



John Millar
Manager Martin Currie
Pacific Trust

Where next for Pan-Asian markets?

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It is some measure of how gloomy investors had grown about the prospects for the Japanese market that, by mid-March, share prices in Tokyo had hit their lowest levels since 1983. Since then, however, share prices in Japan have, along with those in other Asian markets, rallied sharply; investors have, with some justification, taken an increasingly positive view of Asia.

There are a number of broader economic reasons for investors' increasingly positive outlook: worldwide, industrial data has started to improve and capacity utilisation rates are increasing. There are also tentative signs that investors believe that policymakers have succeeded in averting disaster: in recent weeks, started to see a number of improving economic trends. Industrial data globally has started to improve and there are signs that the worst of the inventory adjustment is behind us. Capacity utilisation rates are starting to improve, albeit from very low levels.

In both Japan and the rest of the developed world, policymakers have demonstrated their willingness to do whatever it takes to fix the global economy's many problems. Whether in the form of fiscal stimulus or unconventional monetary policy ('quantitative easing') it seems that the authorities will not stint in their efforts to prevent the world from falling into deflation. There will, of course, be a hefty price to pay in the future, in the form of ballooning fiscal deficits or pent-up inflationary pressures. For now, however, the consensus seems to be act promptly and to deal with the consequences later.

As a result, we have started to see some signs that investors' appetite for risk is rising from extremely low levels. Bond yields have increased. So too have commodity prices. And, having spiked to 90 at the height of the panic in October, the VIX index of implied volatility (the so-called 'fear gauge') has fallen by 55 percent to well below 40.

Given all this, it is unsurprising that Asian markets have been rising and that market leadership has shifted: defensive stocks (the stand-out winners in the second half of 2008) have underperformed, while cyclical and financial stocks have outperformed. That process is at its

most evident in Japan, where the relative performance of classic defensive stocks like the electric power companies and mobile operators peaked as early as December.

For our part, we have increased our exposure to Japan's car manufacturing sector, an area where the expectations of analysts are too low, by buying stocks such as Honda, Toyota and parts maker Aisin Seiki.

So far, so positive, but two pieces of the jigsaw are still missing:

1. **The consumer** - We need to see a return of consumer demand. As we saw in Japan in the 1990s, there is only so much that fiscal stimulus measures can do. There is, of course, some scope for other stimulus packages to drive consumption – take, for example, the 'cash for clunkers' schemes introduced across Europe, which have helped to stimulate demand for new cars.

2. **Corporate earnings** - Equity investors need to identify how much of the bad news on corporate earnings has already been priced into current valuations. In some cases, we still don't believe that analysts' forecasts are sufficiently negative. We remain vigilant for disappointments and, in particular, for hints of capital raising still to come.

In other cases, however, while business conditions seem likely to remain difficult, the share prices of some of Asia's most interesting long-term performers already reflect that: it's in the price. As such, there are selected areas – particularly in Japan – where expectations now look reasonable. This is where the long-term opportunities for investors in Asia currently lie.

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Registered office: Saltire Court, 20 Castle Terrace, Edinburgh EH1 2ES Tel: (44) 131 229 5252 Fax: (44) 131 228 5959
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