

**INVESTMENT TRUSTS** » While chaotic times are likely to remain as we enter 2012, dogged persistence is likely to pay off

# It's been a dog's life



## Andrew Graham

An ancient Chinese proverb holds that it's better to be a dog in quiet times than a man in times of chaos. And for investors in a chaotic period? Well, this year, it's been a dog's life. While 2011 has been a poor year

for stockmarkets around the world, it's been particularly disappointing for investors in Asia. Most Asian equity markets have steeply underperformed the MSCI World index in the first ten months of the year, although Japan has modestly outperformed (in sterling terms at least), thanks to the strength of the yen.

In large part, the sell-off in Asian equities has been a consequence of the successive sovereign-debt crises in Europe and the signs that economic recovery is stalling in the US. As well as a spike in risk aversion – unhelpful for Asian equities on the perception that they are 'risk assets' – these issues have led to lower expectations for growth in GDP and corporate earnings in the Asia-Pacific region, with earnings expectations falling particularly sharply in Australia, India, Taiwan and Singapore. Again, Japan has been the exception, thanks to a quicker-than-expected recovery from the tragic earthquake and tsunami in March; the disaster had led to sharply lowered expectations, which have since been raised again.

Besides the macroeconomic problems in the West, there have been considerable domestic challenges too. Apart from Japan, where deflation and post-earthquake reconstruction remain the key issues, inflation has been the main preoccupation for Pacific policy-makers. Over the past year, central banks have tightened policy in Asia through higher interest rates and more restrictive bank reserve requirements, as well as through measures aimed at specific sectors, such as the housing market. Nevertheless, real interest rates generally remain negative in the region, and inflation in some countries, such as Thailand and South Korea, has remained above the target ranges set by policy-makers. No formal targets exist in China and India, but inflation has been stubbornly high. The authorities are determined to curtail this and will be reluctant to ease policy unless there is a significant deterioration in demand. Indeed, data emanating from both the Chinese and Indian economies over the past few months suggests that policy measures are beginning to bite. India's loan growth has cooled somewhat, and vehicle demand has softened. In China, meanwhile, small businesses are experiencing difficulty in accessing credit and are increasingly turning to the unofficial 'shadow banking' system to source funding.

China's informal banking system poses a particular challenge for analysts, as there is little official data available, particularly on the scale of such lending and the extent to which it represents a systemic risk. Estimates range from Rmb10–20 trillion (US\$1.5–3 trillion) and cover a range of instruments such as bank acceptance bills, entrusted loans, private bond issuance and trust loans. What we do know is that acceleration in this type of lending corresponds with periods of policy-tightening, when borrowers, and especially small businesses, are driven to seek out these high-cost sources of finance; it is surely no coincidence that sales of luxury vehicles and high-end apartments have decelerated. Investors should watch this situation carefully in the months ahead; Chinese policy-makers will doubtless be doing the same.

So, with no likelihood of any easing in policy until inflation appears to be under control, the prospects for 2012 are not immediately bright. But while Asian markets have been heavily punished during the latest bout of global panic, the region's fundamentals remain strong – and the long-term investment case for Asia remains very much intact. At a time when the Western world is struggling with debt and deficit, Asia remains in much better fiscal shape at sovereign, corporate and personal level. Given the global slowdown, Asia's manufacturers are facing weaker near-term demand, but appear to be in good shape overall; balance sheets are generally healthy, and checks on inventory channels suggest that although there are pockets of excess inventory, it is not a widespread problem. This should mean that even a modest improvement in demand will be quickly reflected in business activity.

And while external demand may be weak for some time, domestic consumption in Asia remains robust. Retail sales continue to grow rapidly in China and Hong Kong, for example – and China's forthcoming income-tax reforms will benefit lower- and middle-income families, thus entailing a substantial boost to consumption. September's surprisingly strong Chinese industrial-production figures may indicate the extent to which domestic demand can compensate for the slowdown overseas. And we should remember, too, that the tightening measures employed by Asian policy-makers should ultimately prove positive, if they succeed in checking inflation and avoiding asset bubbles.

Meanwhile, current valuations provide a great deal of comfort for investors in Asia. In Japan, valuations are now pricing in an event similar to the dramatic post-Lehman drop in production. The price-to-book ratios of huge swathes of the market are now lower than in 2008/09. Mitsubishi UFJ, for example, is trading on 0.5x book value, and the overall market is on 0.9x. Some 72% of all Japanese stocks now trade below book value, and 85% of them have dividend yields greater than the yield on Japanese government bonds.

In the rest of Asia too, valuations are now appealing from a historical perspective: the yield spread on the MSCI Asia ex-Japan index over US Treasuries was 76 basis points at the end of August. The only occasion in the last 20 years when spreads have

been higher was at the depth of the 2008/09 crisis. Valuations are therefore attractive across the entire Asia-Pacific region. Should the international turmoil lead to further sell-offs in the next few months, it will only enhance the appeal of Pacific equities for long-term investors.

A long-term view on the current macroeconomic upheaval is important here. Although the equity markets are bound to experience a great deal of uncertainty – and thus volatility – in the short term, Asia's long-term growth story is very much ongoing. So, while 'chaotic times' are likely to remain with us as we enter 2012, dogged persistence is likely to pay off for investors who have the patience to recognise that Asia's remarkably resilient fundamentals and robust secular growth will ultimately be rewarded. 🐻



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