Asia Newsletter

Will Asia Catch Europe's Cold?

By Jason Van Steenwyk

It's been a scary time for international investors. Greece is going up in flames – and not just figuratively speaking, alas. The fiscal conflagration in Europe potentially threatens the heart of the European Union and could potentially skewer the euro itself as a viable currency.

That hurts those who only have a half-way approach to diversification. If your idea of diversification into foreign assets is a 30 percent allocation to the MSCI, you aren't going to be a very happy camper, though you may get some temporary masking of the pain thanks to the depreciation of the dollar relative to other currencies, including the euro.

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A truly diversified portfolio, however, would contain a substantial allocation to Asia – which, thanks to the rapid growth in the Chinese economy, has anchored the global economy in recent years. Although the Asian economy is starting to slow, thanks to a period of anti-inflationary monetary tightening on the part of the regions' central banks, the case for Asia is powerful on both a technical and fundamental basis.

Correlations

A 2010 working paper from the Hong Kong Monetary Authority, bearing the somewhat dry title of "Dynamic Correlation Analysis of Financial Spillover to Asian and Latin American Markets in Global Financial Turmoil (Matthew S. Yiu, et. al), takes a look at the historical interrelation of the U.S., Latin American and Asian markets, including developments as recent as the Bear Stearns collapse of 2008 and subsequent collapse in risky asset prices. Their findings suggest that while there are global systemic risk factors in place that do cause risky assets worldwide to rise and fall in tandem to an extent, it seems to have more to do with the U.S. operating as the lynchpin of the global economy. The reason: While the authors found evidence of market contagion in Asia, historically, due to market events originating in the U.S., the reverse did not seem to be true: U.S. markets did not exhibit a significant negative reaction to market crises in Asia, provided that the Asian problems arose locally. More broadly, the authors found that advanced economies could drag emerging economies down with them; crises in emerging markets did not have the same effect on advanced economies.

Their findings did not explicitly include the European markets in their analysis, but we find the results encouraging nonetheless. While money is fungible, the Greek crisis – and the Irish, Spanish and

Portuguese crises lining up behind Greece – are still European issues, and are still left for the Europeans to solve among themselves.

Changes in Global Allocation Strategies

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The Fundamentalist View

It's encouraging to us to see that regional and emerging markets, other than the U.S., appear to have limited capacity to spread asset price collapses outside of their own back yards.

If anything, continued European difficulties may actually serve to enhance capital flows to Asian markets. The symptoms are technical – volume flees Europe but, dissatisfied with returns available in the debt-ridden U.S. – settles in Asia. But the root causes that should attract capital to the Asian Ex-Japan investment front are still fundamental:

- A strong savings rate across most of the Asian world. Savings rates range from 20.1% in the Philippines to 46.0% in Singapore to 54.0% in China compared to the US with a savings rate of 11.6%, according to data from Aberdeen Capital Management.
- A young population that will continue being productive for decades to come, even as demographics works against the U.S. and Europe.
- A labor market that is the most competitive in the world.
- A burgeoning middle class that accelerates demand for consumer goods and services
- Compelling valuations of about 10.7 times earnings in the Asia Pacific markets, ex-Japan. This is particularly favorable, when you compare the relatively conservative balance sheets of Asian corporations to the highly leveraged balance sheets in the west. Asian managers are still able to deliver strong returns on an equity basis.
- Forward-looking earnings are even more compelling, at 9.4x projected earnings, region wide, according to Khiem Do, Investment Manager of the Asia Pacific Fund, Inc.
- Expected growth rates of 6-8 percent in coming years, driven by expanding middle class populations. This makes Asia the fastest –growing economy in the world, according to Do.

While advanced economies can export financial shocks beyond their borders, emerging markets still have a harder time doing so – except where they can directly influence fuel prices. However, this doesn't apply to Europe, since Europe is a net importer of petroleum and not a net exporter. Our outlook for now is that the problems in Europe will have little effect on Asia, barring a general collapse that significantly affects demand for Asian exports. If this happens, the European problems do have a significant chance of spreading to the United States. As the Hong Kong Monetary Authority white paper shows, problems in the U.S. do have a proven ability to cause asset price declines in Asia. But a U.S. recovery is also proven to have a similar effect as well.

Meanwhile, as investors lose faith in the ability of the MSCI nations to manage their fiscal affairs, and as the U.S. Federal Reserve runs out of quantitative easing ammunition, we expect Asia to benefit by a massive shift in allocations by institutions all over the world. A few years ago, 5 percent was not an uncommon allocation to emerging Asian markets, pointed out Mounir Guen, founder of MVision Private Equity Advisors and a specialist in emerging markets investing. Now, institutions are in the process of recalibrating their allocations to emerging markets to 30 percent – much of which will find a nest in Asia. This represents a substantial flow of capital to the East, and should help support asset prices in Asia. If troubles mount in Europe, these capital flows should accelerate, supporting Asian asset prices and cushioning any contagion effects.

Anthony Michael, the head of fixed income investing in Asia and the Pacific for Aberdeen Asset Management, echoes Guen's sentiments: "Asia's bond markets are often regarded as a fringe market and a much misunderstood asset class by global investors," notes Michael. "Because of this, Aberdeen believes that many investment opportunities in the region have been overlooked." Meanwhile, even as western governments have been forced to increase their debt ceilings, Asian governments have been able to shore up their balance sheets. "Without a doubt, developing Asia is the place to be when considering the optimal risk-return profile," says Michael.

Currencies

A recent update, authored by Percival Stanion of Baring Asset Management, a leading player in regional closed end funds in Asia, noted that investors have been deserting foreign currencies in a flight to the safety of the dollar. This is a response to the short-term uncertainties in the European market, but it has affected Asian currencies as well. However, the underlying fundamentals have not changed. If anything, this development is favorable to new investors buying assets denominated in Asian currencies – whether they are stocks, sovereign debt, or anything else. Barings applauded the Indonesian government's move to shore up its currency. "As an asset class, the better debt dynamics of the region will prevail," writes Stanion.

Money talks: Barings' own portfolios are now "aggressively overweight" in Chinese equities, and in Asian emerging market currencies.

Agnes Deng, Investment Manager of the Greater China Fund Inc., a closed-end fund specializing in China, agrees with this positive stance towards China. "The Chinese economy continues to experience dynamic growth", comments Deng, "and 2011 has seen China surpass Japan to become the world's second-largest economy. The International Monetary Fund forecasts that Chinese economic growth will come in at 9.6% in 2011, followed by 9.5% in 2012. We continue to have a high level of conviction in the power of China's dynamic economy, with its enormous potential for transformation."

Conclusion

The bottom line: Yes, markets are global. And they will become more so. But there are still insulating factors between markets, which is a powerful argument for the value of global diversification. Finally, remember that the European problems are fundamentally driven by debt. Asia's biggest feature is strong balance sheets compared to Europe. Asian assets have strong arguments in their favor for investors, both from a fundamental and technical point of view. Our expectation in the long term: Asia is likely not going to be a victim of European debt woes, so long as exports continue, but the investors' antidote to them.