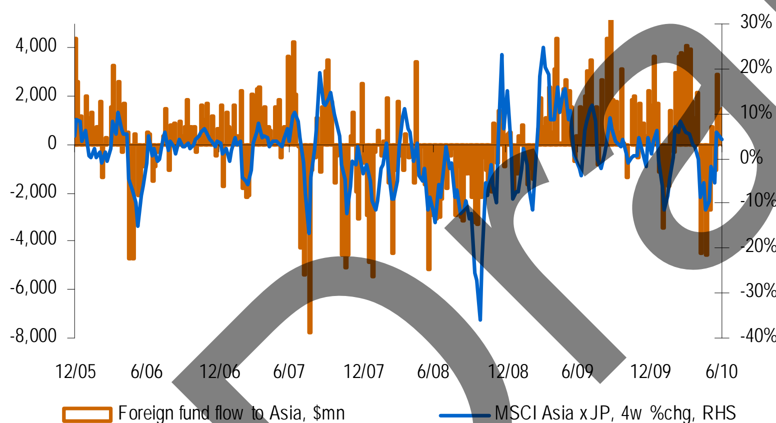
Asia ex-Japan withstands the global financial crisis

by Catherine Yeung, Investment Director at Fidelity

As the world emerges from the worst financial crisis since the 1930s, the difference in the economic performance of the world's regions has widened. As many developed countries are burdened with debt and face years of lower than normal growth, companies and investors are looking to the dynamic markets of emerging Asia as one of the most promising sources of long-term growth.

International financial institutions are increasing their presence in the rapidly developing financial centres of Asia, to take advantage of strong economic fundamentals, the growing number of customers, favourable demographics and deepening financial markets. According to a survey conducted by The Economist Intelligence Unit in March 2010 that studied the investment plans of 100 institutional investors in Western developed markets, the overall trend was to increase the allocation to Asia. In fact, the study found that 90% of respondents expect institutional investors to boost their exposure to Asia over the next three years. In the next 12 months, 58% said they expect to increase their allocation to China, 47% to India and 30% to South Korea. At the same time, only 19% and 12% were planning to increase allocations to Australia and Japan respectively.[1]

Chart 1: Foreign institutional fund flows to Asia
– Four-week moving average MSCI Asia ex-Japan.



Source: BoAML Research

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Some of the reason for optimism by fund managers in Asia can be partly explained by an article in *AsianInvestor*.[2] The article reported that fund managers believed the strength of Chinese demand drove valuations in commodity-related sectors worldwide last year and that this would spread to a wider range of sectors in 2010.

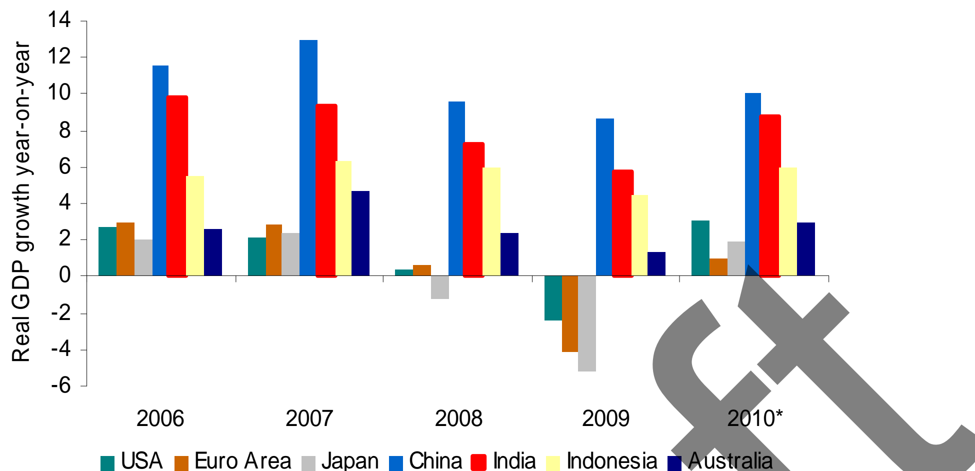
Portfolio managers are, therefore, generally positive about sectors poised to benefit from the growing spending power of the Asian consumer. They favour companies that are ably positioned for corporate recovery and are set to benefit from government spending in areas such as infrastructure.

Another spur for optimism is the relatively low-risk profile of Asian economies when compared with the west, given the lower level of government debt in Asia ex-Japan. The vigilant central banks and growth-oriented policy makers in the region are undertaking reforms to make the region less susceptible to fluctuations in global demand and safeguard the long-term interests of economies and investors.

While there is much discussion about growth in the Asian region, it is interesting to note that Asia still forms a relatively small part of global equity benchmarks, despite its growing contribution to world economic

growth. China accounts for about 2% of the MSCI AC World Index[3], while Asia ex-Japan comprises less than 10% of the index.

Chart 2: Share in world economic growth.



Source: IMF World Economic Outlook, April 2010, *forecast

We believe that there are various reforms and initiatives underway that will make the regional economic and investment landscape in Asia more appealing for Australian and global investors. These are:

1/ Pension funds are growing in importance
Asians are high savers because the lack of a social safety net means that people are required to save to fund their old age. However, a number of Asian countries are developing pension schemes that will provide some social payment to the majority of the aged population – thereby relieving them of this financial burden.

The benefit is that a modern pension system would, for example, give the Chinese greater confidence to spend some of the 2.1 trillion yuan[4] held in savings and in doing so, reduce the economy's reliance on exports by generating local demand.

There is enormous capacity for pension assets to grow, as evidenced by an OECD[5] report showing that only 7.5% of the working population is covered under a mandatory pension plan in non-OECD south Asia, while the figure for non-OECD East Asia and Asia Pacific countries is 18%.

In many instances, revenue falls short of pension and benefit payments, explaining why governments are looking to deregulate the industry as markets mature and assets grow. Asia ex-Japan's pension sector was worth US$747 billion in 2008, representing an increase of 80% from 2004. The sector recorded a 15.6% annual growth rate over the period despite the dip in 2008 that can be attributed to the global financial crisis.

Cerulli Associates forecast growth of 55% between 2009 and 2013, which could boost pension sector assets to US$1.15 trillion by 2013.[6] This compares with growth forecasts of 28% in the US and 30% in Europe over the same period.

The progress-to-date in developing pension schemes in Asia is expected to lead to the creation of more investable assets in the region. In 2008, pension assets accounted for more than 58% of the total investable assets for Asia ex-Japan worth US$427 billion.

The outsourcing of pension asset management will provide many financial managers in the region with large-scale opportunities:

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- **Taiwan** – The country's Labour Pension Fund plans to outsource new mandates worth US$1.2 billion in 2010.

- **India** – Last year a new mandatory pension system was introduced for new employees. It aims to cater to 400 million people in the unorganised sector and small-scale industries. In September last year, the Employee Provident Funds Office, which manages around US$25 billion on behalf of the organised sector (larger companies) 2009 outsourced asset management to four fund houses: HSBC Asset Management; ICICI Prudential Asset Management; Reliance Capital; and the State Bank of India. Collectively, these houses will receive US$2 billion to US$3 billion annually to run domestic bond portfolios.

- **Malaysia** – The country's Employees Provident Fund, a state pension fund, accounts for 50% of daily volume in Malaysia's local equity and bond markets.[7]

2/ Focus on health care
Social reform, such as providing universal healthcare, will reduce the need for household savings such as cash held in bank accounts and other safe liquid assets.

There is a strong movement in Asia to extend access to healthcare services. In China, for example, the healthcare insurance program has expanded from covering less than 20% of urban employees in 2001 to about 50% in 2007. The Chinese government is aiming to extend the coverage to 90% of the population by 2011.[8]

As well as benefiting from demand driven by government reforms, healthcare equipment and service providers are also enjoying consumer-driven demand as people spend a larger proportion of their rising income on health related goods and services.

The reason is that as income grows and basic needs are met, demand for healthcare services generally rises. More importantly for healthcare providers, governments in developing countries will allocate a rising share of their spending to healthcare.

3/ Government economic reform and the impact on industry
Government economic reform is also enhancing long-term growth prospects in Asia. Raising money by selling equity in government-owned companies and reducing subsidies that weigh on government balance sheets will assist domestic budgets.

In India, the government upped the revenue target from the sale of its equity in central public sector units from the 250 billion rupees (US$5.5 billion) in 2009-2010 to 400 billion rupees (US$8.8 billion) in 2010-11.[9] Since late 2009, the Indian government has diluted stakes in Oil India, NHPC, NTPC, Rural Electrification and NMDC, Coal India and Hindustan Copper, among others. Telecommunication reforms undertaken in India have also been successful. The latest 3G-licence auction added 677 billion rupees[10] (about US$15 billion) to the exchequer.

In Thailand, the government said it would help the National Telecom Commission to hold a 3G-licence auction in September 2010.[11]

Early this year, Malaysia named several state-linked companies that may be sold or listed as part of a push to scale back government business interests. Examples include the government's investment arm, Khazanah Nasional Berhad, divesting its remaining stake in Malaysia's national postal company. State oil and gas company, Petroliam Nasional, has identified two more subsidiaries to list.

However one of the most important government initiatives in the Asian region, particularly for India and China, is the deregulation of the oil sector – effectively reducing the fiscal burden of subsidies.

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In India, the price of petrol, diesel, liquefied petroleum gas and kerosene, which comprise 63% of the total consumption of petro products, was subsidised by the government to keep prices artificially low. Under this system, the cost of subsidies was incurred by upstream oil sector companies, the government (by issuing oil bonds) and downstream oil marketing companies

Aside from imposing a huge fiscal strain, subsidies discouraged competition as private-sector organisations did not receive financial support. However, a shift away from controlled pricing was undertaken in June 2010 when retail petrol prices were deregulated and the cost of other price-controlled petro products was increased in a move toward eventually removing subsidies.

Similarly, China's price regulator lifted the factory-gate price on gas by 25%, effective 1 June 2010, and ended a two-decade-long, dual-track gas price scheme, making gas prices more flexible.

4/ Authorities are looking for sources of growth beyond exports to the west

Asian countries are realising that dependence on exports to the stagnant west could hamper economic prospects. Hence, policies are being adopted to promote internal demand and intra-regional trade.

In June 2010, authorities in Taiwan and China signed a much-anticipated agreement in an effort to further boost cross-strait business integration. The Economic Cooperation Framework Agreement promises to reduce tariffs, liberate trade and service flows and eliminate discriminatory measures in certain industries. The pact strengthens the structural case for economic growth in Taiwanese as well as Chinese companies that will benefit from more-open trade with Taiwan.

Throughout Asia, the liberalisation of domestic markets and other reforms including reductions in protectionist policies have helped consumerism take hold. Goods and services once considered luxuries are finding their way into ordinary households. Increasing aspirations and changing lifestyles – along with rising income and recent government initiatives such as shopping vouchers, tax cuts, subsidies and fiscal transfers to low-income groups – have supported consumer demand in the region.

Consumer services, including private education, internet, media and entertainment, tourism, premises maintenance, banking and retail, are growing at a brisk pace. Although high growth is from a low base, the rapid increase in the number of people with moderate disposable income is driving demand for many consumer goods and services.

The World Bank estimates that the global middle class is likely to grow from 430 million in 2000 to 1.15 billion in 2030. The bank defines the middle class as people who earn between US$10 and US$20 a day – adjusted for local prices. In 2000, developing countries were home to 56% of the global middle class, but by 2030 that figure is expected to reach 93%. World Bank research shows that China and India alone will account for two-thirds of the expansion.[12] Many countries in the Asia ex-Japan region are witnessing rapid economic growth. Higher domestic consumption is expected to be achieved as employment recovers and disposable incomes rise.

In China, tax reductions for vehicles with smaller engines and subsidies on appliance trade-ins have proved successful stimulants of demand. Chinese household annual vehicle purchases are running at around 16 million compared with 11 million in the US.[13] Each car produced requires a number of components that include manufactured goods such as electronics and semiconductors.

Consistently, there is pent-up demand for other technology and electronic products in China and other emerging markets. In June 2010, the Chinese government initiated the national rollout of a scheme to replace home appliances. The scheme was initiated in 2009, however, initially it was restricted.

From June 2010 to December 2011, consumers will receive a subsidy worth 10% of the price of five types of new appliances including televisions, refrigerators, washing machines, air-conditioners and computers. This helps Hong Kong, Taiwan and Korean companies that export to China. China is used as an example here, but the theme can be applied across most other emerging economies in the region.

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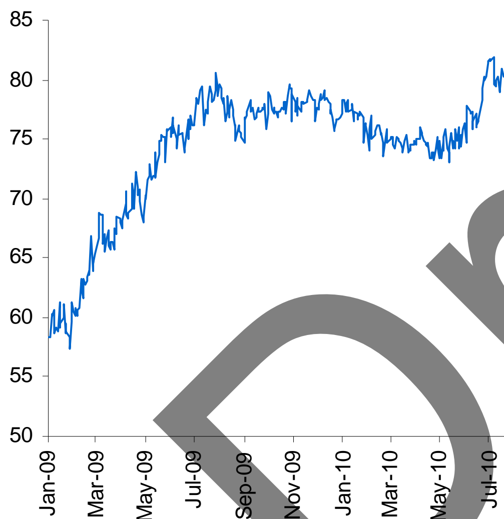
One additional factor insulating Asia from the meltdown on asset markets is higher property prices. Where falling prices were seen, they were limited and not the huge losses experienced in the US and some European countries. Asian Development Bank estimates suggest that house prices rose by 6.4% and 3.3% in China and Malaysia respectively during October to December 2009, from a year ago. Prices rose by 2.5% in Indonesia; although Thailand did see a 5.7% dip in the first quarter of 2010. The three-month average for the first quarter in Hong Kong amounted to 30.1%, while in Singapore prices rose by 25% over the period.[14]

Higher consumption and increased investment are expected to drive Asia's economies in coming years. Merger and acquisition activity by cash-rich businesses are expected to support stock markets across the region. Policy makers are confident of the economic outlook and are withdrawing monetary stimulus. Central banks from China, Thailand, Taiwan, India, Malaysia and South Korea have increased interest rates in the first half of 2010 in order to keep inflation in check.

According to ADB's Asia Economic Monitor released in July 2010, developing Asia is likely expand 7.9% in 2010 compared with an April estimate of 7.5%.

Chart 3: Relative performance of Asia ex Japan equities versus G7, considering MSCI price indices in local currency terms.



Source: DataStream, FIL, July 2010

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Conclusion

Asia ex-Japan's reliance upon international trade left it vulnerable to disruptions in the global economy. However, financial stability owing to fiscal prudence, low debt levels and strict regulations helped cushion the impact on the region. During the global financial crisis, monetary policy makers rose to the challenge and quickly cut interest rates, although fiscal measures took time to seep in.

Asia faces the risk of volatile capital flows – even as its growth outpaces the rest of the world. However, governments are undertaking social and economic reforms to provide a more secure future for its population and businesses. Governments around the region are developing health and welfare social safety nets, promoting consumption and infrastructure spending and protecting investor interests by monitoring capital markets to drive long-term stable growth.

Attractive fundamentals have helped Asia ex-Japan markets outperform G7[15] markets in recent years. So far this year, Asia ex-Japan has maintained a flat relative trend during the global stock-market downturn, which is a significant departure from the past when emerging-market stocks fell more than the global

benchmark during a shakeout.[16] Accordingly, those constructing portfolios should consider an extra allocation to Asian equities.

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14 Figure 17a and 17b, Asia Economic Monitor, Asian Development Bank, July 2010; Data for China and Indonesia refer to residential property price index; Thailand refers to housing price index. Data for China and Malaysia as of the fourth quarter 2009. Data for Hong Kong and Singapore refer to residential property price index. Data for Hong Kong and Singapore is until the first quarter of 2010. Hong Kong's result is a three-month average
15 Canada, US, France, Germany, Italy, Japan, United Kingdom
16 Year-to 23 July 2010 returns for MSCI AC Asia ex Japan were 0.6% in local currency terms against -3.3% for G7. In 2008, Asia ex Japan fell by 49.2% against 39.1% drop in G7. DataStream, July 2010

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