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INSIGHTS

October 2013

A fundamental issue

The wait is over….for now.

The much feared tapering by the US Fed did not materialise. Global markets reacted positively. Asian equity markets, in particular, have recouped the losses from August's sell-offs. Even the worst affected markets such as India and Indonesia, have gained ground.

So what has changed? Nothing. The Fed has merely postponed their decision to taper; in fact it did not rule out the possibility of tapering by year end if US growth and the pace of hiring show greater strength. We could see another round of sell-offs and capital outflows from Asia before the next Fed meeting.

But August's sell-offs did not signal panic.

While there is little doubt that capital left Asia as investors fretted about US "tapering", one fact stands out. The outflow, and its impact, were in areas that fundamental analysis suggests they should be.

India and Indonesia fell on widening current account and currency issues while high valuations was the key reason that Thailand and Philippines sold off. Thailand, Philippines and Indonesia were amongst the three most expensive markets in the region. That investors took profits in these markets should not come as a surprise.

Others such as Singapore, Hong Kong and Taiwan fell to a limited extent. Their weakness signaled nothing out of the ordinary as most had been trading around a flat trend.

China and Korea bucked the trend. The former benefitted from signs of a macro recovery while the latter rose on account of a solid current account surplus and lower proportion of short-term foreign exchange borrowings.

With fundamentals having played a big part in the recent sell-offs, it is timely to pen our fund managers' views on some of these markets.

India….is the worst over?

Are the recent measures by the Reserve Bank of India (RBI) sufficient to buffer Indian equities and the Rupee from another round of "Fed tapering" sell-offs ?

The sell-offs in domestic equities and the Rupee stemmed from a confidence crisis. Persistent negative real rates over a fairly long period of time triggered investments in gold (a large portion of India's imports) and other physical assets that widened the current account deficit. At the same time, rising inflationary pressures forced a tighter monetary response and the resultant rise in the short-term bond yields led to a pull back from foreign debt investors. As a result, the Rupee fell rapidly.

Recent measures by both the government and RBI to attract dollars are expected to stabilise the currency and improve the deficit issue. Measures to attract non resident Indian funds have been particularly impressive. At the same time, import duty on gold has been increasing to stem the current account deficit. Recent trade data shows that measures to curb gold imports have been successful while exports are picking up, thanks to the extremely competitive Rupee. The trade deficit should narrow significantly in the coming months, lending support to the Rupee.

The new RBI governor also surprised the market by hiking the repo rates to curb rising consumer price inflation, especially the food component. While this year's bumper crop harvest should help contain inflation, it appears that RBI is not leaving any room for complacency.

Is it time to bottom fish given that Indian valuations were bombed out during the recent sell-offs?

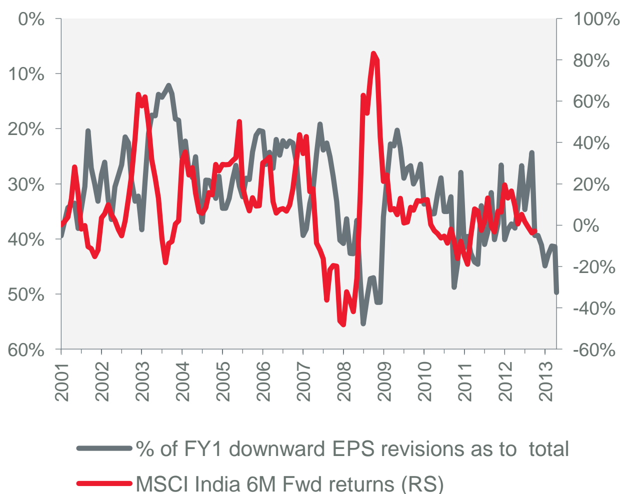
The recent sell-offs in equities, especially cyclicals presents an opportunity to add sharply beaten down stocks with a mid to long term view.

This is based on the premise that on the domestic front bold steps have been taken to stem the deficit. Moreover I think that earnings growth in India has possibly bottomed and that margin expansion and cyclical recovery underway.

Banks in particular became very attractive after the August sell-offs and we accumulated some at compelling valuations. My strategy is to shift from quality and defensives to cyclicals with strong cash flows.

While we are likely to see more volatility in the coming months, the current valuations have amply discounted uncertainty. Besides the earnings downgrades is now close to 2009 Global Financial Crisis which sets the stage for a plausible bottom for markets, if history is a guide (see chart below).

India : Historically, the market has rebounded over the next 6 months from point of sharp downgrades



Source: RIMES, IBES Estimates, Morgan Stanley Research, September 2013

China….is investor caution justified?

Chinese equities are valued at the trough levels of the past crises. While China has issues, is the outlook so bad as to justify these low valuations?

Uncertainty over future earnings sustainability in a number of sectors including banks and property, have kept investors on the sidelines. With economic growth expected to be flat during the second half of the year, earnings growth could decelerate in the second half 2013.

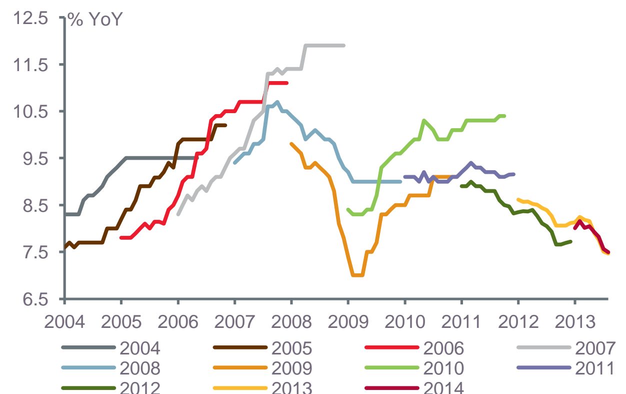
Nonetheless we believe that current valuations have already been priced in much of this uncertainty and offers a margin of safety.

The Chinese government seems set on a path of sacrificing short-term growth for long-term structural gain. What is your take on this?

These are all necessary steps, I think, on the road to sustainable growth. The government looks set in its resolve. It would have been easy to respond to recent growth fears by pump priming. Instead, it stuck to its lower growth path but boosted activity in structurally favoured areas such as low-end consumption and private enterprises.

It resisted the temptation to inject money into the sensitive areas of overcapacity thus producing more unproductive money. That is encouraging.

China: Adjusting to lower growth expectations



Source: IBES, as of 31 August 2013

What advice do you have for clients looking to invest in Chinese equities?

The economy is transitioning from a "Pro-reform but fear the worst" phase to a "Confidently on the right road" phase. This could be painful at times. But I think China is on the right track and the "pain" will eventually be more than offset by the "gain".

Indonesia….challenges and opportunities?

Indonesia has implemented a number of measures to address the balance of payments crisis. Are these sufficient to shore confidence in the market?

The recent policy measures, some of them very bold, have been steps in the right direction. August's trade balance saw a surplus after six months.

Nonetheless we believe further measures are required. Strong domestic demand, current account deficit and a strong currency cannot go hand in hand; the policy makers need to strike the right equilibrium over time. For a start, it is essential to invest in areas that will improve non-commodity exports. This should attract foreign direct investments, a stable source of flows and in turn help to reduce imports.

There may be some pain in the journey to equilibrium, but that will likely give the economy more levers to achieve higher a growth potential in the medium term.

What are the positive medium to long-term drivers you see for Indonesia?

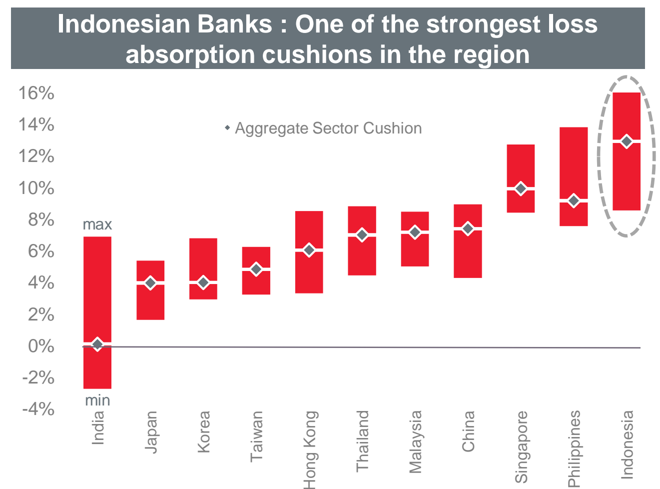
Indonesia remains one of the fastest growing Asian economies and the second fastest growing economy among the G20 countries. Much of this growth will come from strong domestic demand while its low export reliance gives rise to the economy's resilience when faced with a challenging external environment.

The country is poised to capitalise on its demographic dividend; a growing middle class and a relatively young population with increasing labor force participation will likely underpin a structural consumption boom in the coming years.

Valuations in Indonesia are back in the attractive area since the sell-offs. How have you responded?

Indonesia's macro fundamentals remain intact, underpinned by strong domestic demand and rising investments. Any pull-back is therefore an opportunity to accumulate fundamentally strong companies at more attractive valuations. Since the sell-offs, I have increased exposure to Indonesian banks with good deposit franchises as the sector has corrected sharply due to concerns of tighter liquidity and rising interest rates. I have also increased exposure to some property names, which got sold down to attractive valuations which offered a hefty discount to their appraised net asset value.

Indonesian Banks : One of the strongest loss absorption cushions in the region



Source: Morgan Stanley Research, company data Fitch as at Dec 12 except for Japan and India which are dated Mar 13. The red bars indicate the range of loss cushions for banks within a country, and the grey data point shows the sector aggregate cushion.

I would also like to add that Indonesian equity valuations are generally much lower than the index value suggests. The high price to book value is due to one stock, Unilever Indonesia, which accounts for just under 6% of the Jakarta Composite index (source: Bloomberg, 30 Sep 13). This single stock has a price to book ratio of an astronomically high 46x! (source: Eastspring Investments, 30 Sep 13) If all the other 400 plus stocks in the index only traded at an average 1x, the market ratio would still be a high 3.63x, just because of this one outlier This insight should offer top-down investors more confidence in the market!

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