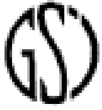


The Issues

October 3, 2010

ASEAN TIGERS

ASEAN stock markets have been star performers in Asia-Pacific YTD. Our regional funds are heavily exposed, with nearly half the assets invested in this subregion. How long will the rally last? Is the outperformance due to the flow of funds into ASEAN stocks because China is taking a (temporary) pause? Or do these rallies have legs, driven by longer-lasting fundamentals? This month's *Issues* addresses how long we believe the rallies in ASEAN bourses may last.

Tiger Economies in the Early 1990s

Japan was the "new-kid-on-the-block" wonder of the developed world in the 1970s and 1980s, with strong trade surpluses and high GDP growth. Forced by the U.S. to revalue, the yen strengthened from 240 to the dollar in 1982 to 130 by 1989. Fund flows into Japan fueled a major asset bubble, which ended in a spectacular burst in 1989.

In the aftermath of Japan's debacle, global funds in search of the next growth wonder in Asia gave the nickname "Tiger Economy" to fast-growing economies such as Taiwan, China and South Korea. In 1993 Barton Biggs, the strategist at Morgan Stanley, infamously declared himself to be "maximum bullish on China/Hong Kong." The Tiger Club expanded in the early 1990s—after uncertainties about the oil crisis of 1990 and Desert Storm (to free Kuwait from Iraq's invasion) dissipated—to include Indonesia, Singapore, Malaysia and Thailand (ASEAN-4). With the injection of large amounts of foreign investment capital, these ASEAN economies grew substantially, well past the mid-1990s.

A proliferation of mutual funds named "Asian Growth," "Asian Tiger" and "Asian Opportunities" were launched during the early 1990s. Rallies in ASEAN-4 bourses built up momentum during 2002. Then the avalanche of money flows in 2003 drove these stock markets up 2x to 3x (Chart 1).

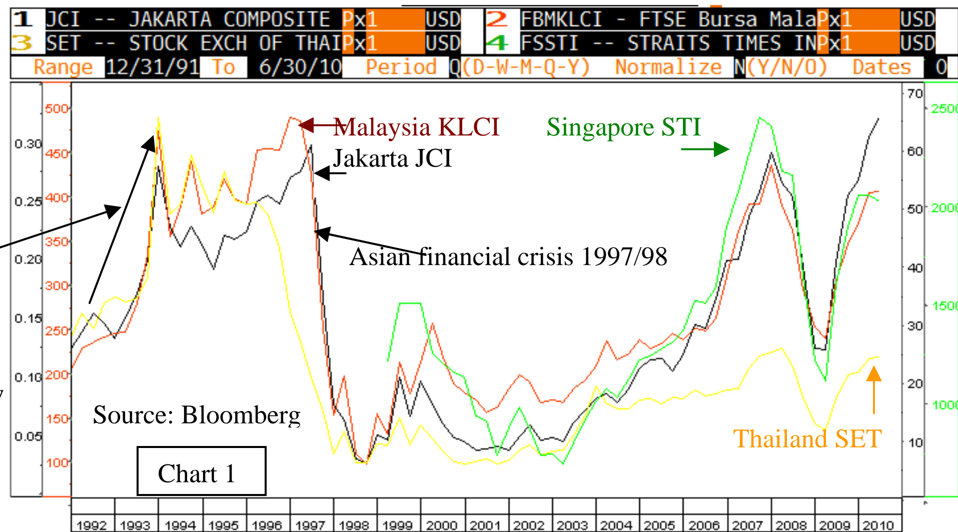


Chart 1

The crowning fund launch was the Asian Tiger Fund listing on the New York Stock Exchange at the end of 1993. Asian bourses peaked in early 1994 followed by volatile moves that made no headway up to 1997.

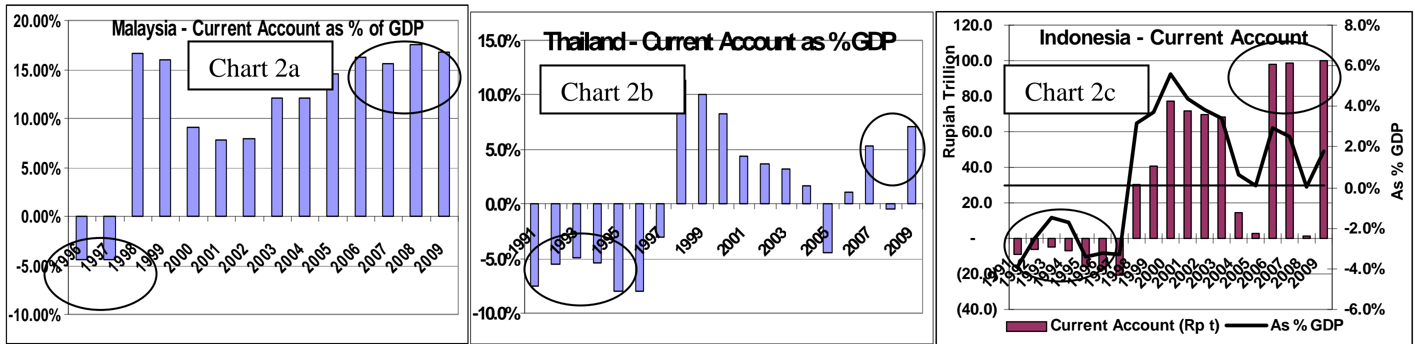
Markets were constrained by expanding current account deficits (Chart 2 series) from rising import demand as these economies embarked on investment and spending up-cycles (Chart 4 series). Thanks to fixed exchange rate regimes at the time, interest rates were lower than inflation in a number of places. Negative interest rates added fuel to the boom. By the end of 1993, a combination of large current account deficits (funded by expanding external debt) and rising inflationary pressures caused formidable clouds to overhang all ASEAN-4 bourses.

By 2007, thanks to deregulation of capital markets in the region, hedge funds were able to borrow huge amounts of baht to attack the Thai currency, forcing a large devaluation. That event was the catalyst for a domino contagion of spreading currency attacks. As foreign creditors withdrew funding, the financial crisis jumped from one over-indebted Asian economy to the next over 1997-1998. The damage was so severe that the Tigers in ASEAN-4 went into a crouch over the next decade. It was not until the global equity boom in 2007 that some of these bourses challenged the pre-crisis levels of 1997 (Chart 1). Interestingly, Thailand's SET is still substantially below its 1997 peak.

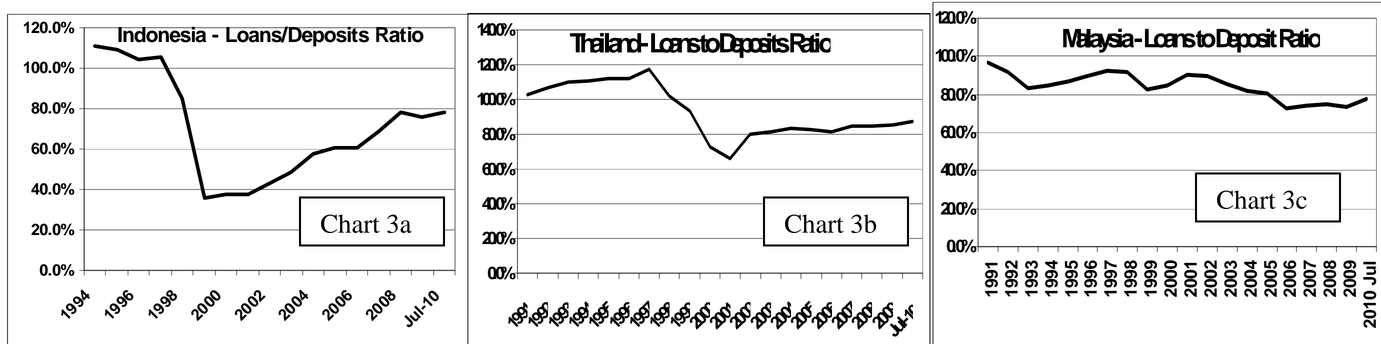
Trends in Current Accounts, Bank Liquidity and the *Investment Cycle*

As the following Charts 2 to 4 show, current accounts, fixed investments and bank liquidity in Indonesia, Malaysia and Thailand in 2010 are in a completely opposite situation compared with the early 1990s.

Current Accounts in Surpluses for Consecutive Years (as opposed to deficits—Chart 2 series) .



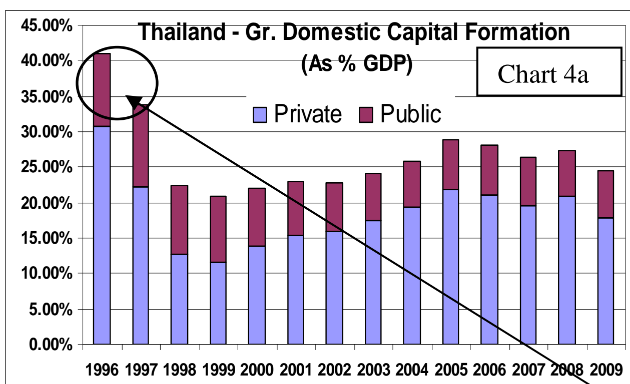
→ **Plentiful Liquidity in Banking Systems** (trend decline in loans-to-deposits ratios—Chart 3 series)

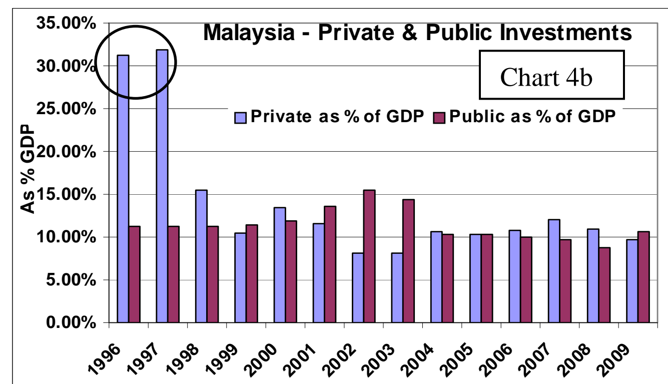


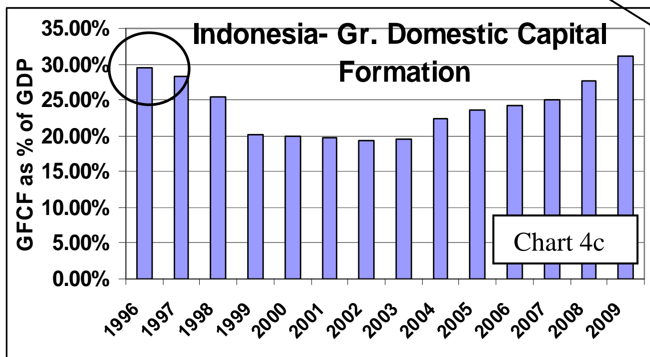
Sources Charts 2-4: Bank of Thailand, Bank Negara, Indonesia, Bank Negara Malaysia.

Investment Cycles Now on Cyclical Upturn (Chart 4 series)

Stock Market Level = Liquidity x Confidence: The **sweet spot of a bull market run** comes when an economy is enjoying a mix of plentiful liquidity and the early phase of an uptrend in the investment (and thus business) cycle on rising domestic confidence. These ASEAN bourses are currently at various points in this sweet spot.







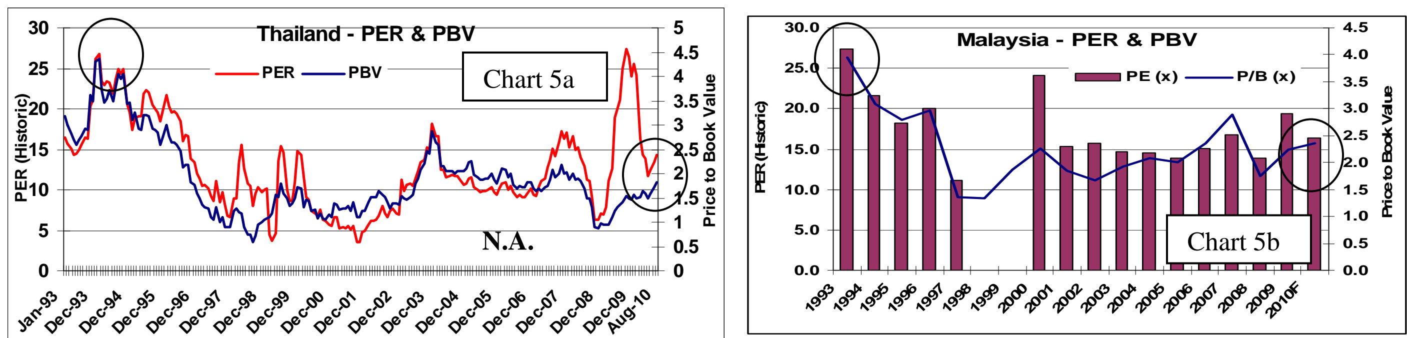
Last major ASEAN investment cycle: mid-1990s.

Indonesia had the earliest investment cycle upturn in ASEAN thanks to **sound government policy moves**.

Jakarta was the best performer in 2009 and YTD 2010.

Example of what can happen in other ASEAN bourses—if governments pursue the right policies.

PER and PBV Valuations Not Expensive, well below their hot Tiger Economy days of 1992-93. (Chart 5 series)



Sources Chart 5 series: Stock Exchanges of Thailand and Kuala Lumpur.

Technical Signals—Flow of Funds

In 2003, driven by the Tiger Economy momentum theme, massive foreign fund inflows fueled a dramatic rally, doubling to trebling the index levels of ASEAN-4 markets. By comparison, foreign funds' participation so far in 2010 has been muted. Momentum runs are theme driven, and no ASEAN theme is being brandished by investment banks at present.

Conditions in 2010 are comparable to 1992—markets edging up, gaining double-digits stealth-like, over time, as overall sentiment remains constrained by languishing concerns over global growth: in 2010, by the global financial crisis-induced recession of 2008-09, and in 1992 by the oil shock-driven recession of 1990-91.

But a key difference now is that locals have been the drivers behind rallies in Indonesia, Thailand and Malaysia. Locals bought in the depth of the red-shirt protests in May, while foreigners sold and led the Thai market rally. Foreigners have been leaving Malaysia for years. Locals alone have driven the double-digit gains on Malaysia's KLCI thus far in 2010.

These markets are still in the sweet spot, and we expect their rallies to continue. As global funds are still light in these markets, foreign flow of funds should continue to be net buying. When global funds enter ASEAN-4 (a combined market cap of ~US$1.5 trillion and population of over 330 million) *en masse*, that will, once again, be a good technical signal that finally marks the market top of this cycle.

Conclusions

Central banks in the U.S. and the eurozone are in various stages of quantitative easing mode. While growth remains anemic in these regions, easy liquidity policies continue and interest rates stay low. Part of the flood of global liquidity is moving into Asia, driving asset prices (stocks, real estate, currencies). Within the Asian region, China's economic up-cycle is already overheating, and the government is determined to hold the renminbi down (to fight hot money inflows) and deflate the property price bubble. In contrast, major ASEAN economies are still in the early phases of their economic up-cycles. Capital inflows into ASEAN thus look set to continue.

As domestic sectors in these economies boom, surpluses in trade and current accounts will shrink. The key question then is: should a current account deficit surface, how would that be funded? If funded by FDI (foreign direct investments), it would be hugely positive. If financed through external debt, then sooner rather than later the party will end.

The key to attracting FDI is strong and effective government leadership to break up corruption, cronyism and rigid labor laws, and raise transparency to improve visibility of investment returns for investors. What Indonesia has achieved so far, by reining in government spending and subsidies that substantially brought down inflation, is a good example of the self-feeding virtuous circle—witness the strong performance of its bourse.

Over the next few years, we expect many labor-intensive manufacturing companies in China to move part of their operations overseas to diversify and lower manufacturing costs. Anecdotal evidence from our company visits points to the beginning of that trend, with Indonesia and Thailand being the recipients of FDI from China. For those ASEAN countries that can achieve strong FDI inflows from China and others, we expect the current rallies in their bourses will be just the first leg of a much stronger secular run.

The NAVs The GSI Asian Capital Growth Fund—US$27.51; The Long Short Fund—US$25.24 (Sep 30, 2010)