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MARKET INSIGHTS

THE ONLY THING TO FEAR IS FEAR ITSELF

SEPTEMBER 2015

"...and the end of all our exploring will be to arrive where we started and know the place for the first time." TS Elliot

Any feelings of performance related smugness we had in 2015's first half, quickly dissipated in August as China growth and devaluation war fears rose to the fore. Yet, the extent of the subsequent selling in relation to actual developments suggests this selling has been exaggerated to the point where many Asian equity markets and currencies look good value. The burning issue seems to be, "When do we take advantage of that value?"

Certainly, when one compares the pricing differential between the equities earnings yield and bond's redemption yield, (Fig.1.) equities globally look attractive – unless profits collapse, which seems unlikely.

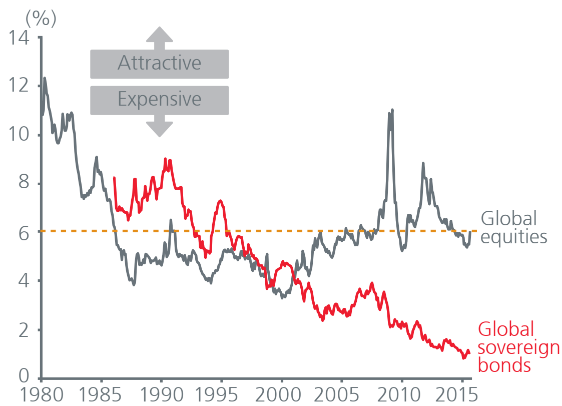
Media headlines, for example, are almost unanimously bearish, but this bearishness is not being matched (yet) by many Asian investors if the questions we are receiving are any guide. We are asked repeatedly, "Is it time to buy?" and rarely, if ever, "Should I sell?"

This investor sturdiness is reflected in a remarkable resilience in actual net flows into and out of Asia's bond and equity markets; there seems little in the way of foreign capital flight from many Asian equity and bond markets (foreign capital flight from the banking system, especially China's, is a different story).

While Indonesia's rupiah, for example, has fallen some 14% against the US dollar since January, foreign net holdings of Indonesian bonds[1] rose from Rp462 tr in January to a peak of Rp541tr in early August, falling slightly to Rp529tr as of early September.

It is a similar story with Indonesian equities. Despite the market falling some 15% in the year to date, sustained net foreign selling only began in earnest in early August. Net foreign purchases[2], having peaked at Rp19.4tr in April are, as at early September, back to where they were at the start of 2015.

Fig.1. Global equities look attractive vis a vis Sovereigns and do not signal recession



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Source: Bank of America Merrill Lynch and Thomson Reuters Datastream from Datastream as at 7 September 2015. The graph shows the equity earnings yield and the global sovereign bond redemption yield, both in historical terms.

[1]Indonesia Ministry of Finance from Bloomberg, as at 7 September 2015. [2]Jakarta Stock Exchange from Bloomberg as at 7 September 2015. [3]Consensus Economics Inc. [4]Electricity output, freight shipments, passenger travel and industrial production – as being the four factors less likely to be "fudged". [5]According to Capital Economics as at August 2015. [6]Consensus Economics Inc as at 10 August 2015.

Neither market suggests panic. Bearing in mind that Indonesia is Asia's worst hit market this year, this development is encouraging. It is a two-edged sword, however.

One could argue with equal certainty that either (a) this investor resilience is a signal of underlying investor confidence (in which case one should buy as valuations fall to attractive levels), or the exact opposite (b) that the net foreign outflow is so small in relation to previous inflows that the potential downside is huge, especially should the US raise interest rates and/or profits come under pressure (in which case, one should take advantage of any rallies to sell).

So which is it; "a" – time to invest, or "b" – still time to sell?

The clue as to which is correct might lie in the reasons given for the recent selling – slowing China growth, the (supposedly) related depreciation of the renminbi and China's inflated "A" share equity market. All reasons falter under scrutiny.

Let us consider China's growth fears first. Since January, China's 2015 consensus growth forecast[3] has been reduced from 7.0% to 6.9%. (As the consensus growth forecast for the US has fallen from 3.0% to 2.3% over the same time, one can legitimately ask where the real growth fears should lie).

Slowing Chinese growth should come as little surprise to anyone; after all, China's government has signalled for several years that growth will slow as it navigates the treacherous and difficult waters in repositioning its investment and export led economy towards domestic consumption led growth.

Slower growth should also come as little surprise to those who question the official growth data preferring to look at the four measures espoused by Premier Li Keqiang[4]. But even on this basis, it looks as though China's 2015 growth would come in at around 4%[5]. The basic message is, "China's growth is slowing, not stalling". There is a world of difference.

And the Asia Pacific fallout from slower Chinese growth? Apart from Australia, which could be badly impacted, the rest of Asia will be hurt, but still insufficiently to prevent forecast growth of around 5% in 2015[6] (excluding Japan).

Fig.2. Impact on China's suppliers based on a 14.6% fall in China's imports in 2015†

	India	Indonesia	Korea	Malaysia	Philippines	Singapore	Thailand
Fall in exports ($bn):	-3.76	-6.64	-13.88	-2.11	-0.78	-2.16	-1.38
Lost income as % GDP	-0.2%	-0.7%	-1.0%	-0.6%	-0.3%	-0.7%	-0.4%
2015 growth forecast at:							
December 2014	6.3%	5.4%	3.5%	5.0%	6.1%	3.2%	3.9%
August 2015	7.7%	4.8%	2.6%	4.8%	5.8%	2.3%	2.9%
2016 GDP forecast††	8.0%	5.2%	3.3%	5.0%	6.0%	2.8%	3.6%

	France	Germany	Italy	Netherland	Russia	UK	
Fall in exports ($bn):	-2.45	-14.17	-1.98	-0.58	-8.66	-3.61	
Lost income as % GDP	-0.1%	-0.4%	-0.1%	-0.1%	-0.5%	-0.1%	
2015 growth forecast at:							
December 2014	0.8%	1.3%	0.4%	1.3%	n.a.	2.6%	
August 2015	1.2%	1.9%	0.7%	2.1%	-3.5%	2.6%	
2016 GDP forecast††	1.6%	2.0%	1.2%	1.8%	0.4%	2.5%	

	Australia	Japan	NZ	US	Brazil		
Fall in exports ($bn):	-25.2	-18.08	-3.54	-11.99	-12.2		
Lost income as % GDP	1.7%	-0.4%	-1.9%	-0.10%	-0.50%		
2015 growth forecast at:							
December 2014	2.8%	1.2%	3.0%	3.0%	n.a		
August 2015	2.4%	0.8%	2.5%	2.3%	-1.6%		
2016 GDP forecast††	2.9%	1.7%	2.5%	2.7%	0.6%		

Downgrade Upgrade

Fig.2. Source: Data is that presented in The Guardian (UK) as at 1 September 2015 based on official sources. †The data is calculated on the assumption that the 14.6% year on year fall in the seven months to July extends to the whole of 2015. It allows for the fact that different economies are impacted differently. Australia, for example, has seen its exports (mostly minerals) to China fall some 26%. ††Consensus Economics as at 10 August 2015.

This is not to pretend that it is plain sailing; it is not. An on-going concern for us is the rising level of corporate debt. Although net debt of the non-financial companies is only around 55~60%, it has risen rapidly from 30% since 2011. Over this period, the return on capital employed fell from 14% to 9%. Put simply, the increased debt has not generated a commensurate rise in profitability, which makes one wonder exactly how the additional borrowing was utilised – a major reason for investor caution, it seems.

If one cannot convincingly lay the cause for recent selling at the door of China's slowing growth, perhaps the clue lies in China's currency devaluation. The grounds here appear even weaker, as Fig.3 and Fig.4 below illustrate.

As is evident, China's August devaluation against the dollar was not only far less than many other Asian devaluations vis a vis the dollar but also the CNY has appreciated some 30% on a real effective exchange rate basis since 2011[7].

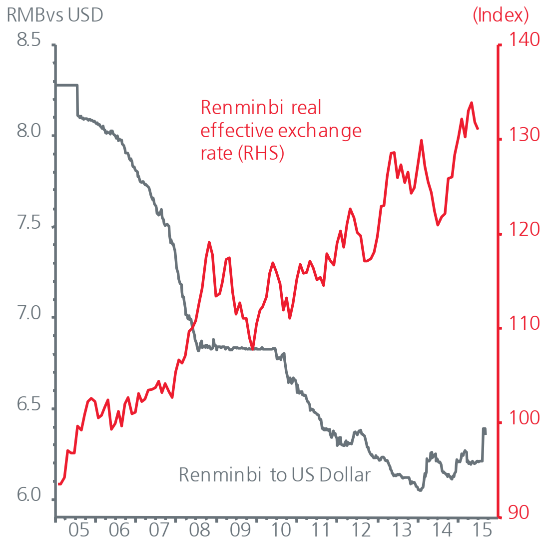
Both facts support the People's Bank of China's assertion that the August devaluation was a further step in the "internationalisation" of its currency. It is easy to see why China wants to move in this direction; some 22% of its trade is settled in renminbi, up from 8% in 2012 and 0% five years ago[8].

In short, The People's Bank's explanation as to why it devalued the currency seem to hold water especially as the IMF[9] now thinks that the renminbi is no longer under- valued (although there is no denying that the devaluation does assist slowing exports).

Which brings us to the fall in China's "A" share equity market. While the media has talked about an "A" share bubble, valuations at the peak were not out of line with the 10-year average as can be seen below. Moreover, valuations based on the consensus 12 months forward earnings forecasts are now well below the 10 year average.

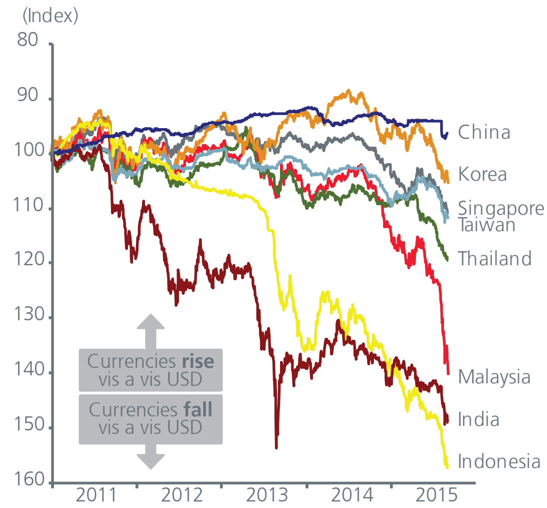
It must also be noted that foreign investors can only invest in China's onshore "A" shares if they have access to a foreign quota; most foreign investors obtain their China exposure via Hong Kong listed "H" shares. The reality is that the bulk of the investing world is insulated from movements in the "A" share market.

Fig.3. The RMB has steadily appreciated since 2005



Source: Thomson Reuters Datastream as at September 2015.

Fig.4. RMB depreciation vis a vis USD is smaller and later than other Asian currencies



Source: Thomson Reuters Datastream as at September 2015.

[7]JP Morgan real effective exchange rate measured on a CPI basis from Datastream as at 7 September 2015. [8]As calculated by Citi and reported in the Financial Times as at 29 July 2015. [9]Transcript of a Conference Call on the China Article IV.

As illustrated below, (Fig.5.) "H" share valuations not only remained well below past peaks but also are again hovering around their historical lows. Far from looking like a "bubble", Hong Kong's "H" shares look like good value.

The "A" shares only briefly flirted with "bubble" territory and even then, at far lower levels than has been seen historically. It is difficult to lay the equity panic at the door of "bubble valuations".

Fig.5. The Shanghai PE multiple expansion was far below previous peaks. Hong Kong "H" shares remain attractively valued.

Source: Eastspring Investments, IBES (based on the HK and Shanghai Stock Exchange indices) from Datastream as at 7 September 2015. The "Rolling Peg" is defined as the prospective price earnings multiple (based on the IBES consensus earnings per share forecast) divided by (1 + the prospective EPS growth forecast according to IBES).

Rather, the culprit seems to lie in the manner in which that "A" share rally was financed – margin financing rose from a low of around 1½% of market capitalisation in mid-2014 to a peak of just over 4% in early 2015. (It has now fallen to lower than 2¾%).

In other words, it is the highly volatile nature of the funding that drove the rally rather than the valuations that are of concern. The manner in which the authorities have tried to sustain the domestic market is also a matter for concern, but should not impact underlying growth.

The bottom line is that the major reasons for Asia's sell-offs, while no doubt impacting sentiment, looks to have been exaggerated.

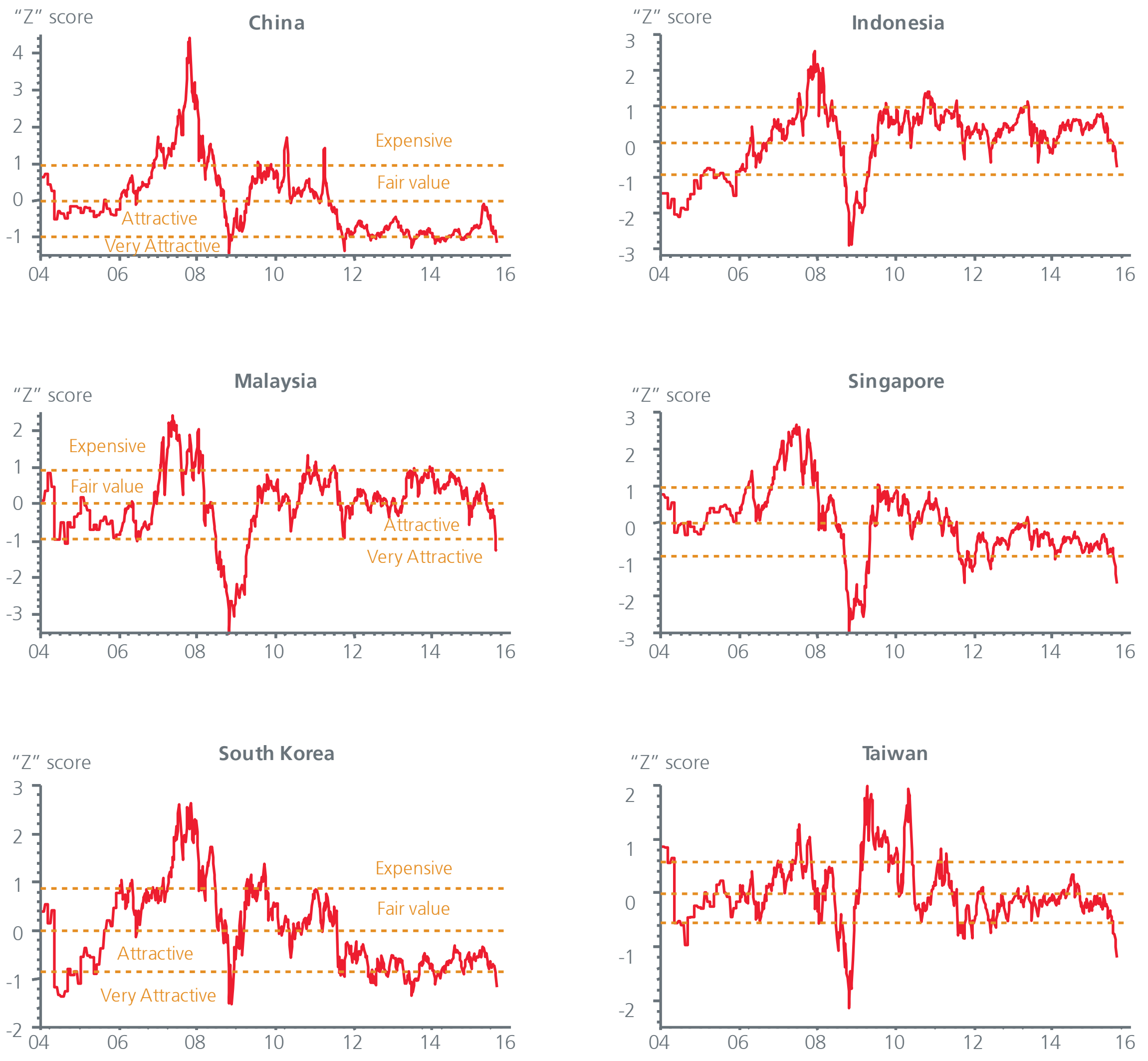
"One picture is worth a thousand words", the saying goes. Fig.6. on the following page illustrates the valuations for some Asian markets as in early September based on the existing profit forecasts. Does value exist? You decide.

But a word caution; even if many Asian valuations look attractive, fear and uncertainty can make attractive markets even more attractive!! Follow the profit forecasts closely; if these start to fall, that attractive value might not be so attractive.

With valuations as low as these, it is easy to see why our clients are asking, "Is it time to buy?" Certainly for investors willing to take on the risks outlined above, valuations today are definitely worth considering.

The proof of the pudding is in its eating; how are we positioning our funds? There has, in fact, been little change since last quarter. We remain overweight equities versus bonds and are focused on the North Asian markets (Japan, China, Korea and Taiwan). We see selective value in Europe and Emerging Europe. Within bonds, we continue to focus on high yields within Asia and US. Asian high dividend stocks look good value. Any trading resulting from August's turmoil has been mostly within these on-going boundaries.

Fig.6. Asian equity markets slide into "Very Attractive" territory. Will investors "Bite"?



Source: Eastspring Investments, IBES and MSCI from Datastream as at 7 September 2015. The "Z" score is an equally weighted index that measures the deviation of the prospective price earnings multiple (based on the IBES consensus earnings per share forecasts) and the historical price to book ratio, from their 10 year trend line. The middle dotted line is the 10-year average; the two out lines are the boundaries within which around 70% of all values lie.

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