nikko am

Nikko Asset Management

From The EQUITY Desk

MONTHLY OUTLOOK

October 2014

Summary

- Asia Pacific markets succumbed to profit-taking after registering seven consecutive months of positive USD based returns. The MSCI Asia Pacific ex-Japan Index was down 7.2% for the month in USD terms as the strengthening dollar magnified the lost. Southeast Asian markets held up better than its North Asian counterparts despite being more vulnerable to the potential interest rate hikes in the United States.

- The Australian market was the worst performing market in the region recording a decline of 11.4% as the prices of iron ore in Australia broke through the USD80 mark and the Australian dollar was significantly weakened.

- North Asian markets reacted more negatively than its Southeast Asian counterparts triggered by the potential raising of interest rates. Southeast Asian markets were resilient in September.

- Overall, we are positive on the Asia Pacific markets. There is likely to be a huge dichotomy in terms of performance of individual markets. With the China-related markets accounting for almost 35% of the Index, the revitalised China stock markets will pull up the region and play catch up to the World Index. We are positive that President Xi Jinping is probably the strongest and best positioned leader to implement the necessary reforms that China needs and that it will eventually be appreciated by the markets.

Peter Sartori
Head of Asian Equity
Nikko AM Asia Limited

ASIAN EQUITIES

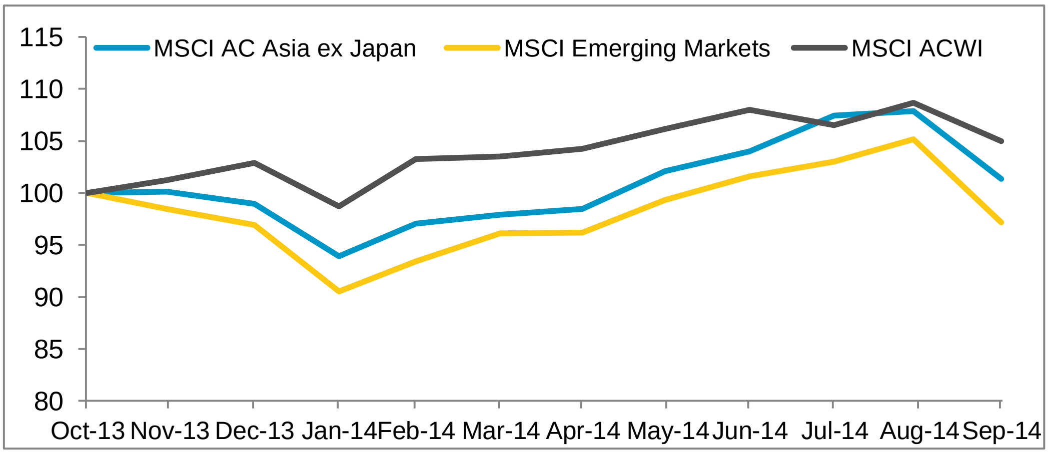
ASIA PACIFIC EQUITY MARKETS TOOK PROFIT AFTER SEVEN CONSECUTIVE MONTHS OF POSITIVE RETURNS

Market Review

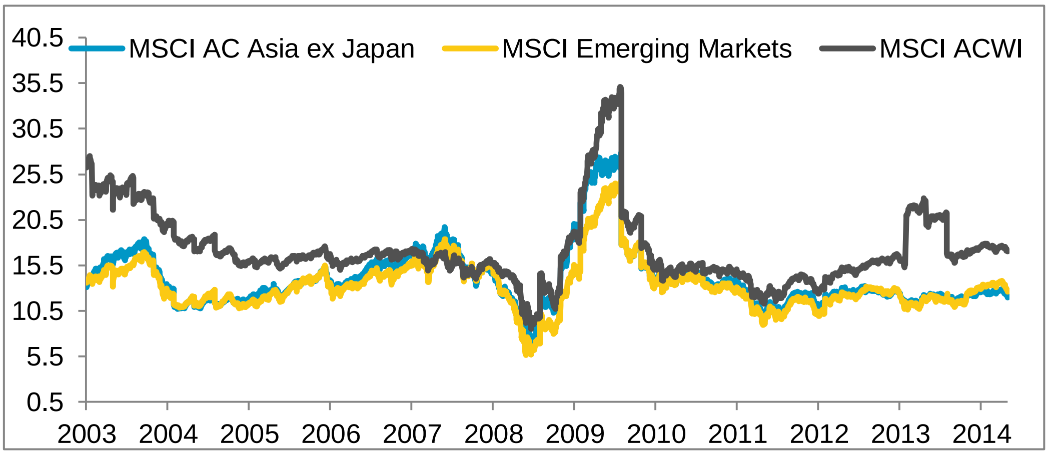
- *Asia Pacific markets succumbed to profit-taking after seven consecutive months of positive returns*

After registering seven consecutive months of positive USD based returns, Asia Pacific ex-Japan markets succumbed to profit-taking. The MSCI Asia Pacific ex-Japan Index was down 7.2% for the month in USD terms as the strengthening dollar magnified the lost. Surprisingly, the Southeast Asian markets held up better than its North Asian counterparts despite being more vulnerable to the potential interest rate hikes in the United States. Southeast Asia has been a bigger beneficiary of the fund flows from the Quantitative Easing Program in the United States since 2009 and any reversal is likely to hit them harder.

1-Year Market Performance of MSCI Asia ex Japan vs Emerging Markets vs All Country World Index



MSCI Asia ex Japan vs Emerging Markets vs All Country World Index Price-to-earnings

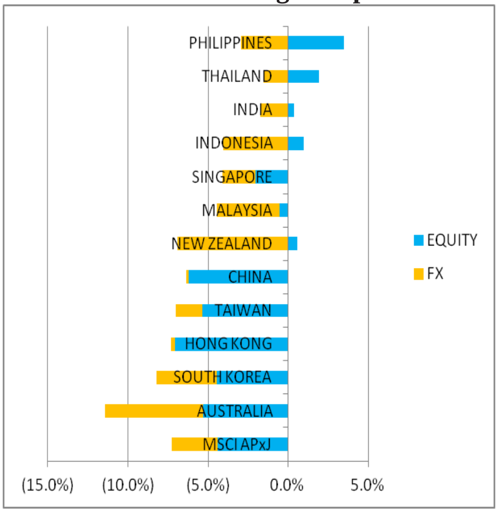


Source: Bloomberg, 30 September 2014. Returns are in USD. Past performance is not necessarily indicative of the future performance.

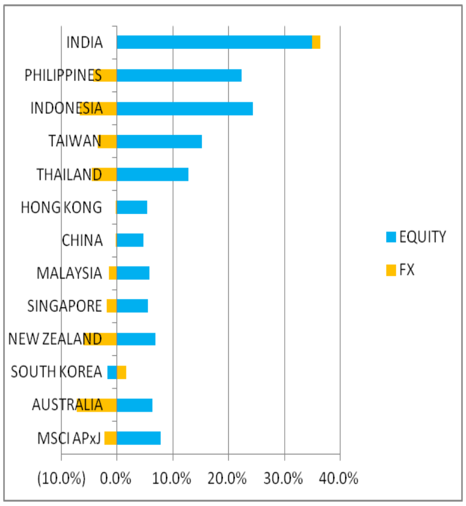
The Australian market suffered on increased prices of iron ore

The Australian market was the worst performing market in the region as the prices of iron ore in Australia broke through the USD80 mark. At the same time, the significantly weakened Australian dollar also spooked the markets as it plunged 6.4% for the month. Banks saw its first significant profit-taking since May 2013 when tapering talks spooked the markets. Resources sector which has been weak for the last 12 months also took a leg down after iron ore prices finally succumbed to the lacklustre demand from China. The MSCI Australia Index was down 11.4% in USD terms.

For the month ending 30 Sept 2014



For the period from 1 Oct 2013 to 30 Sept 2014



Note: Equity returns are in local currencies while FX and MSCI APxJ returns are in USD. Returns are based on historical prices. Past performance is not necessarily indicative of the future performance.
Source: Bloomberg, 30 September 2014

North Asian markets reacted more negatively than its Southeast Asian counterparts triggered by the potential raising of interest rates

As the market sell-off was triggered by the potential of the Federal Reserve raising interest rate earlier than expected, it was surprising that North Asian markets reacted more negatively than its Southeast Asian counterparts as North Asian markets which have huge current account surplus are expected to withstand the tapering better. It is noteworthy that North Asian markets have performed very well over the last 6 months and hence they are more vulnerable to profit-taking. However, Hong Kong and China markets were impacted by the protests in Hong Kong demanding free elections of a Chief Executive of Hong Kong rather than a Chief Executive that is elected by candidates who is pre-approved by Beijing. Stocks in Hong Kong and China went on a downward spiral with the MSCI Hong Kong Index retreating 7.3% in USD term while MSCI China Index declined 6.4%. Korea and Taiwan were not spared from the sell-down either. Korea continued to suffer from sluggish economic numbers on the back of the yen depreciation which made Korean exports less competitive. At the same time, Hyundai Motor Group's recent corporate governance issues which involved its purchase of land at 150% above the land valuation from the government also led investors to sell down the market. The MSCI Korean Index was down 8.2% in USD term while Hyundai Motor Corp was down 21.2% in USD term. Taiwan, which has benefitted from the new iPhone release (where 30% of the bill of materials for the phone was produced by Taiwanese) suffered from a sell on fact mentality as the launch of the new iPhone 6 and 6plus led to profit-taking. Technology stocks bore the brunt of the sell-down with the MSCI Taiwan Index down 6.0% in USD terms. Nonetheless, it was still the best performing among the North Asian markets.

Southeast Asian markets were resilient in September

Southeast Asian markets were surprisingly resilient in September. Although the MSCI Southeast Asian Index was down 2.9% for the month, both Philippines and Thailand managed to eke out small gains. Strong GDP number in Philippines supported the market while in Thailand, robust domestic liquidity from local investors despite continued foreign selling resulted in MSCI Thailand hitting a new year high. Indonesia was subjected to profit-taking after the elections as more political manoeuvres were being made just before the President-elect, Jokowi, takes office on 20th October.

India retreated in September but did well for the year-to-date period

Although India was marginally down for the month of September where the MSCI India was down 1.4% in USD term, it was a commendable performance considering that the market is the best performing market in Asia with the MSCI India up 23% year-to-date. There is currently a tug-of-war between investors in India with one group believing that the markets had run too hard and that despite the majority that Modi has, he is unable to do much to improve the economy; while another group believes that India is like China 15 years ago and that with the sweeping election win, Modi will make the significant changes that India needs to catch up with China. This has led to a stalemate in India where the markets are directionless and swayed around easily on any new moves and announcements made by the government.

Market Outlook

WE ARE POSITIVE ON THE OVERALL ASIA PACIFIC MARKETS

We are positive on the overall Asia Pacific markets

We are positive on the overall Asia Pacific markets although there is likely to be a huge dichotomy in terms of performance of individual markets. However, the MSCI Asia Pacific ex-Japan Index has been underperforming the MSCI World Index for the last five years primarily due to the underperformance of heavily-weighted China-related countries such as Hong Kong and China. The MSCI China Index was up only 21% for the last five years compared to the MSCI Asia Pacific ex-Japan Index which was up 43% while the MSCI World Index was up 73%. With the China-related markets accounting for almost 35% of the Index, the revitalised China stock markets will pull up the region and play catch up to the World Index. We are positive that President Xi Jinping is probably the strongest and best positioned leader to implement the necessary reforms that China needs and that it will eventually be appreciated by the markets.

We are increasingly more positive on the China equity markets in the next two quarters

Given the volatile performance of China in the last three months, as China was the best performing market in July and August as well as one of the worst in September, we are increasingly more positive on the China equity markets in the next two quarters. The recent divergence in performance between the HK-listed China shares and the Shanghai Stock Exchange demonstrated the optimism that domestic investors in China have for the reforms that President Xi Jinping has initiated since the end of last year. We are positive that these reforms are what China needs and that investors will eventually appreciate the positive impact that it will have on the Greater China region and eventually, improve the quality of growth in China benefitting the Asian economies. This, coupled with a potential revitalisation that India will have a significant impact on Asian growth going forward. We believe that investors are overly pessimistic on Asia due to its high inverse correlation with the US dollar and we will focus more on its fundamentals going forward.

We are more positive on the North Asian economies among the Asian countries

Among the Asian countries, we are more positive on the North Asian economies given its huge current account surpluses which are likely less impacted from the outflows that could potentially happen from an earlier-than-expected interest rate hikes. China will benefit from the on-going state-owned enterprise reforms and the new influx of capital likely resulting from the Shanghai-Hong Kong Connect program where investors can now invest into the Shanghai Stock Exchange without the need for the cumbersome Qualified Foreign Institutional Investors program.

We are now turning more positive on Taiwan

We are now turning more positive on Taiwan especially the technology sector after the recent sell-off. We have advocated that too much hype was going into the iPhone 6 launched but the recent correction has provided an opportunity to buy into the quality supply chain which faces much less competition. Taiwan is also seeing a new revitalisation of domestic consumption as inflation remains under control while wages rise, though still mediocre but is finally ahead of inflation (especially with property prices being flattish this year). Market valuations are also now more palatable going into 2015E earnings. We still remain underweight on Korea. The recent Hyundai Motor Group saga reflects the fundamental problem in Korea that the extremely complex cross-holding structure of the chaebols has little regard for minority shareholders interest. Although the country is trading at a huge discount to the region, we are not convinced and the strategy would be to stick with companies with simpler shareholding structure and have more regards for shareholders' value.

We have increased our underweight exposure on Southeast Asia

We have increased our underweight position in Southeast Asia. Although nothing is fundamentally wrong with the Southeast Asian countries, we believe that the current valuation is not justifiable for the region in the shorter term. Expectations for Indonesia and Philippines are running high while Thailand has bounced mainly due to a low base and ample domestic liquidity. However, with the exception of Philippines, growth expectations are too high for Indonesia and Thailand and there is likely to be disappointed. In addition, the potential of rate hike in the US is also likely to impact these countries more than others in the region. Having said that, there are good quality companies in both Philippines and Thailand which we are looking for as entry points. These companies are mainly in the insurance, consumer and healthcare sector.

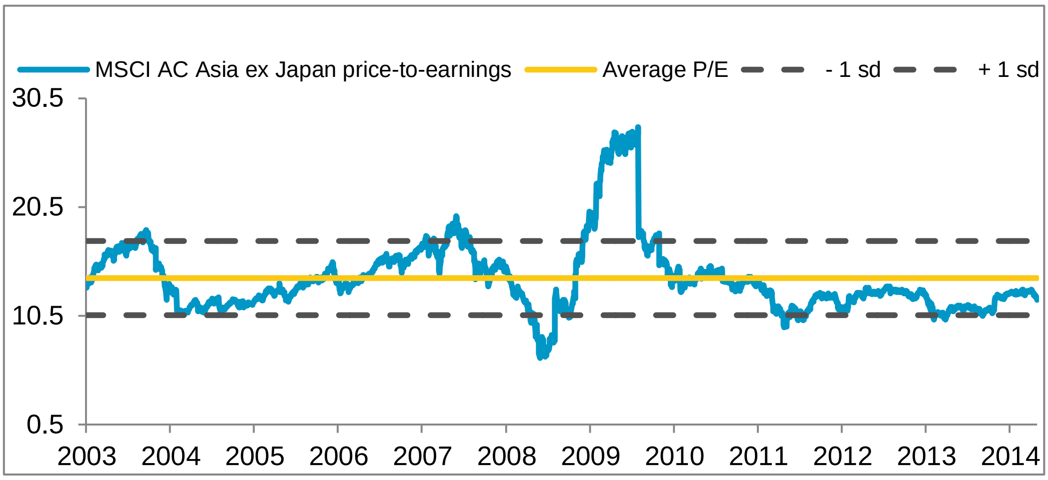
We continue to be bullish on India

As mentioned, in India, there is a current tug-of-war between the bear and the bull camp. We continue to be on the bull camp and believe that with the right execution, India will likely return to its hyper growth phase in the early to mid-2000s. Coming from such a low base, there are many opportunities that Modi can tap on that could put India back into a sustainable growth path. At the beginning of September, we have turned negative on Australia primarily on our negative view on the heavily weighted resources and banking sectors. In resources, we have been underweight for the last two quarters while in banking, we think that the high valuations is hard to justify given the growth outlook and that wholesale funding environment might be tougher for these banks given the interest rate outlook.

Appendix

MSCI Asia ex Japan Price-to-book

MSCI Asia ex Japan Price-to-earnings



Source: Bloomberg, 30 September 2014. The horizontal lines represent the average (the middle line) and one standard deviation (sd) on either side of this average for the period shown. Past performance is not necessarily indicative of the future performance.

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