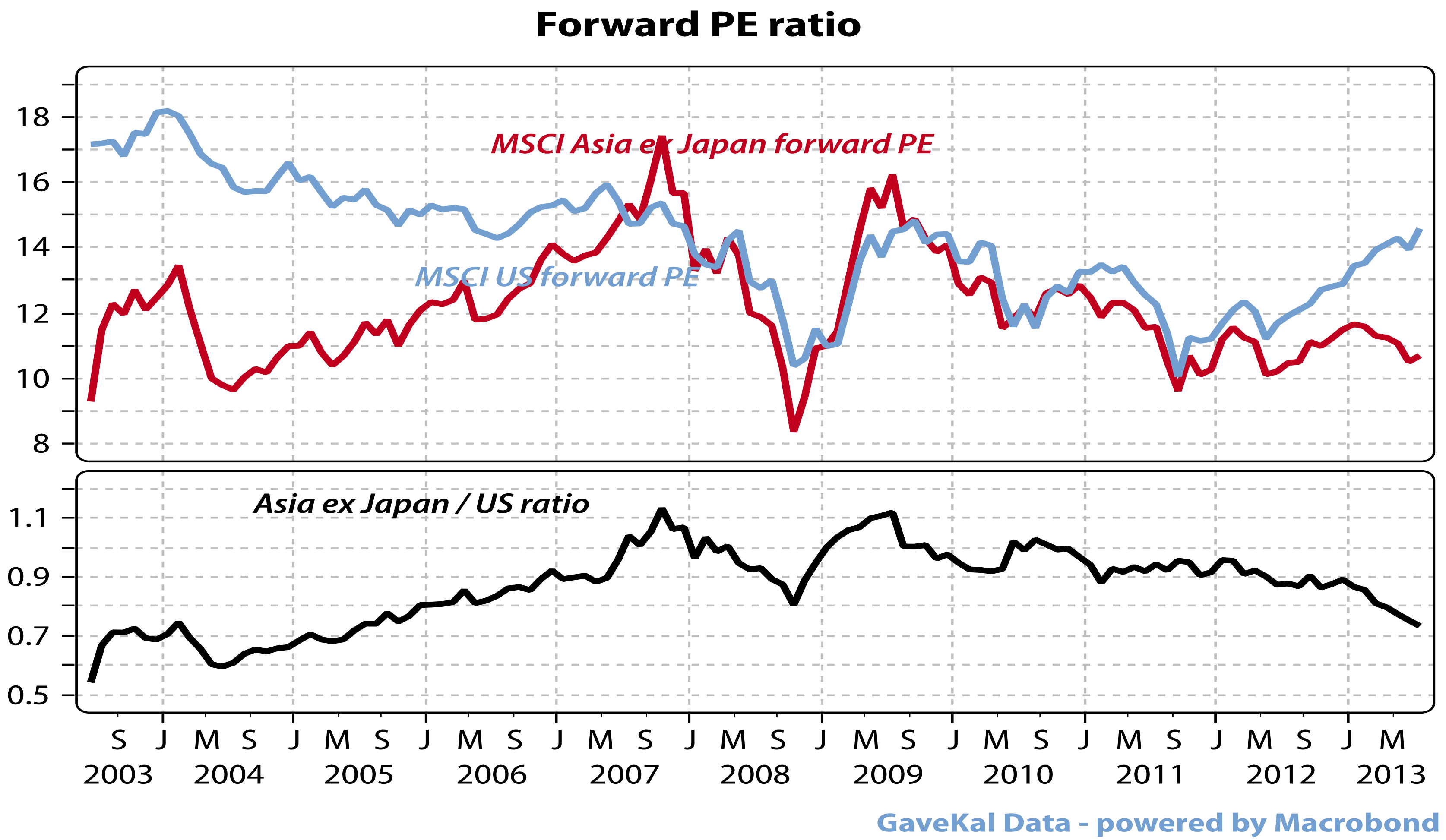
GaveKal
CAPITAL

Have Asian Markets Finally Turned?
December 2013

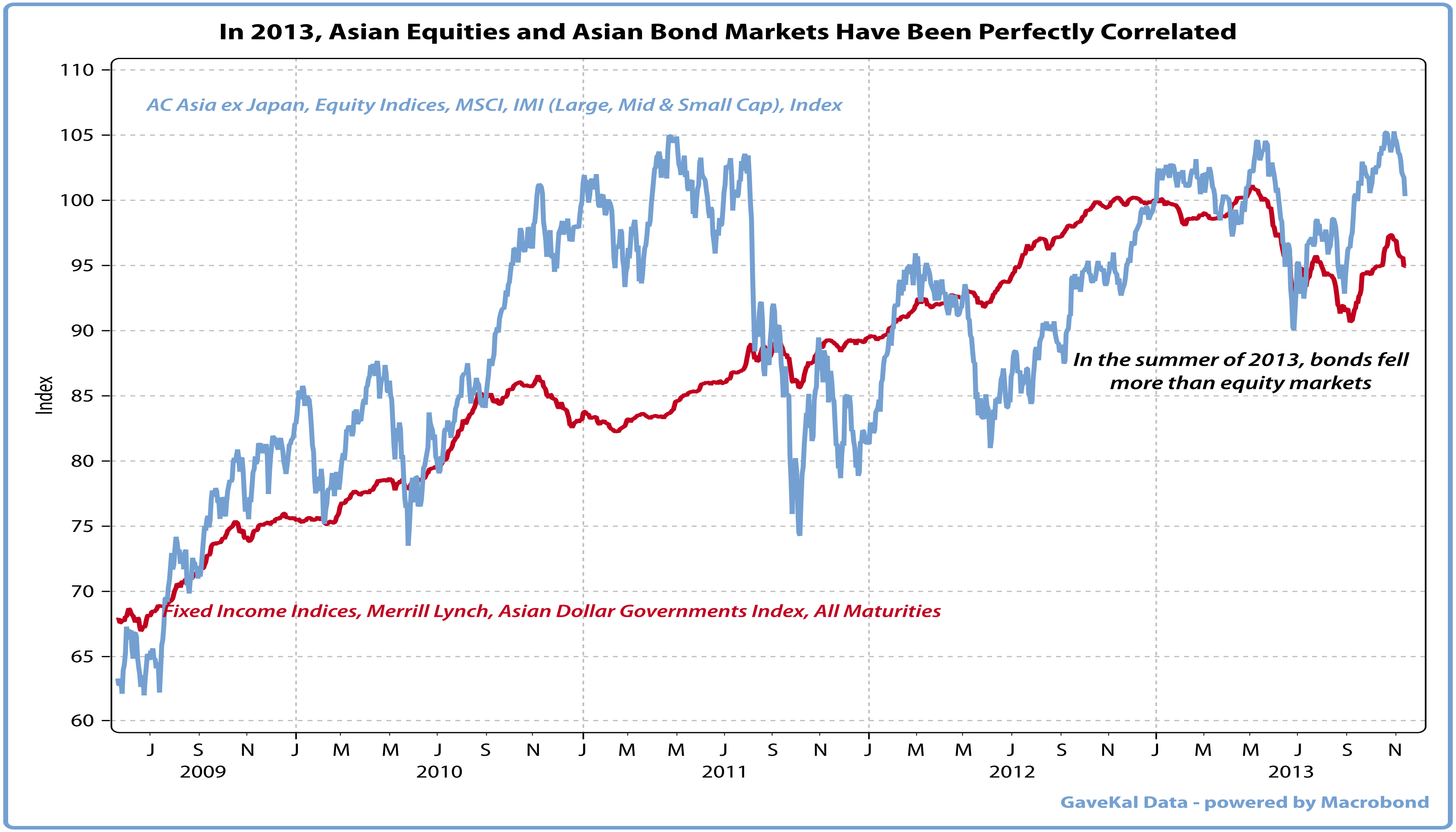
A very challenging summer

Asia has suffered a massive de-rating – and being a growth investor in markets that are de-rating is no fun



Source: GaveKal Capital Limited

At the same time, over the past year, diversification across asset classes did not work



Source: GaveKal Capital Limited

Does Asia’s deserve its de-rating?

Asia – A out-of-favor region

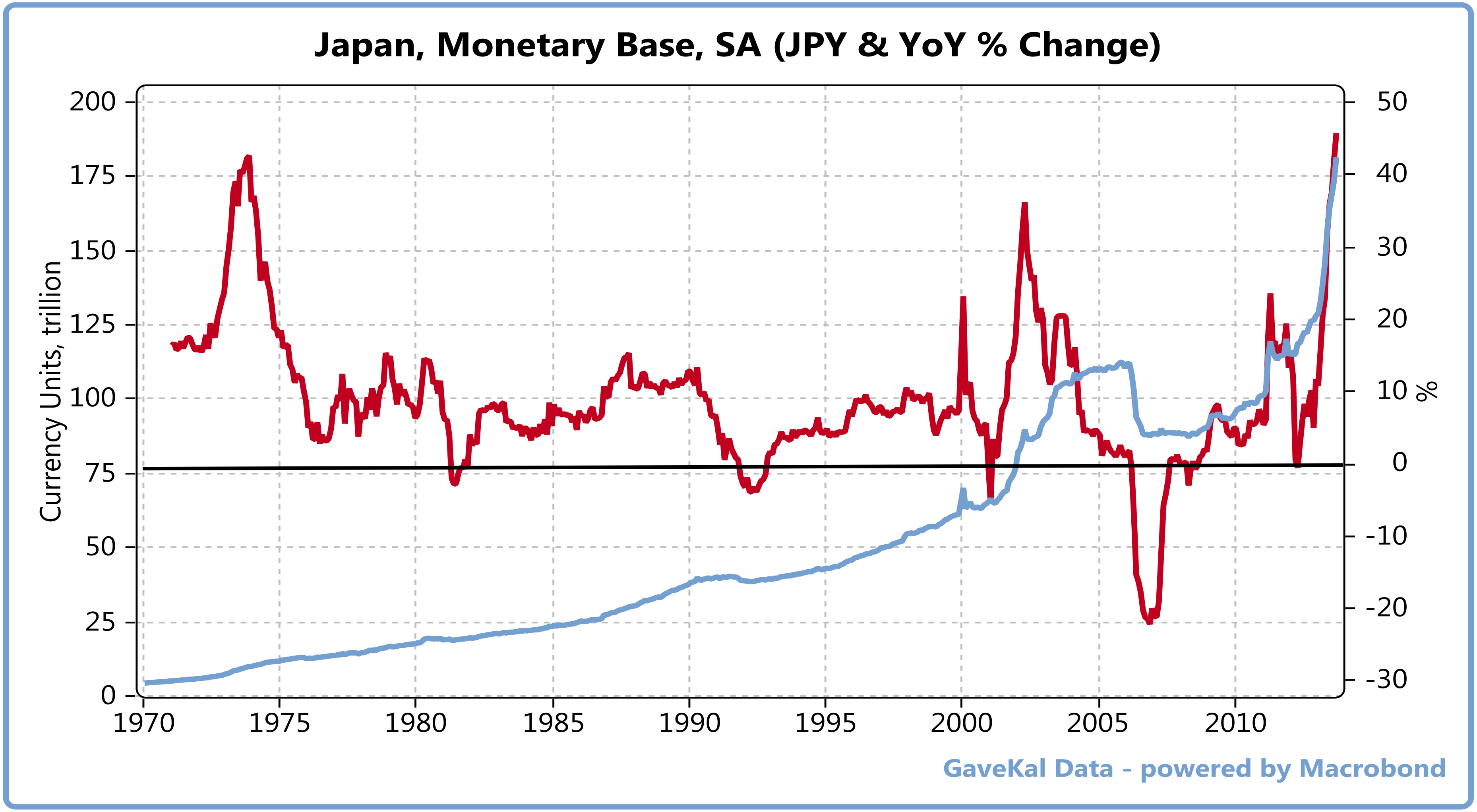
Three major concerns:

1. Is Abenomics over?

2. Is the much-talked-about hard landing in China imminent?

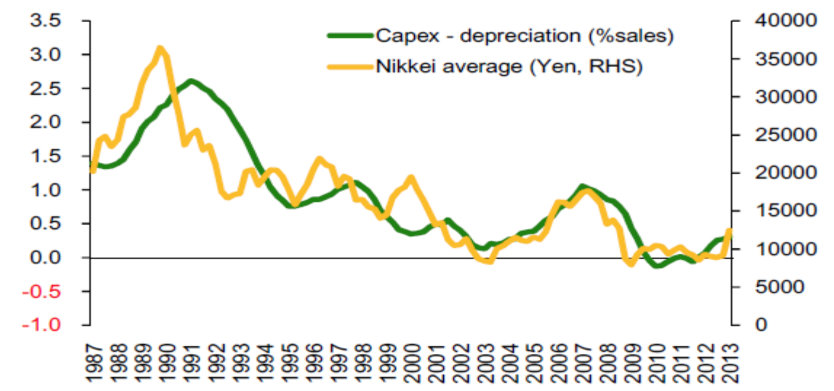
3. Are other Asian economies heading into a crisis?

The first arrow is still on … Japan's monetary base continues to skyrocket



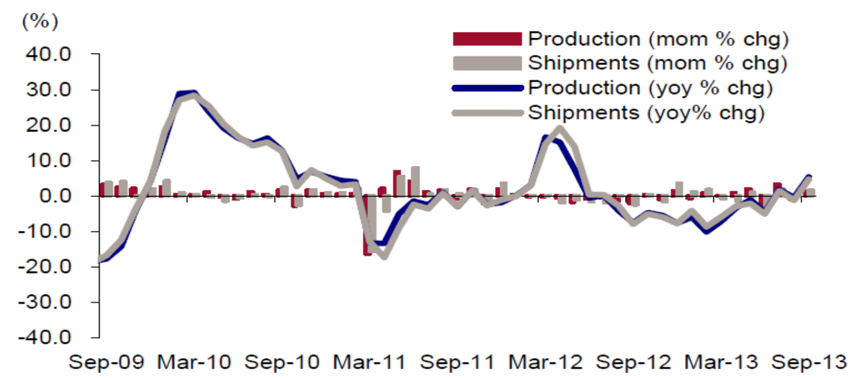
Cyclical recovery continues

Net Capex Ratio (% Sales) and Nikkei Average



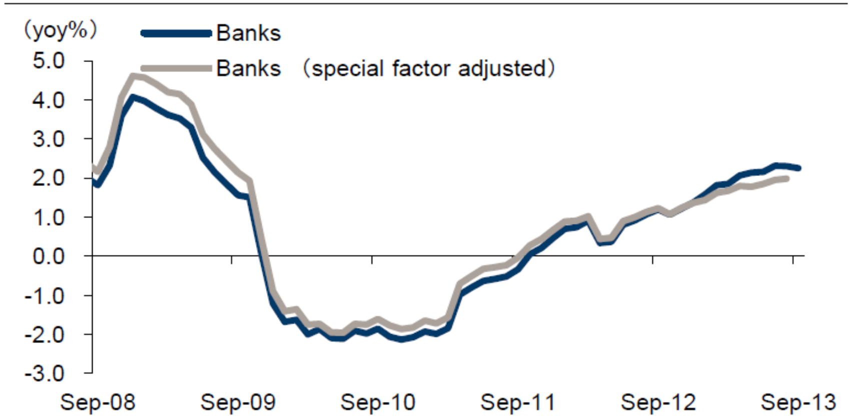
Source: MoF, Bloomberg, UBS

Industrial Production and Shipments



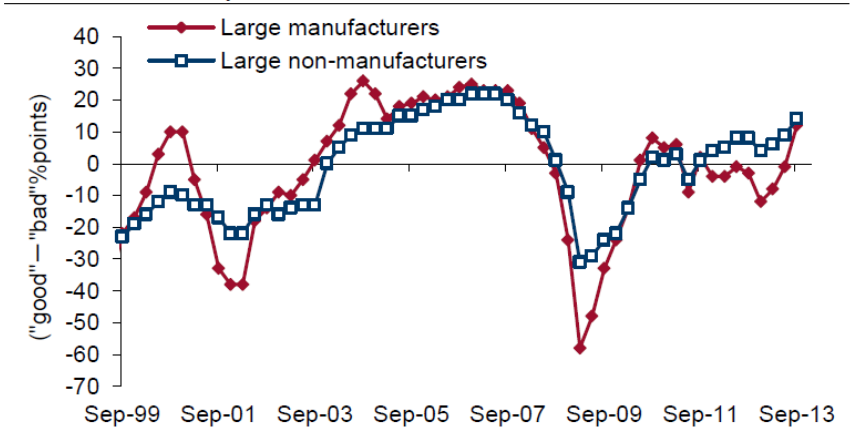
Source: METI, Credit Suisse

Average Outstanding Bank Lending (Banks and Shinkin Banks)



Source: BoJ, Credit Suisse

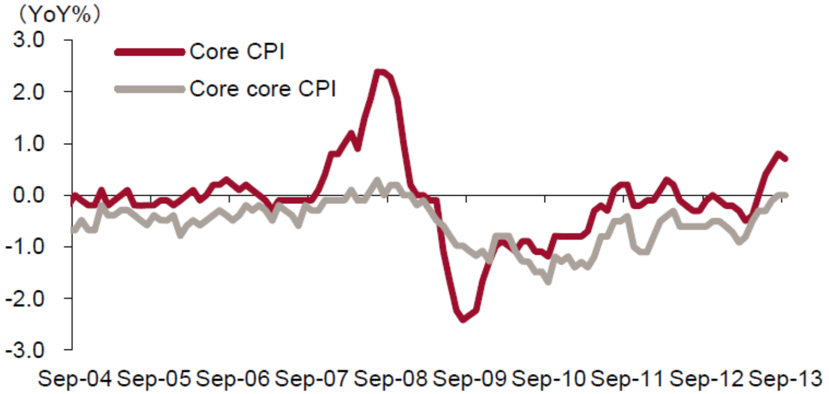
BoJ Tankan Survey (Business Conditions DI)



Source: BoJ, Credit Suisse

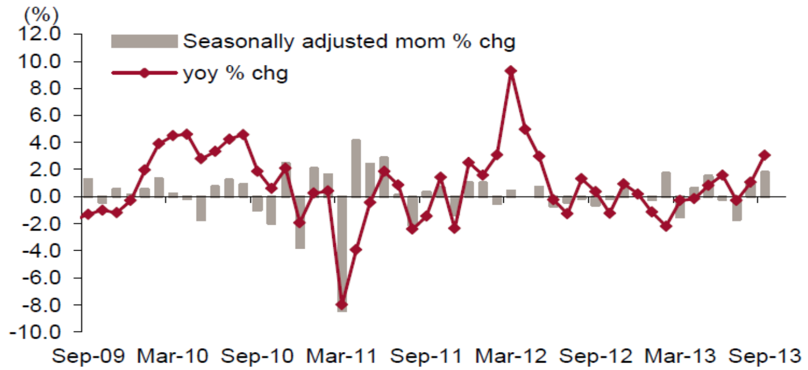
Cyclical recovery continues

CPI



Source: MIC, Credit Suisse

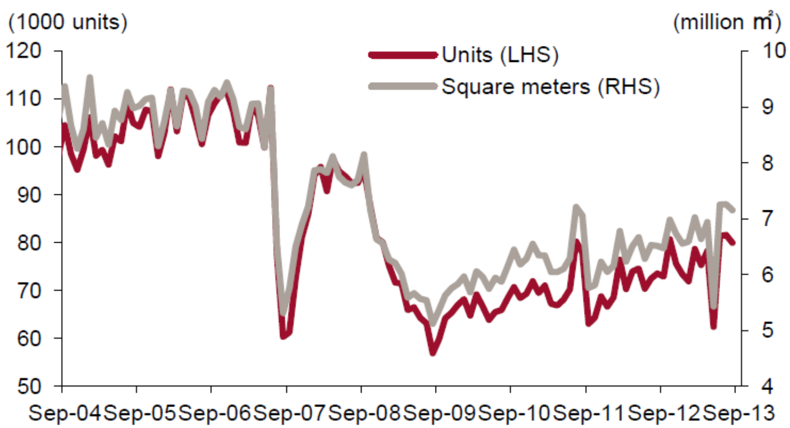
Retail Sales



Note: Retail sales indices, % mom chg.

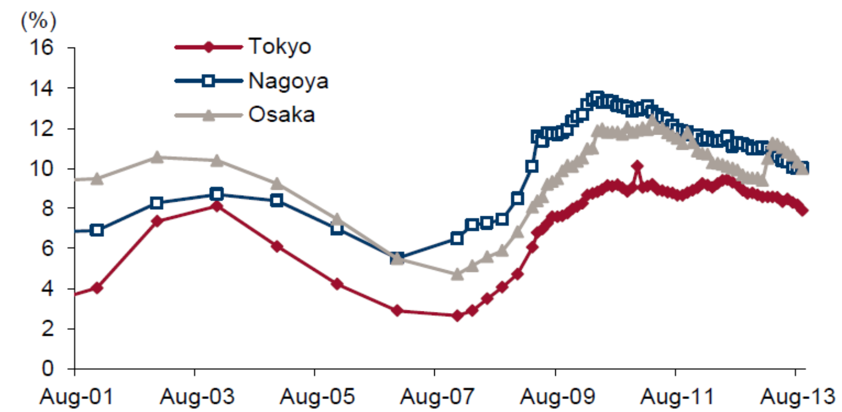
Source: METI, Credit Suisse

New Housing Started



Source: MLIT, Credit Suisse

Average Office Vacancy Rates



Source: Miki Shoji, Credit Suisse

The third arrow – A free option

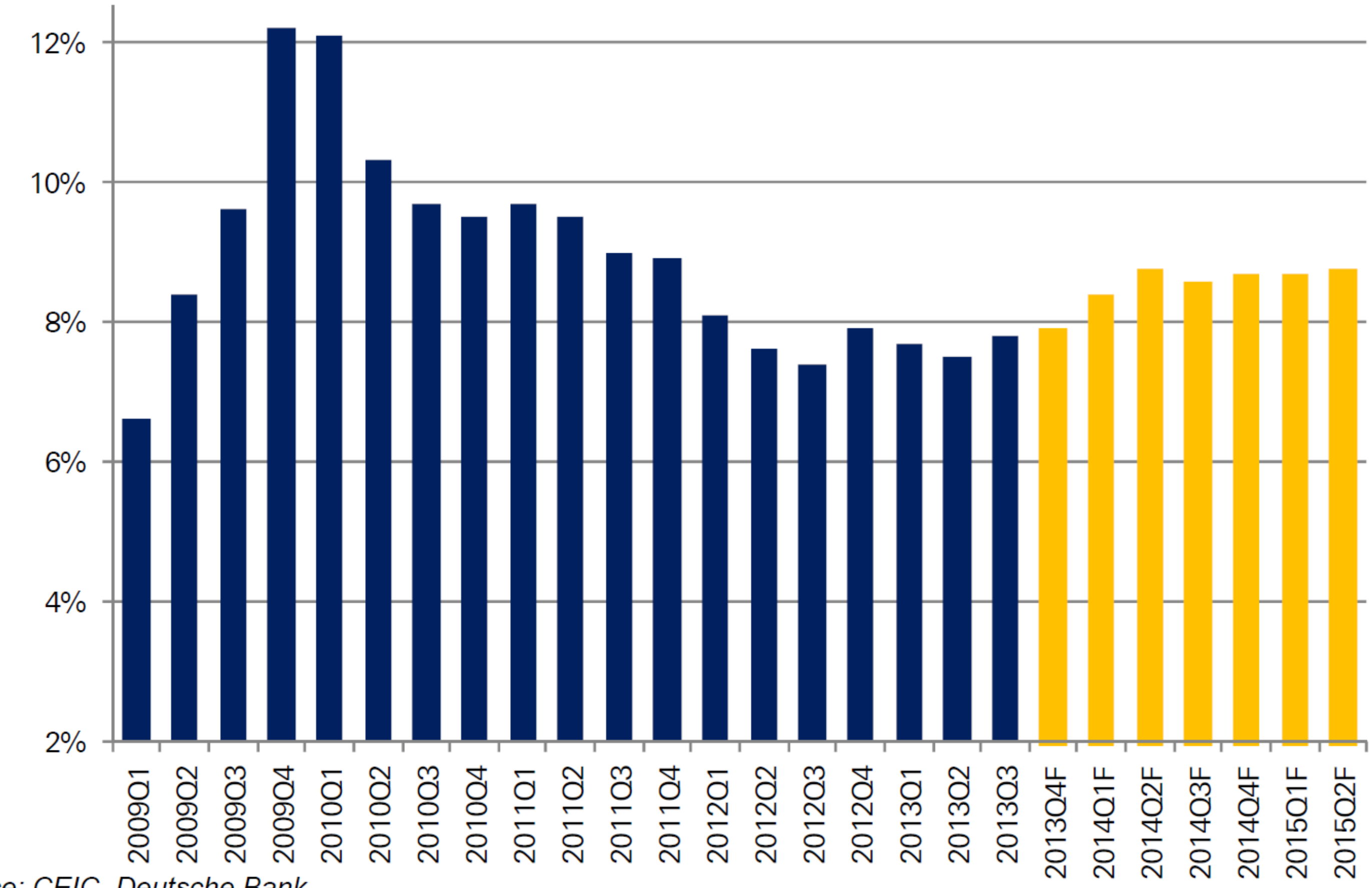
- ¥2 trillion tax breaks capital investment and corporate income
- Encourage industrial consolidation which includes consolidation of capacity and retrenchment of labors
- Trade liberalization which leads to more efficient land use; possible rice subsidies cut on Trans-Pacific Partnership (“TPP”) deal
- Deregulation of property investment and medical services in major urban areas
- Creation of NISA accounts could lead to large flows into equities

Source: GaveKal Capital Limited

China : Again No Hard Landing

Again no hard landing

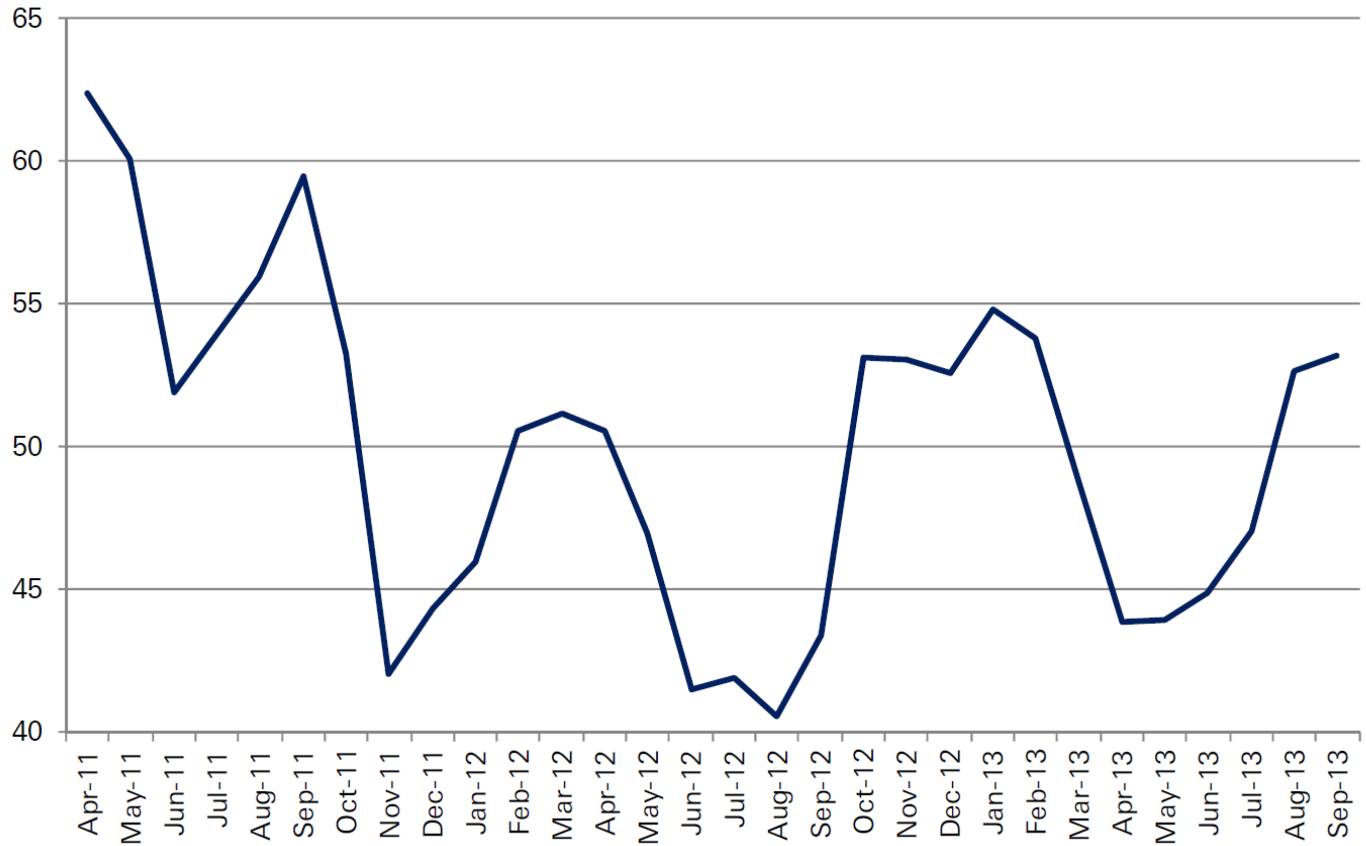
GDP growth forecast, yoy %



Source: CEIC, Deutsche Bank

Inventory restocking

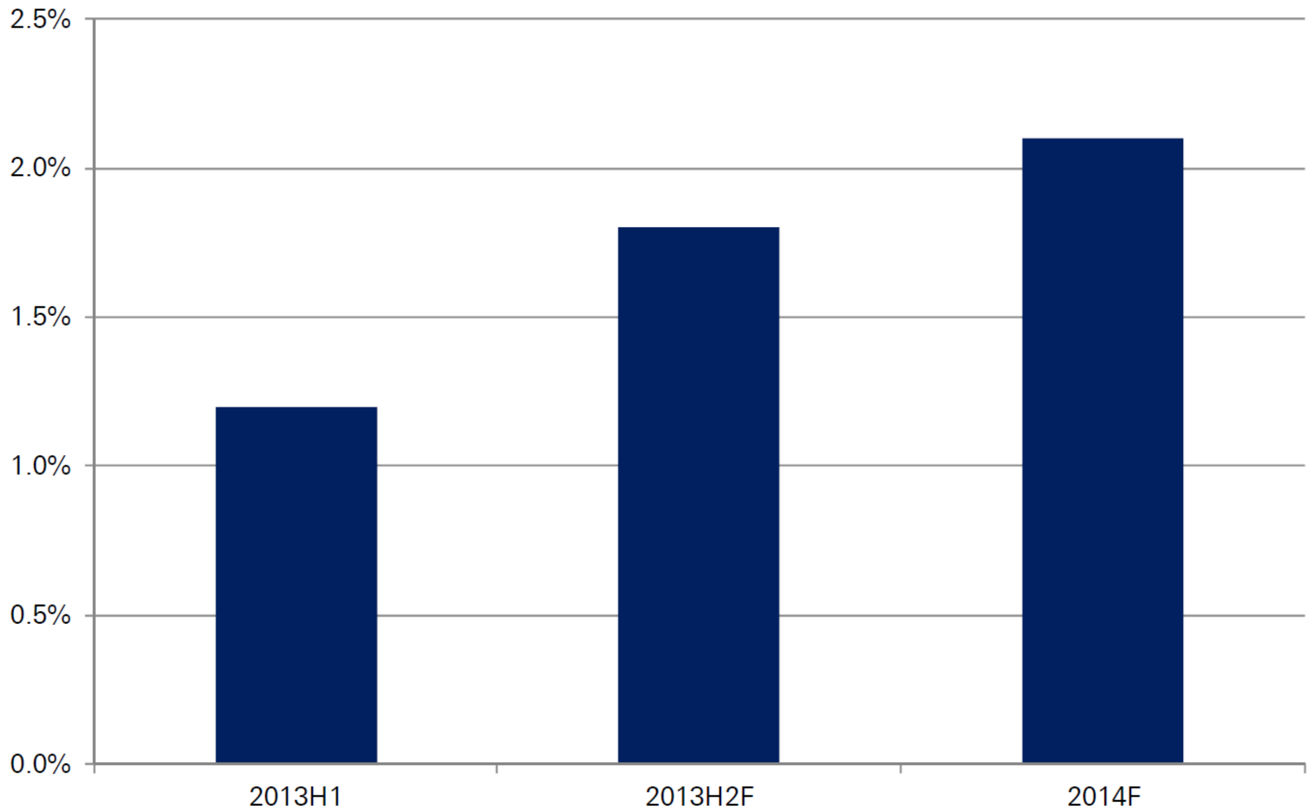
HSBC PMI raw material price index



Source: Deutsche Bank, CEIC

Export recovery : G3 demand for China exports

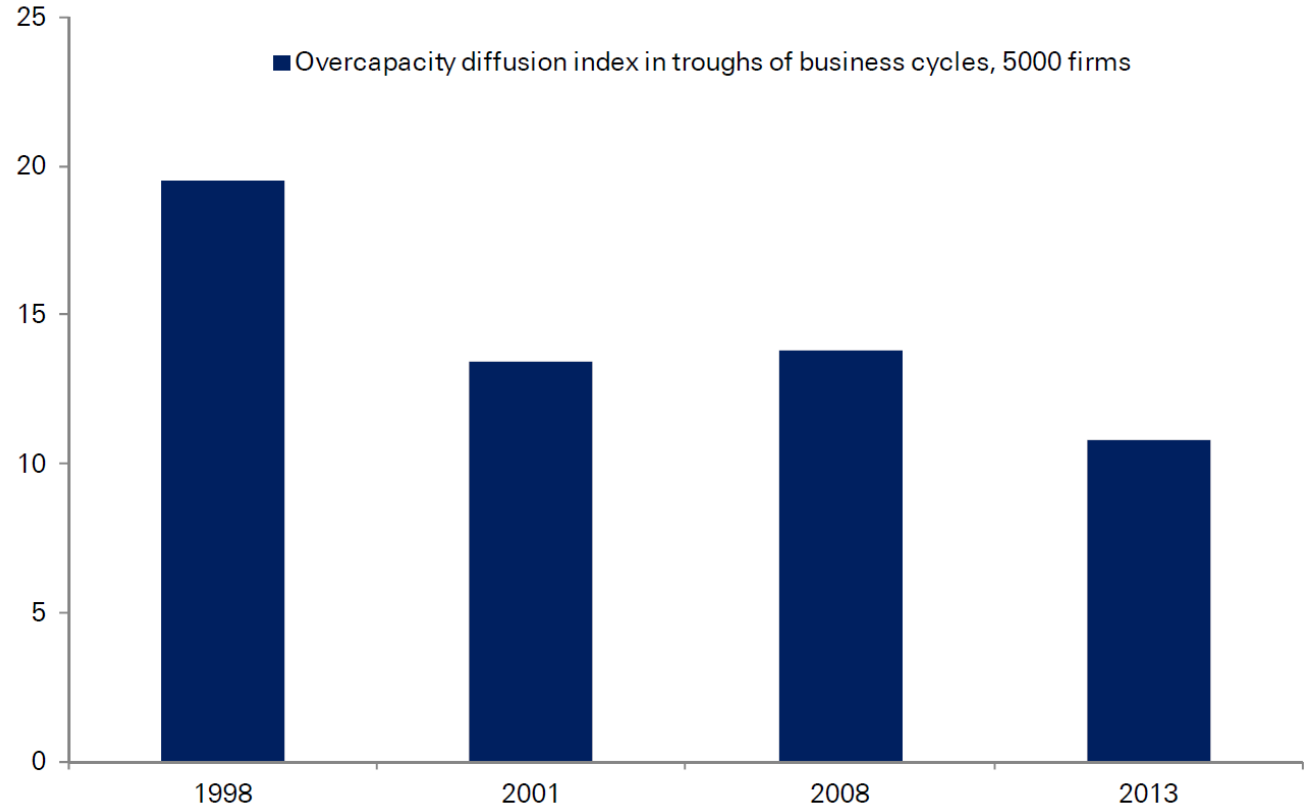
G3 GDP growth forecast, yoy %



Source: Deutsche Bank, CEIC

Why this downturn is no worse than previous ones?

Overcapacity today is less serious than in past three downturns



Source: Deutsche Bank, WIND

Simultaneously, no more excessive credit-driven cycle

Source: GaveKal Capital Limited

Market outlook : Expect re-rating of MSCI China in coming 6 months on growth acceleration and reforms

MSCI China index forward P/E ratio

Source: Bloomberg Finance LP, Deutsche Bank

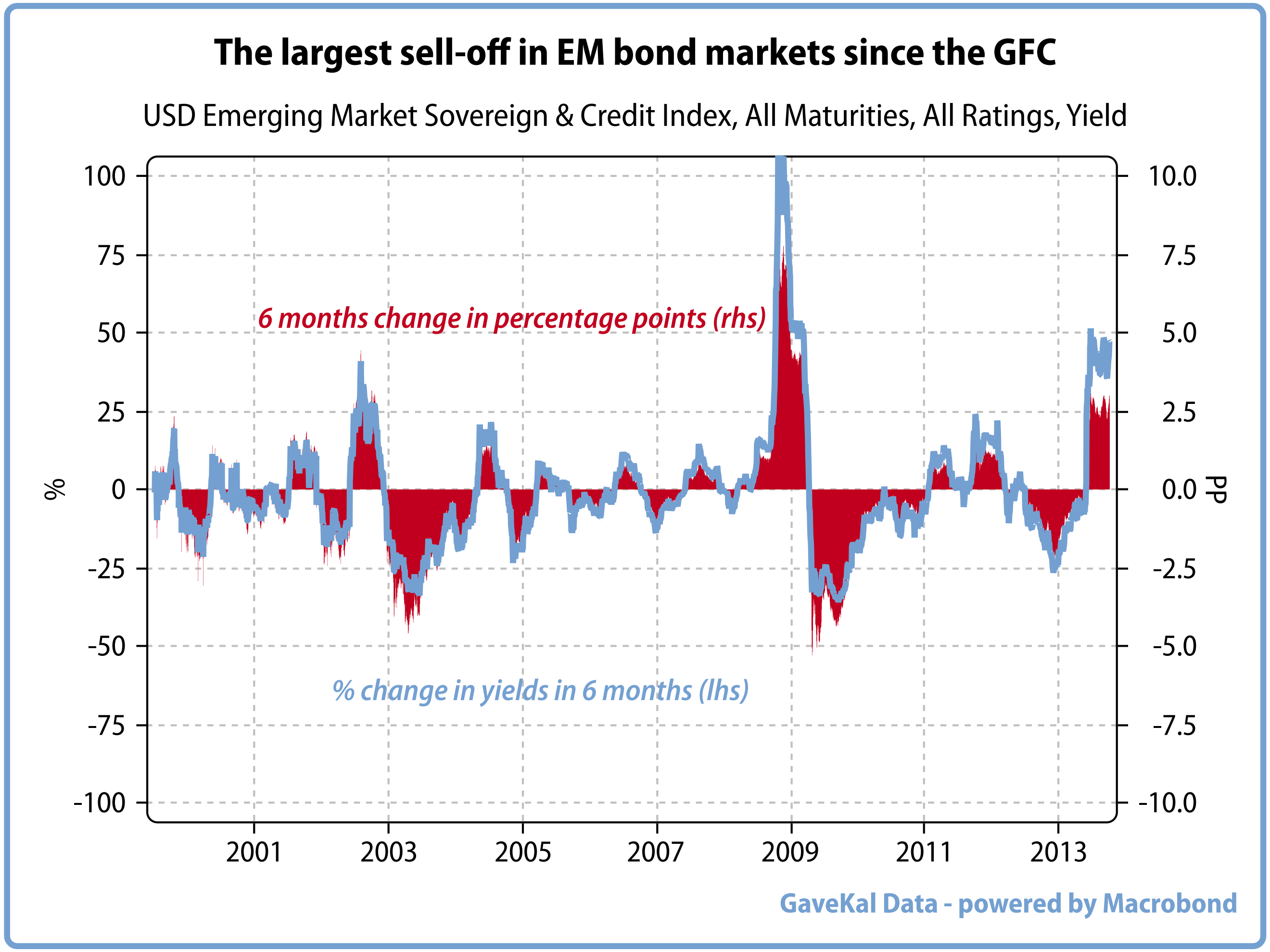
Is reform dead? No

Reform		
#1	Deregulation	• Providing private firms with much greater access to financing and lower funding costs (by 5-6ppts) • Raising SOE's net dividend payout ratio from 0.4% to about 30%
#2	Domestic Reforms	• Opening up trans-pacific partnership ("TPP")
#3	Financial Liberalization	• Interest rate deregulation • Capital account liberalization – achieving basic convertibility in 3-5 years and other financial reforms
#4	Land and Hukou Reforms	• Granting titles of land use rights to all rural families in the coming five years
#5	SOE Reforms	• Breaking up large SOEs by separating their social functions from commercial functions
#6	Property Tax	• Stabilizing property market
#7	Social Security Reforms	• Consolidating the civil servant pension system with the enterprise pension system
#8	Municipal Bond Market	• Developing a municipal bond market – addressing LGFV risk

Source: GaveKal Capital Limited

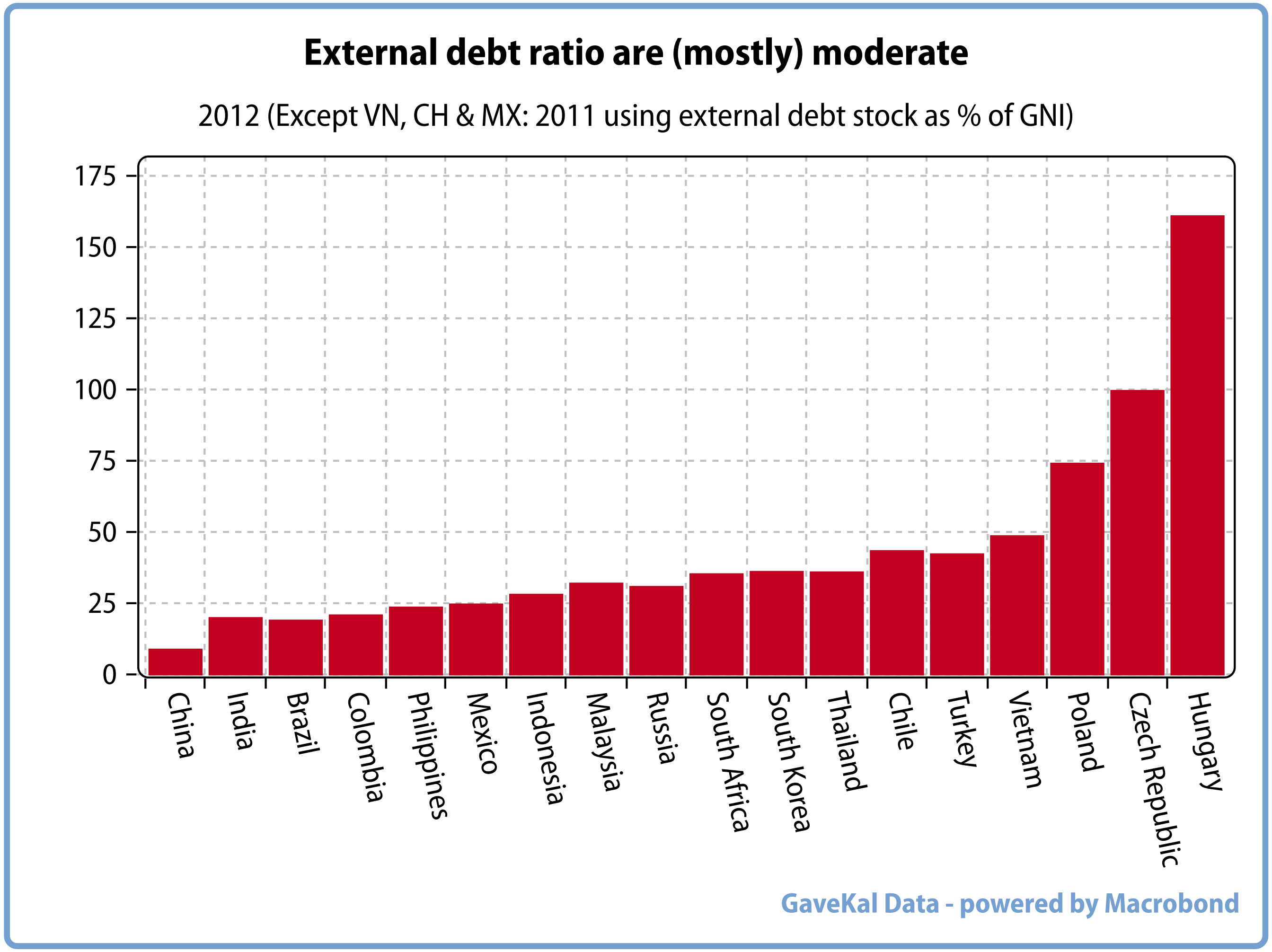
Other Asian Markets : Some Adjustments But No Crisis

Another liquidity shock ...

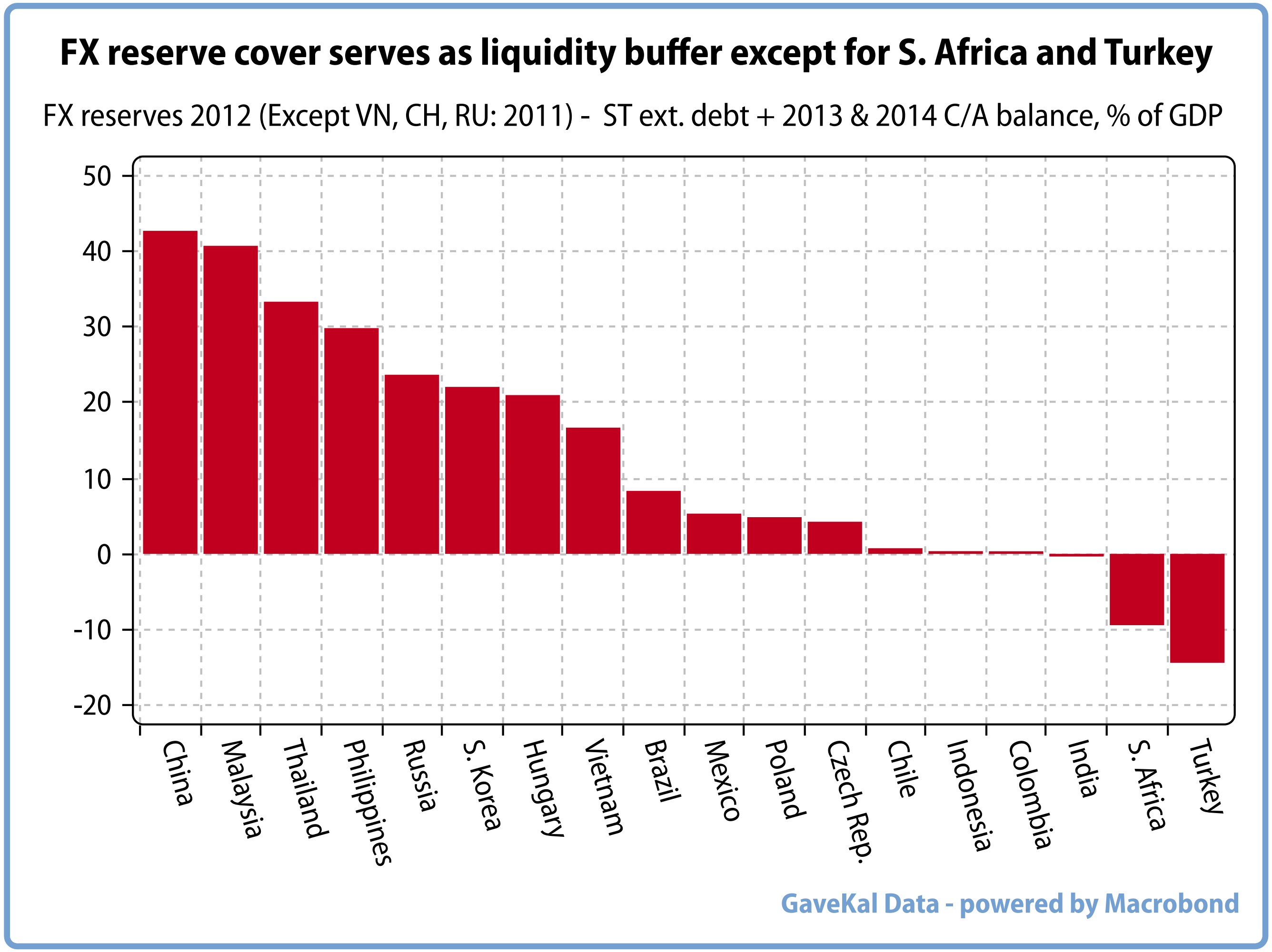


Source: GaveKal Capital Limited

But Asia is in much better shape

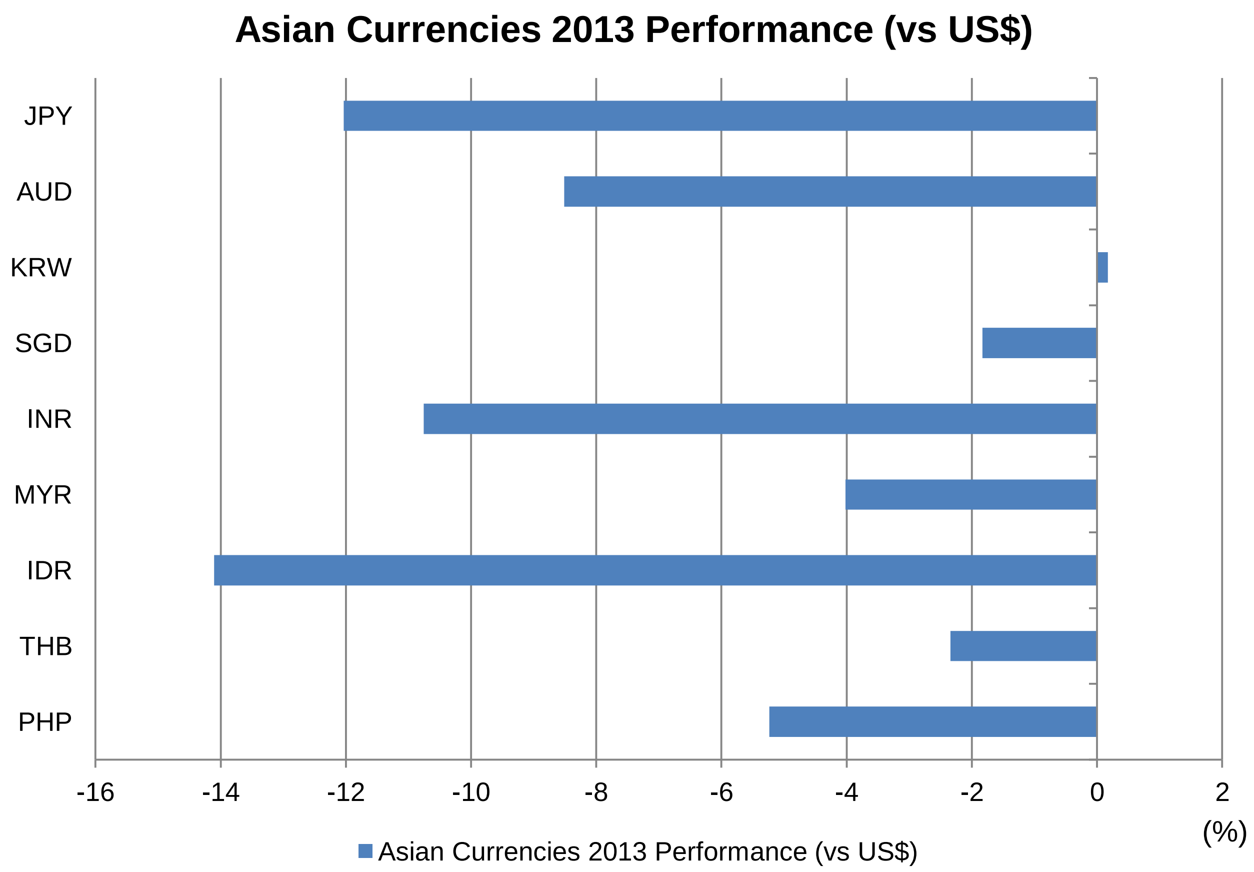


... With external positions mostly well covered



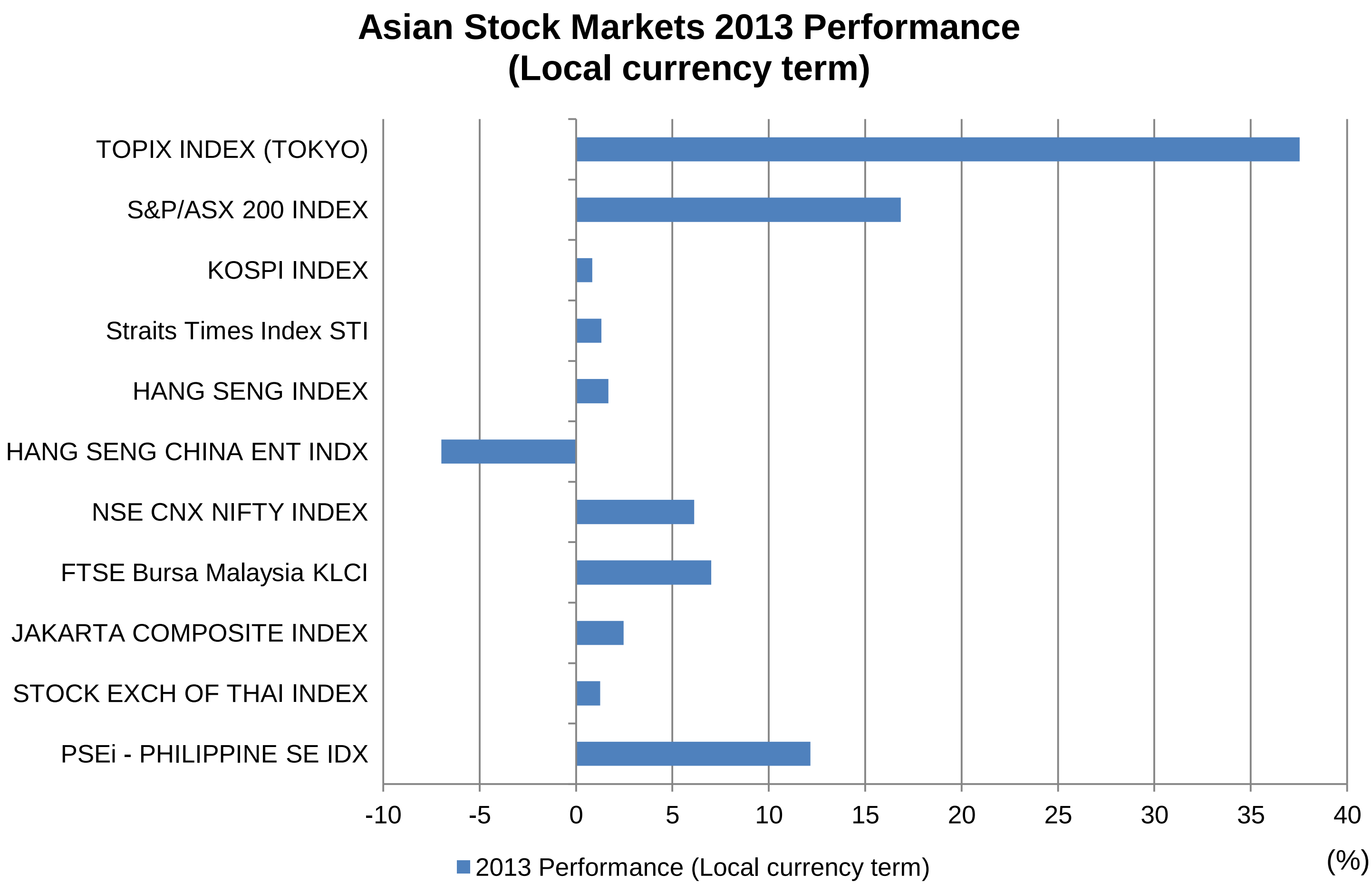
Source: GaveKal Capital Limited

Adjustments through currency devaluation



Source: Bloomberg (YTD as of 5 Nov 2013)

But stock markets hold up in local currency terms



Source: Bloomberg (YTD as of 5 Nov 2013)

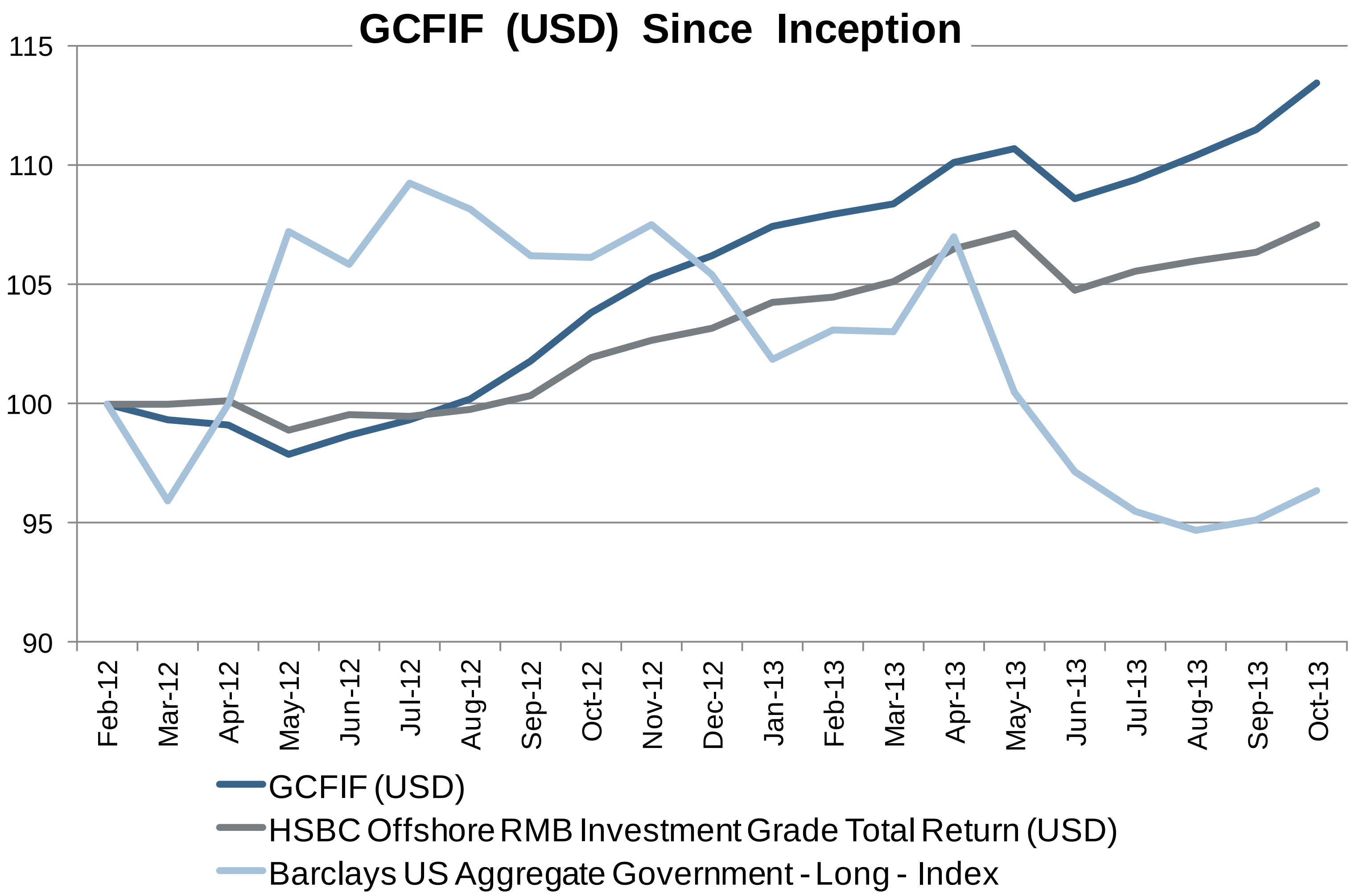
An under-estimated development which will have a massive impact on the region: the internationalization of the RMB

The RMB is the best performing currency of past three years

Source: Bloomberg (YTD as of 9 Nov 2013)

Source: GaveKal Capital Limited

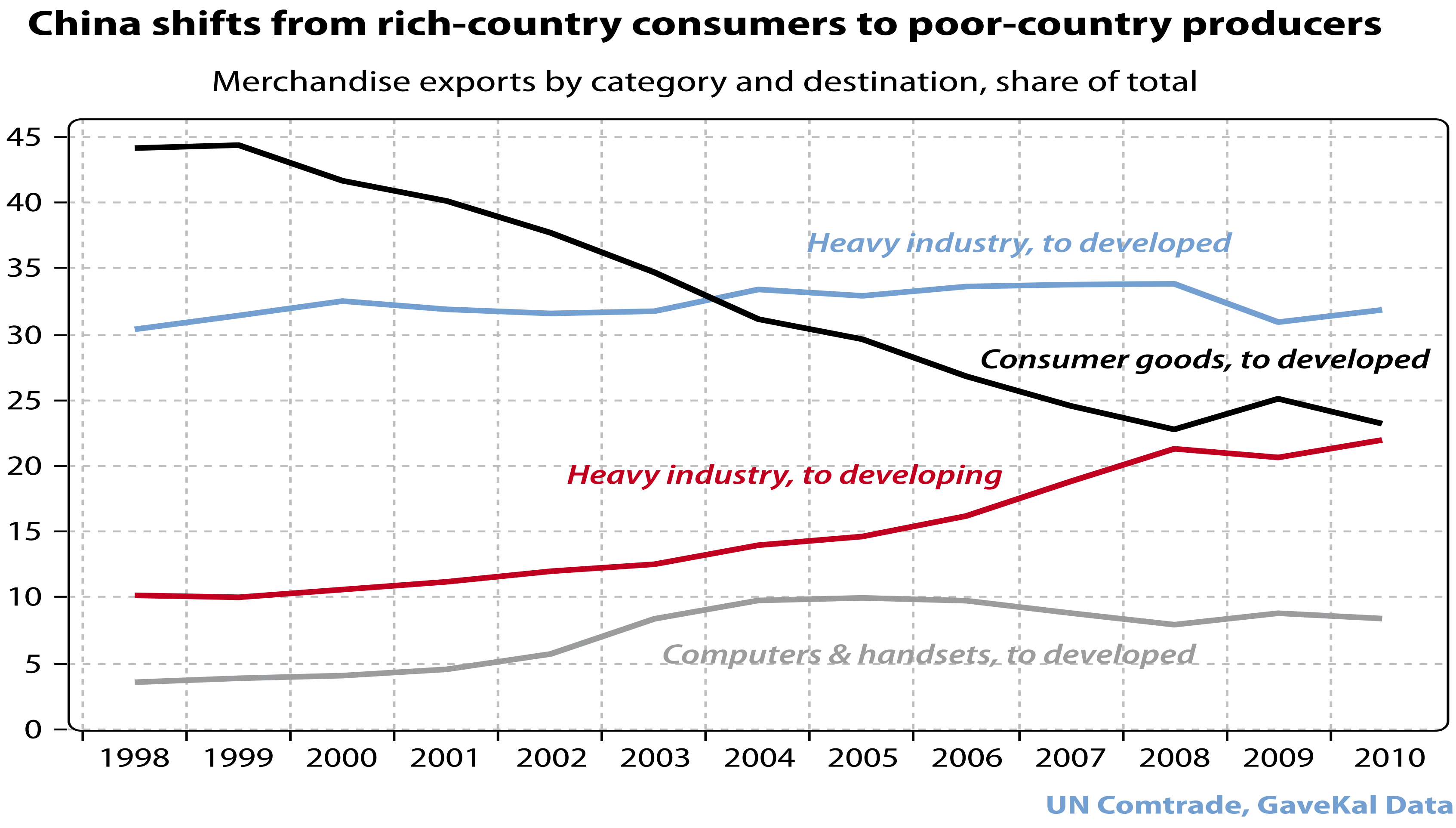
Dim-Sum bonds have been a beacon of stability – In fact, RMB bonds remain the asset of choice to diversify risk



Source: GaveKal Capital Limited

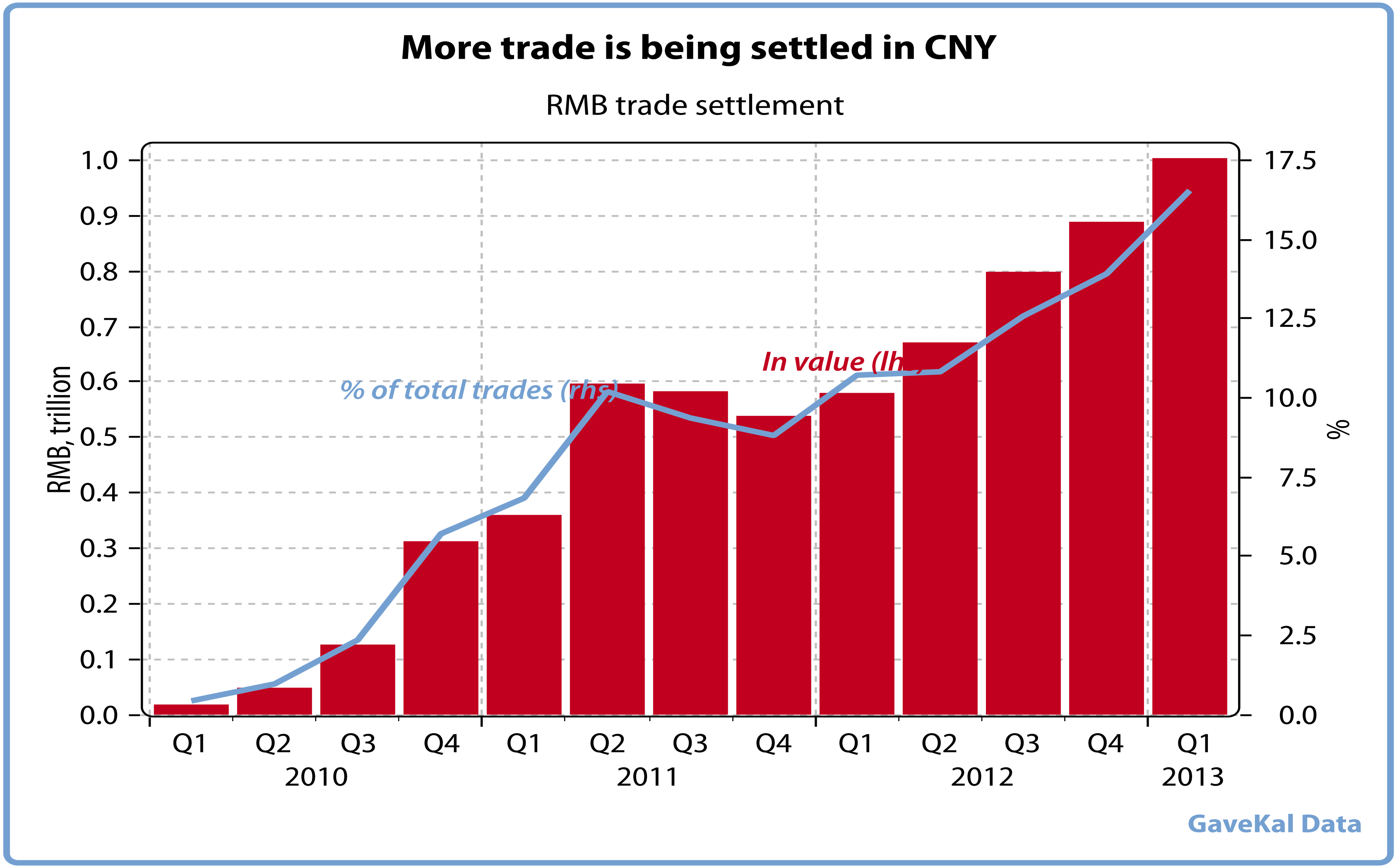
First, there was the trauma of the 2008-09 crisis – a wake-up call for China on its dependency on the US$

China's goal is also to move up the value chain – this is another deflationary force. China is allowing emerging markets to industrialize on the cheap!

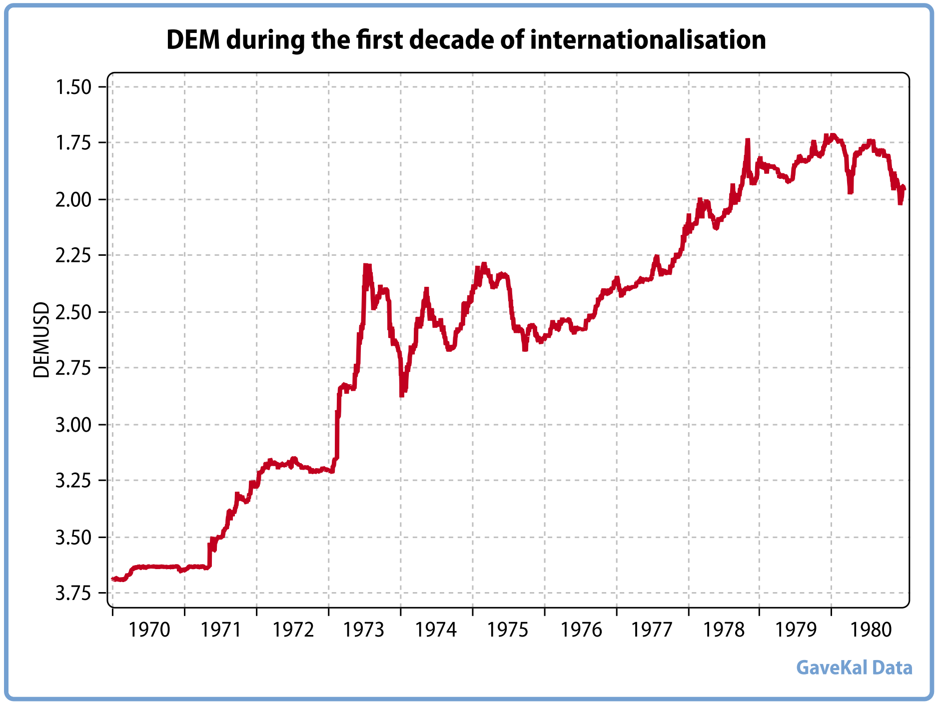


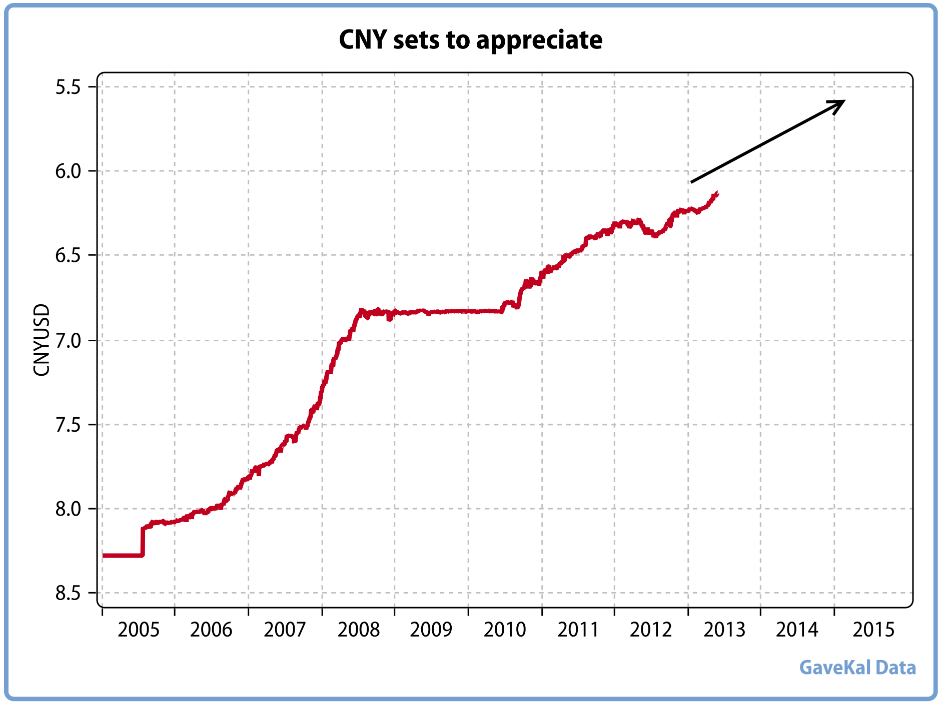
Source: GaveKal Capital Limited

As a result, RMB is already in top 10 currencies… while capital controls are still on!

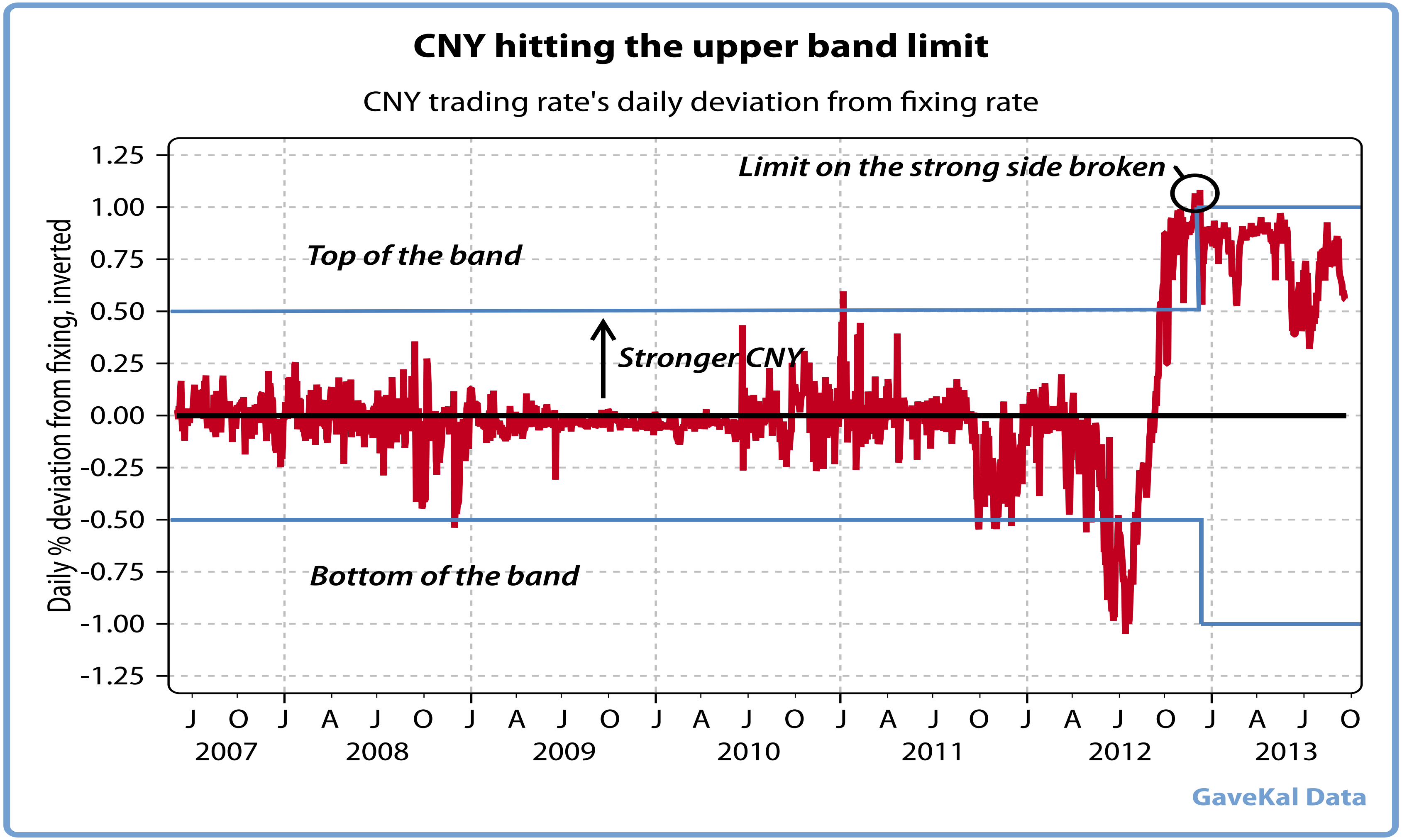


As China tries to replicate within the emerging market world what Germany did in Europe in the 1970s, RMB bonds are to portfolios what the Bunds of the 1970s





Of course, this means more currency volatility…



Source: GaveKal Capital Limited

But it also makes for a great risk-reward trade

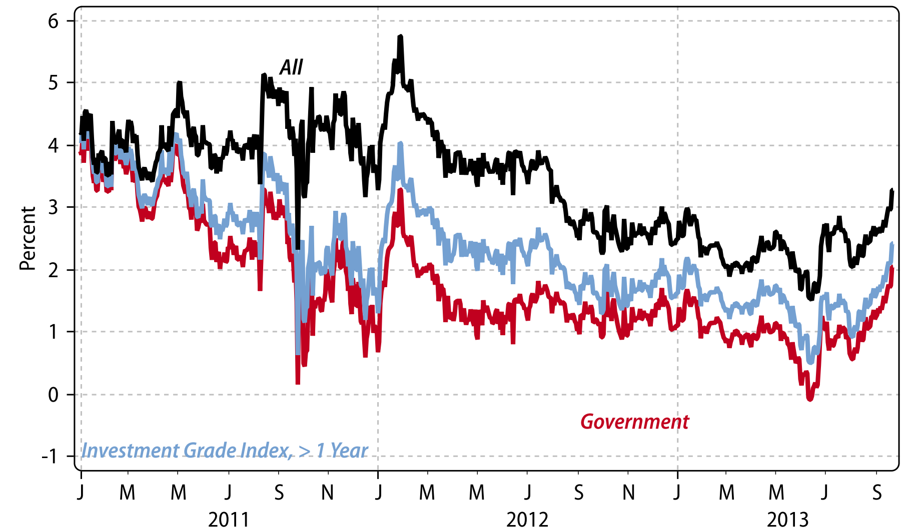
Investment grade bond yield spread

Dim sum bond yield minus global

GaveKal Data

A proxy for expected CNH bond yield - effective yield + currency expectation

Merrill Lynch dim sum indices, adjusted for CNY 12m changes implied by NDR

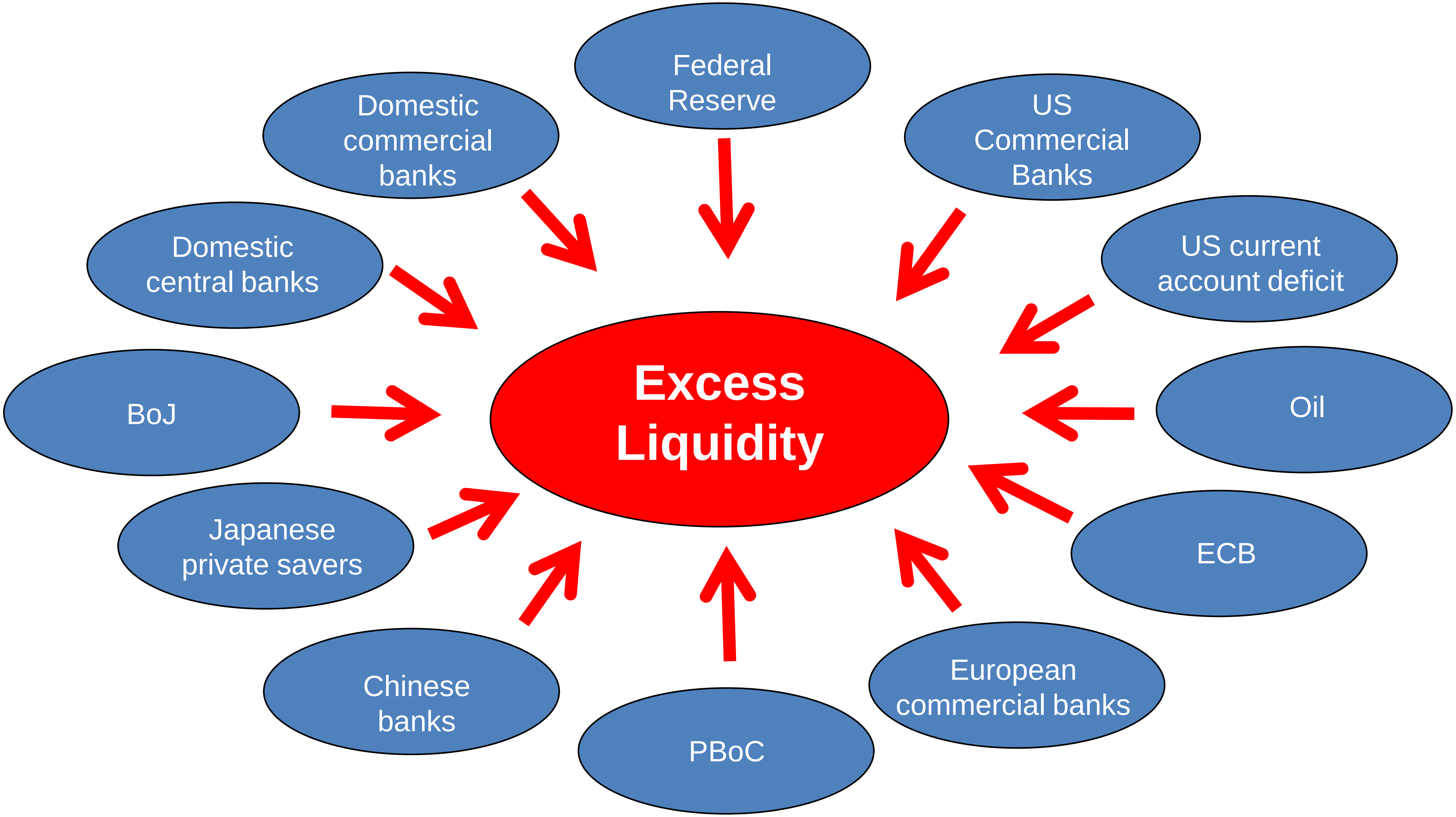


GaveKal Data

Source: GaveKal Capital Limited

From front-running the Chinese to front-running the Japanese?

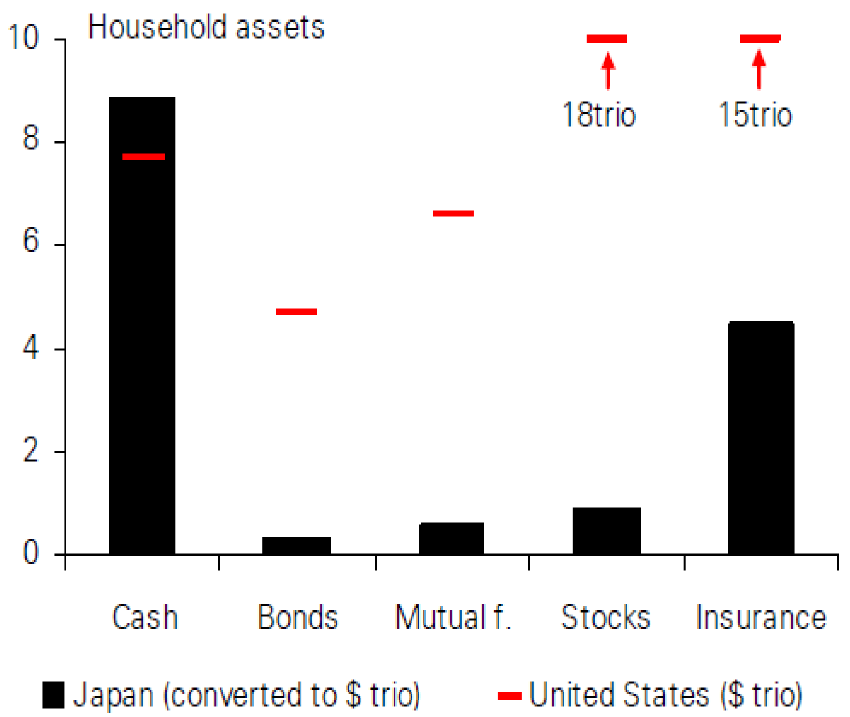
The challenge today is figuring out where the excess liquidity will come from? And where it will go...



Source: GaveKal Capital Limited

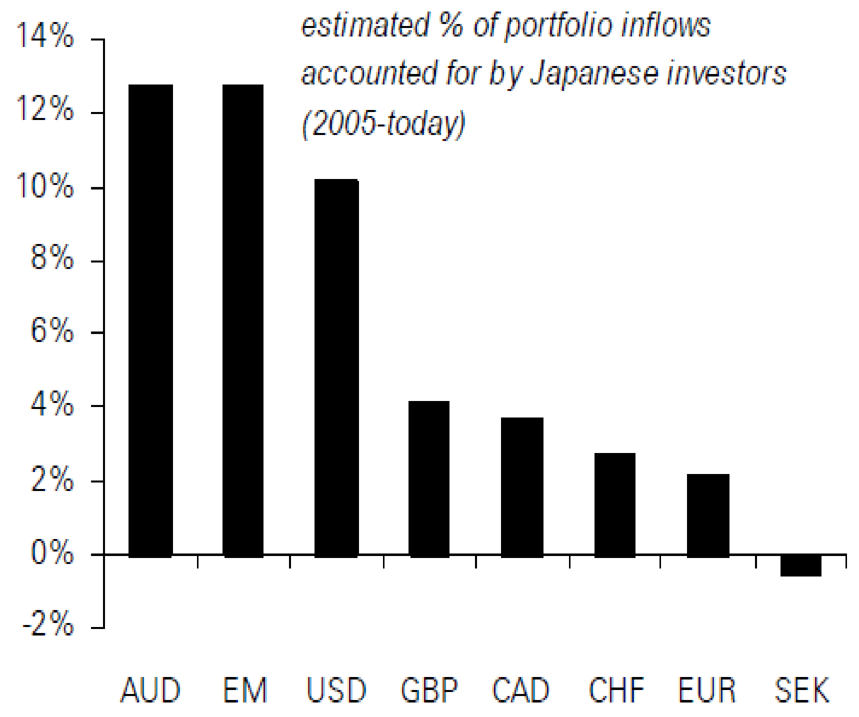
Now that the Yen is weakening, will the Japanese keep their savings in cash at the bank?

Japanese Households Have More Cash Than All of US



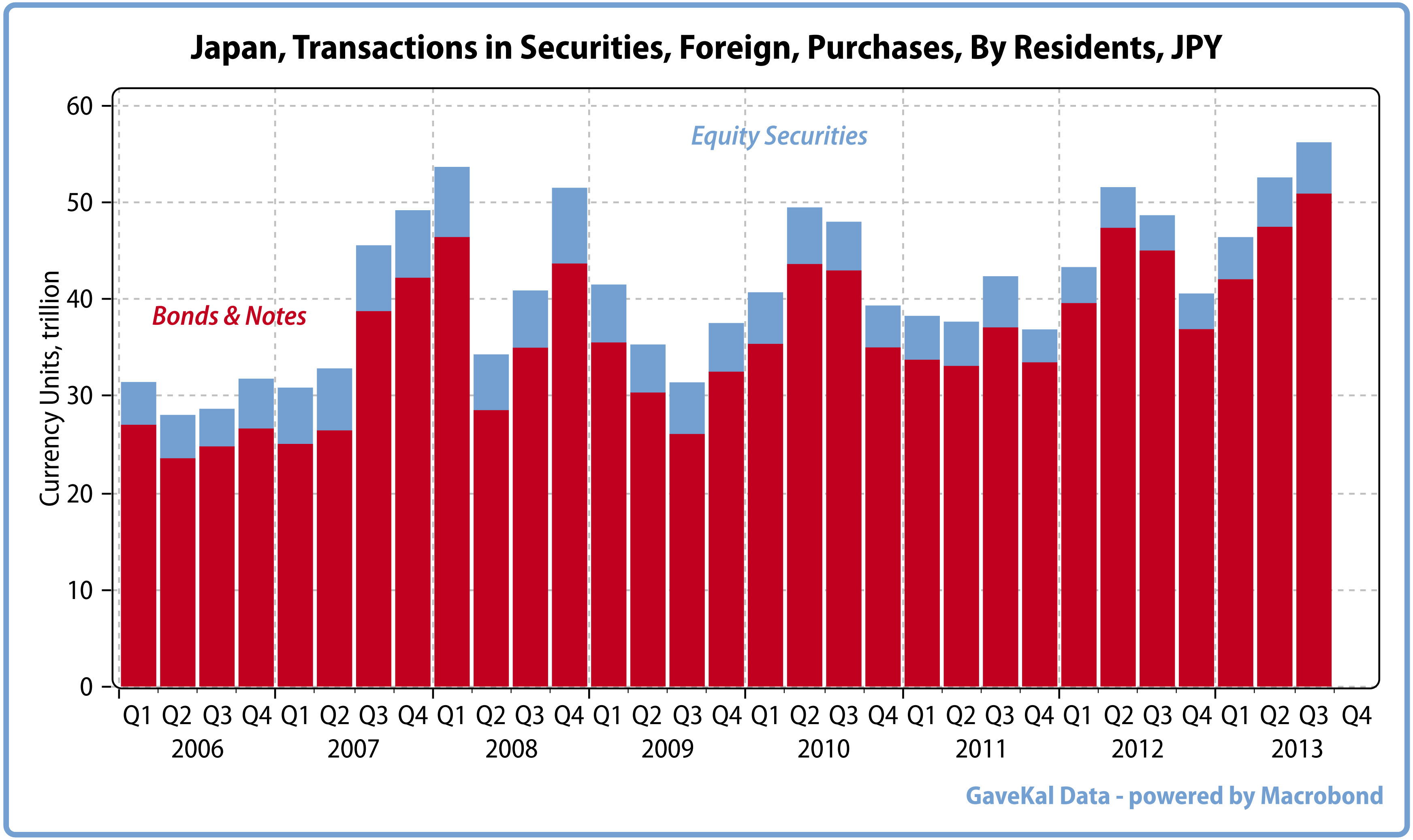
Source: Deutsche Bank, Bloomberg Finance LP ,

Where Japanese Outflows Go Matters



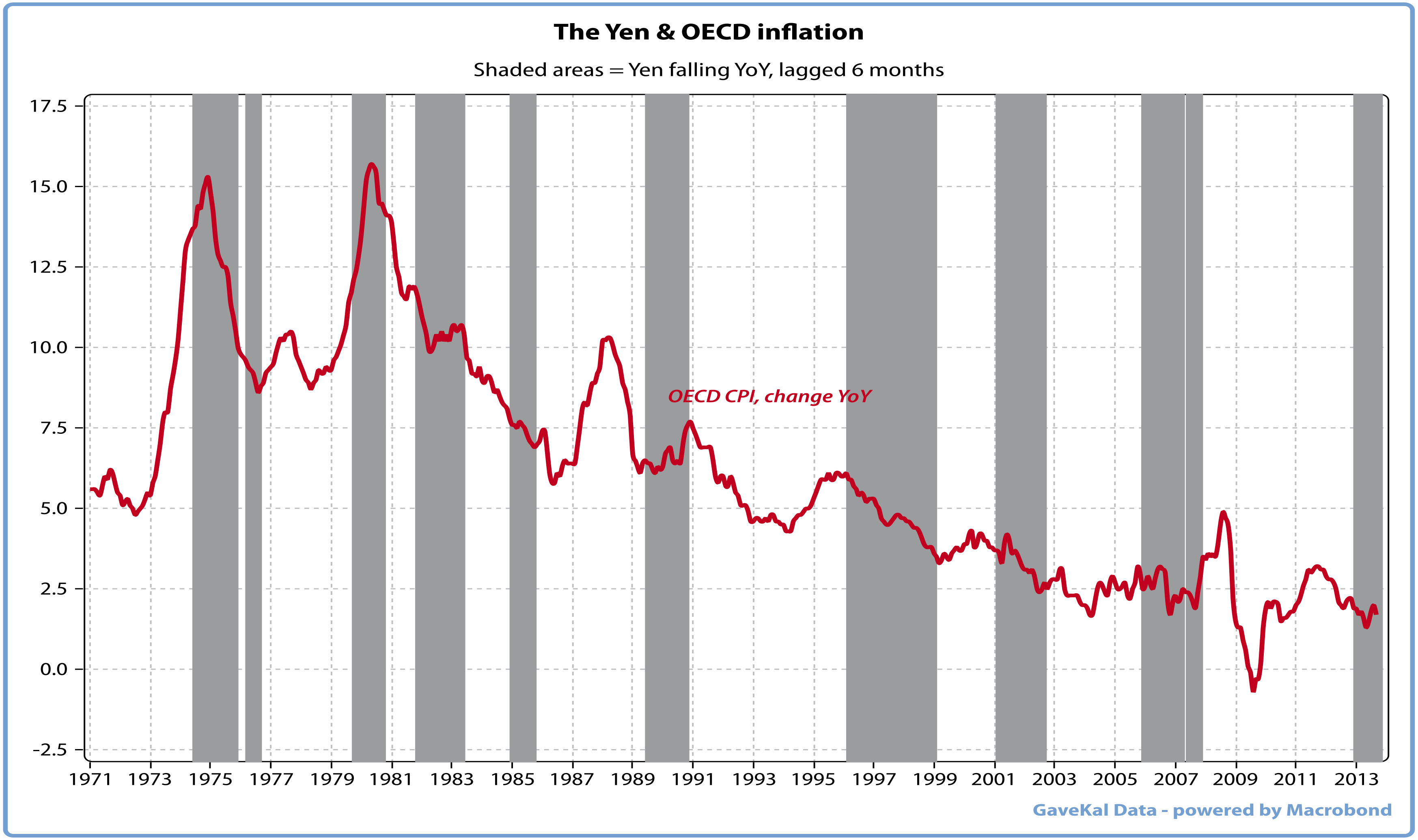
*Source: Deutsche Bank, Bloomberg Finance LP; *We calculate cumulative portfolio outflows from Japan to these countries divided by cumulative total portfolio inflows from respective statistical authorities*

So far, the exodus of Japanese capital has been marginal... But it could yet be a big theme for 2014!



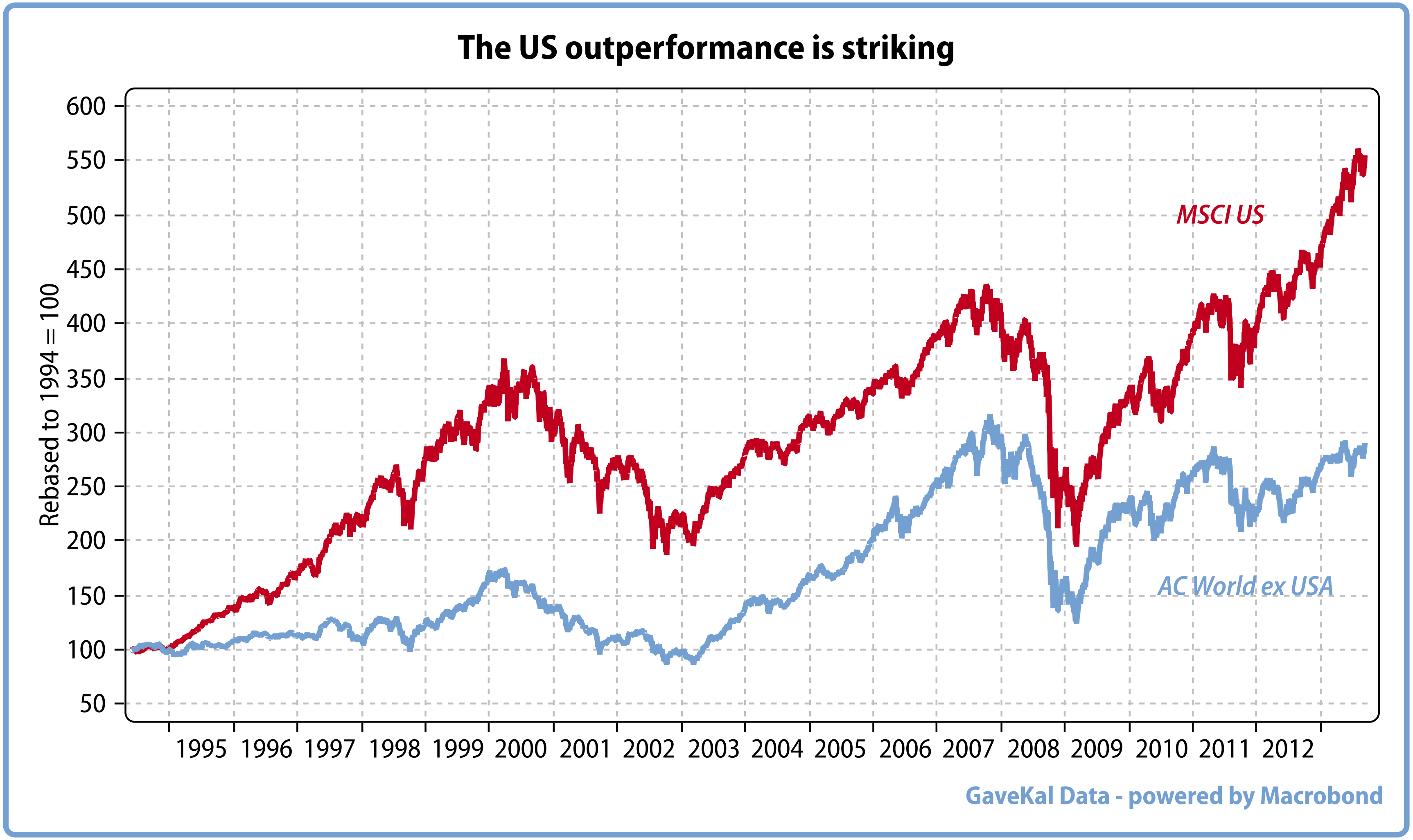
Source: GaveKal Capital Limited

Weak Yen periods are fundamentally deflationary



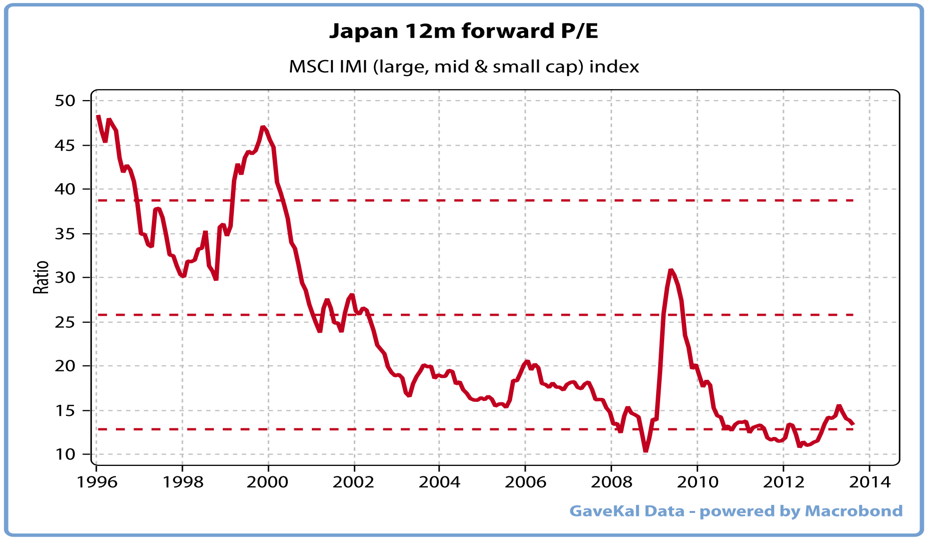
Source: GaveKal Capital Limited

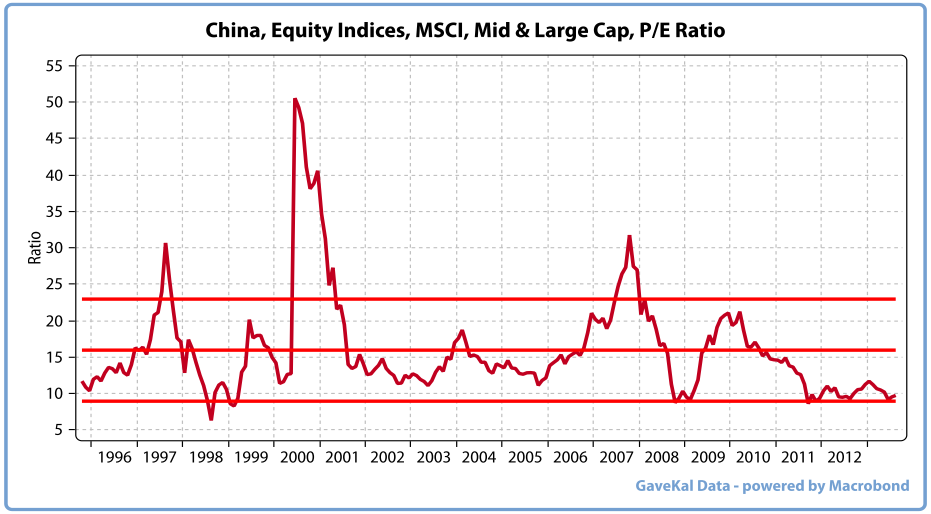
Momentum players will want to favour the US

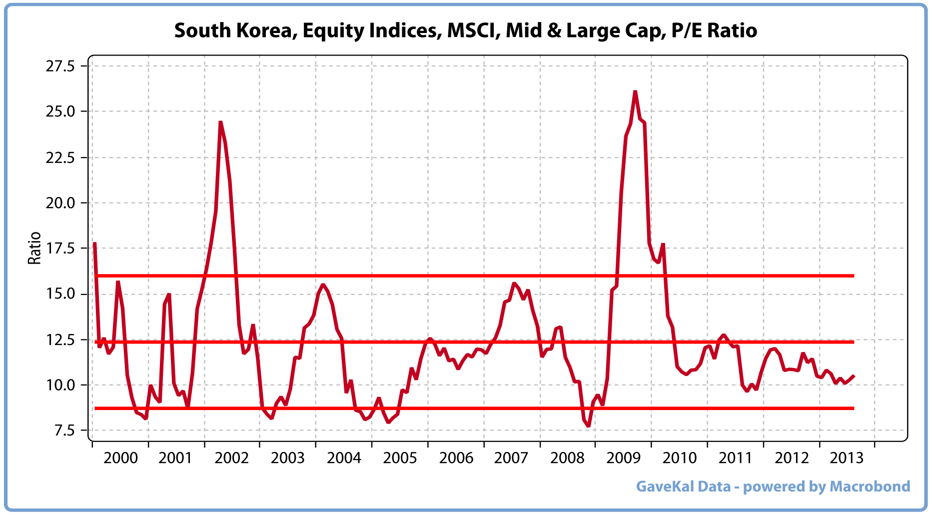


Source: GaveKal Capital Limited

But in Asia, most markets are now very attractively valued



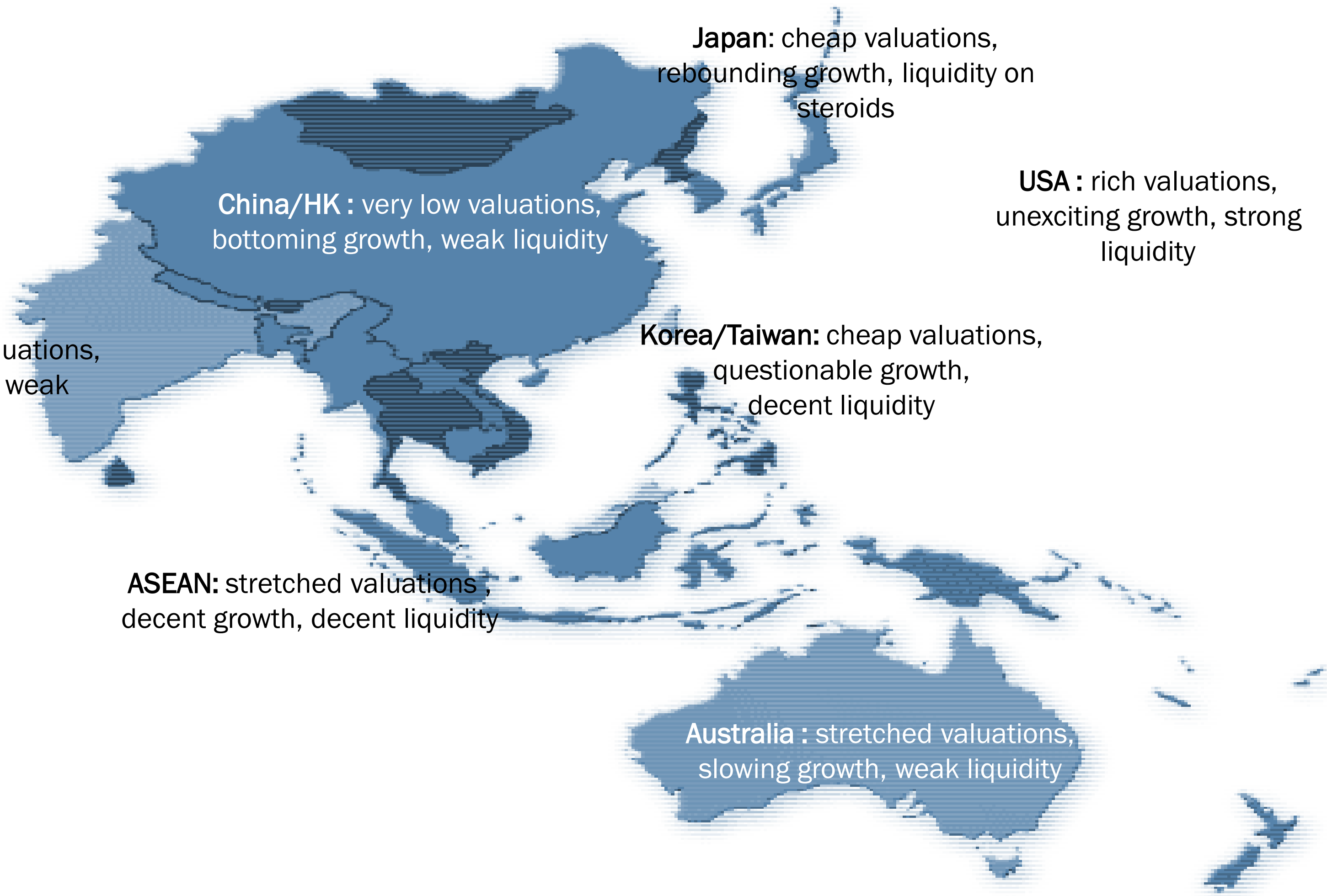




Where will Japanese savings go could be the big driver of 2014 performance

Europe cheap valuations, decent yield, lame growth, lame liquidity growth

USA : rich valuations, unexciting growth, strong liquidity



Source: GaveKal Capital Limited

Structuring a portfolio in this changing environment

Will Western equity markets remain the shelter in the storm? Three possible scenarios

Investors obviously feel that developed market equities will remain the best shelter in the storm. However, given the growing valuation gap, we are becoming uncomfortable with that assessment. After all, there are three ways to look at the valuation dichotomy.

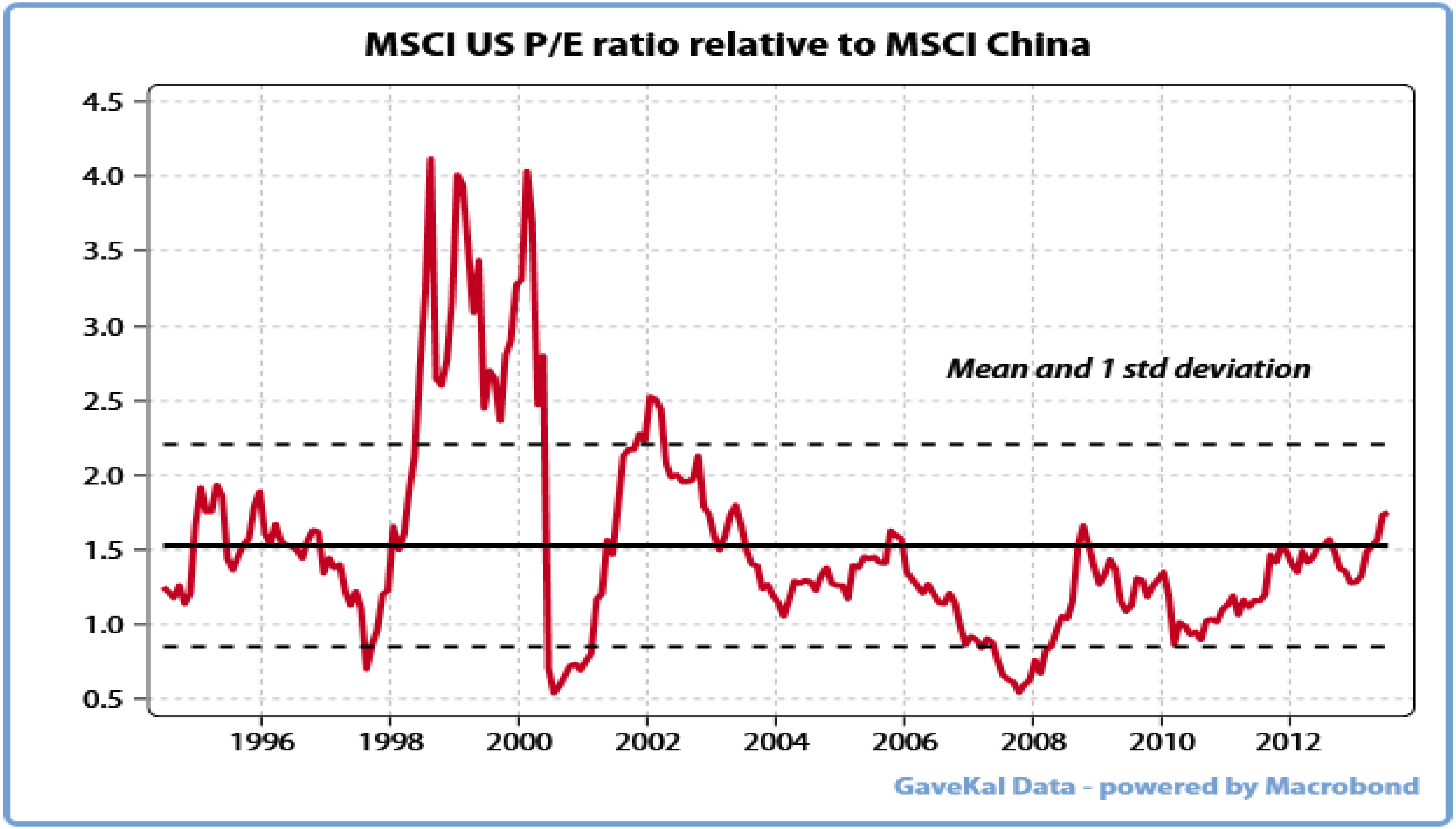
- The first is to say that the tailwinds to the Western economies (shale gas, robotics, ultra-easy monetary policies, fiscal and regulatory policy visibility…) are just so strong that the valuation gap between emerging markets and developed markets can only accelerate from here. In this scenario, one would want to continue buying developed market equities at the expense of almost anything else.

- The second is to say that, if developed economies really start growing as fast as Western equity markets are increasingly starting to discount, then we should not worry too much about an emerging market growth slowdown. Instead, **we should use the recent sell-off in EM growth stocks as a terrific opportunity to increase exposure to Asian and emerging market equities on the cheap**.

- The third, and more worrying conclusion would be that, while emerging markets are rightly discounting a growth slowdown, developed markets are not, probably because of the excess liquidity created by central banks. However, if/when the spigots get tightened and/or growth in developed markets is unable to build on the recent momentum, then the valuation gap might close not through a re-rating of emerging market equities, but a de-rating of developed markets. This latter possibility has to be a concern.

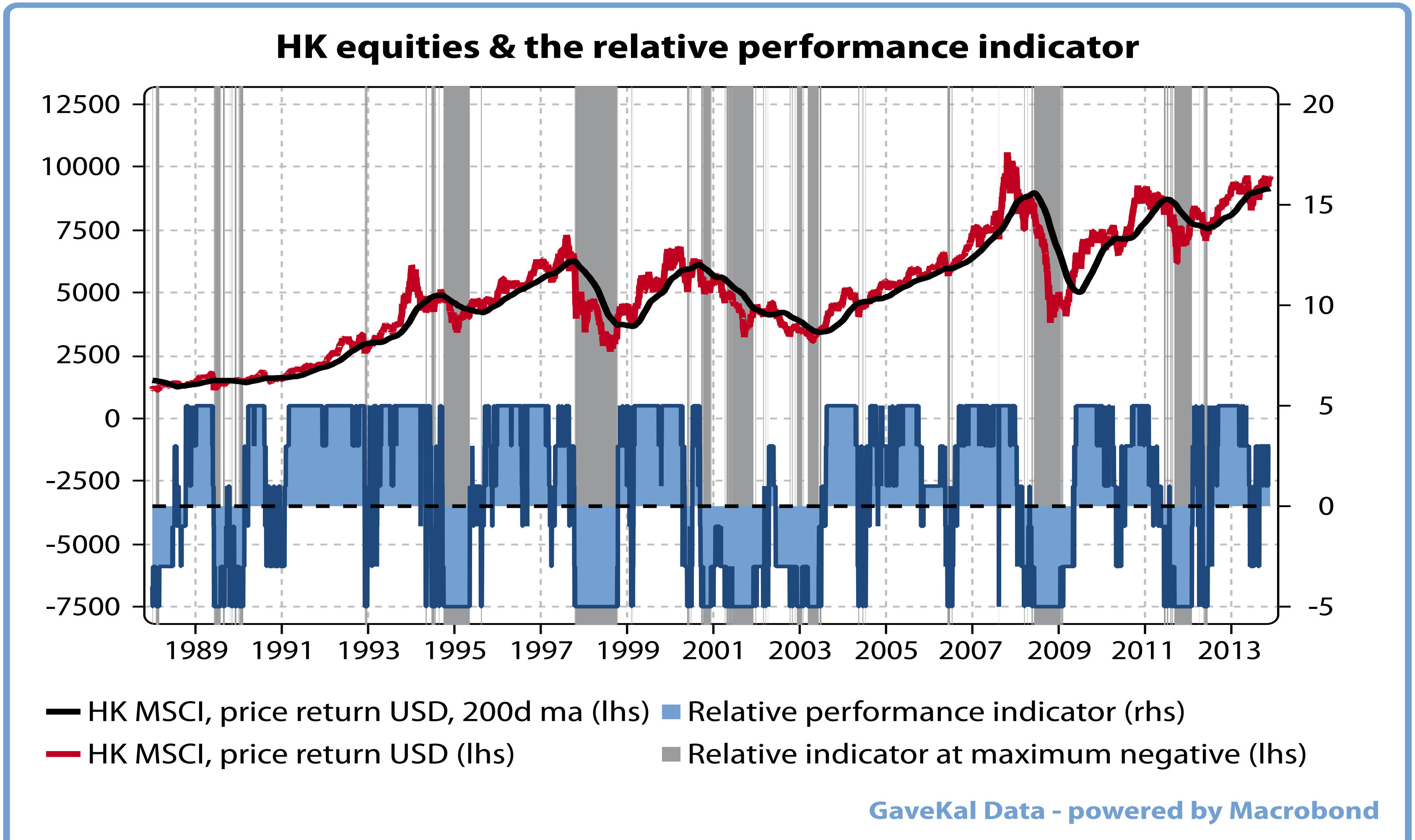
Source: GaveKal Capital Limited

Will the growing valuation gap close through US equities falling? Or Asian equities rising?



Source: GaveKal Capital Limited

What we need is for the momentum to stabilize – this seems to be happening



Structuring an Asian portfolio

- With US equities looking mildly overvalued, with Asia having underperformed for four years – and with the Fed set to withdraw domestic liquidity growth, moving away from US equity markets and towards Asian equities seems like an obvious choice.

- However, within Asia, one wants to focus on markets that have the least foreign liquidity constraints. Indeed, with the Fed set to taper and the US current account deficit shrinking, any market or economy dependent on the 'foreign dollar' to thrive will continue to struggle. As recent weeks have shown, that includes a good bit of ASEAN and India, but also potentially Australia, New Zealand and perhaps Taiwan or Korea

- Instead, one wants to focus on 'self-funded' markets, namely Japan (where liquidity growth continued to be strong), China (where valuations are back to record lows), Hong-Kong (whose structural tailwinds remain compelling)…

- Having said that, the recent sell-offs means that a number of quality blue-chip companies in some of the above 'stricken' markets are now selling at very compelling valuations. Even when the underlying companies have little to do with the domestic economies; this is the case, for example, of Samsung Electronics in South Korea, or HCL technologies in India.

Source: GaveKal Capital Limited

Appendices

Firm History

2001	GaveKal founded in London by Charles Gave, Anatole Kaletsky and Louis-Vincent Gave. The firm specializes in global economic and asset allocation research.
2002	GaveKal opens headquarters in Hong Kong
2003	Launch of the GaveKal Asian Balanced (Caymans) Fund, which seeks to capture the returns of Asia's accelerating growth through a highly diversified portfolio of pan-Asian equities, bonds and currencies.
2006	GaveKal Capital, LLC, a US registered investment advisor, opens office in Denver, Colorado.
	Alfred Ho and Marco Lai join GaveKal to help launch the Launch of GaveKal Asian Opportunities UCITS Fund. In time, the GaveKal Asian Balanced Fund is wound down and investors are invited to subscribe to the Asian Opportunities UCITS Fund.
	Launch of the GaveKal Platform Company UCITS Fund (Bloomberg: GAVPLAT), a global long-only equity fund that seeks to identify innovative companies that are profiting from the successful investment of intangible capital.
2007	Launch of the European Divergence Fund in a joint venture with Corriente Capital. The fund seeks to exploit the mispricing of credit risk among European Economic and Monetary Union sovereigns.
2008	With Marshall-Wace as a partner, GaveKal launches Marshall Wace GaveKal Asia Limited, a joint-venture company that manages the Asian Opportunities UCITS Fund and launches a Japanese equity market neutral hedge fund.
2010	GaveKal purchases Dragonomics, an independent research and advisory firm specializing in China's economy and its influence on Asia and the world. Arthur Kroeber, Dragonomics founder, becomes Head of Research for GaveKal.
2011	Launch in the US of the GaveKal Platform Company Mutual Fund advisor and institutional share classes (NASDAQ: GAVAX, GAVIX).
2012	Launch of the Asian Growth UCITS Fund & China Fixed Income UCITS Fund.
	GaveKal Platform Company Fund becomes GaveKal Knowledge Leaders Fund.
2013	Marshall-Wace and GaveKal jointly agree to unwind the JV with all staff and mandates involved in long-only products moving to GaveKal and the Japanese equity long-short strategies moving to Marshall-Wace.
	GaveKal launches the GaveKal Dynamic Futures UCITS fund.
	GaveKal launches the GaveKal Asian Value UCITS fund.

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For more information

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