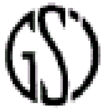


The Issues

July 1, 2011

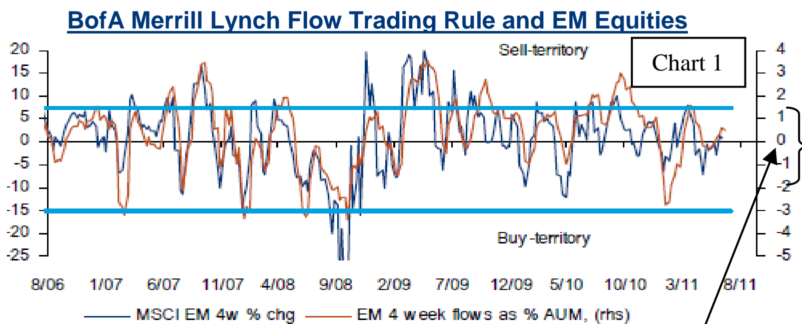
FLOW OF FUNDS—IS ASIA DECOUPLING?

Most of Asia Pacific ex Japan is booming. Shop rents in Hong Kong have hit an all-time high thanks to the strong influx of mainland Chinese shoppers. Office vacancy rates in central business districts of Singapore and Hong Kong are at very low single digits. The overall rise of residential property values in China, Taiwan, Hong Kong and Singapore has forced respective authorities to take various restrictive measures. Current speculation in Malaysia is that something similar is afoot, as home values in popular areas of Kuala Lumpur and the Klang Valley have risen 30% to 50% since 2H09.

Asia ex Japan has increasingly decoupled from economic dependence on the U.S. and EU. The importance of external sectors has declined over successive cycles: The marked slowdown in industrial production (and export growth) YTD and the narrowing of the current account surpluses in a number of Asian economies have not dented buoyancy in the domestic sectors of these economies. Domestic spending and investments are driving growth, funded by domestic savings.

Correlation of Stock Markets

However, in terms of day-to-day to shorter-term correlations, bourses in the region have not fully decoupled from Wall Street, the key barometer on the global stock market scene. Indeed, it might take a long time for the high day-to-day positive correlation to subside because of the flow-of-funds factor from global investors in the region.



Net Fund Flows to EM, US$m

	07/20/11	YTD
Total EM	-1,087	-5,656
Global EM Funds	-602	-776
Asia	111	-2,737
EMEA	-374	1,073
LatAm	-223	-3,215

Table 1

Sources (Chart 1 & Table 1): BofA Merrill Lynch calculations, Bloomberg, EPFR Global.

Chart 1, above, shows the close correlation between performance of the MSCI Emerging Market Index and the degree and direction of flow-of-funds from global investment in emerging market (EM) portfolios as tracked by BofA Merrill Lynch. Note that fund flows amounting to only a range of 1% to 2% of assets under management (AUM) were sufficient to drive high single-digit moves in the MSCI EM Index. Table 1, above, shows YTD net outflows from EM of US$5.7 billion (nearly half in Asia). The only regions enjoying positive fund inflows were emerging Europe and Africa.

Size of EPFR Universe of Asia x Japan Funds (Incl. ETF) vs. Stock Market Capitalizations

US$b	China H shares, etc.	Hong Kong	Indonesia	Korea	Malaysia	Singapore	Taiwan	Thailand
MSCI Country Index Mkt Cap US$bn	676.00	306.0	108.0	594.0	124.0	196.0	431.0	76.0
Stock Exch Mkt Cap US$bn		2711^	407.0	1,100.0	444.0	390.0	780.0	279.0
ETF Size US$b / as % MSCI Mkt Cap	11.3	26.6 / 3.8%	1.4 / 1.3%	7.1** / 1.2%	1.6 / 1.3%	3 / 1.5%	2.8 / 1%	0.7 / 1%

*EPFR universe Asia x Japan funds - US$252b inclusive ETF (US$54.5bn total on Far East x J)

**Includes Equity Linked Notes US$1.7b on Korean shares by Korean brokers. Excludes US$8.7b of WRAP accounts

^Inclusive H-shares and red chips

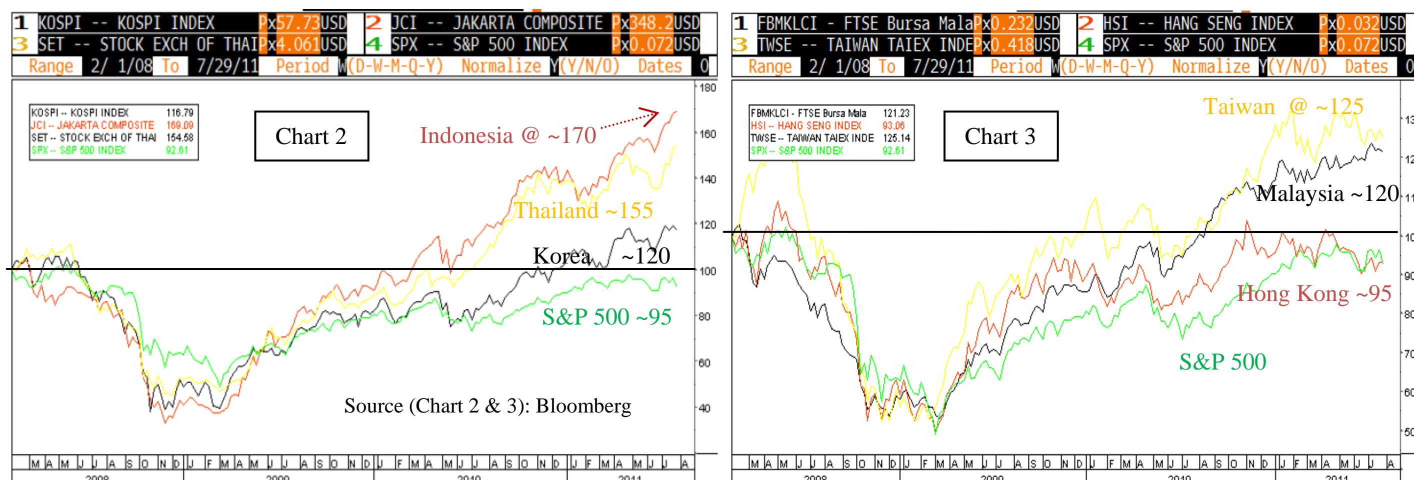
Sources: Various Stock Exchanges, EPFR & Bloomberg (fund flows and turnover) MSCI Indices data, Blackrock (ETF data)

Table 2

How could such a relatively small amount of fund flows drive stock market trends? Like commodities, changes in stock prices are dictated by demand imbalance at the margin, involving 1% to 2% or less of total supply. At times when market sentiments are macro news prone, marginal flow-of-funds can often be the tipping point for herd

psychology to self-feed and buying or selling momentum to snowball. At US$252bn, the aggregate total of regional funds (including ETFs), are sizable relative to market caps of MSCI Index constituents (Table 2), the latter at only 26% (ASEAN) to 55% (Taiwan and Korea) of the actual total market cap of respective bourses. MSCI indexes are the benchmarks or "anchors" of most foreign funds. When an anchor moves, herd psychology does the rest to set *shorter-term* stock market trends in motion.

Longer-Term Performance Has Decoupled
The following charts illustrate the outperformance of ASEAN markets vs. the S&P since early 2008 through the global financial tsunami, the recovery, the first PIG eurozone crisis in spring 2010 and its most recent reemergence.



Positive economic fundamentals (rises in spending and investments funded by domestic savings) → strong local confidence → <u>local individuals and institutions buying their own stock markets</u> (Table 3) → outperformance of ASEAN.

<u>Data on Fund Flows—EDFR Industry Survey & Asia ex Japan Stock Exchanges</u>

US$b Table 3	China (H-shares etc.)	Hong Kong	Indonesia	Korea	Malaysia	Singapore	Taiwan	Thailand
<u>Net Foreign Buying US$b</u>								
2010 (EPFR*) US$b / as % MSCI Mkt Cap	15.9 / 5.2%	3.1 / 1%	2.8 / 2.6%	8.1 / 1.4%	1.4 / 1.1%	0.7 / 0.4%	5.3 / 1.2%	1.9 / 2.5%
Stock Exch data	N.A.	N.A.		20.0	5.0		8.9	2.7
1H 2011 (EPFR) US$b / [as % turnover]	-3.1	0.04	0.04	0.60	-0.10	-0.80	2.80	-0.40
Stock Exch Data	N.A.	N.A.	2.50	0.10	0.90	N.A.	0.5	
			Differences indicate buying by locals using funds parked abroad			Taiwanese repatriating funds abroad using foreign funds as conduit?		
<u>Av Monthly Turnover 1H2011</u>		189.0	13.3	144.0	18.5	37.6	80.0	30.0

<u>Although on a day-to-day or shorter-term basis, bourses are still correlated with Wall Street, once overall sentiment stabilized, ASEAN bourses, driven by local buying, were able to rebound strongly and hit new highs. Thus, over time, performance of these bourses has decoupled from Wall Street</u> (not yet for Hong Kong, due to uncertainties in China).

The Past and the Present
The 2009 bull market was supported by strong investor *confidence* (better global economic outlook) on ample *liquidity* from money printing by the Fed (QE1). The 2009 recovery continued into 2010, driven by more money printing, QE2 and the ECB's bailout of PIG banks through bridging loans to repay foreign interbank loans, including taking PIG bonds onto their books. In short, the ECB helped reliquefy French, German and other EU bank lenders.

As the world entered 2011, it became increasingly clear that the <u>money printing *had not and could not* resolve structural issues in the U.S.</u> of (a) indebted households having to raise savings and restructure their balance sheets, and (b) the low rate (secular decline) of capital investments by U.S. companies. With the federal government having exhausted its spending stimulus capacity, a third structural issue of how to reduce the massive budget deficit, ~10% of GDP, has emerged. It's structural because the total of "mandatory" items, i.e., outlays required by law such as social

Security, Medicaid, other social services (66% of the federal budget), political "untouchable" defense spending (20% of total outlays) and interest payments on Federal debt now amounts to over 90% of total budget expenditure.

PIG problems have resurfaced and the situation has worsened from a sovereign debt issue to *a bank run*. Private sector bank deposits in Greece have shrunk 15% since end 2009—of that 10% was in 1H01. While EU political leaders bicker over political semantics on how not to call a default a default, the bank run is accelerating as Greeks send funds abroad and overseas lenders call in loans. The severity of the liquidity squeeze from the capital outflows must be driving the Greek economy into a state of implosion. In varying degrees, similar trends must be taking hold in Portugal and Ireland.

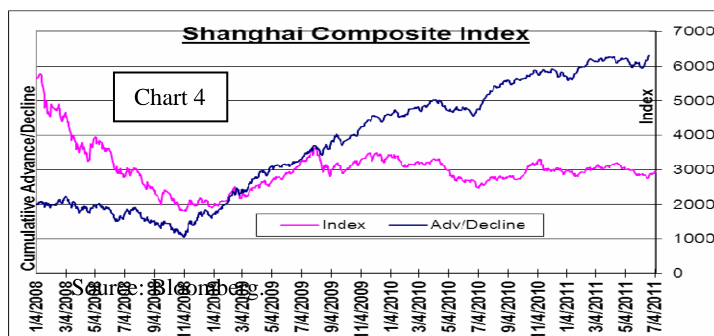
Will the liquidity shrinkage contagion spread to Spain? As we saw during the Asian financial crisis, economies reliant on overseas borrowings and, hence, capital outflows, are the most vulnerable. The threat of contagion, if it is happening, represents the (good side) vigilante role of the market exerting pressure on politicians in Spain and Italy (SI, for short) to pursue necessary economic and structural reforms. Fortunately, in the case of SI, there is time. Spanish government debt is one of the lowest among developed economies. And most of Italian government debt is funded by domestic savings (at a very high 17% of GDP). Contagion risk of a wholesale drying up of liquidity spreading to SI is small.

Conclusions and Investment Policy

In the case of the U.S., the slowdown in economic growth has, by now, mostly been discounted by the market. However, aggregate bottom-up analysts' earnings growth expectations for the S&P, at +18% YOY, still looks out-of-step with the top-down picture. The risk is that certain stocks and sectors will likely disappoint in terms of earnings performance.

The PIG issue in the EU is worsening. Credit is the artillery, or lifeline, of an economy. Total bank loans are actually shrinking in Greece. Sooner or later, the implosion of the economy will drive Greek citizens to give their government leaders the thumbs down. The potential for a messy fallout, with Greece leaving the euro currency and the contagion spreading to Portugal and Ireland, has risen considerably.

The wild (and bad) side of markets is volatility running amok, thanks to the leveraged impact of derivatives feeding on the herd psychology of basic human nature. We see major global markets still stuck in volatile trading ranges. Asian bourses will be affected by shorter-term bursts of fear, volatility of major global markets and profit-taking by locals. But, as discussed above, selloffs have proven to offer good buying opportunities for investors with longer views in bourses in Asia ex Japan that enjoy strong local confidence and positive economic fundamentals.



We have followed a policy of disposing of weaker holdings in favor of cash, including those that have done well, when they reach full valuation or move into overbought territory as global markets near the upper end of their trading bands. On selloffs driven by negative news/events, that liquidity is our fire power to buy on the cheap stocks and sectors in Asia with strong fundamentals. Over recent months, liquidity in our funds has thus ranged from 10% to 20%. The focus of our regional funds is on ASEAN, at nearly half of our regional fund exposure.

In our Greater China Fund, we have focused on stocks and sector situations in Taiwan. China is still in adjustment, and we believe market expectations for an early peaking of inflation rates and easing of monetary policy are too optimistic. One of the barometers on overall public confidence in China is the cumulative advance-to-decline line on A-shares. Investors have avoided major index stocks (prone to policy risks,) focusing instead on non-major-index and smaller-cap stocks. The two-year uptrend of more stocks rising than falling indicates good overall confidence (Chart 4) Tightening by Beijing has not yet had dented the public's "feel-good" psyche, which is why consumption and investments have remained buoyant. That, in turn, implies inflation pressure in China will not abate anytime soon.

The Net Asset Values GSI Asian Capital Growth—US$29.59 & The Long Short Fund—US$26.52 (July 28, 2011)