



**ASIAN EQUITIES >>** Asian markets have been hit hard – but Asian equities remain resilient and look very attractive

# LOOKING TO THE LONG TERM IN ASIA



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While most global indices are well down for the year, developing Asian markets have been hit especially hard in 2011.

Investors have fretted about inflation in the region, policy measures to fight it and the mounting evidence of a slowdown in the West. In contrast, inflation has hardly been a problem in Japan. As well as being buffeted by global macroeconomic headwinds from the US and Europe, Japanese equities were naturally the worst affected in the aftermath of the tragic Tohoku earthquake. While the subsequent recovery in Japanese manufacturing output has been remarkable, we believe it has yet to be fully recognised by the market.

One consequence of Asian equities' lacklustre performance this year is that valuations across the whole region now look very attractive. Until recently, significant undervaluation had been a cornerstone of our investment case for Japan, but not for the other Asian markets. So just how cheap are they? Given the differences between Japan and the rest of Asia, it is worth examining the value case for both separately.

### Unlocking Japan

Taking Japan first, recent years have seen persistent domestic price deflation, a strong currency, a lack of positive policy developments and a collapse in industrial production after the 2008 financial crisis. Then came the devastating earthquake. The cumulative effect is that the Japanese market currently trades at a discount of more than 50% to its long-term average (on a price/book measure). More than half of its listed companies have a price/book ratio of less than one, yet the same index is home to scores of the strongest, most innovative companies in the world. While many investors recognise this remarkable value, the question we are most often asked is what catalyst could unlock it? While we would love the macro headwinds to abate, the clearest answer we can give is that the future direction of corporate earnings remains critical in determining the future level of the Japanese market.

The current macro environment does present serious obstacles to earnings, but we can still find companies with the potential to beat earnings estimates over the next 18 months. Central to our investment philosophy is the knowledge that analysts and other market participants consistently underestimate operational gearing, and hence the extent of the earnings recovery following a crisis (such as the earthquake). Martin Currie Pacific Trust does have exposure to cyclical areas of the Japanese market, such as the automobile industry, where we think the positive surprises will be strongest. But until we see a return to global growth or a meaningful weakening in the yen, we will focus on companies with steady, visible top-line growth or where there is a convincing cost-reduction or industry-restructuring story.

While Japan's equities have been trading well below their historical average for years, stocks in the rest of Asia have fallen away from theirs in 2011. At present, valuations in the MSCI Asia Pacific ex Japan index are one standard deviation below their long-term average. An analysis of the past two decades shows that this level has provided an excellent entry point for investors. According to RBS data, in five out of six comparable episodes since 1990, the average one-year return from this point has been 16% in US dollar terms.

Of course, there may well be further declines to come. If Asian indices were to fall another 20%, for example, this would bring valuations to two standard deviations below their long-term average. Taking comparable lows as a starting point, RBS data shows an average 12-month return of 60% and a three-year return of 100%. However we may not reach such depths this time around. For now, we believe current levels are sufficiently attractive to make a convincing case for investing in Asian equities. But investors should look to commit money to the region gradually – so that they can profit from the potential rises from the current levels, but also take advantage of adding more heavily should markets fall further.

So if Asian valuations are compelling, what about earnings prospects? The slowdown in the West and China's ongoing struggle with inflation means that earnings visibility is limited.

Given the higher materials, energy and labour costs, companies with a demonstrable capacity to manage them, or to pass them on to others, should be better placed than most. Analysts have been revising their estimates down for some time, but as we know, analysts are notoriously poor at predicting turning points. For investors, there would be comfort in sticking with the pack until the sell-side starts to revise its estimates up again. But at current valuations we can look through this uncertainty in the knowledge that we are buying into an asset class that is supported by stronger economic fundamentals than those in the developed world.

### Long-term strategy

As the short-term challenges in the region abate, investors should be able to refocus on the diverse long-term opportunities that the Asia Pacific region offers – from the highly developed markets of Japan and Australia to the emerging giants of India and China; from the technological powerhouses of Korea and Taiwan to the rising stars of Southeast Asia. It is this combination of resilience and diversity that makes Asian equities such an appealing proposition. And, for the time being at least, seriously good value can be added to the list of attractions. ■



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