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Asian shares in a world of de-leveraging

Key points

- Asian equities have fallen sharply on the back of the global financial crisis reflecting the vulnerability of Asia's export markets, the exit of foreign capital and the impact of earlier monetary tightening.
- The slump in Asian export markets is clearly a negative and will cut sharply into Asian growth rates this year.
- But Asian equities are likely to be out-performers over the next five to ten years reflecting reasonable valuations, the lack of debt in Asian economies, stronger financial systems compared to the US and relatively favourable demographics.

Introduction

Asian shares have been hard hit by the global financial crisis and subsequent global recession. However, at a time when the medium term outlook for US, European and Japanese shares is fraught with uncertainty there are good reasons to believe Asian shares (ex Japan) will perform well over the next 5 to 10 years. This note looks at the key issues surrounding Asian shares.

Review of Asian shares through the bear market

From their 2007 highs to their recent lows Asian (ex Japan) shares have fallen around 60%. This is a bit worse than the over 50% falls in US, World and Australian shares.

Decline in share markets from their 2007 highs

	% fall from 2007 high to recent low in local currency terms
US	-52
UK	-44
Europe	-55
Japan	-59
World (MSCI)	-52
Australia	-51
China A shares	-72
Asia, ex Japan	**-61**

Source: Bloomberg, AMP Capital Investors

Unlike during the 1997-98 Asian crisis, the slump in Asian shares has not been of Asia's own making. Asia did not have major structural or cyclical imbalances of the sort that led to the Asian crisis – current accounts were in reasonable shape, foreign exchange reserves were high, inflation was up but largely driven by the commodity boom (as was the case elsewhere) and shares were not particularly overvalued.

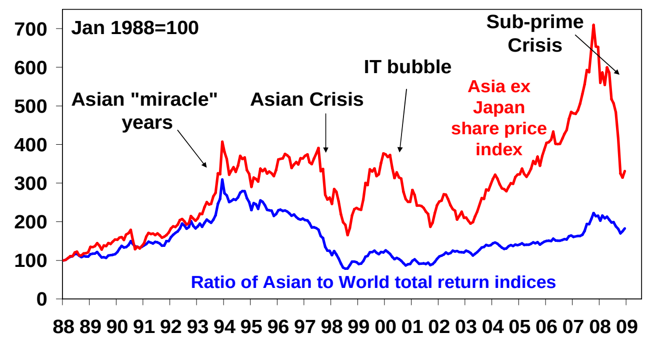
Asian shares have been dragged down by the global financial crisis which has seen foreign investors exit and their export oriented cyclical economies hit hard. The outlook for Asian growth is bleak over the year ahead thanks to the slump in their export markets. Many Asian countries literally saw their exports fall off a cliff late last year (with declines of 20 to 30% typical over the year to December). Singapore, Hong Kong, South Korea and Taiwan are in recession or close to it. Growth looks like being pretty soft in China and India compared to year ago levels. But then again 5.5% average growth in developing Asia this year as forecast by the IMF is far better than the 2% slump forecast for the US, Japan and Europe.

Asian share markets are usually high beta, moving in an outsized fashion compared to US shares since their economies are more cyclical and their share markets seem more influenced by foreign capital (which rushes in during the good times and rapidly retreats in the bad). So the relative underperformance of Asian shares over the last 18 months is not particularly unusual for a global bear market.

Asia still in a secular bull market versus world

This slump has seen Asian shares pull back versus global shares, which has served to reverse a blow-off in Asian shares that occurred in 2007. But the relative out-performance of Asian shares versus global shares since 2001 is still intact. The next chart shows the performance of Asian equities in absolute terms (top line) and relative to global equities as measured by MSCI indices (bottom line). When the relative return line is rising, Asian shares are out-performing global shares and vice versa for falls.

Asia (ex Japan) v World Equities



Source: MSCI, Thomson Financial, AMP Capital Investors

It is worth noting that while Asian shares have outperformed global shares since 2001, the ratio in the previous chart (ie the blue line) remains below 1990's peak levels suggesting that it may still have a long way to go.

Reasons to be overweight Asian shares strategically

Beyond the usual short term uncertainties, there are several reasons to believe Asian shares will outperform global shares over the next five to ten years.

Firstly, **Asian countries do not suffer from the consumer indebtedness and "de-leveraging"** (or unwinding of debt levels) that is now causing big problems in most Anglo countries (particularly the US, UK and New Zealand and potentially in Australia and Canada).

A basic dynamic in recent times has been that the US has been the world's dominant consumer and absorber of global savings or capital and Asia has been the dominant producer, saver and capital supplier. Whereas the personal savings rate has been around zero in the US and gross national saving has been around 15% of GDP, in Asia household savings rates are typically around 20 to 30% and gross national saving is running around 40% of GDP.

This paradigm now looks like it is being pulled apart. The global financial crisis that started in the US has caused a collapse in the supply of credit to US households. On top of this, US households have seen their wealth levels plunge (with shares down 50% and house prices down 25%) and their confidence about the economic outlook slump which is all resulting in a desire to cut debt levels and boost savings. The end result is a rapid unwinding of debt levels and rising savings rates in the US. This is likely to stretch out over several years and will have the effect of severely constraining US economic growth over the medium term, even after it recovers from the current recession. A similar phenomenon is occurring in the UK and to a lesser extent in Europe and Australia.

Asia is vulnerable to this trend in the short term as the rush to save in the US is cutting demand for Asian exports. Against this, Asia and Asian consumers specifically do not have the debt constraint hanging over US consumers because their savings rates have been so much higher and debt levels are extremely low. So they are well placed to grow over the medium term unlike the debt constrained consumers in the US and other Anglo countries.

Secondly, and related to this, **the Asian financial system is not impaired like the US financial system** which is going through a gut wrenching adjustment from a huge dependency on credit markets back to a system more dependent on banks. Asia's financial system never became as dependent on credit markets and its banks are far less exposed to the toxic debt now causing big losses for US and European banks.

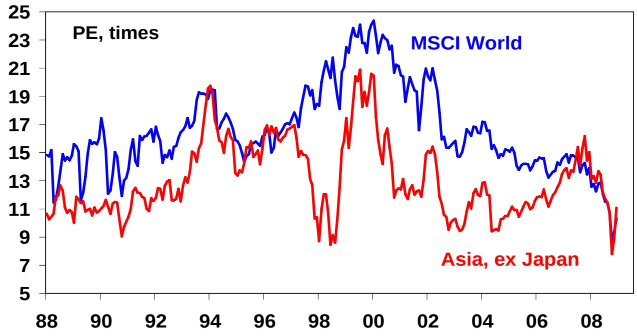
From an overall perspective Asia's strong current account surpluses and high savings rates and high foreign exchange reserves means it is in a relatively strong position in a world of de-leveraging in rich countries and increased risk aversion in credit flows. This should favour capital surplus countries in contrast to the US. The events of the past 18 months have highlighted how macro economic risk has shifted to the US and away from Asia in contrast to the situation in the late 1990s.

Thirdly, **Asian countries are highly dynamic and clearly focussed on achieving western per capita income levels**. This contrasts with Europe and Japan which are constrained by a lack of dynamism reflecting more rigid economies.

Fourthly, **Asia generally benefits from more favourable demographics**. Asia along with most other emerging markets (excepting Eastern Europe) is projected to have faster population growth and a lower dependency ratio (ie the ratio of children and retirees to working age people) than in developed countries. This contributes to a faster potential growth rate in the labour force and hence faster potential economic growth overall. China is an obvious exception but it still has a large underutilised rural workforce it can draw on.

Finally, **Asian equities are now back to trading on a similar valuation to global shares**. After trading on a higher forward PE ratio (ie the ratio of share prices to consensus year ahead earnings expectations) than global shares they are now back to being in line. This is indicated in the next chart. They also trade on a slightly higher average dividend yield than do mainstream global shares (which are dominated by the US, Japan and Europe).

12 month forward price earnings ratios - Asia v world



Source: Thomson Financial, AMP Capital Investors

Expect Asia to out-perform over the next few years

The table below provides a rough guide as to potential share market returns over the medium term. They are based on current starting point dividend yields and assume share prices rise with nominal economic growth. While actual returns are likely to be wildly different the reasonable dividend yields and stronger growth potential in Asia support the case for several years of out-performance from Asian shares. Quite clearly dividends are likely to be cut so the yields in the table below probably overstate actual dividend yields a bit – but this is an issue for all countries and won't affect relativities.

Projected five to 10 year equity returns, %pa

	Dividend Yield	+ Growth	= Return
US	3.4	5.0	8.4
UK	6.2	4.0	10.2
Europe	6.7	3.8	10.5
Japan	2.9	2.8	5.7
World	**4.4**	**4.7**	**9.1**
Asia, ex Japan	**4.9**	**8.0**	**12.9**
Australia	6.5	5.5	12.0

Source: Bloomberg, AMP Capital Investors

Conclusion

Asian shares are likely to be relative out-performers over the next few years helped by high savings rates in a world of de-leveraging, reasonable valuations and relatively strong growth prospects.

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