Schroders

2010: A year in Asia ex Japan

Louisa Lo, Head of Asia ex Japan Equities, looks ahead to 2010

- With the global recovery path unlikely to be smooth, we believe Asian stockmarkets will face increased volatility in 2010
- Having merely undergone a cyclical slowdown, Asia's economic prospects have already improved considerably in 2009, with all the major countries coming out of recession
- However, with the outlook for the global economy still far from equivocal, we remain defensively positioned with a focus on good quality domestic companies.

"While we are erring on the side of caution in the near term, investors should not lose sight of Asia's robust longer-term investment potential"

After the extraordinary performance of Asian equities in 2009, it would now appear that the easy money has been made. So what now? Although the global economic environment has improved and the mood of the markets has swung from fears about the possibility of an economic depression to expectations for a strong recovery, risks remain. The key question is whether the rebound will be self-sustaining or will stall as government stimulus measures are withdrawn. Either way, the recovery path is unlikely to be smooth, and Asian equities will likely face increased volatility as a result of that in 2010, keeping us cautious.

The global recovery looks tenuous

While there unquestionably has been a marked improvement in the economic numbers, it has largely been driven by better cost discipline and inventory re-stocking after significant scaling back of production during the global downturn. Moreover, this has also occurred in the absence of any meaningful pick up in end demand. So while Asian exports have rebounded, they are still well below their pre-crisis rates of expansion and unlikely to recover to these levels anytime soon.

Another concern is that monetary policy is being tightened at the margin amid signs of nascent asset bubbles and emerging inflationary pressures. Although they appear well contained within the region, the next move by most countries on interest rates is likely to be upwards. That said, we do not foresee any aggressive tightening of monetary policy in Asia in 2010; however, governments around the world will start withdrawing stimulus measures introduced in 2009. There have already been more hawkish comments globally on monetary policy, and given the unprecedented scale of the fiscal stimulus in 2009, we are unlikely to see this repeated in 2010, so will have to rely more on private investment and consumption rather than government handouts. The worry here is that final demand will not be strong enough to take up the growth baton, so the global economy could falter again.

We remain convinced about Asia's long-term investment potential

That said, while we are erring on the side of caution in the near term, investors should not lose sight of Asia's robust longer-term investment potential. Economic fundamentals in these markets are undoubtedly stronger than in the West, which should enable them to continue to perform relatively well should the global recovery stall. Having merely undergone a cyclical slowdown (a collapse in the export market), Asia's economic prospects have already improved considerably in 2009, with all the major countries coming out of recession. Longer term, Asia also faces few of the long-term challenges – such as having to work through a long and painful process of reducing debts on both a government and consumer level – of its richer counterparts in the developed world.

Rebalancing growth towards private consumption

Government balance sheets in the Asia region are also in a strong position, banks are well capitalised and household and corporate debts levels are modest. Continued urbanisation should also support a more diversified economy; one that can eventually reduce its reliance

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on the pure export-led model as Asia has in the past been characterised. In fact, we believe that there is also a growing realisation amongst Asian governments about the necessity to transform their growth models away from their dependency on exports towards private consumption. This could not come at a more opportune time.

China, for one, has already started taking steps towards rebalancing its economy, with the government introducing an array of incentives to entice households to spend more. This has already had some success, with domestic demand surprisingly resilient throughout the downturn. Longer term, Beijing is also widening the social safety net, in a bid to ease households' concerns about future pension and healthcare costs and to encourage consumption. This positive trend is not limited to China. Governments across the region are also taking gradual steps to end their excessive reliance on exports, as it is becoming increasingly evident that private consumption will be necessary to sustain long-term healthy economic growth.

Markets likely to remain volatile as uncertainties remain

So where does this leave the markets? We believe that Asian stockmarkets are likely to remain volatile over 2010 as uncertainties remain. While we do not necessarily anticipate a sharp market correction, earnings expectations have been significantly revised up. This could prove to be disappointing given that the aforementioned global imbalances that have plagued the markets have yet to be resolved, which will likely act as a headwind to economic growth further out, hampering regional earnings growth. So with the outlook for the global economy still far from equivocal, combined with the excellent performance of Asian stock markets in 2009, we would not be surprised to see profit taking, with long-term investors switching into companies with strong fundamental support.

This sits well with our approach to investing, with our portfolios currently defensively positioned. Moreover, with the markets now 'normalising', we would expect to see more differentiation at both the sector and company level, and in turn, a market conducive for stock pickers in 2010. Areas of particular interest to us are in the Asian consumer space, insurance, property, infrastructure-related, as well as yield-focused companies, where we are finding valuation merit, and which should do well in this environment. Not only do they offer some downside protection should markets stumble, but they should also benefit from their exposure to Asia's increasingly important consumption and investment trends. On the other hand, we remain cautious on those stocks most sensitive to the global demand outlook, where we feel that valuations and market expectations are too high.