

## Pacific Basin Market Overview – December 2011

For much of the fourth quarter of 2011, anxiety surrounding the ongoing European sovereign debt crisis has kept the Pacific Basin equity markets largely range bound, although most indices managed to trend higher from their October lows with the help of unexpectedly buoyant economic data from the U.S. The MSCI AC Asia Pacific Free Index including Japan gained 0.66% and the MSCI AC Asia Pacific ex Japan Free Index gained 3.96%, resulting in declines of 17.31% and 17.98%, respectively, for the full year.

Japanese equities extended their losses, declining for a third consecutive quarter in the October-December period. The Tokyo Stock Price Index (TOPIX) eventually closed 3.7% lower in local currency terms for the fourth quarter of 2011, after fluctuating widely in reaction to some erratic shifts in investor risk tolerance. A series of positive economic indicators from the U.S. helped to mitigate some of the initial unease about global growth, while an agreement among European governments on measures to tackle the debt crisis also helped the Japanese market to rebound in November. The equity market sell-off resumed when speculators started to shift towards other financially vulnerable Euro zone states such as Italy and Spain, forcing their government bond yields up to unsustainable levels. Downward revisions to corporate earnings projections by Japanese companies that are suffering amid the protracted strength of the yen undermined market sentiment too, despite intervention by the Japanese authorities in the currency markets. An agreement among the main central banks to coordinate action to avert a liquidity crisis, together with solid economic numbers from the U.S., led to a rebound in the TOPIX in early December, but the market later became top-heavy toward the end the quarter along with the yen's appreciation against both the U.S. dollar and the Euro.

Japanese economic indicators reflected the negative impact of the output disruption caused by the flooding in Thailand, faltering European demand and weaker domestic demand. Industrial production data was unexpectedly weak, declining by 2.6% month-over-month (mom) as the flooding in Thailand temporarily disrupted output. In contrast, the survey of production forecasts suggested a solid recovery from the temporary decline in November, with a sustained rebound of +4.8% (mom) in December and +3.4% (mom) in January. European austerity measures and supply chain disruption were reflected in the trade figures too. Nominal exports in November posted a second consecutive monthly decline, decreasing by 4.5% year-over-year (yoy) after a 3.7% decline in October, as demand for major export product categories such as automobiles, electronics and machinery diminished. In the meantime, domestic demand has continued to stagnate. Real consumer spending in November declined for the ninth month in a row, shrinking by 3.2% (yoy). This unexpectedly large drop was partly attributed to the end of temporary policy measures, such as subsidies for the purchase of fuel efficient cars and home appliances. Also, the core Consumer Price Index in November continued to decline at a rate of -0.2% (yoy).

Many companies have reduced their earnings forecasts during the review period due to the strengthening yen and uncertainty about overseas economic conditions. In this context, performances were subdued across all sectors during the quarter. Softer equity markets and sovereign debt woes in the Euro zone particularly weighed on the Financials. In contrast, the defensive Communication sector was stable amid the market downturn. The Capital Goods sector outperformed too as large-cap stocks rallied in October following the massive sell-offs during the previous quarter.

The MSCI China Index outperformed the region, gaining 8.1% during the period as foreign investors welcomed the cut in the Reserve Requirement Ratio. On the other hand, China's A-share index extended its decline, as mainland investors became more concerned about the weak property market. China's Purchasing Managers' Index dropped to 49 in November from 50.4 in October, with the sub-index of new orders sliding to just 47.8 from 50, which is the first contraction since February 2009. Along with expectations of further monetary easing, the Financial sector led the gains (+17.3%) while Healthcare (-11.1%) and Telecommunications (-2.0%) lagged behind due to further price cuts and investors' disposal of defensive stocks. In Hong Kong (+5.7%), the Industrials (+11.3%) and Technology (+17%) sectors led the gains. Freight rates surged due to greater cooperation and partnership among carriers. Consumer discretionary stocks, which include gaming stocks, also performed well.

The MSCI India Index (-14.3%) was the worst-performing market in Asia against a backdrop of rising oil prices coupled with policy inaction. Industrials caused the biggest drag on the index, declining 35%, while the best performing sector was Information Technology (+1.5%). In Australia, the MSCI Index gained 6.5%. Outperforming sectors included Healthcare (+14.4%), Telecommunication Services (+13.3%), Industrials (+11.5%) and Financials (+9%). Meanwhile, Consumer Staples (+2.8%) and Materials (+2.4%) underperformed relative to the market.

In Korea, the benchmark gained 5.9%, largely due to gains in the Technology sector. Large cap technology stocks outperformed the index as quarterly earnings are likely to exceed consensus expectations. The death of North Korean leader Kim Jong-il on the morning of December 17 caused the index to decrease 3.4% on the following Monday. Financials pulled the index lower along with Consumer Discretionary stocks. On the other hand, export dependent Taiwan (-0.4%) underperformed the region, weighed down by the Financials (-4.4%) and Materials (-2.4%) sectors.

Most markets in the ASEAN (The Association of Southeast Asian Nations) region outperformed, with the exception of Singapore (-1.6%). Thailand (+11.5%), Malaysia (+10.8%), the Philippines (+6.8%) and Indonesia (+5.4%) all rallied during the fourth quarter. Property stocks with residential exposure were undermined by more government policy measures, this time aimed at dampening foreign demand. Thailand's outperformance was driven by energy names as oil prices surged.

## Market Outlook and Strategy

During what has turned out to be an extremely difficult year for investors in 2011, we correctly maintained a cautious attitude towards both the OECD (Organization for Economic Co-operation and Development) growth prospects and the major equity markets. At the same time, we presumed that the superior fundamentals of the Asia Pacific region would help to insulate these equity markets from the global turbulence. As it turned out, we were overly sanguine about the prospects for the Asia Pacific in general, and many of these markets performed worse than the developed regions.

However, at the risk of once again erring on the side of too much optimism, we will uphold our relatively constructive outlook for regional stock markets over the next few months.

The global economic outlook is still difficult. We believe Europe will experience weak growth and there is still a possibility that peripheral countries might be unable to refinance their sovereign debt at acceptable interest rates. Action by the European Central Bank is encouraging, however, and this might have bought some time by providing massive quantities of low cost funding to the Banking sector. This should help to maintain bank solvency and should also provide them with incentives to purchase new Government bond issues. Meanwhile the outlook for the U.S. economy has brightened considerably in recent months, with employment growth accelerating and industrial production turning positive.

Growth is slowing in the Asia Pacific region, especially in the export and manufacturing related sectors. However, this can be viewed positively given that it is very quickly alleviating the region's inflationary pressures and allowing most governments to begin the process of policy loosening. In our judgment, equity market fundamentals are becoming more supportive, especially now that the negative global environment is already widely recognized and already priced in.

Despite the volatile environment, our country strategy has been consistent and we see few reasons to make any substantive changes. The economic backdrop is obviously problematic, but, in our opinion, markets already reflect the more negative scenarios. We will maintain overweight positions in the smaller ASEAN markets of Indonesia, Thailand and the Philippines. As we have stated a number of times, these countries have large populations but lie at a relatively early stage of economic development. As such, they are more insulated than other countries from the global economic gyrations, while domestic consumption will be one of the main determinants of economic growth and stock market returns going forward. Although it is tempting to take profits, we believe their valuations are still reasonable and their longer-term secular growth prospects are sustainable.

We will also keep the overweight exposure to Korea. This market succumbed to a wave of foreign selling in 2011 given its perceived gearing to global growth. While this is still a valid issue, our view

remains that Korean companies have diversified sales to the strongly growing emerging economies. They have also garnered market share in a number of industries such as motor vehicles, shipbuilding, engineering, and telecom equipment.

Our key strategic underweight position remains Chinese companies. We acknowledge that this has become more of a consensus position and therefore some of the negative issues are now being priced into this market. Moreover, it appears that the authorities are beginning to consider loosening monetary policy given the easing of inflationary pressure. Continued volatility and short-term rallies are therefore a possibility. Nevertheless, valuations are still not attractive enough to compensate for the risks involved in owning Chinese companies. Our broad view remains that the Chinese economy may achieve a soft landing, but we can capitalize on this better through positions in Australian resource companies, Korean exporters, and Taiwanese listed stocks with Mainland operations.

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*MSCI AC Asia Pacific ex Japan Index is an unmanaged free float-adjusted market capitalization index that is designed to measure the equity market performance in the Asia Pacific region excluding*

*Japan. The Tokyo Stock Exchange Price Index (TOPIX) is an unmanaged capitalization weighted measure (adjusted in U.S. dollars) of all shares listed on the first section of the Tokyo Stock Exchange. One cannot invest directly in an index. P/B ratio is a ratio used to compare a stock's market value to its book value. Book value is the total asset of a company minus total liability.*

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