

Emerging Asia: Cyclical Lifts Reinforce Secular Supports

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The ongoing economic rebound in Emerging Asia can be characterized as nothing short of spectacular. For 2009 as a whole, the region's gross domestic product (GDP) is currently poised to expand 6.2%, which would represent a record outperformance of almost ten percentage points over the growth in developed economies, according to the latest International Monetary Fund (IMF) projections (Chart 1). The output is all the more intriguing in light of the prevailing notion that exports currently remain the linchpin of the region's growth prospects. An extended period of sluggish output in developed economies was supposed to exert considerable drag on growth in Emerging Asia, as was the case in previous global economic downturns. So why was the prognosis so wrong this time?

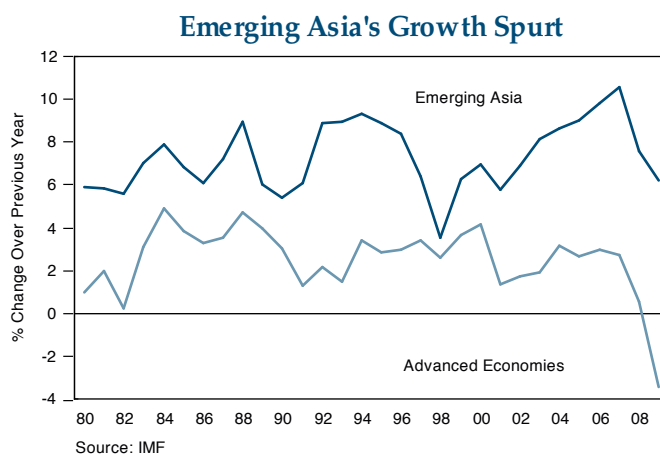


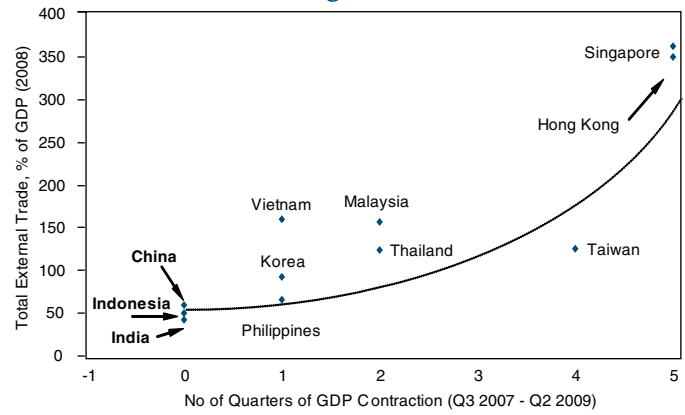
Chart 1

One possible explanation is that the Emerging Asian region may be less homogeneous than is widely perceived, rendering broad-brush conjectures inadequate, if not misleading. In this regard, we find it instructive to look into individual country performance over the past two years. Chart 2 shows a scatter plot comparing the number of quarters of GDP decline against the dominance of external trade for each country.

Understandably, Hong Kong and Singapore, both small and highly open economies, were most vulnerable to the vagaries of global demand. But one can make a few other interesting observations.

1. GDP in the region's large economies – China, India and Indonesia – did not experience outright contraction in any quarter over the data period.
2. Five economies – Hong Kong, Malaysia, Singapore, Taiwan and Thailand – experienced technical recession, which is normally defined as two or more consecutive periods of quarter-on-quarter of GDP decline.
3. By the second quarter of 2009, the entire region had swung back to expansion mode.

A Heterogenous Asian Bloc

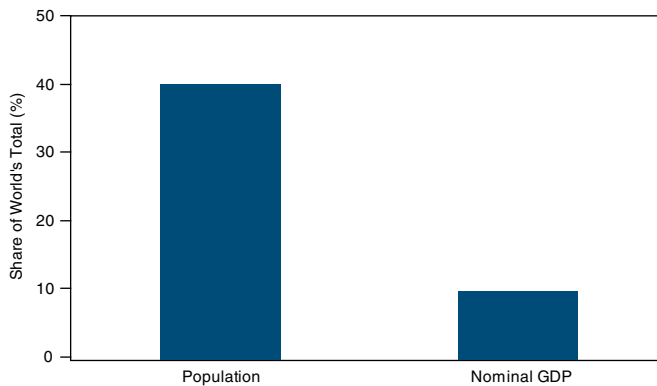


Source: JPMorgan

Chart 2

India, China and Indonesia (“ICI”) possess several similar traits. All three currently rank within the top five of the world’s most populated nations. It is not surprising that they navigated the global crisis relatively unscathed, as domestic demand, underpinned by the large population, effectively provided a cushion. Together, they account for two-fifths of the world’s population (Chart 3). Yet their combined GDP is currently just 10% of the world’s total. Nevertheless, if governments of these countries can implement the right macroeconomic policies, potential growth projections for the ICI countries should be encouraging, given that supportive supply factors are reinforced by an emerging middle class, a relatively youthful population and a rapid pace of urbanization.

India + China + Indonesia



Source: World Bank Group data for year 2008

Chart 3

More generally, a greater need for intraregional differentiation of economic structure underscores the evolving secular maturation of individual economies. While almost exclusively dependent on exports in the past, the growth drivers for the region's large economies have in fact been shifting – albeit gradually – in favor of domestic sources of demand, notably investment. This secular trend received a cyclical lift in the past year, as policymakers around the world acted aggressively in response to the global credit crisis, implementing economic stimulus spending as well as easing monetary policy.

Emerging Asia entered the crisis from a position of strength, thanks in large part to the hard lessons learned only a decade ago in the Asian currency crisis. Prior to the Lehman Brothers collapse, macroeconomic policies were progressively tightened to contain market excesses. In the three years

to September 2008, the People's Bank of China increased the required reserve ratio by a whopping ten percentage points to an all-time high of 17.5% (as of September 2008). Over the same period, the Reserve Bank of India and Bank of Korea raised their benchmark rates by 300 basis points and 200 basis points respectively to respond to the concern of economies overheating. As it turned out, the early tightening provided the scope for subsequent monetary easing.

On the fiscal policy front, most Asian countries had the “will and wallet” to spend. This was an outcome of underspending in the earlier years, given the need to counter overheating risks. In China's case, the infrastructure-centered stimulus package of CNY4 trillion (\$588 billion USD) in November 2008 was both timely and necessary for longer-term productivity gains. Undoubtedly, concerns have been raised over potential economic wastage. The reality, however, is that China's infrastructure needs remain massive, especially in the less developed hinterland regions. The lack of a comprehensive and modern rail network presents a case in point. The total route length of China's rails is barely one-third that of the European Union, despite the fact that China is more than twice as big in geographical size, and has a population that is close to three times that of the E.U.

Arguably, policymakers across the region appear less enthusiastic when it comes to stoking consumption demand through exchange rate appreciation. While this smacks of mercantilist inclinations, one needs to distinguish policy intent from the evolving economic reality. Since early this year, China has overtaken the U.S. as the largest market for autos. Its presence is rapidly growing in a similar way in the luxury goods market. According to industry reports, China has overtaken the U.S. in total consumption of luxury goods, and is poised to exceed Japan to be the world's largest consumer of luxury goods by 2010. China also has the highest number of internet users; this will likely have a positive effect on PC demand. Based on projections by Airbus, the Asia-Pacific region will account for close to 30% of new passenger aircraft orders over the next two decades, outstripping both North America and Europe.

The dominance of industrial countries is winding down and the global economic field is becoming more level. As Chart 4 highlights, the GDP spread of G20 members has become steadily less concentrated since the turn of this decade, with the G7 share declining to less than 70% from a peak of close to 83%. True, Emerging Asia will likely continue to be sensitive to business cycles in

developed economies. However, a growth strategy that is based solely on latching on to G7 export demand may be less effective than in the past. Simply put, Emerging Asia must learn to view itself as more of a customer, and less of a producer. We believe policymakers in Emerging Asia will, over time, warm to the benefit of currency gains in boosting households' real spending power.

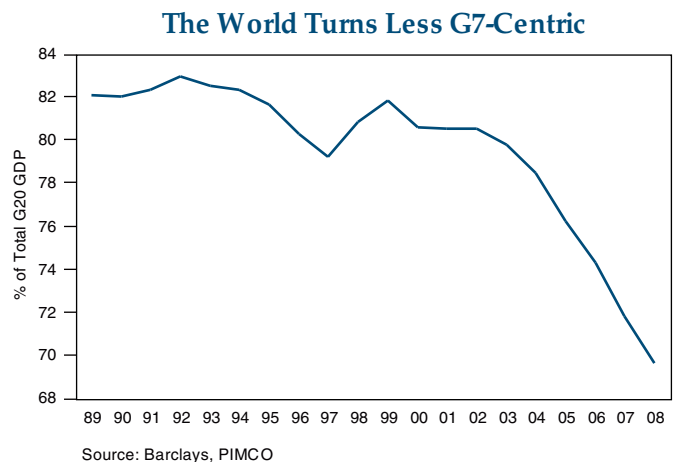


Chart 4

Given our positive view on Emerging Asia, we are attracted by a growing range of investment opportunities.

In U.S. dollar-denominated bonds, we think A-rated credits issued by Korean quasi-sovereign entities have the potential to offer value. The recent restraint on offshore debt issuance should mitigate the supply overhang of Korean issues and encourage bond spreads to converge toward their peer group

levels. We also believe Indonesia (Ba2/BB-/BB) has a good chance to regain its investment grade status over the next three to five years, provided that macroeconomic policies continue to be aimed at bolstering its long-term growth potential. Selected high yield corporate credits across the region that stand to benefit from the secular rise of China, notably the commodity players, present interesting opportunities.

In the local currency space, Emerging Asian currencies should gain significantly on the back of the secular decline of the U.S. dollar. Most will likely benefit from a return of generalized risk appetite. The Chinese yuan and Korean won appear undervalued versus their underlying fundamentals, while the odds that Singapore resumes its currency appreciation to control imported inflation have risen.

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¹ Based on estimates from World Luxury Association and British consulting firm OC&C

² Indonesia was rated Baa3/BBB/BBB- (Moody's/S&P/Fitch) prior to the onset of the 1997-1998 Asian crisis.

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