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Schroders
Outlook

2012: A year in Asia

Richard Sennitt, Fund Manager, Asian ex Japan Equities, looks ahead into 2012

- Growth in Asia will continue to outstrip the developed world, and will be the key driver of global economic expansion
- 2012 may prove an interesting time for investors to find opportunities in the market
- Asian government debt to GDP is still relatively manageable and there is certainly room for more fiscal stimulus if required

"Valuations have now reached levels that have historically been a good buying environment for Asian investors."

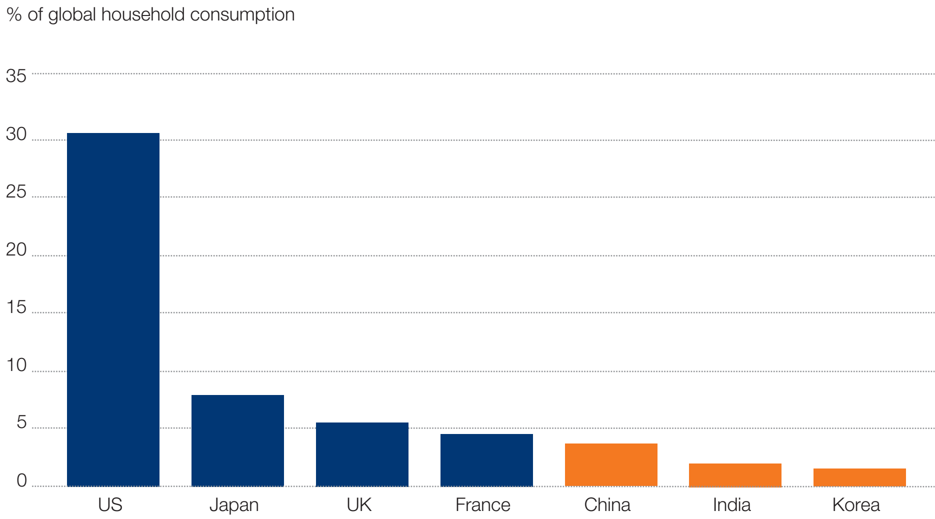
As much as we would like to say that Asian investors will wake up on 1 January to a world free of inflation, where export demand has magically bounced back, global growth is soaring, volatility and debt have disappeared, and China has swooped in and saved us all – this simply won't happen.

The problems of 2011 will follow us into 2012 and, the truth is, we are in for a difficult 12 months. Although Asia won't be immune to the headwinds, it is in a better position to withstand them as it continues its shift from an export-driven growth model to a market that is increasingly driven from within.

Home is where the growth is

With most analysts forecasting that Europe will slide back into recession in 2012 and the US will remain on an economic 'go slow' for some time, Asian governments are increasingly appreciating the need to mobilise their own consumers. The present downturn has highlighted the unsustainability of Asia's present model as the region simply cannot achieve further growth by relying on 300 million Americans to keep buying their goods.

Asian consumption set to rise strongly (Chart 1)
Global household consumption



Source: IFS, CEIC, Citi Investment Research, 31 July 2009.

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> "Asian economies will continue their shift from the current export-driven growth model to a market that is increasingly driven from within."

In a breakdown of global consumption (chart 1), we see that the US currently makes up more than 30% of household consumption, while the main Asia (ex Japan) economies contribute relatively little to the overall total. The likes of China and India each contribute less that 5% to global consumption, despite a population of 1.4 billion in China and 1.2 billion in India. With a rapidly growing middle class and rising urbanisation across the region, the potential of the Asian consumer is unparalleled. However, from an investor's point of view, this is still a difficult market, and tapping into this potential is likely to be a long-term challenge.

What we will see over the medium term are increased efforts on the part of Asia's governments to steer their countries away from being a population of savers to a population of spenders. This would include strengthening social security nets, such as healthcare provision, to enable people to feel confident enough to spend. Until this happens, economies in the region will continue to rely on developed markets to buy the majority of the goods they produce.

With signs of protracted sub-trend growth in the West, the likes of China, Hong Kong and Korea will certainly see a slowdown in growth in 2012. Singapore – seen as a bellwether of Western demand because of its heavy reliance on trade – has already said that its economy is likely to suffer a sharp slowdown next year as export orders from developed countries wane. Despite these expectations, growth in Asia will continue to outstrip the developed world, and will be the key driver of global economic expansion. However, for now, exports still matter for this region.

Hunting season

Asian equities were hard hit by the general flight to safety that characterised the second half of 2011. Risk sentiment indicators suggest the region's markets spent much of the period in panic mode, having seen double-digit losses year to date. Overall, we are seeing a major rebasing to people's expectations, and downward economic growth means that corporate earnings will also need to be revised lower throughout the region.

It's important to remember, however, that Asia went through its own financial crisis a decade before the West. This gave companies in the region the chance to short up their balance sheets, and now Asian companies tend not to be saddled with too much debt and have decent levels of cash. Despite this, earnings and leading indicators point to further downward earnings revisions over the coming year.

In terms of individual economies, estimated earnings in Taiwan have already seen sharp declines. This is partly because Taiwan's corporate sector is high transparent – with many IT companies issuing monthly sales numbers – allowing analysts to factor in any concerns earlier than they would for the rest of the region. While this makes Taiwan an interesting region for investors, from a valuations point of view, we are likely to see more downward revisions for corporates across the rest of Asia in the early part of next year.

Following the market turmoil of 2011, next year may prove an interesting time for investors to find opportunities in the market. Valuations have now reached levels that have historically been a good buying environment for Asian investors. However, with fear overriding all other emotions in the market, short-term performance is impossible to call. Investors should, therefore, focus on companies with internally generated cash flows, which would help shield them from any short-term turbulence emanating from the global economy. Longer term, we are confident that from current market levels, there is very good potential to make significant gains in Asia.

In terms of strategy, income represents a substantial portion of Asia's long-term total return, and dividend yield strategies continue to be among the strongest performing equities strategies in the region. In 2012, we are more likely to see companies surprise with higher dividends than expected as the extensive capital-raising activities of 2009/10 means that companies can now afford to pay out cash raised. In Asia, balance sheets are strong and pay-out ratios are back to historically low levels which should provide some comfort for the sustainability of dividend versus earnings.

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Richard is a fund manager for Asia (ex Japan) Equities, and is based in London. His investment career commenced in 1993, when he joined Schroders as an analyst on the Japanese Equities team. He is an associate member of the UK Society of Investment Professionals (UKSIP), a member of the CFA Institute, and holds a Bachelor of Arts degree from Oxford University.

Inflation takes a backseat

This time a year ago, Asian investors were almost entirely focused on the issue of inflation. The region was simply growing too fast; this was putting upward pressure on rates and threatening to erode economic growth. Although prices in the region are still rising, there are signs that inflation has peaked and global economic events are likely to remain the market's main concern over the coming year.

One of the fallouts of a slowdown in the outlook for global growth is that commodity prices are likely to pull back and, as Asia is a net importer of commodities, it will be a beneficiary of this trend. As a result, we are likely to see monetary tightening activity ease and, should the global economic environment deteriorate in 2012, Asia is in a strong position to withstand a further slowdown as authorities across the region still have tools to stimulate their economies. This is in stark contrast to the West – where rates are at rock bottom and public finances are stretched. Overall, Asian government debt to GDP is still relatively manageable and there is certainly room for more fiscal stimulus if required. Central banks in Australia and Indonesia have already cut rates, while Singapore's central bank has begun the gradual appreciation of the Singapore dollar. While this puts Asian economies in a strong position, going into next year, the region does have one potentially big problem – China.

The China problem

The big issue for the region as a whole is loan growth in China and whether the authorities can engineer a soft, rather than a hard, landing. Here, the biggest concern has been the rapid expansion of credit. As a highly managed economy, China's loan growth has – until recently – come through the banking system. However, since 2008, we've seen an explosion in shadow banking – a form of private lending that bypasses the normal channels. Although Chinese authorities have recently announced measures to curb such activities and bring these loans back onto balance sheets of banks, action has been late in coming and the horse has already bolted.

With authorities having already begun buying shares in some lenders, hopes of a loosening of monetary policy into 2012 have intensified. In this respect, we believe the market is jumping the gun. In our view, Chinese authorities are unlikely to tighten or loosen policy to any meaningful degree as we move into what is likely to be a very nervous year for the market. This means that fixed-asset investment as a percentage of GDP is likely to remain high. As for the rest of the region, there are no signs of over investment or of any 'bubbles' building up. Capital expenditure for sales is at a very low level for the region, compared to history, therefore, there is considerable room for more investment over the coming year. This is good news for investors – with the will to hold their nerve.

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