained strong, having been rebuilt following the financial crisis of the late 90s. This has meant that in the face of slack demand from developed countries, governments in the region have been able to boost local demand through domestic bank credit (as well as public spending). Weakness in the West could also, paradoxically, be positive for Asian economies to the extent that that they are not generally able to satisfy strong domestic demand and strong external demand simultaneously. There may be less pressure on commodity prices, for which regional economies compete, too.

While equity markets, and indeed most asset classes, have been highly correlated in the last two years, with 2009 essentially a reversal of 2008, we see 2010 as the year in which investors begin to differentiate between sectors and countries. This applies also to fixed income, where we see relative value in investment grade versus US benchmarks, as well as in selective currency and credit opportunities.

Logic suggests returns for both asset classes will be more muted than in 2009. Looking at equities, company earnings growth has recovered recently, helped by cost-cutting and inventory restocking. Yet it remains difficult to ascertain how such one-off factors may have distorted returns; thus there is considerable margin for error in saying what happens next. In absolute terms valuations are no longer cheap but nor are they expensive. We think the region may deserve a higher premium, even after last year's outperformance, reflecting fundamental strengths, including low levels of corporate, personal and government debt.

As we have argued, with the inherent imbalances in the global economy still not addressed, and the risk of policy exit mistakes, the likelihood of a global correction appears to have been carried over from last year. If a correction does take place, the bonus for investors who took the view that by mid-09 local markets had already steepened too quickly is that they should get a second chance.

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