INTRODUCTION

ASIAN GROWTH DRIVING GLOBAL RECOVERY

The emerging Asian economies are leading the world out of recession, but valuations are not as generous as they once were, and so investors must be selective when choosing their allocations. Elisa Trovato reports

Emerging economies are undoubtedly leading the way out of recession, but the big question in every investor's mind is whether their recovery is sustainable or whether a correction of some kind is looming. "We need to see earnings that support these share prices," says Alex Tarver, product specialist, global emerging markets, at HSBC Global Asset Management. "If there is any sign that some of these rallies are not justified, there could be a small pull back, or a big pull back, more likely a pull back of some kind."

The MSCI emerging markets index jumped 85 per cent as at August 12, since reaching a four-year low on October 27 in 2008, outperforming the MSCI World Index, which increased by 39 per cent since November 20 last year, its lowest point during the same two-month period. The real driver behind emerging markets growth is Asia; recently released data from the four emerging Asian economies which have reported global gross domestic product (GDP) figures for the second quarter – China, Indonesia, South Korea and Singapore – show that these economies grew by an average annualised rate of more than 10 per cent.

These results are even more impressive when considering that the developed economies are still in a recession, although the Eurozone has shown initial signs of recovery as the region's two biggest economies, Germany and France, announced an unexpected growth of 0.3 per cent in the second quarter, after having each suffered four consecutive quarters of negative growth.

Recent estimates from the International Monetary Fund (IMF) indicate that, by 2013, emerging economies' contribution to GDP will overcome that of the developed countries, as it will grow from the current 48 per cent to 52 per cent. As a consequence, it is expected emerging markets will steadily increase their weight in terms of market capitalisation at global level.

"Markets are driven by strong economic and profit growth," says emerging world guru Mark Mobius, executive chairman of Templeton Asset Management, who oversees $25bn (€18 bn) of emerging market assets. "If a country has a strong economic growth, its companies will generate profits," he says.

"With markets like China, which is growing at 8 per cent, or India, growing at 6 per cent, Asia is top of our list," says Dr Mobius, emphasising that now that valuations are "a little rich" compared to late last year, stock-picking is more important than ever.

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Markets like Latin America, Eastern Europe or Russia, are also looking very interesting on an individual company basis, even if they are not growing as fast as Asia. "In some of these countries, companies are going out of business, and the strong companies can get market share," says Dr Mobius. "We are picking the survivors, those who have a strong balanced sheet and that are going to take market share."

In terms of sectors, consumer stocks look attractive. With rising per capita income and strong demand for consumer and other goods, the earnings growth outlook for these stocks is positive. "We want to get exposure to any company involved in services and products for the consumers; this includes consumer banking," he says.

Commodity stocks also look attractive. "With the tremendous increase in money supply that we are seeing globally, commodity prices will continue to remain high and maybe even go higher," says Dr Mobius.

Manpreet Gill, Asia strategist at Barclays Wealth in Singapore, believes that Asia is and will remain the most economically dynamic region in the world, both in the short and long term basis. But he also emphasises that it is important to be more selective. "We still like the region," says Mr Gill explaining that they have been overweight Asia ex-Japan equities since late March-April, "but on a relative valuation basis it is not cheap anymore; it is fairly valued but it is beginning to be slightly pricey."

China, for which Barclays Wealth expects a growth rate of 9.6 per cent in 2010, is one of the most attractive economies, for its strong growth rate and export side.

THE RISK OF CORRECTION

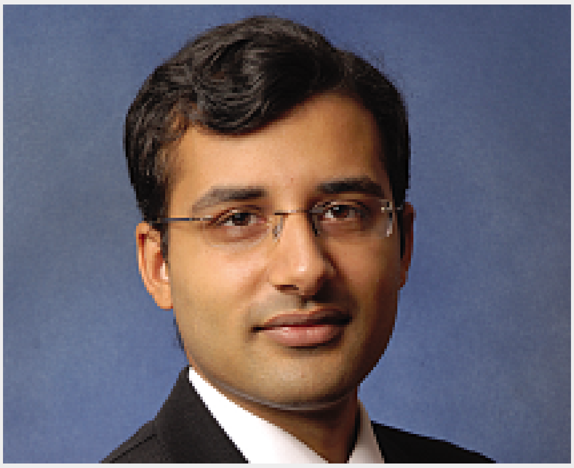
"We expect China to lead the world out into a recovery," he says, admitting though that the risk of correction there is closer than for any other markets. "A risk of correction is valid for the whole region, but we may see it coming a little sooner in China than anywhere else, because the economic data have been the strongest and the policies have been put in place the earliest in China than anywhere in the region, and also because it is one of the highest beta markets."

Mr Gill believes investors should not worry about it. "If and when they see the correction, they should use that to add an exposure, rather than worrying and take all their profits now and wait for a downturn," he says. "When you see markets go down, those are the days you should be buying because that allows to average at lower levels. This is a strategy that makes more sense, especially for private investors."

India is a much more domestic demand driven economy and less exposed to global export and it represents an interesting diversification angle in the portfolio, over and above long term growth forecasts, says Mr Gill. Singapore and Hong Kong are also appealing being extremely open economies. "If you are buying into the recovery and into the long term growth of the region, it makes sense to be invested in economies that have high beta exposure to the region," he says.

In terms of investment themes, Mr Gill suggests a focus on domestic consumption spending in China, which is less than 40 per cent of its GDP, compared to 65 per cent for the US. A rebalancing of China's economy towards greater domestic consumption is likely to occur, predicts Mr Gill. "This is not going to happen overnight but given China's track record to making large policies of changes, it could happen faster than anywhere else."

Infrastructure is a sustainable theme in Asia and it makes more sense today than ever both from the equity and the sector point of view. According to the Asian Development Bank, Asia needs overall infrastructure investments of approximately $8,290bn (€5,800bn) over the next 10 years. Importantly, most stimulus packages had infrastructure investments as the key focus, and in many cases they span the next couple of years.



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The relatively healthier government finances give Asian economies, and to a certain extent Latin American economies, more leeway to make beneficial structural changes. They are also sustained by strong consumer basis and trade balance surplus. "Emerging economies have more weapons to come out of the crisis than rich countries," says Mr Tarver at HSBC. "Bric countries [Brazil, Russia, India and China] are going to be the stronger ones in the longer term. But the best place to be at the moment is around Bric, in markets like Korea and Taiwan, as these countries are playing catch-up."

The more liquid Bric countries recovered quickly, says Mr Tarver. Even India and Russia which lagged a bit have both caught up, in India after the political elections, and in Russia thanks to the commodity rally. "In Korea, there are reasonably strong banks with good balance sheets, good management and good underlying models," says Mr Tarver. "The fascinating thing about emerging markets banks is that they grow organically, they don't need to borrow money to grow. Their lack of sophistication is a good thing."

As bilateral trade between Taiwan and China continues to strengthen, Taiwan's economy begins to recover and the outlook for domestic companies improves. Countries like Taiwan, Korea or China or India, which have a good industrial or technology basis, will benefit from the improvement, stabilisation or potential growth in the developed world, explains Mr Tarver.

In contrast with what appeared to be the analysts' consensus a few months ago, when the United States was thought to be the country that would lead the world out of the financial crisis, distributors are now looking to emerging markets to add risk in their clients' portfolios.

Roberta Gamba, head of Emea portfolio construction at JPMorgan private bank explains that the group's rebalancing of portfolios involved increasing the percentage of Asian equities in March. "For our managed accounts, we have taken three steps in the last few months all directed to increasing allocation to Asia ex Japan," she says.

In JPMorgan private bank, the strategic allocation to emerging markets/Asia ex Japan is, at this stage, 20-25 per cent of the equity allocation, depending on portfolios' risk profiles. In a balanced portfolio, which has a strategic exposure to equity of roughly 40 per cent, this implies an allocation of 6-8 per cent to emerging markets and Asia ex Japan, split between 2 per cent to emerging markets and between 4 and 6 per cent to Asia ex Japan. "We really think that the main driver behind all emerging markets' growth is going to be in Asia in the coming decades," says Ms Gamba.

In addition to in-house fund unit JPMorgan Asset Management, the private bank employs in clients' portfolios third-party asset managers both for emerging markets and Asia. These are selected by the London-based JPMorgan private bank's due diligence offshore team, which covers Europe, Asia, Middle East and Latin America."We choose the managers that best reflect our views," she says, explaining that the regions they like the most are Asia and Latin America, while they are still a bit sceptical on Eastern Europe. The core allocation both to emerging and Asian economies is a diversified one, says Ms Gamba, explaining that they may take specific views only on Bric economies, which are the biggest.

GREATER CHOICE

While the private bank in Emea tends to use only one manager for the global emerging markets, for Asia ex Japan a wider suite of products is available. "We have seven or eight managers for the region and we usually recommend two or three of them, as we don't want any of them to have more than 2 per cent portfolio allocation," she says.

But in the Far East, where investors tend to have a much higher allocation to their local markets, there is room for more flexibility. For Asian investors, current asset allocation to emerging markets/Asia ex Japan is about 40 per cent of their total equity exposure, as opposed to the 20-25 per cent in Europe. "Since their allocation is much higher, there is much scope to go granular and make a tactical move on a specific country," says Ms Gamba.

European clients are definitely less risk tolerant than their Asian counterparts, she says. The perception of risk for Asian or Middle Eastern investors is very different, because they live in very volatile and very risky countries, she says. "In Emea, we might get to 40 per cent of our equity exposure to be in emerging markets/Asia ex Japan, but it is going to be a slow process, because it needs education for the clients to become comfortable to the premium in volatility they get when investing in these regions." Nevertheless she predicts a further increase in strategic allocation to emerging markets at the end of the year at JPMorgan.

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Some emerging countries are very volatile and will remain such like Venezuela, says Ms Gamba. "But in the Bric economies structural changes are taking place. We would expect their equity markets to remain slightly more volatile than developed markets but not as much as we used to see in the past," she says.

This is also due to the fact that investors attitude to emerging markets has changed, believes Ms Gamba. In addition to being used for tactical overlays, Asia and the major emerging economies are now a more strategic allocation for investors, and this contributes to stabilise money flows and reduce the level of volatility. However – even if they have increased their weight significantly during 2009 in terms of stock market capitalisation, from 9.45 per cent of the MSCI All Country World Index at the end of 2008 to a little over 12 per cent in mid August – emerging economies remain small markets where small money flows in or out can still make a big impact.

"Investors tend to sell when markets are down and tend to buy when markets are up," that's the biggest mistake as nobody can tell when is the top of the market and when is the bottom," says Dr Mobius. "We strongly urge investors to average their investments, determine how much they want to invest and invest it over a one to four year period, a little bit each month, so they can catch the average prices going in," he says.

Over the longer term, bull markets last longer than bear markets and go up in percentage terms more than the markets go down, he explains. "If investors can be disciplined, they will be in much better shape."