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2010 OUTLOOK
ASIAN MARKET COMMENTARY

Asia ex Japan Outlook: Grab the Tiger by the Tail?

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2010 Outlook Asian Market Commentary

Asia ex Japan Outlook: Grab the Tiger by the Tail?

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While Asian economies seem poised for faster economic growth than the developed world, these superior prospects are already incorporated into equity valuations, leaving Asian equities vulnerable to near-term disappointment.

At this time last year, fears of a global depression gripped the investment world and panic selling prevailed. Asian equities were crushed more than other markets, as investors quickly capitulated on the notion of "decoupling" and dumped any asset that was not a U.S. Treasury bond. The world was a scary place for investors. However, fear and panic create opportunity. We felt that unlike previous downturns, Asia was not the weakest link in the global economy, having entered the crisis from a position of strength. From our outlook last year[1]:

> In many ways, 2009 will be the moment of truth for investors in Asia. It will become increasingly clear over the course of the year whether the region, especially the Chinese economy, has the wherewithal to withstand a slumping U.S. economy without suffering a painful bust. We still feel the region's fundamentals are solid and better positioned for long-term growth than those of the developed world, but these assumptions will be strongly tested in the coming quarters. Although investors may need to temper their growth and return expectations going forward—as we do not see a return to the heady valuations of the past few years anytime soon—now is the time to begin increasing strategic allocations to Asia, especially should markets come under renewed weakness in 2009 as we expect. While the macro outlook is certainly challenging and not without risk, valuations today provide a margin of safety for long-term investors.

Well, perhaps we were wrong about return expectations. The MSCI All Country Asia ex Japan Index[2] returned 67% in local currency terms, its second best calendar year since our data begin in 1988. It seems the year of the Ox turned out to be more like the year of the Bull (Exhibits 1–4).[3] What then for the upcoming year of the Tiger? We think it will also live up to its namesake—unpredictable, dangerous, and not to be taken lightly.

We still expect to see a divergence in economic fortunes between the debt-burdened developed countries and the dynamic emerging world, with Asia remaining a key driver of global growth. However, these superior fundamentals already seemed priced into asset markets. Valuations are stretched, leaving Asian equities vulnerable to disappointment. We think a case can be made that Asian and emerging markets equities will underperform next year even amid economic recovery. At a minimum, we expect a sizeable pullback in the markets at some point in 2010, as the global economy tries to adjust from a

[1] Please see our December 2008 Market Commentary *Asia ex Japan 2009: The Moment of Truth.*

[2] We have taken a pan-Asian view of the region, combining emerging Asia with the "developed" markets of Hong Kong and Singapore while excluding Australia from our regional analysis. Please see our separate discussion on Japan and Australia in Appendix B.

[3] For further discussion of 2009 performance for Asia ex Japan, please see our Market Commentary & Calendar Year 2009 in Review publication.

stimulus-driven recovery to sustainable, endogenous growth.

In other words, we are tactically neutral on Asia, but remain strategically bullish. In fact, 2010 may present another opportunity for investors to increase exposure to this region, based on our expectation that a correction in the markets will allow valuations to move back in line with fundamentals. Currently we do not yet see a broad asset bubble in Asia, although the potential for one to develop is present. Overall, we think investors need to be cognizant of the price risk facing Asian equities and proceed with caution, but also be prepared to grab the tiger by the tail and go along for the ride.

Economic Outlook

Our broad view of the global economy and its drivers has not changed since our August 2009 Asset Allocation in the Current Environment report *Now What?!* The current recovery in the global economy is largely driven by massive monetary and fiscal stimulus from both the developed and emerging worlds. While such measures were needed to avert a global depression, they are temporary in nature and not the basis for sustainable economic growth.

We see 2010 as a difficult transition year for the global economy and Asia. The boost from liquidity injections and stimulus will begin to fade over the course of the year, and uncertainty regarding how stimulus will be withdrawn (or maintained) will likely result in increased market volatility.

Looking back, we based our confidence in Asia on the inherent strengths of generally low debt levels among households and a banking sector that was not dangerously leveraged. Current account surpluses and foreign exchange reserves put Asia in a good position to handle a financial crisis. Unlike previous crises, Asian policymakers had the flexibility to engage in their own fiscal and monetary stimulus.

As a result, the region has bounced back sharply, helping to lead a global recovery. To be clear, however, this recovery has been driven in large part by China's massive domestic stimulus. To offset a sharp collapse in exports, China unleashed a loan-driven surge in domestic fixed investment (i.e., infrastructure projects and property construction). The government also created incentive schemes and gave tax breaks to citizens to encourage consumption. This led to strong Chinese imports that helped provide a boost to the rest of Asia. The effects of China's stimulus were felt elsewhere, as Chinese stockpiling and restocking boosted flagging demand for commodities and raw materials, helping countries such as Australia and even Brazil. This created a positive feedback loop in the region, as each country's domestic stimulus interacted with Chinese demand, not to mention other stimuli from Western economies.

For 2009 as a whole, the average consensus forecast real GDP growth rate for the ten Asian economies we track is 0.5%, compared to -4.0% for the G3 major economies of the Eurozone, Japan, and the United States. If weighted by each economy's relative size, Asia is expected to grow 5.7% in 2009 given stronger growth in China and India[4] (Exhibit 5).

[4] Asia is not a homogenous place. Open economies like Hong Kong and Singapore were hit especially hard, as trade and finance were the areas most affected by the "Great Recession." Export-dependent economies such as Korea and Taiwan, and to a lesser extent Malaysia and Thailand, suffered sharp technical recessions. However, large countries such as China, India, and Indonesia only underwent sharp slowdowns. Given their sizeable populations, these countries could rely on domestic demand to see them through, while India and Indonesia were not export-dependent economies to begin with. Indeed, "Chindonesia" was a buzz word in 2009 given

A key theme for next year, therefore, is a continuation of economic divergence and policy uncertainty. For 2010, Asia is expected to achieve an average real growth rate of 5.3%, compared to 1.8% for the G3, reflecting the different causes of the recessions in the developed and emerging worlds, namely, private sector deleveraging. The rebound expected in much of the developed world is well below what history would suggest following such a steep recession because lower interest rates have not produced the desired spending (or "dis-saving") by households and expansion by the private sector. We do not envision the developed world, especially the United States, undergoing a "normal" recovery driven by credit creation. Asia, however, could very well experience a robust recovery if consumers and businesses save less and borrow more, offsetting weaker external demand from the West.

Unemployment is expected to remain lower in Asia than in the developed world, hovering around 6.3% during the course of 2010, compared to 8.8% in the G3 (and 10% or higher in the Eurozone and the United States). This compares to roughly equal average unemployment between G3 and Asia in 2008. A healthy Asian consumer will be key to any potential domestic demand revival in Asia.

This story of a "two speed" global economy is well known, yet most commentary gives scant attention to the implications of this growth divergence. Namely, that divergent growth should result in divergent inflation pressures and therefore divergent trends in policy tightening. Exhibit 5 shows how average inflation in Asia is expected to rise from an estimated 1.9% in 2009 to 3.2% in 2010, while the G3 economies are expected to rise from a muted average inflation of -0.4% for 2009 to only 0.8% in 2010.

Herein lies the dilemma facing Asian policymakers. If growth is as robust as predicted, inflation pressures could mount and force tightening in Asia ahead of the West. This is already starting to happen, with Australia embarking on a series of rate hikes and China starting to rein in its credit boom (Exhibit 6). However, if growth is to remain sub-par in the West, it is unclear how much tightening Asian economies can withstand, or whether growth can be sustained at projected levels.

For now, such concerns seem to be on the backburner, as economic data continue to come in strong. The first part of 2010 may appear boom-like, as the global economy enjoys the tailwinds of previous stimulus and economic data benefit from a "low-base effect" on growth rates. For instance, China recently reported a 55.9% annual rise in imports, while Korea and Taiwan reported export growth to China of over 90% year-over-year in December. Such figures must be seen in the context of the collapse in global trade and economic activity over late 2008/early 2009.

Exhibit 7 shows the V-shaped nature of the global recovery. After suffering the largest contraction on record for the OECD Index of Leading Economic Indicators (LEI) and its Asia subset,[5] we have now seen the sharpest rise. However, what should be apparent from this chart is that growth *momentum* is starting to peak; indeed, growth momentum in Asia has clearly rolled over. Last year there was much talk about how markets were rallying on the "second derivative" effect of negative economic data

how well these three economies fared. Still, every economy felt the effects of bankruptcies and rising unemployment. See Exhibit 5.

[5] The Asia subset of the OECD LEI includes China, India, Indonesia, Japan, and Korea. The recent slowdown in the Asia LEI is not attributed to Japan, which given its steeper contraction in 2009 is still posting rising LEI momentum.

becoming less weak (but still poor). Over 2010 we will see this process in reverse—economic data will be positive, but improving at a slower pace. Exhibit 7 does not imply a coming contraction in growth, as both the level and the rate of change in the LEIs imply economic expansion. However, while the level of activity matters more for economies, it is the rate of change that seems to matter most for markets, as this shapes future expectations.

Our view is that Asian economic growth will likely be stronger than that of the developed world; we are agnostic as to whether Asia will meet or exceed current GDP forecasts. We see risks to both the downside and upside, as it is unclear to what extent stimulus measures will be removed. It seems that markets are caught between a rock and a hard place. Should growth prove too strong, focus will return to inflation fears, rising interest rates, and policy tightening. On the other hand, too little growth will dash market expectations and a renewed deflation or growth scare will emerge. Whether or not an actual "double dip" occurs over the coming year, *fears* of such an outcome have the potential to whipsaw markets.

China Bust?

All eyes are on China. The RMB 10 trillion (approximately US$1.4 trillion) loan surge is rightfully a cause for concern. If in early 2007 (before the global credit crisis erupted) Chinese Premier Wen Jiabao felt compelled to describe China's economy as "unstable, unbalanced, uncoordinated, and unsustainable" it is little wonder that bearish sentiment toward China is increasing; economic growth has simply switched its dependency from external demand to credit stimulus.

However, the loan surge is not as scary as it sounds. Figures compiled by Goldman Sachs show that some companies used a large proportion of borrowed funds to pay down or restructure debt, while other companies simply took loans and redeposited the funds in higher interest-bearing instruments. The loan-to-deposit ratio for the Chinese banking system has rebounded from its 2008 lows, but remains at 2007 levels. Of course, recent warnings by prominent Chinese business leaders leave no question that wasteful development is taking place, and it is clear that property markets are more than frothy, especially at the luxury end. China can reap some benefits from increased infrastructure spending, especially in the vast hinterlands away from the costal cities, but there is also excess capacity growing in certain industries.

China certainly appears bubbly in some respects. Still, a major difference between China's growing property bubble and other emerging markets credit busts is that China's binge is built largely on the deployment of domestic savings, not a build up of foreign-denominated debt. While this does not justify wasteful investment, it does mean the fallout can be less severe (but not painless). In contrast to corporations, which have taken on debt, the vast majority of Chinese households are not leveraged at all. For now, our basic view is that China is not on the verge of collapse. There are certainly economic excesses developing in the economy, but it is not yet dangerously overheated.

A real risk in 2010, however, is that the Chinese economy rebounds too strongly, forcing policymakers to throw on the brakes in a heavy-handed manner. A sharp slowdown in China (which is different from a bust) has the potential to trigger a growth scare in Asia and roil global markets. Tightening measures have been incremental so far (verbal "guidance" and

warnings about lending, modest hikes in reserve requirements for banks, and increased lending and deposit rates), but if the authorities feel they are losing control of the economy, they will respond.

Inflation will be the key variable to watch, not only in China, but across Asia. Clearly, one mechanism to release inflationary pressures is to allow currencies to appreciate against the U.S. dollar. For now, with the Chinese RMB effectively re-pegged to the U.S. dollar since last year, other Asian governments have been reluctant to let their currencies rise. Signs of growing inflation pressure in China (as well as threats of protectionism from the West) should result in a gentle appreciation of the RMB at some point next year.

Overall, despite all of the talk of bubbles, we do not yet see signs of a broad-based asset bubble in Asia along the lines of what existed in the mid-1990s (Exhibit 8).[6] Asian policymakers are keenly aware of the risk, having suffered the consequences of previous busts. However, if growth in the West fails to revive, there is a good chance that policymakers will err on the side of caution and run simulative policies to offset lagging external demand. The risk of bubbles forming at some point is real.

From Pessimism to Optimism: A Valuation-Driven Rally

Economic resilience aside, Exhibit 9 shows the damage wrought to profits across the region from the global recession. Real earnings per share (EPS) fell 48% from their 2008 peak through September 2009, on par with the 54% collapse seen over 2000–02, and return on equity (ROE) has also fallen to trough levels. The "Great Recession" has effectively wiped out all the EPS growth since the end of 2003. This is important, as it is still not clear how much of the run-up in profits in Asia over 2003–08 was related to a housing/credit boom in the West or to fundamental economic growth tied to the region.

With EPS plummeting, the rally over the past year has clearly been predicated on a V-shaped recovery in profits along the lines of the V-shaped recovery in economic activity in the region. What we find most remarkable is the speed at which markets have gone from pricing in the end of the world to now valuing stocks as if it were back to business as usual.

Exhibit 10 shows the extent to which historical returns in Asia have been driven by valuation expansion (speculative return) and earnings growth (economic return). Unlike the other blockbuster return years of 1993, 1999, or 2003, which combined both growing earnings and valuation re-rating, the 2009 rally was driven entirely by multiple expansion, or the behavioral switch by investors from pessimism to optimism (if not from fear to greed!).

Exhibit 11 shows our normalized valuation metrics, which have swung from 1 standard deviation undervalued late last year to noticeably above their post-1988 averages.[7] At the end of December, Asia ex Japan traded on normalized P/E ratios ranging from 18.5 to 21, compared to average valuations between 16 and 17.

Looking at price-to-book (P/B) valuations for individual countries, most markets in Asia are above their post-1995 norms if not close to 1 standard deviation above average (Exhibit 12).

[6] For further discussion of China and asset bubbles in Asia, please see Appendix A.

[7] We have adjusted our historical mean and standard deviations calculations to exclude the very high price-earnings (P/E) ratios during the years 1993 and 1994 to achieve a more "normal" distribution.

Current valuations are not extreme, but they are stretched and we currently view Asian equities as slightly overvalued.

Of course, the key issue regarding current valuations is the extent to which profits rebound relative to expectations. While our metrics based on normalized earnings are elevated, forward P/E ratios based on consensus estimates are more benign, ending December slightly above historical average at 14. However, even on a forward basis, Asian equities had become overvalued by late summer, with the recent improvement in forward multiples reflecting rising earnings expectations, not falling stock prices (Exhibits 13 and 14).

Asian EPS seem to have bottomed in September 2009. Yet consensus estimates see earnings approaching peak 2008 levels by the end of 2010, implying 69% earnings growth relative to current trailing EPS, or 24% growth based on estimated calendarized consensus 2009 EPS provided by Morgan Stanley.[8] Are such expectations reasonable?

Although high rates of growth from depressed levels are feasible, it is worth noting that it was not until the end of 2004, or two years into a global recovery, that Asian EPS recovered to their previous cycle highs. Current valuations are back to 2006 levels, a time when the global economy was firing on all cylinders, which is clearly not the case today. In other words, while the stage is certainly set for a rebound in profits, investors have already paid up for this, and will need to see upside surprises in order to see further multiple expansion. Thus, equities are vulnerable to disappointment, as there is a lot of presumption baked into current prices.

Are Relative Valuations Justified?

Of further concern is the relative valuation of Asian equities to developed markets. Asia ex Japan is trading at a 12% premium to developed markets on a P/B basis, compared to the near 20% *discount* on offer in October 2008, let alone the near 40% discount in 2003. Historically, Asian (or emerging markets) equities trading at a premium to developed markets has been a warning flag. As Exhibit 15 shows, relative valuations are back to the levels seen at the 2007 market peak.

However, one could argue that today's relative valuations are justified given the better economic prospects for Asia. If the developed world remains in a semi-slump, then investors should pay up for growth potential; if fundamentals diverge, then shouldn't valuations?

This is precisely what took place over the previous "emerging markets mania" of the early 1990s, when emerging markets equities traded at substantial valuation premiums to developed markets. From 1992 to 1995, Asian equities traded at an average 20% premium to developed equities, with a peak relative valuation premium of over 70% by the end of 1993. In hindsight, this clearly seems excessive, but like all manias, there was initially some logic behind it. During this period, the Asia Tiger economies were roaring[9] as the developed economies were reeling in the aftermath of the early 1990s recessions (the savings and loan crisis in the United States,

[8] Given the lags and differences in reporting periods for companies, current trailing EPS do not reflect final 2009 earnings, which will not be known until well into 2010. Thus, 2010 forward growth estimates are based on estimates for final 2009 EPS (adjusted for different fiscal year-ends among companies).

[9] Not to mention general excitement over the opening of the former Soviet bloc economies (and especially Russia itself) and liberal reforms in Latin America. China, meanwhile, was opening up to large foreign direct investment.

Japan's burst bubble, the stresses of German reunification, the ejection of the United Kingdom from the European Exchange Rate Mechanism, etc.).

Importantly, this divergence in economic cycles led to diverging profitability. Developed markets' ROE embarked on a steady decline from 1989 to 1994, while Asian ROE climbed higher. From 1991 to 1995, Asian ROE averaged 12.3%, compared to 8.9% for developed equities; by early 1994, Asia was generating a level of ROE 70% above that of developed markets. As a result of superior earnings growth, money poured into the region's relatively illiquid markets,[10] sending prices through the roof; 1993 saw the MSCI All Country Asia ex Japan Index post a 105% return, its best year on record.

Exhibit 15 shows how the rise in relative ROE was accompanied by the rise in relative valuations. Conceptually, a market can support a higher P/B valuation if it is achieving a higher level of ROE (more earnings are being generated for every unit of equity). However, this only makes sense if the higher level of ROE is sustainable. Asian equities saw their valuation premium collapse as ROE began to decline in the lead up to the Asian financial crisis and the developed world began to recover amid the tech boom.

The key point is that should divergent economic growth result in divergent profitability, Asian equities can indeed support a valuation premium to developed markets. However, this growth must be sustainable, and even then at some point you are simply paying too much for perceived growth. Stronger economic growth does not always translate into superior asset returns—valuations still matter.

Exhibit 16 takes this a step further, and breaks down the drivers of returns for Asian and developed market equities over various time periods. Total returns for investors are based upon income and price returns, with the price return composed of the growth in earnings and the change in valuation multiples (P/E expansion or contraction).

Over the boom period from 1991 to 1994, Asia delivered a total return average annual compound return (AACR) of 28.1%, compared to only 10.2% for the MSCI World Index. This stellar performance was the result of not only superior earnings growth (10% relative to -3.0%), but also larger valuation expansion, worth an annualized 13.6%, compared to only 11% for developed markets.

Now compare the last cycle. From 2003 to 2007, Asia generated a total return AACR of 32%, compared to 17.5% for developed equities. However, most investors may be surprised to find that EPS growth was actually slightly higher for developed markets at 24.2% annualized, compared to 22.7% for Asia. This is contrary to the idea that emerging markets generate higher profits due to higher economic growth. The fact is that 2003–07 was a global earnings boom, and companies in the developed world reaped just as much as those in emerging markets; in fact, both regions were selling goods to each other.[11]

[10] Based on data from the S&P/IFC Global Stock Market Factbook, total net equity portfolio flows of $43.3 billion poured into emerging markets in 1993, equivalent to 19% of the previous year's market capitalization of the MSCI Emerging Markets Index. For context, 2007's net equity flow of $138.6 billion accounted for only 6% of market cap.

[11] It could be argued, however, that financial sector profits in the developed markets helped drive outsized earnings growth over the last cycle, and are unlikely to return. Still, given the GDP growth differentials over the period, most investors would have assumed that profits would be higher in Asia. Investors should remember that stronger economic growth does not always translate into earnings per share growth.

Valuations are what led Asian/emerging markets equities to nearly double the return from developed markets. Asia ex Japan began the period with a trailing P/E ratio of 15.3, compared to 23.2 for the MSCI World. Asia enjoyed a 4.6% annual valuation re-rating as P/E ratios rose to 19, while developed markets suffered a -7.5% valuation de-rating as P/Es fell to 16. Again, beginning valuations matter immensely.

Exhibit 15 highlights another interesting point about the 2003–07 cycle. For the majority of the previous cycle, Asian equities generated a similar level of ROE to developed equities, but traded at a much lower relative valuation discount than their relative profitability would suggest was appropriate. In other words, investors were not willing to pay up for the growth prospects of Asia, most likely thinking that the boom in profits was not sustainable, given lingering memories of the 1990s. However, by 2007, investors had fully embraced the decoupling theme and were paying premium valuations for weakening ROE—a warning of overvaluation.

Today, with Asian ROE holding up better than that of developed markets, a relative valuation premium seems justified. However, unlike the previous cycle, investors are already paying up for Asia's superior growth prospects. For Asia to outperform going forward, equities are going to have to deliver both better earnings growth *and* multiple expansion. While strong multiple expansion could occur if an Asia/emerging markets mania does unfold, investors need to be aware that stronger earnings growth is already in the price.

Market Outlook: Long-term Positive, Near-term Nervous

If fear and doubt gave birth to the bull market of 2009, then the optimism toward Asia that we see heading into 2010 is a source of concern.

First, Asian equities remain vulnerable to a correction. Exhibit 17 shows overbought/ oversold measures for Asia ex Japan based on the rolling six-month rate of change and deviation from the market's 200-day moving average, or primary trend. Both of these charts show a clear mean-reverting tendency.

The collapse over 2008 and 2009 saw Asian equities become more oversold than during the Asian financial crisis. The subsequent rally, however, drove equities to nearly 3 standard deviations overbought by last August, second only to the explosive run-up over 1993. While momentum has clearly peaked (as markets cooled somewhat over the fourth quarter), history shows that after such a run-up Asian equities will move back to at least neutral, and more likely to 1 standard deviation oversold, before turning up sharply again.

With the Asia ex Japan Index ending December nearly 15% above its 200-day moving average, or close to 1 standard deviation above average, a correction of that magnitude is not without question. Exhibit 18 shows the depth and duration of Asia ex Japan market declines and subsequent rallies since 1988. Today's normalized P/E ratios are similar to, if not higher than, those seen in mid-2004 and mid-2006 when Asian equities suffered 20% sell-offs over the course of a month.

Both pullbacks were related to monetary tightening and inflation concerns. The U.S. Federal Reserve (Fed) began its previous

tightening cycle in 2004, and fears that the Fed was going to tighten too much in response to rising inflation and bond yields led to the 2006 shakeout. The 25% dip in early 1994 also coincided with the beginning of a Fed tightening cycle, although valuations were drastically higher then than they are today. Concerns over monetary tightening, either by the Fed or Asian central banks themselves, will be a key catalyst in any market pullback in 2010.

The run up in relative performance (and valuations) also hints that Asian equities (and emerging markets equities in general) may be due for a spell of underperformance. Exhibit 19 shows the rolling 12-month relative performance of Asia ex Japan versus various markets. Again, the mean-reverting tendency of markets is clearly on display. Asia's relative outperformance has reached prior peak levels and appears to be rolling over, even versus Japan!

To be clear, these charts are based on *relative* performance; Asian equities could still rise, but simply less than other markets, or simply be hit harder than others amid a shakeout. It seems that Asian equities may be in a tough spot. If global growth disappoints next year, Asian equities may be hit harder than others due to their high relative valuations and high-beta status. However, even if global growth meets or exceeds expectations, Asian equities may lag behind as other regions play catch up.

Second, as a net importer of commodities, Asian equities have historically lagged other emerging markets amid sharply rising commodity prices. This was clearly on display in early 2008. While Asian equities peaked in October 2007, Latin America and the Europe, Middle East, and Africa region (driven largely by Russia) reached new highs as commodity prices surged over the first half of 2008. Should stronger-than-expected global growth in 2010 result in sharply rising commodities, we would expect a repeat of such underperformance.

Of course, Asian equities may very well continue to rise in the coming months. Nothing says valuations cannot become more stretched and markets more overbought, as the forces of sentiment and momentum can feed on themselves. Conversely, we could simply be dead wrong and Asian equities could have another blockbuster year as an Asia/emerging markets mania unfolds in earnest.

Exhibit 20 shows that after a sharp drop in 2008, net inflows to emerging market equity mutual funds soared to $80 billion over 2009, exceeding their 2007 highs by $26.5 billion! Indeed, retail investors have been enthusiastic buyers of emerging markets equities, dumping developed markets shares. Though continued fund flows are likely, investors should not base their investment decision solely on the potential for a mania to form.

Finally, economies might diverge or decouple, but market correlations remain high, even relative to the elevated correlations seen over the past ten years (Exhibit 21). So the travails of the developed world may still weigh on Asian markets, especially given the large retail fund flows, which can reverse just as easily as they pour in. The true test of "decoupling" is when developed markets suffer a pullback and Asia does not. Such a development would signal that the world's attention has truly shifted East.

Conclusion

A key lesson for investors to remember is that there is a difference between economics and markets. Market moves are based largely on changes in *perceptions* of fundamentals. So while the economic outlook for Asia is relatively robust,

this perception is already in the price. Our view is that 2010 will be a transition year for the global economy, as policymakers attempt to withdraw stimulus from the system. Heightened uncertainty over the economic outlook is likely to increase market volatility and result in a period of market consolidation and muted equity returns. In sum, our views on the prospects for Asia and our investment advice are as follows:

- Asian markets will face a growth paradox in 2010. The stronger the economic rebound, the more pressure to reduce stimulus and fight inflation, and the more pressure on markets. Stronger growth in Asia/emerging markets should result in divergent inflation and policy responses. Indeed, Asian policymakers may be on the front lines of policy tightening, as the expected growth divergence between Asia and the developed world should result in divergent monetary policies. Failure to tighten risks stoking asset bubbles along the lines of what occurred in the mid-1990s, the last time there was a broad divergence in economic cycles where fixed exchange rates helped fuel speculative excesses.

- We do not currently see a broad asset bubble in Asia, although the risks of one developing are high if monetary policy is kept too loose and currencies are not allowed to rise. Despite the economic excesses building in China, we do not see a China collapse next year. However, the risk of a China growth scare is large, should policy be tightened aggressively.

- We view Asian equity valuations as slightly overvalued, but not excessively so. Still, Asia's superior growth prospects are already incorporated into current relative valuations. Given the vulnerability of Asia/emerging markets equities to a policy-tightening-induced growth scare (either in the United States or, more importantly, China), we are concerned that Asian equities may underperform next year and are *tactically neutral* on the region. We do not envision another market meltdown (absent a collapse in the Chinese economy), but Asian equities could easily suffer a 15% to 20% shakeout at some point, if not more, should global equities broadly correct harder. The timing, as always, is unclear.

- Investors should rebalance allocations back to policy targets, if not slightly below for those with a real tactical bent, especially if any run-up over the coming quarters pushes allocations above desired limits. However, we do not encourage investors to try and time these markets. Previous pullbacks have been sharp but quick, and there remains the possibility that our concerns are misplaced. After being fortunate enough to make the right call last year, we run the risk of being spectacularly wrong in 2010.

- Investors interested in increasing exposure to Asia and emerging markets from a strategic perspective need to be very cognizant of the "entry price risk" they face. Investors should devise a plan to slowly average in to positions, with the flexibility to put more money to work after a tumble. Any shakeout or consolidation should be viewed as an attractive entry point.

Overall, we are tactically neutral on Asia, but strategically bullish. So far, we do not yet see enough excesses, whether market-based (valuations) or economic (leverage, overvalued currencies) to warrant a negative view on Asia from a long-term perspective. While we feel 2010 is likely to prove a more challenging year than 2009's slingshot advance, investors need to be prepared to grab the tiger by the tail.

Bubble Watch
Appendix A

There is much talk of asset bubbles forming in Asia. These concerns rightly stem from the recent surge in stock prices in the region, low interest rates globally, and China's massive credit surge. While we see the formation of an asset bubble in Asia as a distinct possibility, if not the likely outcome of the reflationary monetary policies being implemented globally, we do not yet see the signs of a broad asset bubble in Asia. In China, perhaps, but not across Asia.

True, many Asian markets have doubled from their bear market lows (especially when measured in US$ terms). However, Exhibits 22 and 23 show that despite the sharp rebounds, most Asian markets remain 20% to 30% below their 2007 peak levels. Strong returns alone do not signal a bubble. This is a classic example of confusing a rate of change with a level.[1] Meanwhile, valuations are stretched, but far from the bubble levels seen in 2007 or 1993–94, when P/E ratios of close to 30 were on display. Similarly, most Asian currencies are still below their 2007 highs, let alone the overvalued levels of the mid-1990s (Exhibit 4). Property prices are making new highs in China and Hong Kong, but not other markets in Asia; property excesses remain geared toward the luxury end of the spectrum.

Still, the risk of asset bubbles forming (the polite term for an investment mania) is real. Given attempts to maintain either explicit or implicit currency pegs to the U.S. dollar, Asian economies are effectively importing a monetary policy that is wholly inappropriate for their structurally faster-growing economies. Furthermore, ultra-low interest rates in much of the developed world create an incentive to seek a higher rate of return elsewhere; money flows to where it is treated best, and excess liquidity will eventually find its way to faster growing parts of the world.

But loose monetary policy alone does not inflate a bubble (ask a Japanese central banker). The additional ingredients of economic stability, overconfidence in asset prices, and growing leverage are required. Exhibit 8 shows the average loan-to-deposit ratios for the banking systems in China, Hong Kong, Korea, Malaysia, and Singapore. Though a crude and incomplete measure,[2] we can see the dramatic deleveraging that occurred following the Asian financial crisis, and that Asian banking systems today are far from the excesses of their previous asset bubble. After briefly rising in 2007, loan-to-deposit ratios are still falling, as liquidity in the system remains in the form of deposits and has not yet been transformed into loans. While deepening financial markets and economic development may mean loan-to-deposit ratios never reach the highs seen in the mid-1990s, leverage does not seem to be rising across Asia.

So how do you know an asset bubble when you see one? When economic growth becomes dependent on rising asset values, instead of asset values being driven by economic growth.[3] Andy

[1] It takes a 100% rally to recover from a 50% decline. Most Asian markets fell between 60% and 70% amid the meltdown. Furthermore, when measured in inflation-adjusted (real) US$ terms, many markets remain below the levels seen in the mid-1990s.

[2] A loan-to-deposit ratio higher than one implies there are more loans in the banking system than underlying deposits, and is a sign of a leveraged financial sector.

[3] It is the circular flow of credit being extended based on the collateral value of current assets to invest in similar assets based solely on the expectation of further asset price gains.

Xie, former Morgan Stanley economist and now independent consultant, has characterized the clearest warning sign as when companies and individuals begin to derive a growing share of their profits or income not from their primary economic business or employment, but from exposure to asset markets. We saw this in Japan in the 1980s, across much of Asia (and especially Southeast Asia) during the mid-1990s, in the United States over the past decade (first technology, then housing), and purportedly in China today.

The bottom line is that for a real bubble to take off, we need a period of economic stability and a level of confidence in the economic outlook that allows "animal spirits" to possess the private sector to lever up in the belief that asset prices will continue to rise. Arguably none of these factors are yet in play. However, the longer that economic growth diverges between Asia and the developed world, and the longer that monetary policies are kept extremely loose, the greater the likelihood of asset bubbles forming down the road.

Looking specifically at China, however, the economy does appear bubbly. Yet, as mentioned earlier, China's excesses are built largely on the deployment of domestic savings, not foreign-denominated debt. Chinese policymakers are making a calculated bet that they will have the ability to effectively pay off any bad loans accumulated by the private sector. This is what occurred following similar busts in the early 1990s and the massive restructuring of bank balance sheets before the 2005 share listings in Hong Kong. In other words, it has been argued that bank lending in China should be viewed as government obligations. While borrowers may default as projects go bust, China will stand behind its banks.

Still, there will be consequences from China's loan binge. The assumption is that China will be able to bundle nonperforming loans and slowly pay them off over time, in the hopes that a growing economy will dent the eventual costs. Estimates by GaveKal Research put potential losses stemming from bad loans generated over 2009 and 2010 at 5% to 7% of GDP. Such figures are nothing to scoff at, but should be viewed in the context of estimated Chinese fiscal deficits of 3.3% for 2010, compared to 12.5% for the United States. In other words, China can afford to bail out its banks this time around.

Nonetheless, China can only pull off this trick a limited number of times. The more excess is allowed to build, the bigger the eventual bust. But it should be remembered that such excesses can build for extended periods of time without suffering the final consequences. Japan's bubble was decades in the making, while warnings over U.S. household debt levels began in the late 1990s. In other words, China could be in its credit bubble phase for some time.

The Heavyweights in the Corner: Japan and Australia

Appendix B

We have chosen to separate Japan and Australia from our "Asia" discussion as we believe the economic and market dynamics, although intertwined, are different from those of the rest of the region. Below we review the outlooks for these two developed markets.

Japan

Japan was among the worst-performing stock markets in 2009, returning only 9.3% in local currency terms. While Japan did enjoy a brief period of outperformance in the beginning of 2009, a stubbornly strong yen crushed corporate profits and intensified deflationary pressures weighing on the economy. Furthermore, a series of poorly communicated policy announcements by the incoming Democratic Party of Japan rattled investor confidence. In short, instead of following the global rebound theme, Japan was embroiled in its own idiosyncratic story (or tragedy), as investors chose to chase returns elsewhere.

Where does this leave the world's third largest stock market and (for now) second largest economy? As argued in more detail in our October report,[1] we have become neutral on Japanese equities from a strategic sense. A tactical case can still be made for Japanese equities in 2010, as the market remains undervalued, oversold, and unloved, especially relative to the rest of Asia. If a strongly recovering global economy next year results in a weakening yen, Japanese equities could substantially outperform other developed market equities, even Asian equities, given the current level of depressed valuations. Should growth disappoint next year, Japan's valuation discount should provide some buffer relative to high valuations elsewhere. However, political risk remains an issue in Japan, as does the timing of a catalyst for a lasting bull market. For those with a tactical bent and the gumption, we would not be surprised to see Japan enjoy one of its bursts of relative outperformance next year.

Australia[2]

They don't call it the "lucky country" for nothing. Australia fared much better than most economies over the "Great Recession" of 2008 and 2009 despite the seemingly dangerous combination of a leveraged banking system, a heavily indebted household sector, and an overvalued housing market. To the chagrin of those commentators (your author included) who thought Australia would suffer a deleveraging-driven recession alongside the likes of the U.S. and U.K.

[1] Please see our October 2009 Market Commentary, *Japan: Will the Sun Ever Rise?*

[2] Given that Australia is the largest market in the region aside from Japan, developments in Australia can have a significant impact on Asian benchmarks and index strategies. For instance, Australia accounts for 28% of the MSCI AC Asia Pacific ex Japan Index, larger than China and India combined. Australia also accounts for 68% of the Pacific ex Japan "developed Asia" construct. In 2009 the MSCI AC Asia Pacific Index returned 58%, compared to the 67% return for MSCI AC Asia ex Japan Index, as Australia weighed on performance. Adjusting for currency impacts, however, both indices returned 72% and 73%, respectively, as the strength of the Australian dollar boosted returns. Overall, investors need to be aware of their exposure to Australia in their "Asia" benchmarks in addition to their standard developed markets equity exposure.

economies, Australian real GDP growth did not contract on a year-over-year basis in 2009.

Several factors supported Australia through the global credit crunch. First, the blow to the economy was softened by surging net exports as China took advantage of plummeting commodity prices to snap up raw materials from resource-rich Australia. Second, given that most mortgage debt in Australia is variable rate, the 425 basis points (bps) worth of policy rate cuts by the Reserve Bank of Australia (RBA) resulted in a quick boost to household income in the form of lower interest expenses. And third, fiscal stimulus was applied early and aggressively. Goldman Sachs JBWere Research estimates that over 2008–10, government investment and transfer payments to households will amount to 3% of GDP, making Australia's direct fiscal stimulus one of the largest globally as a percentage of GDP. Additional tax cuts bring the total fiscal stimulus close to 5% of GDP. The combined effect of these factors allowed Australia to break the negative feedback loops that developed in the United States and elsewhere, by which rising unemployment triggered mortgage defaults and plummeting house prices, thereby forcing further consumer and business retrenchment.

This is not to say that Australia escaped unscathed; the economy came to a grinding halt, corporate profits collapsed, and the stock market was hit hard, falling 50% peak to trough over 2007–09 (Exhibit 23). This reflected the collapse in earnings, with the entire run-up in earnings per share since 2003 having been erased, begging the question of whether such profits were largely illusionary to begin with, tied more to the financial economy than the real economy (Exhibit 9).

Australian equities have rallied strongly this year, reflecting not only the relative health of the economy, but also the prospects for an Asia-led global recovery. The MSCI Australia Index returned 37% in local currency terms in 2009, driven almost entirely by the financial and materials sectors, which accounted for 83% of the market's return, while composing 71% of market capitalization (Exhibit 24).

Perhaps of greater importance for investors was the surge in the Australian dollar, which rose 40% against the U.S. dollar, 20% against the GBP, and 34% against the euro over 2009. Exhibit 4 shows how currency movements impacted performance across markets: in local currency terms, Australian equities lagged behind the MSCI Asia ex Japan Index by some 30 percentage points; in US$ terms, Australian equities returned 77%, besting most Asian markets and vastly outperforming developed markets equities.[3] Thus, global investors benefited mightily from exposure to Australia, albeit mostly from its currency.

Looking forward, Australia may have to deal with the consequences of its success. Of concern is whether Australian growth will in fact surprise on the upside. Part of the strength of the Australian dollar reflects the fact that the RBA was the first major central bank to tighten monetary policy, having raised policy rates 75 bps since September 2009 to 3.75%. Should the economy begin to boom, a real risk is that the RBA continues to tighten rates, thus hitting households with higher mortgage costs, while a strong Australian dollar squeezes the non-mining economy.

It remains to be seen whether Australia will totally avoid the impact from deleveraging seen in other Anglo-Saxon economies. On the one hand, Australia may be the developed economy best suited to benefit from any potential Asian asset bubble that may emerge over the coming years.

[3] Indeed, from the perspective of an unhedged Australian-dollar based investor, 2009 would seem a lackluster year for global equities, with the MSCI AC World Index returning only 5.0% in A$ terms.

However, that is not yet a foregone conclusion. Aside from mortgages, private sector credit continues to contract in Australia, and employment and wage growth have not yet picked up sharply, implying that domestic demand remains weak. A two-tiered economy could emerge where those industries tied to natural resources and Chinese demand appear robust, while other portions of the Australian economy undergo a weak recovery. Indeed, 2010 real GDP growth for Australia is expected to be 2.7%, not exactly booming (Exhibit 5). In addition, the most recent Australian PMI survey continues to show lack of expansion in aggregate Australian manufacturing, with a reading of 48 (above 50 implies expansion).

From an equity standpoint, following the 50% rally from the March lows, valuations have become slightly expensive, with our normalized price-earnings (P/E) metrics all above 18, or almost 1 standard deviation above post-1970 averages (Exhibit 25). While P/E ratios based on forward consensus earnings estimates are only slightly above their historical average, this is down from 1 standard deviation above average at the end of September, with the recent improvement in forward multiples not reflecting falling stock prices, but rather rising earnings expectations (Exhibits 13 and 14).

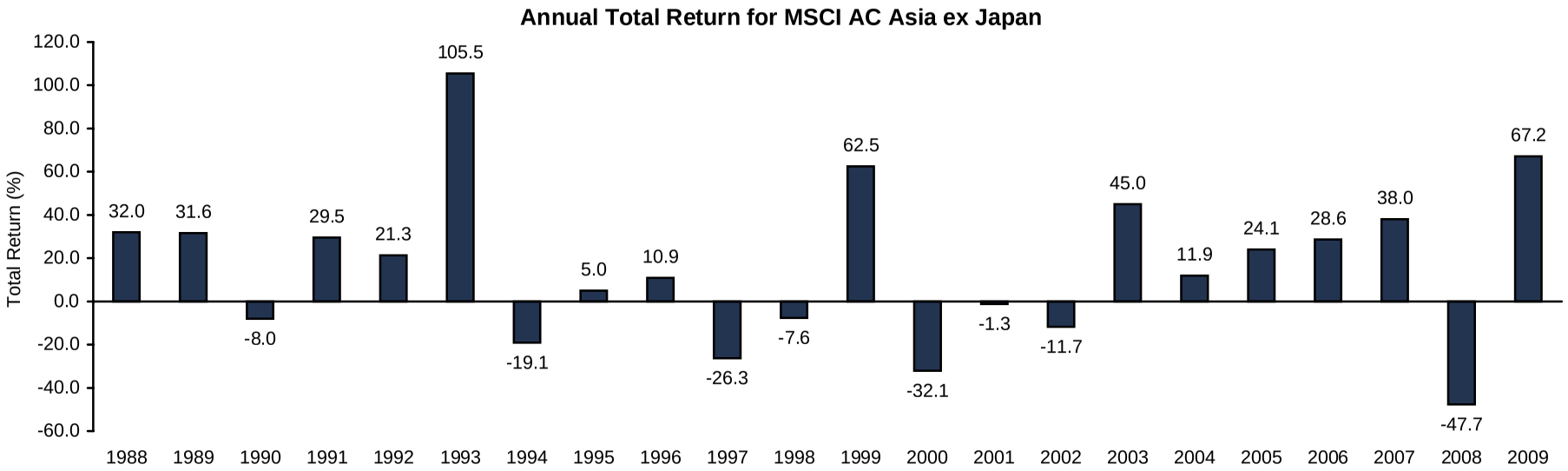
And herein lies the risk—Australian equities seem priced for strong recovery both at home and abroad. Any disappointment on either front could see the market falter. Like the rest of Asia, Australia owes much of its recent resilience to both Chinese demand and domestic stimulus. Clearly a pullback in China's appetite for commodities or a global slowdown in 2010 is market negative. In other words, 2010 could see the reversal of the factors that buoyed Australia in 2009—a fading impact from fiscal stimulus, rising interest rates, and moderating Chinese demand.

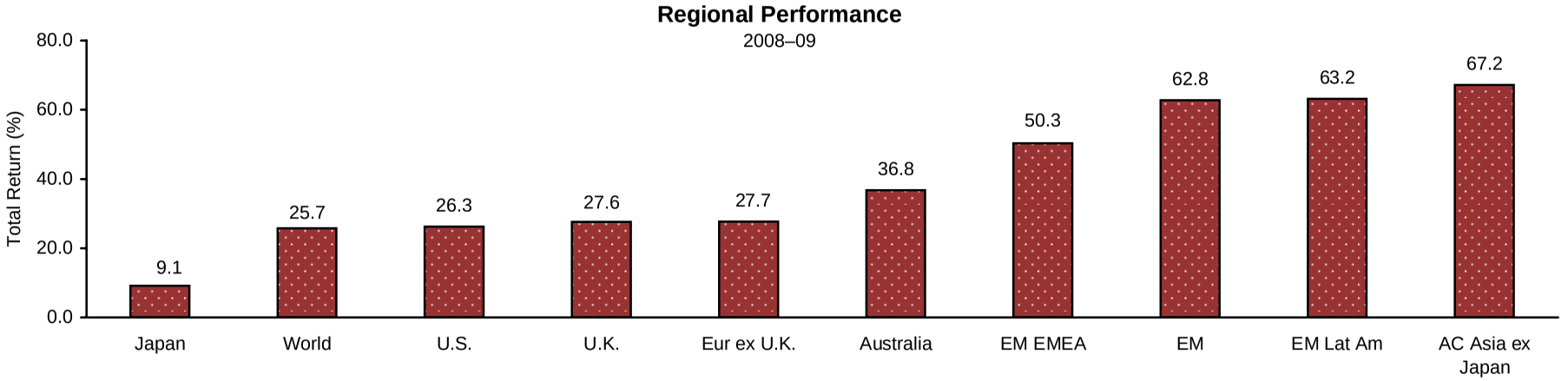
Overall, though the Australian economy seems detached from the travails of the developed world and more geared toward Asia, its stock market remains tied to global markets. Exhibit 26 shows rolling three-year correlations for Australian equities. While correlations between global equity markets are elevated everywhere, Australian equities are showing a higher correlation to developed markets equities (0.90) than to Asia ex Japan equities (0.76). Correlations are inherently unstable and can easily diverge, especially if Australia and Asia truly "decouple" from the rest of the world, yet it would seem that problems in the northern hemisphere could still spell trouble for Australian equities in 2010. Given that markets are priced otherwise, we remain a bit cautious.

Exhibit 1

Asia ex Japan Equity Performance

1988–2009 • Local Currency



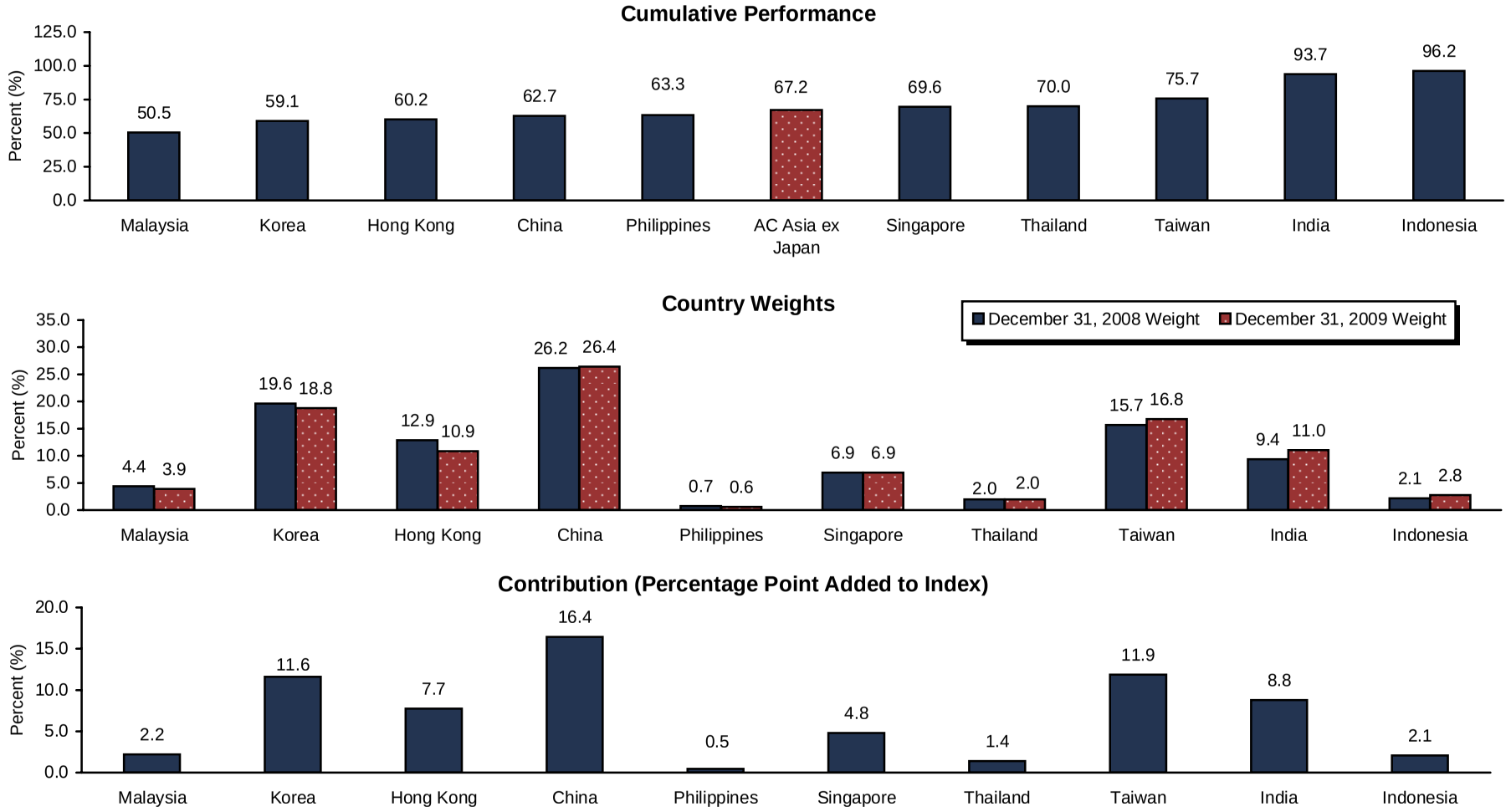


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Exhibit 2

Country Performance Attribution for MSCI All Country Asia ex Japan Index

December 31, 2008 – December 31, 2009



Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Contribution represents the sector's percentage point addition to the AC Asia ex Japan Index return of 67.2%. Sector contributions are calculated by multiplying the sector's December 31, 2008, weight by its cumulative local currency return from December 31, 2008, to December 31, 2009. Percentages may not total due to rounding. Performance is measured by gross total returns in local currency.

Exhibit 3

Sector Performance Attribution for MSCI All Country Asia ex Japan Index

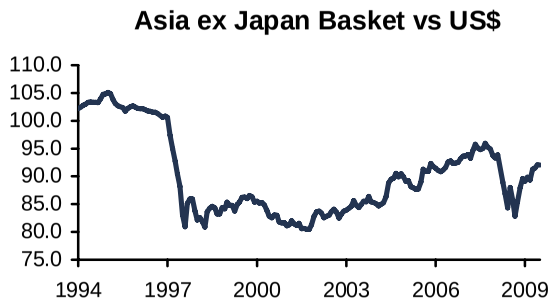
December 31, 2008 – December 31, 2009

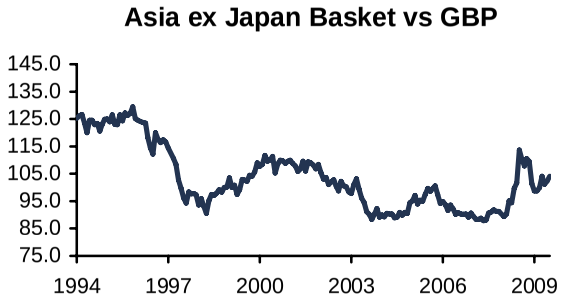
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Contribution represents the sector's percentage point addition to the AC Asia ex Japan Index return of 67.2%. Sector contributions are calculated by multiplying the sector's December 31, 2008, weight by its cumulative local currency return from December 31, 2008, to December 31, 2009. Percentages may not total due to rounding. Total returns for MSCI All Country indices are gross of dividend taxes.

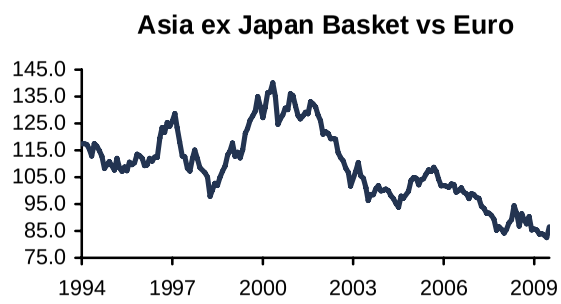
Exhibit 4

Asian Exchange Rate Movements

June 30, 1994 – December 31, 2009







2009 Total Returns

	Local Currency Return (%)	USD Return (%)	Currency Impact (ppt)	GBP Return (%)	Currency Impact (ppt)	Euro Return (%)	Currency Impact (ppt)	Aus Dollar Return (%)	Currency Impact (ppt)
AC World	30.0	35.4	5.4	20.6	-9.4	31.2	1.2	5.0	-25.0
AC Asia ex Japan	67.2	72.5	5.4	53.6	-13.5	67.2	0.0	33.8	-33.4
China	62.7	62.6	-0.1	44.8	-17.9	57.6	-5.1	26.1	-36.6
Hong Kong	60.2	60.2	-0.1	42.6	-17.6	55.2	-5.1	24.2	-36.1
India	93.7	102.8	9.1	80.6	-13.1	96.5	2.8	57.2	-36.5
Indonesia	96.2	127.6	31.4	102.7	6.5	120.5	24.3	76.5	-19.7
Korea	59.1	72.1	13.0	53.2	-5.9	66.7	7.6	33.4	-25.7
Malaysia	50.5	52.1	1.6	35.4	-15.1	47.3	-3.2	17.9	-32.6
Philippines	63.3	68.0	4.7	49.6	-13.8	62.7	-0.6	30.2	-33.1
Singapore	69.6	74.0	4.4	54.9	-14.6	68.6	-1.0	34.9	-34.7
Taiwan	75.7	80.2	4.6	60.5	-15.2	74.6	-1.0	39.7	-35.9
Thailand	70.0	77.3	7.3	57.9	-12.1	71.8	1.8	37.5	-32.5
Australia	37.0	76.8	39.7	57.4	20.3	71.3	34.2	37.0	---
Japan	9.3	6.4	-2.9	-5.3	-14.5	3.1	-6.2	-17.5	-26.8
EM ex Asia	56.6	85.3	28.7	65.0	8.4	79.6	22.9	43.7	-13.0

Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Graphs are based on monthly data. Asia ex Japan currency basket is the cumulative differential between returns for the MSCI AC Asia ex Japan Index in local currency terms and the corresponding returns in US$, GBP, and euro terms. Thus, it represents the movement of Asian currencies weighted by each country's market capitalization in the MSCI Index. Currency baskets are rebased to 100 on December 1987 (not graphed).

Exhibit 5

Select Macroeconomic Indicators

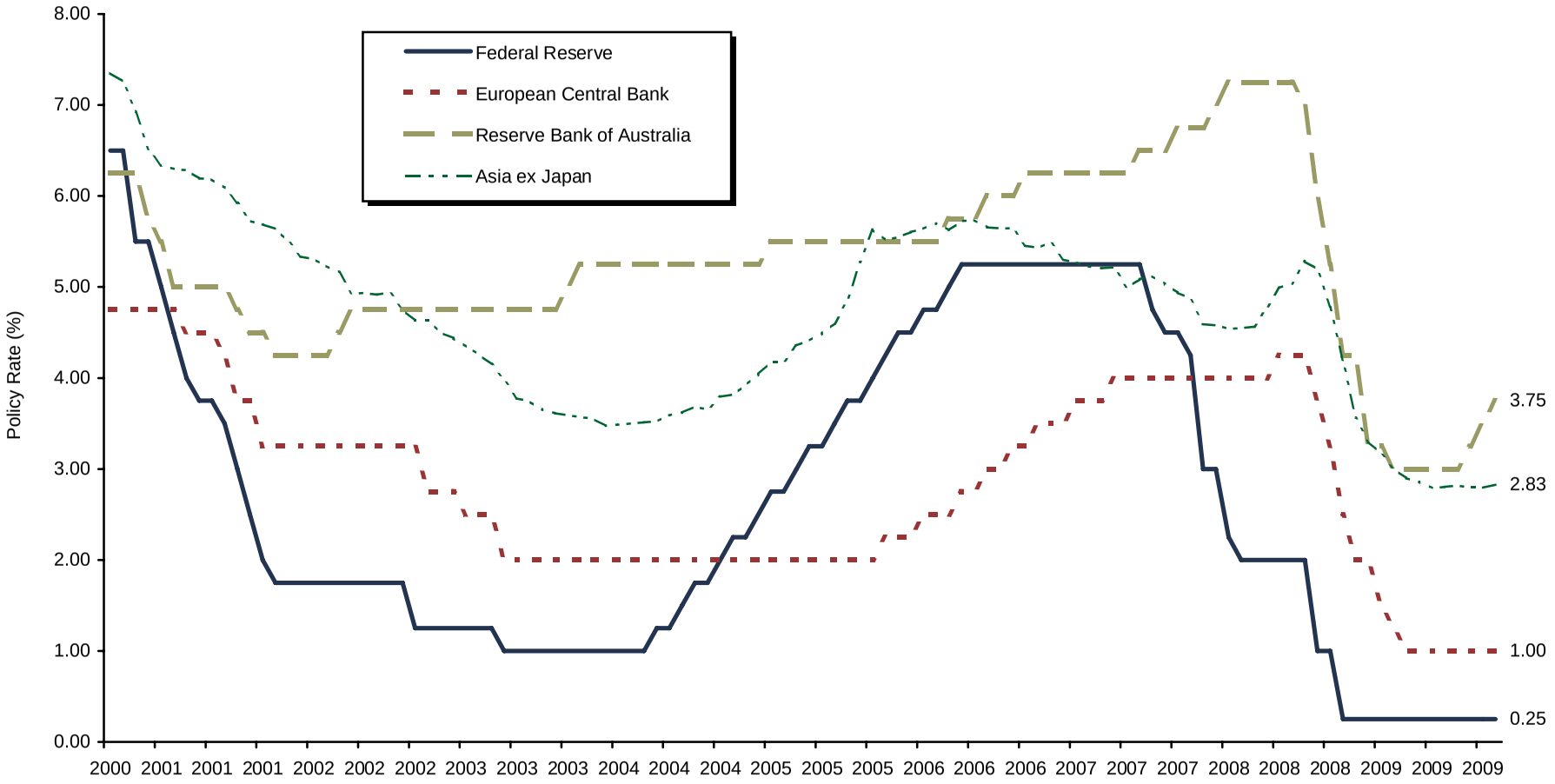
		Real GDP Year-over-Year Change (%)			Consumer Price Index Year-over-Year Change (%)			Unemployment Rate (%)			Fiscal Balance Percent of GDP (%)		
		2008	2009	2010	2008	2009	2010	2008	2009	2010	2008	2009	2010
China		9.0	8.5	9.6	5.9	-0.6	2.6	9.2	10.3	10.7	-0.4	-3.4	-3.3
India		6.7	6.1	7.6	9.0	9.2	6.9	9.1	9.5	9.9	-6.1	-8.0	-7.2
Hong Kong		2.4	-2.8	4.2	4.3	0.5	1.7	3.6	5.4	5.0	-0.3	-1.9	-1.6
Korea		2.2	-0.2	4.5	4.7	2.8	2.9	3.2	3.7	3.5	1.2	-4.5	-4.7
Singapore		1.1	-2.3	5.5	6.5	0.2	1.7	2.2	3.4	3.8	1.5	-3.2	-4.3
Taiwan		0.1	-3.9	4.2	3.5	-0.8	1.0	4.1	6.0	5.8	-0.9	-5.0	-4.7
Indonesia		6.1	4.4	5.4	9.5	4.8	5.8	8.4	7.7	7.7	-1.9	-2.6	-1.6
Malaysia		4.6	-2.6	4.4	5.4	0.7	2.1	3.3	5.0	5.2	-4.8	-7.9	-8.1
Philippines		3.8	1.6	3.7	9.3	3.1	4.4	7.4	8.0	8.5	-0.9	-3.7	-3.2
Thailand		2.6	-3.4	4.0	5.5	-0.8	2.8	1.4	2.7	3.4	-1.1	-5.7	-4.2
Asia ex Japan	(Avg)	3.9	0.5	5.3	6.4	1.9	3.2	5.2	6.2	6.3	-1.4	-4.6	-4.3
Asia ex Japan	(GDP-Weighted)	6.7	5.7	7.6	6.9	0.5	3.2	---	---	---	---	---	---
Australia		2.4	0.9	2.7	4.4	1.8	2.4	4.4	5.7	6.4	1.2	-3.6	-3.3
Euroland		0.6	-3.8	1.2	3.3	0.3	1.1	7.5	9.5	10.6	-1.9	-6.5	-7.2
Japan		-0.7	-5.7	1.4	1.4	-1.2	-0.9	4.1	5.3	5.8	-2.7	-7.7	-8.3
US		0.4	-2.4	2.7	3.8	-0.4	2.0	5.7	9.3	10.0	-3.2	-11.9	-12.5
G3	(Avg)	0.1	-4.0	1.8	2.8	-0.4	0.8	5.8	8.0	8.8	-2.6	-8.7	-9.3
World	(GDP-Weighted)	2.7	-0.8	3.8	5.5	1.4	2.5	---	---	---	---	---	---
G7	(GDP-Weighted)	0.2	-3.4	2.0	3.2	-0.2	0.9	---	---	---	---	---	---
BRICs	(GDP-Weighted)	7.5	5.1	7.5	7.8	1.9	4.2	---	---	---	---	---	---

Sources: Consensus Economics, Economist Intelligence Unit, Goldman Sachs Research, and Thomson Datastream.
Notes: Data for 2009 and 2010 are estimates. GDP-weighted data are provided by Goldman Sachs.

Exhibit 6

Policy Rates

November 30, 2000 – December 31, 2009

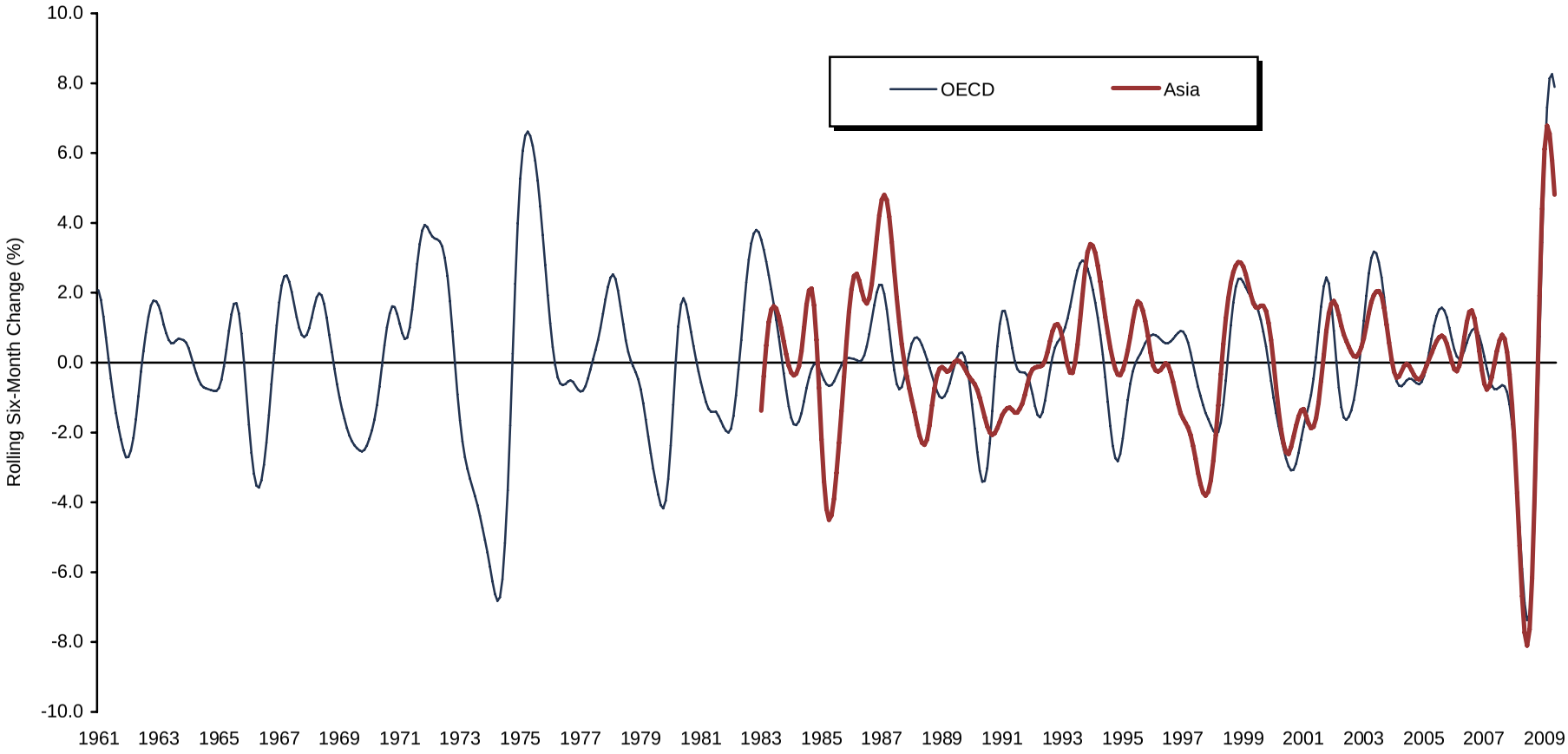


Source: Thomson Datastream.
Note: The Asia ex Japan policy rate is the simple average of the policy rates for China, Hong Kong, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan, and Thailand.

Exhibit 7

OECD Composite Index of Leading Economic Indicators

July 31, 1961 – November 30, 2009

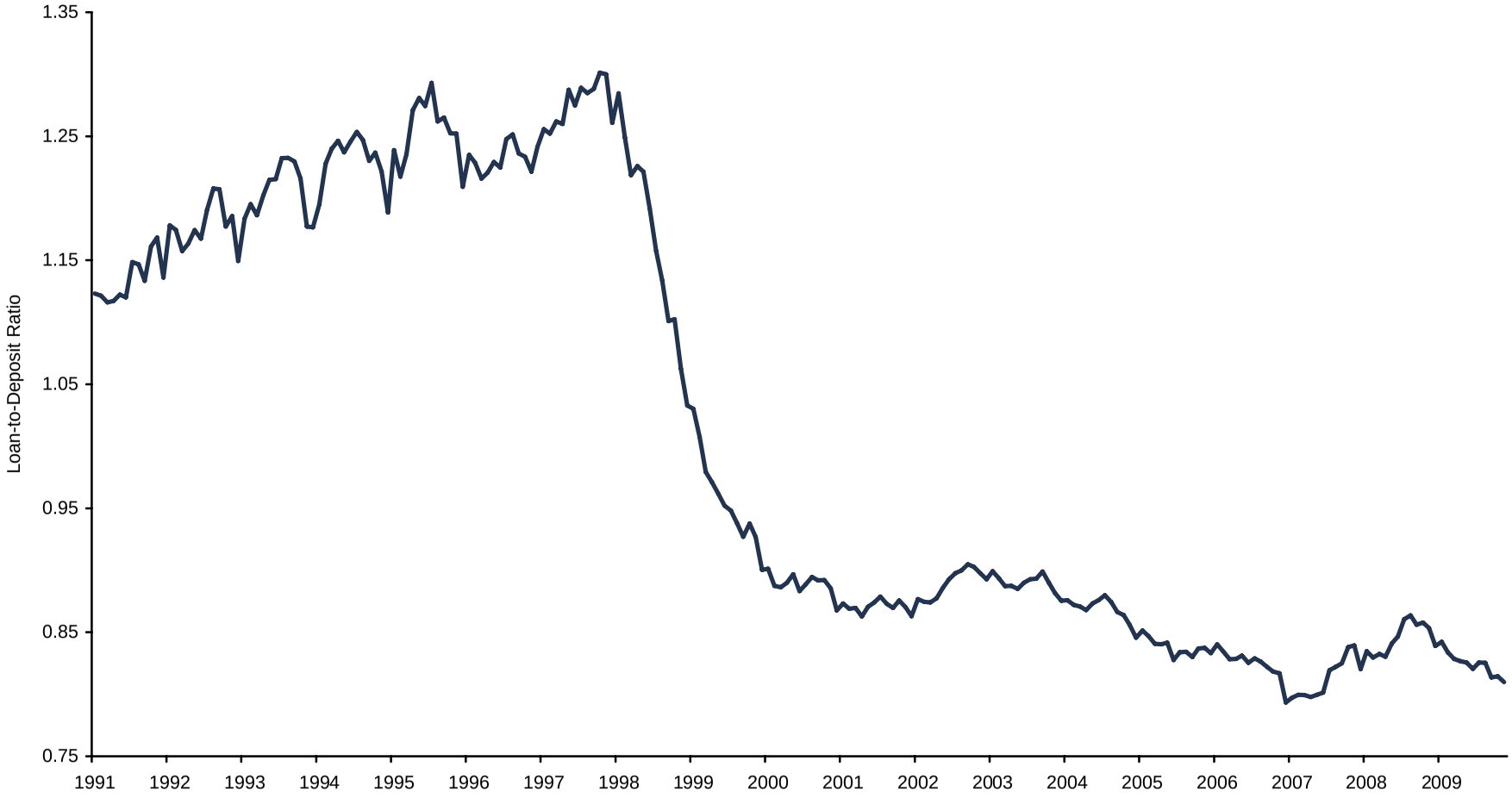


Sources: OECD and Thomson Datastream.
Notes: The OECD composite of leading indicators covers a wide range of economic indicators designed to signal turning points in the economic cycle. OECD composite covers 29 economies, including the Eurozone, Japan, the United Kingdom, and the United States, and other members of the OECD. The Asia leading indicators data cover China, India, Indonesia, Japan, and Korea and start in 1983.

Exhibit 8

Asia ex Japan Bank Deleveraging

January 31, 1991 – November 30, 2009



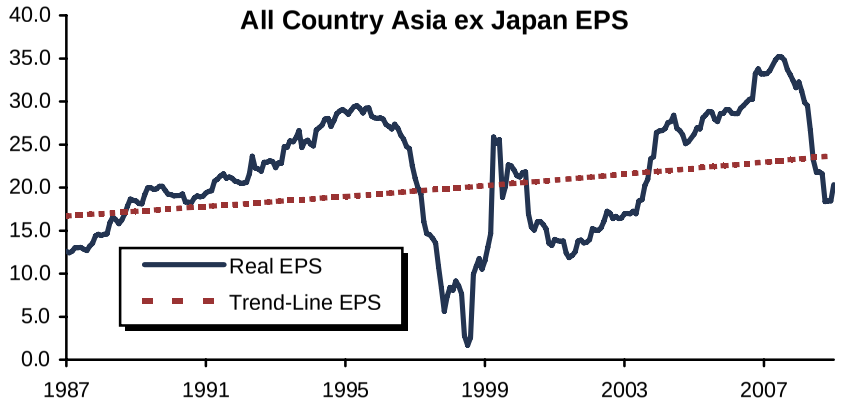
Source: FactSet Research Systems.

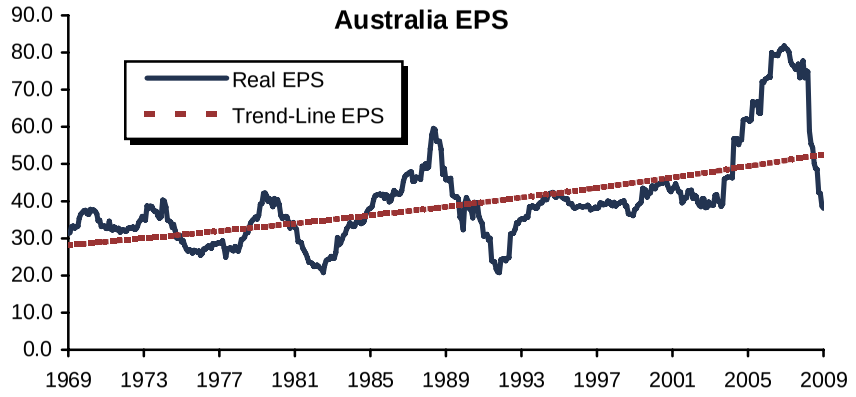
Notes: The loan-to-deposit ratio is calculated by dividing aggregate bank loans by total deposits. A loan-to-deposit ratio over 1.0 is a sign of a leveraged banking system as loans are being financed by means other than deposits. The composite Asia ex Japan loan-to-deposit ratio is the simple average of country-level loan-to-deposit ratios. From January 1991 through November 1996, the calculation includes Hong Kong, Korea, and Singapore. Malaysia was added in December 1996 and China in January 2007.

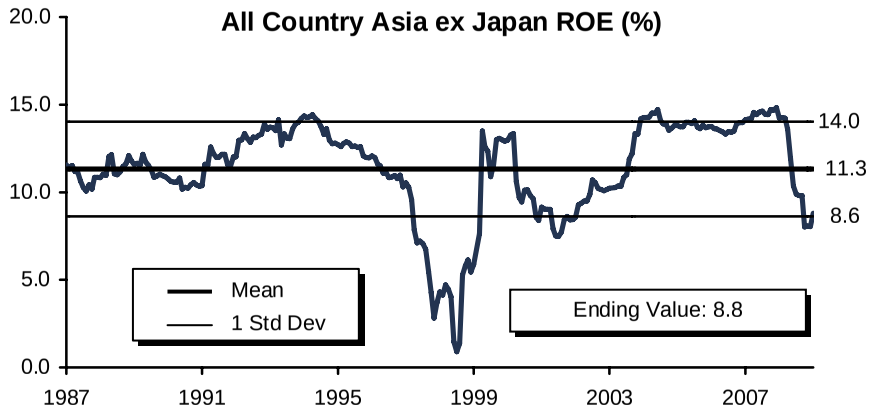
Exhibit 9

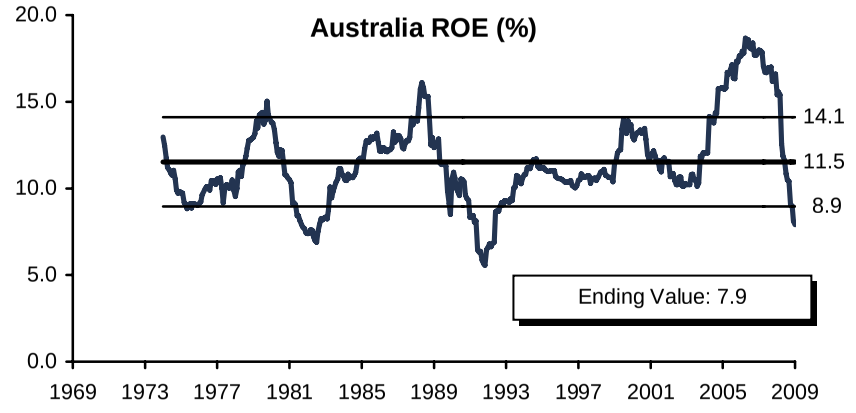
Real Earnings and Return on Equity

December 31, 1969 – December 31, 2009







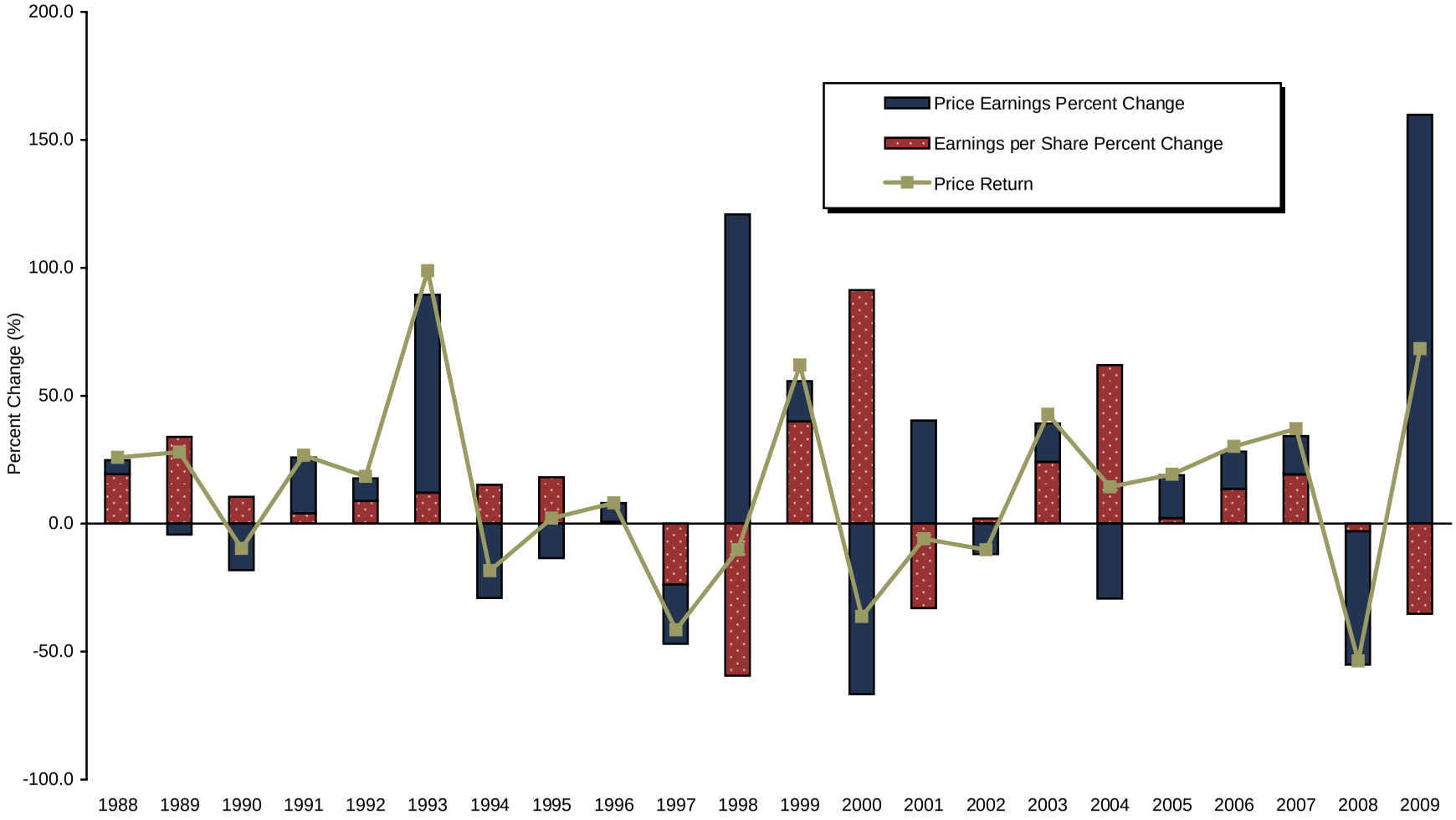


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Real earnings per share (EPS) for the MSCI All Country (AC) Asia ex Japan Index are based on EPS in US$ terms deflated by the U.S. CPI. Real EPS for the MSCI Australia Index are based on EPS in Australian dollar terms deflated by the Australian CPI. Trend-line earnings based upon simple linear regression. Data for AC Asia ex Japan start on December 31, 1987. Australia ROE data start on December 31, 1974. Valuation history for the AC Asia ex Japan Index is re-created for the pre–November 1995 period by taking the market cap–weighted average of country level valuation data. From 1974 to 1991, the index includes only Hong Kong and Singapore. In 1992, Indonesia, Malaysia, the Philippines, and Thailand are added; in 1994, India; and in 1995, China, Korea, and Taiwan. Starting in November 1995 the official MSCI value is used.

Exhibit 10

Annual Drivers of Return: MSCI All Country Asia ex Japan

1988–2009 • U.S. Dollars

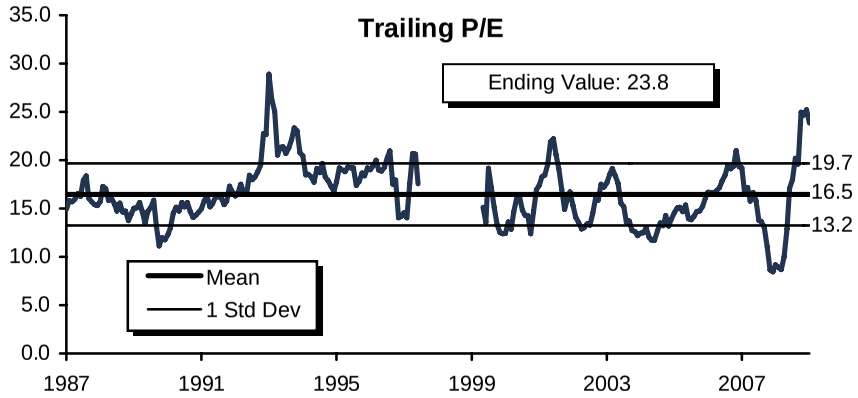


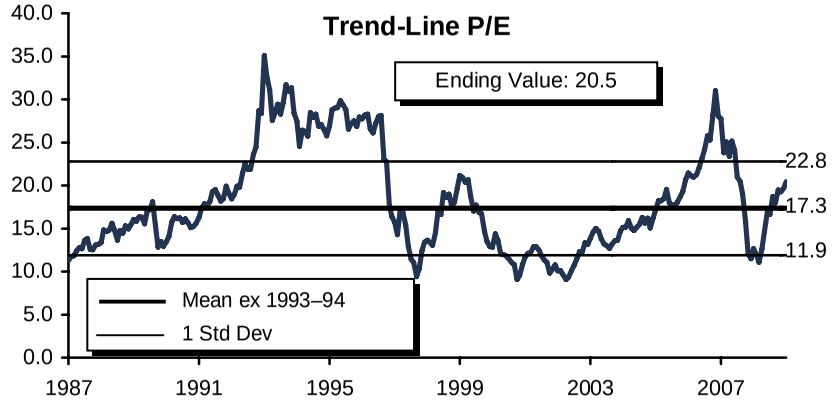
Sources: MSCI Inc. and Thomson Datastream.

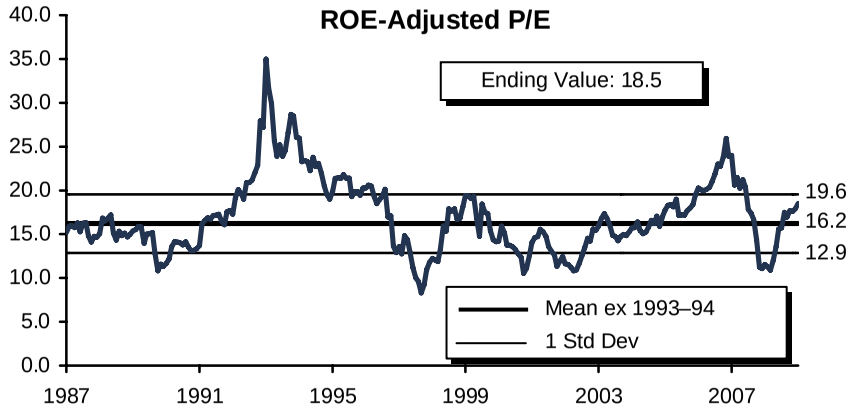
Exhibit 11

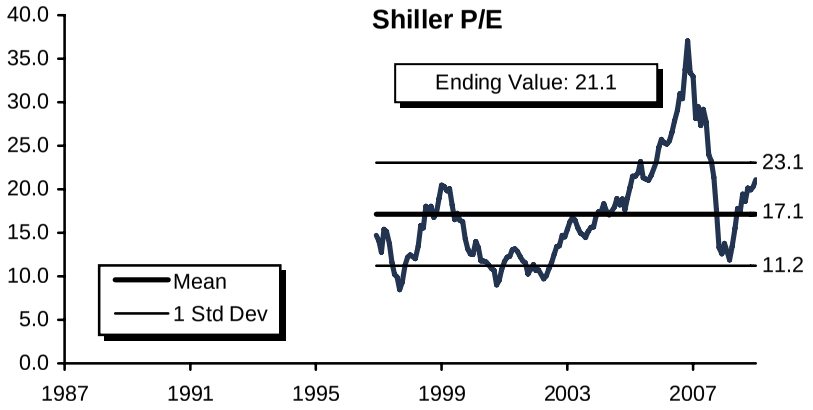
MSCI All Country Asia ex Japan Price-Earnings Valuations

December 31, 1987 – December 31, 2009







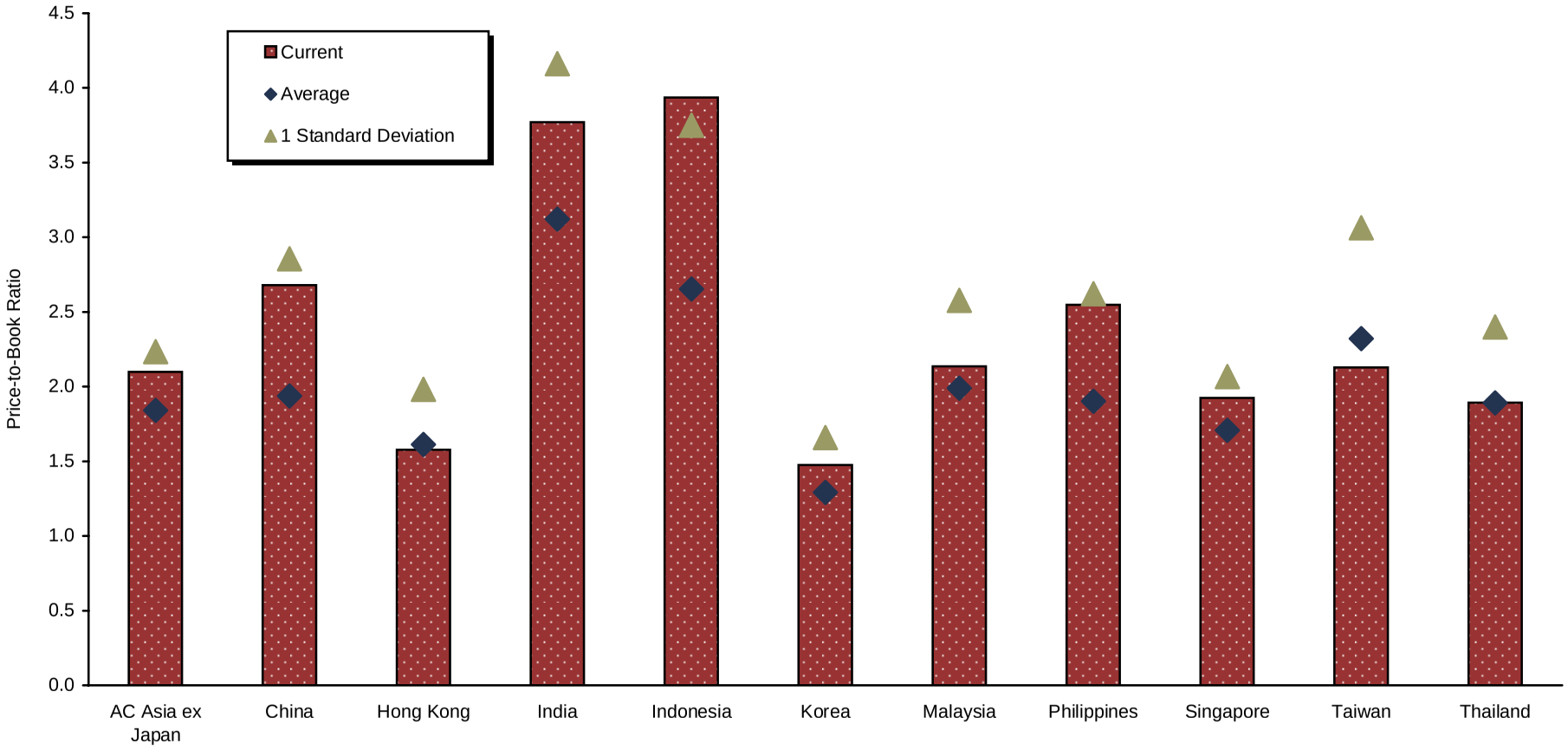


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: We have removed outlier data from June 1998 through March 2000 from the trailing price-earnings (P/E) graph due to negative earnings resulting in nonsensical P/E ratios. We have removed the years 1993 through 1994 from our mean and standard deviation calculations for the return on equity (ROE)–adjusted and trend-line P/E graphs to achieve a more normal distribution. Valuation history for the All Country Asia ex Japan Index is re-created for the pre–November 1995 period by taking the market cap–weighted average of country level valuation data. From 1974 to 1991, the index includes only Hong Kong and Singapore. In 1992, Indonesia, Malaysia, the Philippines, and Thailand are added; in 1994, India; and in 1995, China, Korea, and Taiwan. Starting in November 1995 the official MSCI value is used.

Exhibit 12

Asia ex Japan Price-to-Book Ratios

November 30, 1995 – December 31, 2009

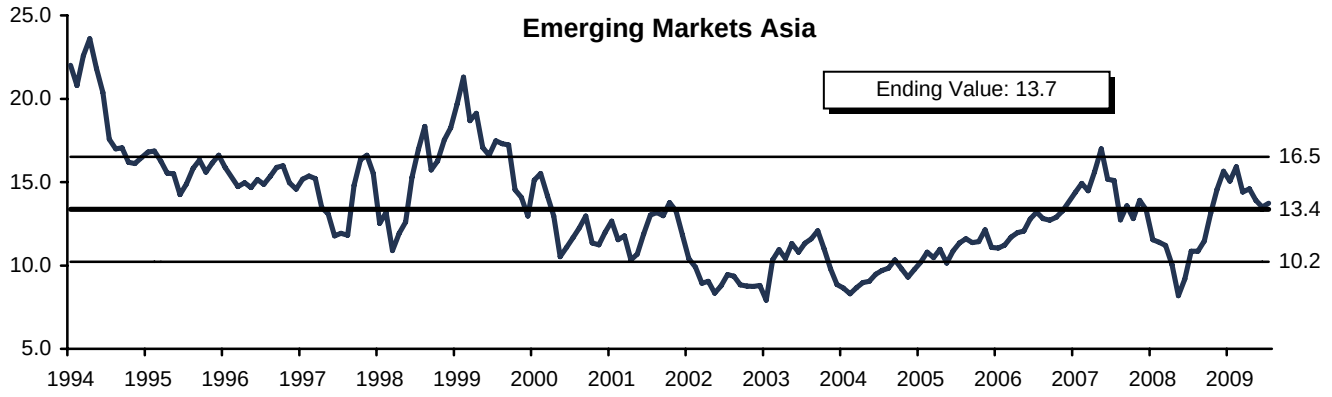


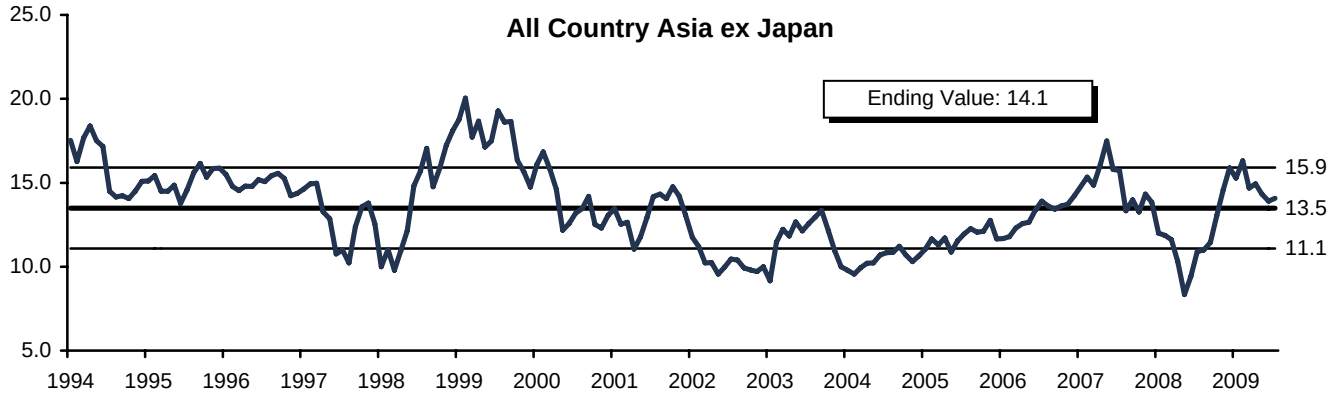
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Mean and standard deviations are based on post-1995 data for each market.

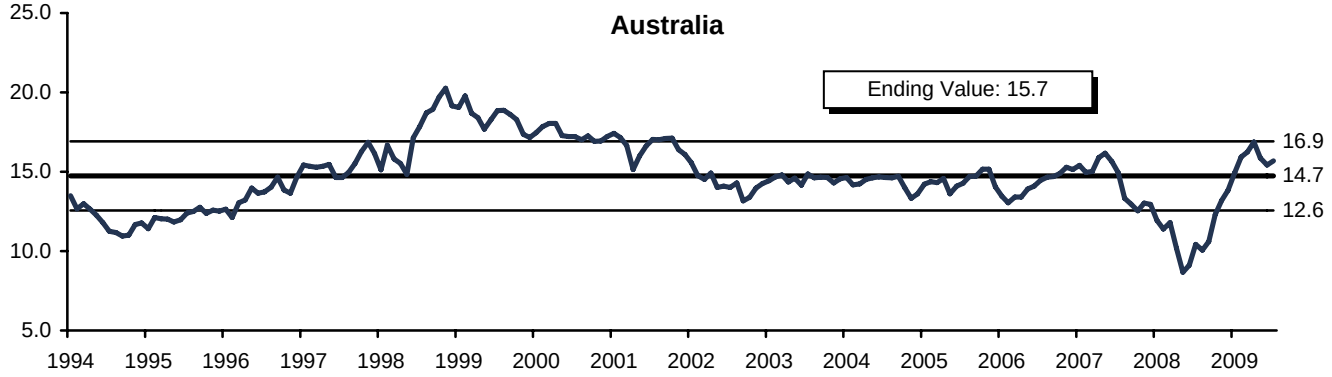
Exhibit 13

Forward Price-Earnings Ratios

June 30, 1994 – December 31, 2009





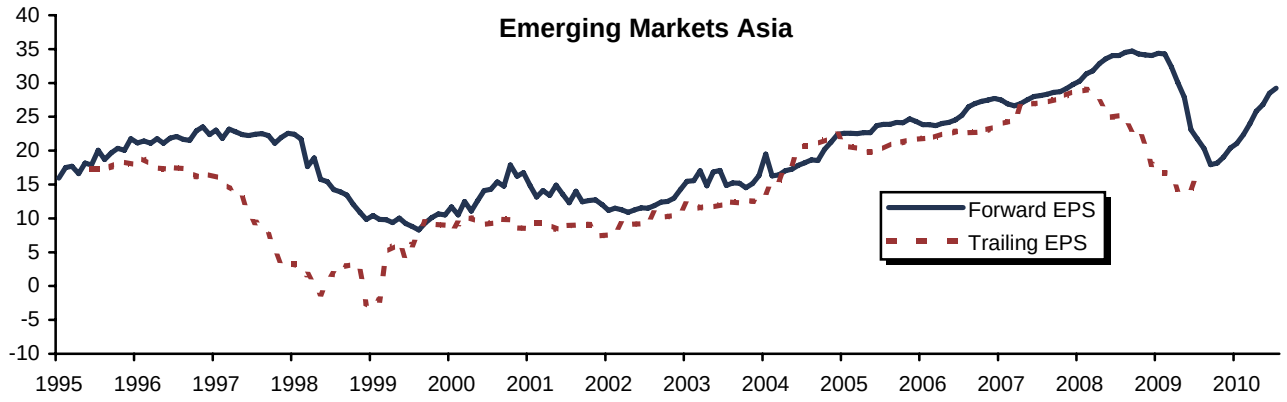


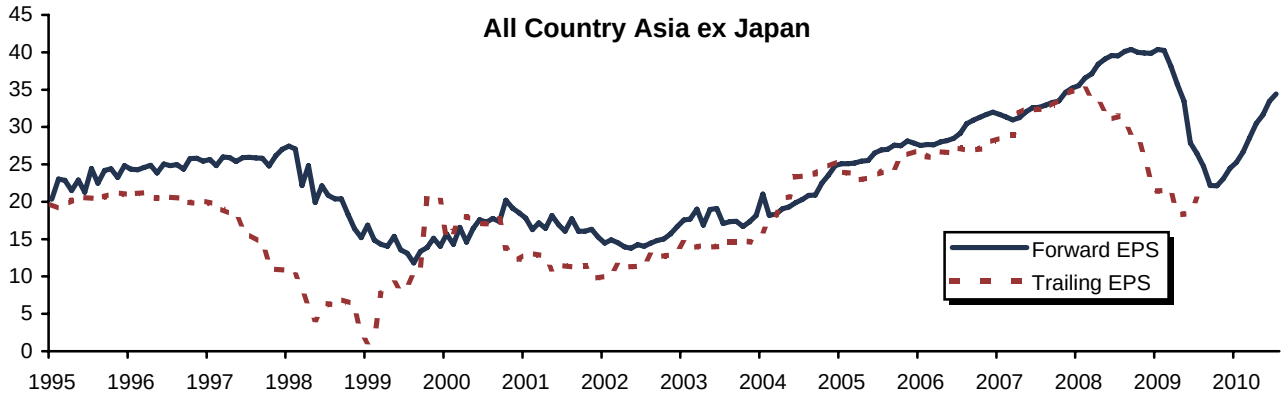
Sources: FactSet Research Systems and MSCI Inc. MSCI data provided "as is" without any express or implied warranties.

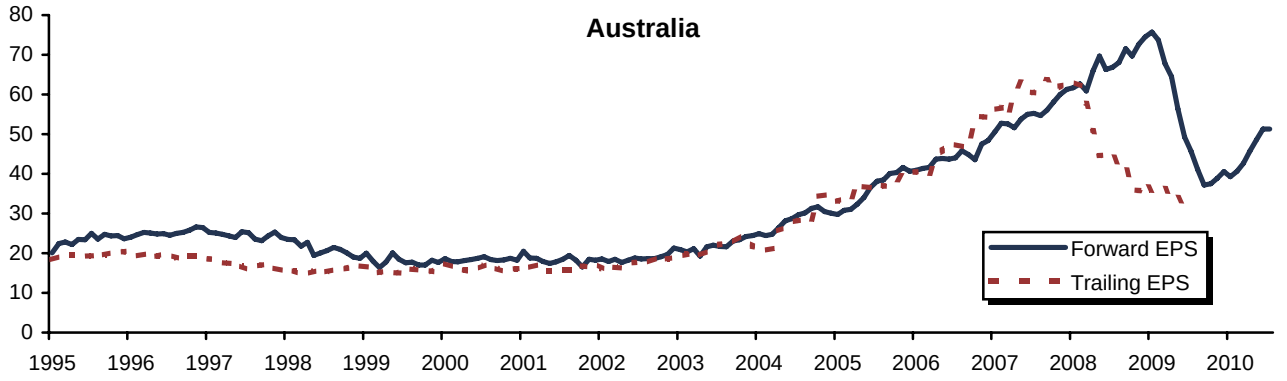
Exhibit 14

Forward Earnings Estimates

June 30, 1994 – December 31, 2009





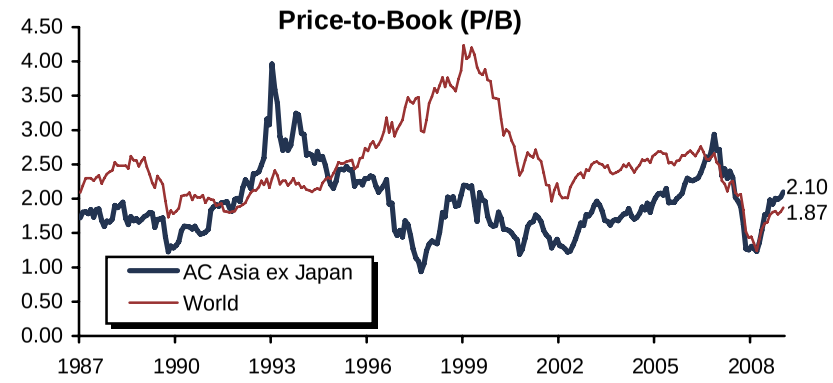


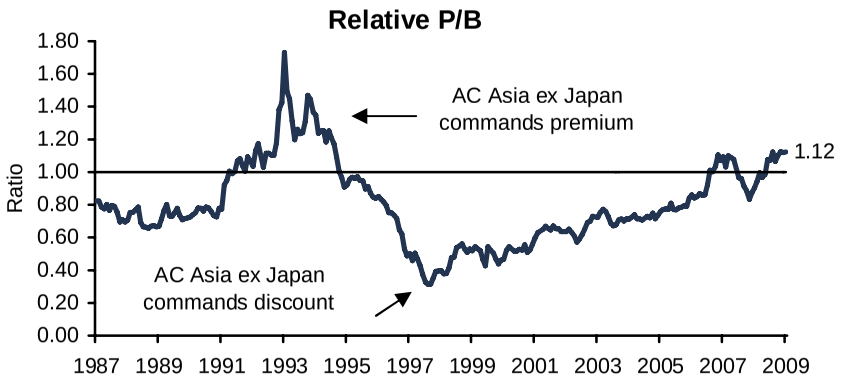
Sources: FactSet Research Systems and MSCI Inc. MSCI data provided "as is" without any express or implied warranties.
Notes: Forward earnings per share are graphed leading by 12 months.

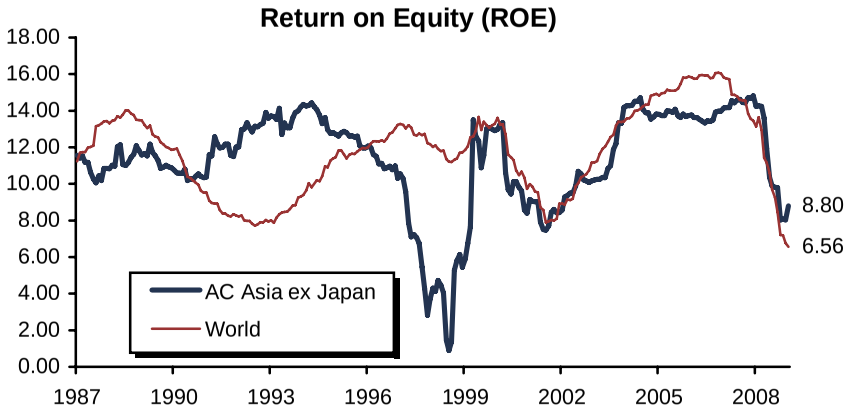
Exhibit 15

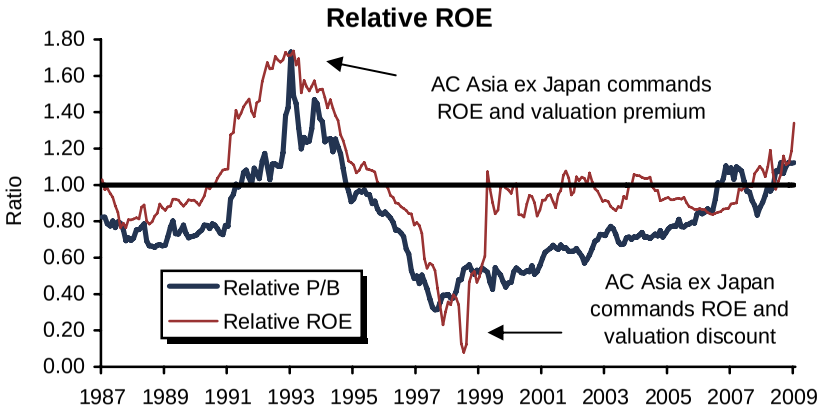
Asia ex Japan Relative Valuation

December 31, 1987 – December 31, 2009









Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Relative valuation graphs show MSCI All Country Asia ex Japan's valuation as a percentage of the World's valuation.

Exhibit 16

Drivers of Return

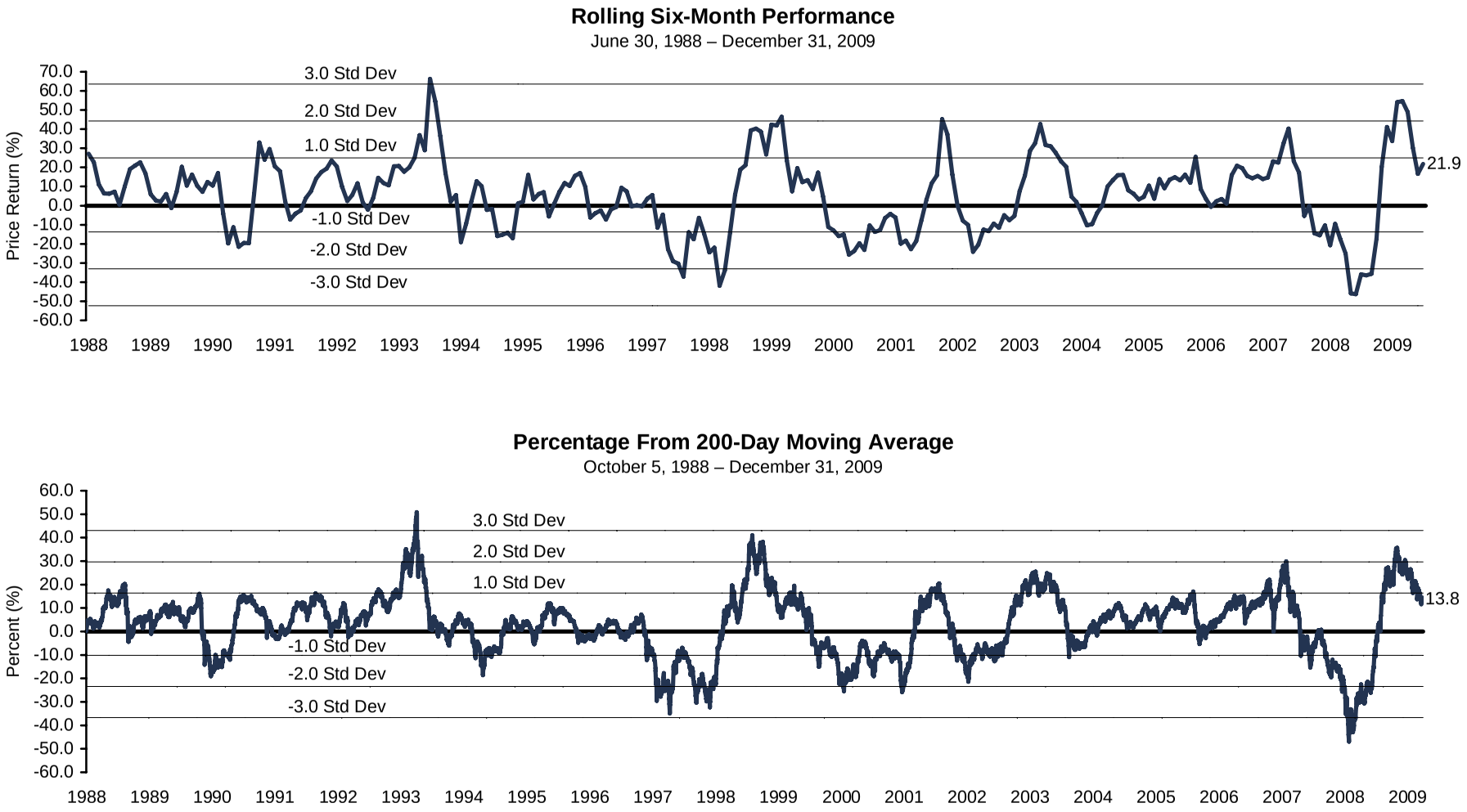
Average Annual Compound Returns • U.S. Dollars

		MSCI AC Asia ex Japan	MSCI World
Full Period (22 years)			
Start Date	End Date		
12/31/1987	12/31/2009		
	Total Return	10.2	7.2
	Income Return	2.6	2.2
	Price Return	7.4	4.9
	Earnings Growth	5.2	2.9
	Valuation Expansion	2.2	2.0
	Beginning P/E	14.9	18.6
	End P/E	23.8	28.5
1990s Emerging Markets Bubble (4 years)			
Start Date	End Date		
12/31/1990	12/31/1994		
	Total Return	28.1	10.2
	Income Return	2.6	2.4
	Price Return	24.9	7.6
	Earnings Growth	9.9	-3.0
	Valuation Expansion	13.6	11.0
	Beginning P/E	12.3	15.3
	End P/E	20.5	23.2
Tech Boom (5 years)			
Start Date	End Date		
12/31/1994	12/31/1999		
	Total Return	0.7	20.2
	Income Return	2.0	1.8
	Price Return	-1.3	18.1
	Earnings Growth	-12.4	8.3
	Valuation Expansion	12.7	9.0
	Beginning P/E	20.5	23.2
	End P/E	37.3	35.7
Global Rally (5 years)			
Start Date	End Date		
12/31/2002	12/31/2007		
	Total Return	32.0	17.5
	Income Return	2.9	2.3
	Price Return	28.3	14.9
	Earnings Growth	22.7	24.2
	Valuation Expansion	4.6	-7.5
	Beginning P/E	15.3	23.2
	End P/E	19.2	15.7

Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Based on trailing earnings per share. Figures are expressed as average annual compounded rates.

Exhibit 17

MSCI All Country Asia ex Japan Index Momentum

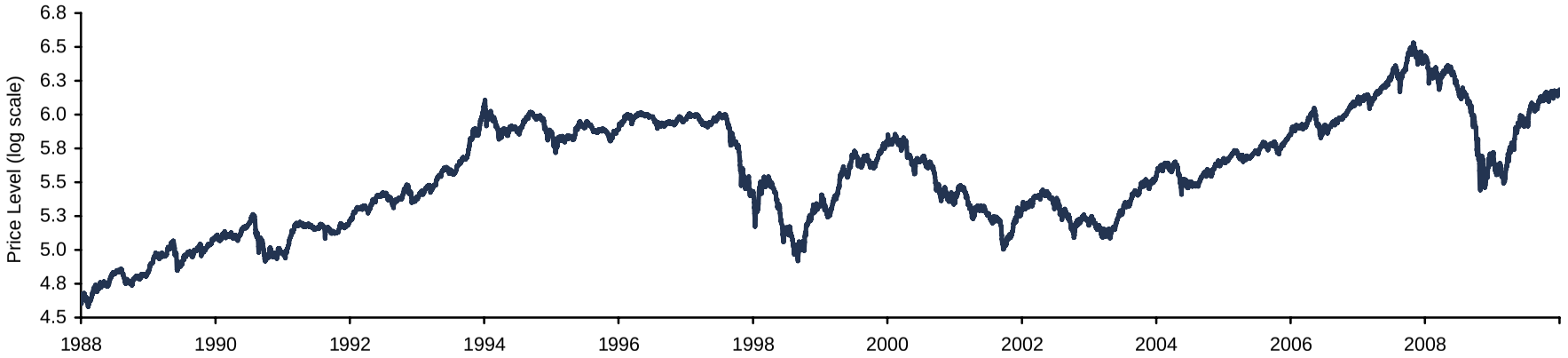


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: The top graph is based on monthly price returns in local currency. The bottom graph is based on daily price levels in local currency.

Exhibit 18

MSCI All Country Asia ex Japan Declines and Subsequent Rallies

January 1, 1988 – December 31, 2009 • U.S. Dollar



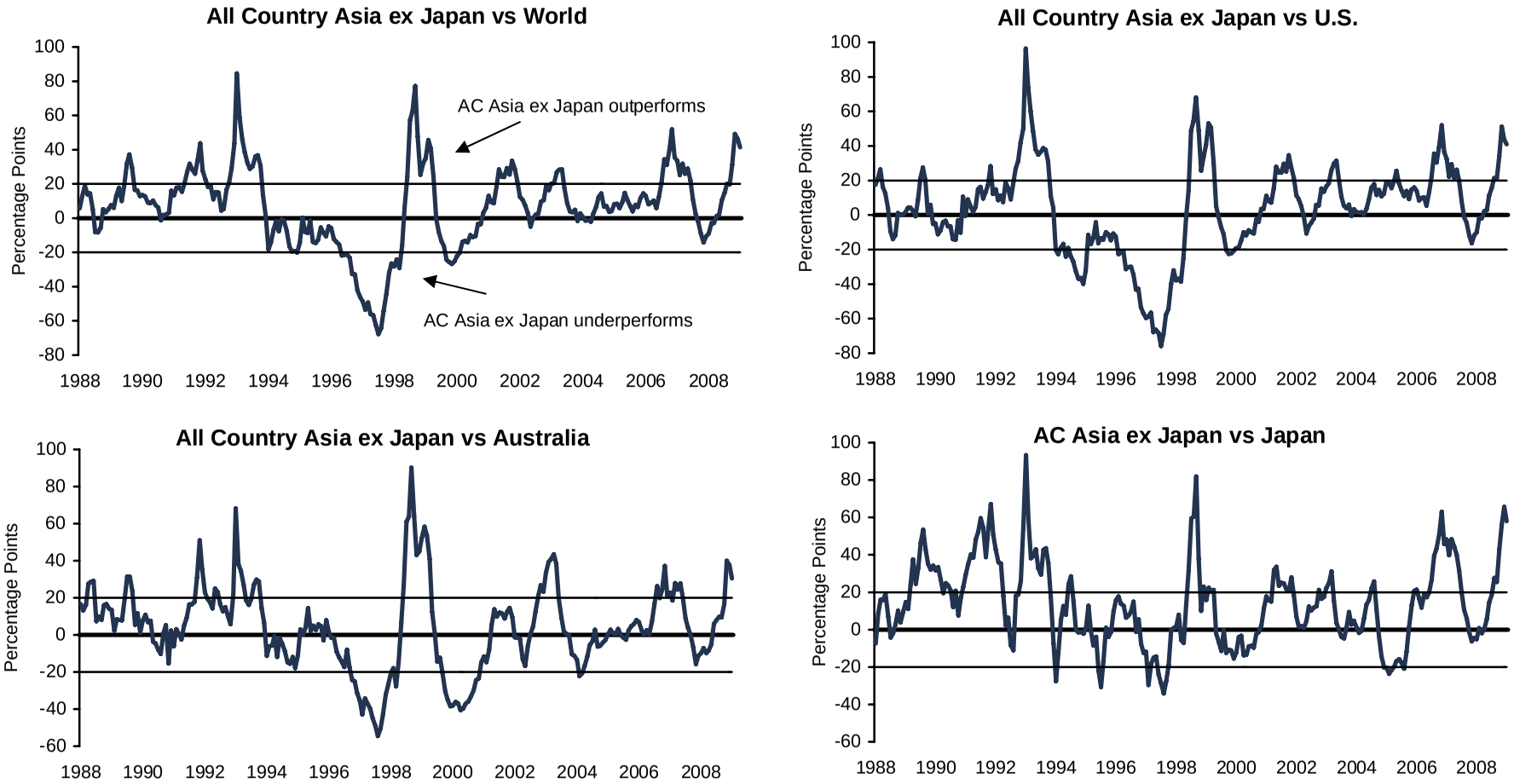
Date of Peak	Date of Trough	Peak to Trough	Decline (Months)	Subsequent Rally	Subsequent Rally (Months)
July 23, 1990	September 28, 1990	-29.2	2.2	228.9	39.3
January 5, 1994	March 21, 1994	-25.2	2.5	22.2	5.6
September 8, 1994	January 24, 1995	-25.9	4.5	34.5	15.2
April 30, 1996	January 12, 1998	-56.9	20.4	44.7	2.4
March 25, 1998	September 1, 1998	-46.4	5.3	155.3	17.3
February 11, 2000	September 21, 2001	-57.3	19.3	55.1	7.1
April 24, 2002	April 25, 2003	-30.1	12.0	75.9	11.6
April 13, 2004	May 17, 2004	-21.3	1.1	89.1	23.7
May 8, 2006	June 13, 2006	-19.7	1.2	102.2	16.5
October 29, 2007	March 17, 2008	-29.3	4.6	19.4	1.5
May 2, 2008	October 27, 2008	-60.2	5.8	31.6	2.3
January 6, 2009	March 2, 2009	-20.4	1.8	99.7 *	10.0 *
December 31, 2009 *	???				

Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Bear markets are defined as a price decline of at least 19%. Analysis based on daily data from January 1, 1988, through December 31, 2009. The graph is displayed in logarithmic scale.
* Represents the current data point but does not imply the market has reached its peak.

Exhibit 19

Rolling 12-Month Relative Performance

December 31, 1988 – December 31, 2009 • Local Currency

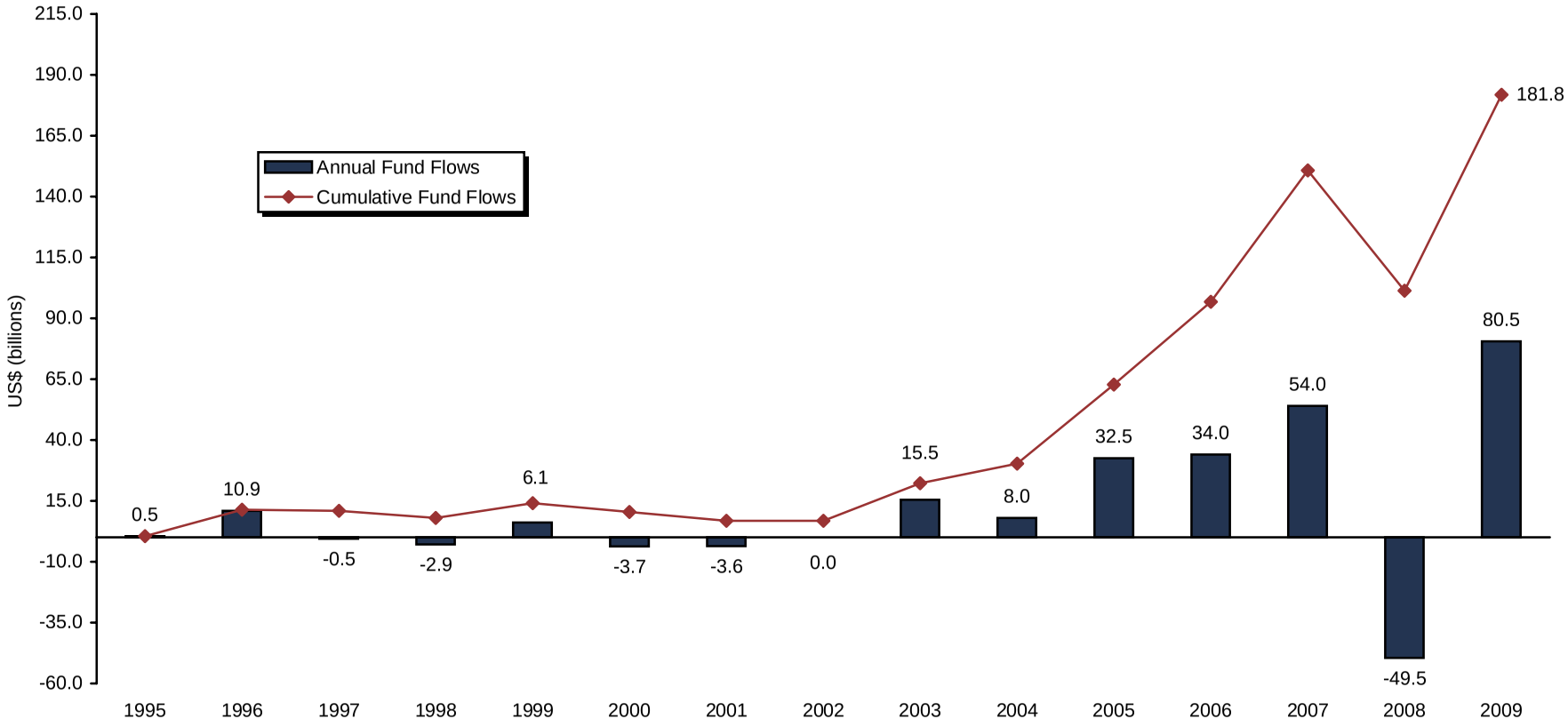


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Graphs show the percentage point difference between the rolling 12-month total return of All Country Asia ex Japan and each market in local currency. Total returns for developed markets indices are net of dividend returns. Total returns for All Country Asia ex Japan are gross of dividend returns.

Exhibit 20

Net Annual and Cumulative Inflows into Emerging Markets Funds

1995–2009

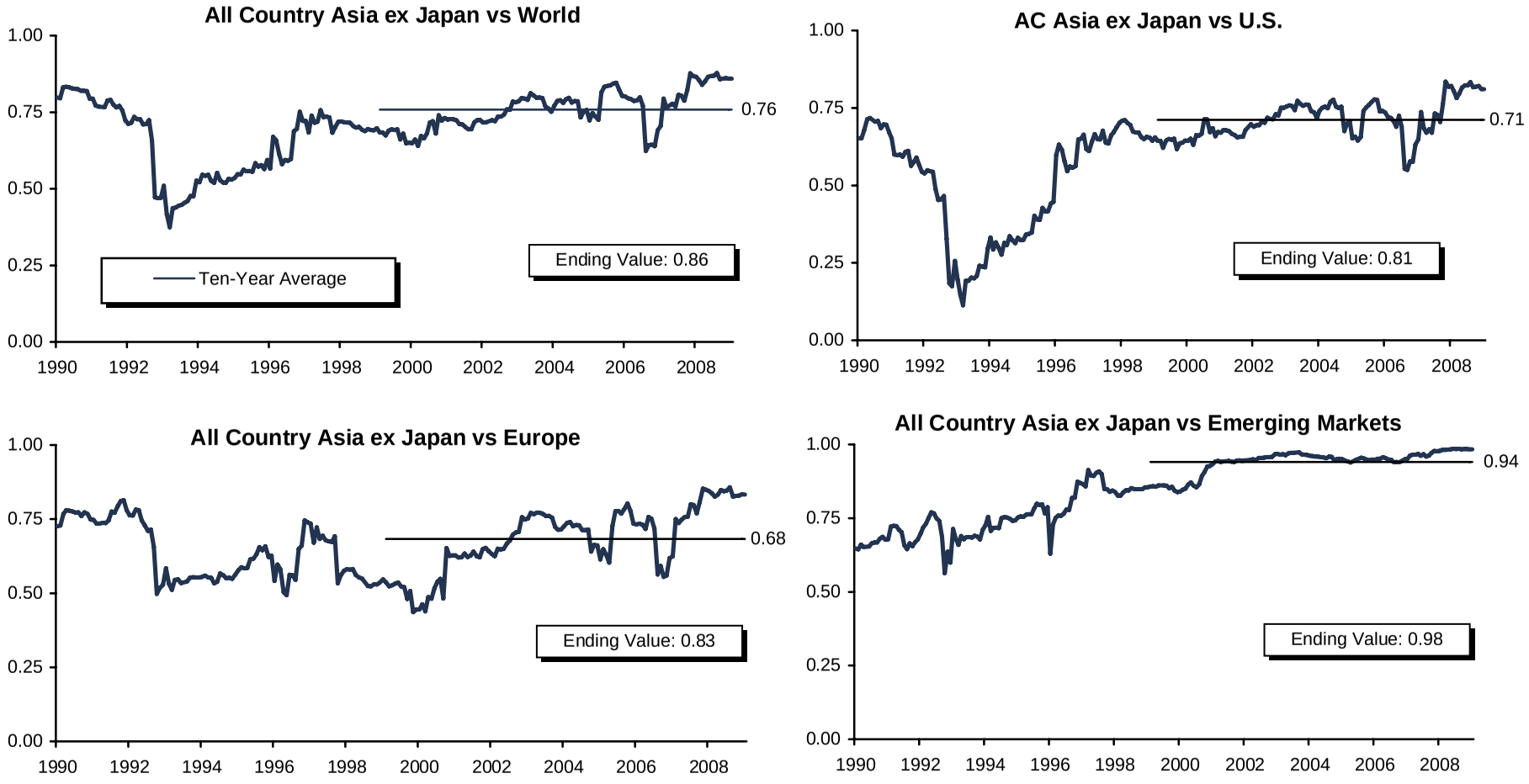


Sources: EPFR Global and Morgan Stanley Research.
Note: Fund flows cover all dedicated emerging markets equity funds.

Exhibit 21

All Country Asia ex Japan Rolling 36-Month Correlations

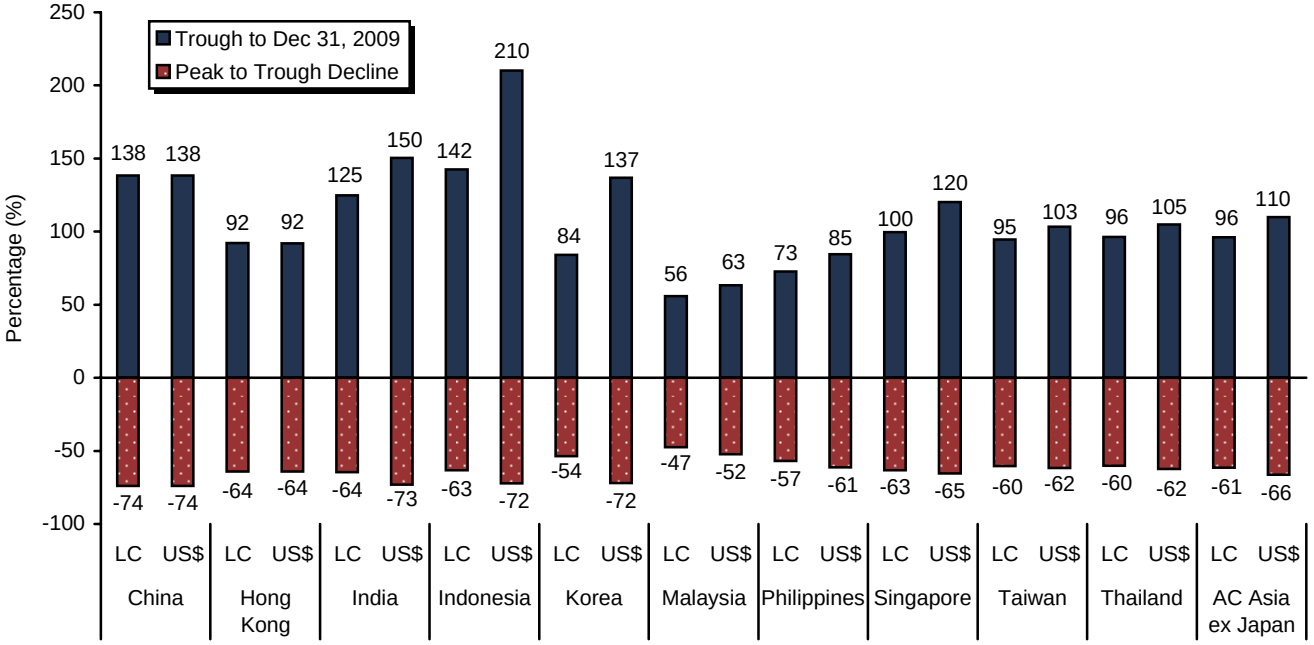
December 31, 1990 – December 31, 2009



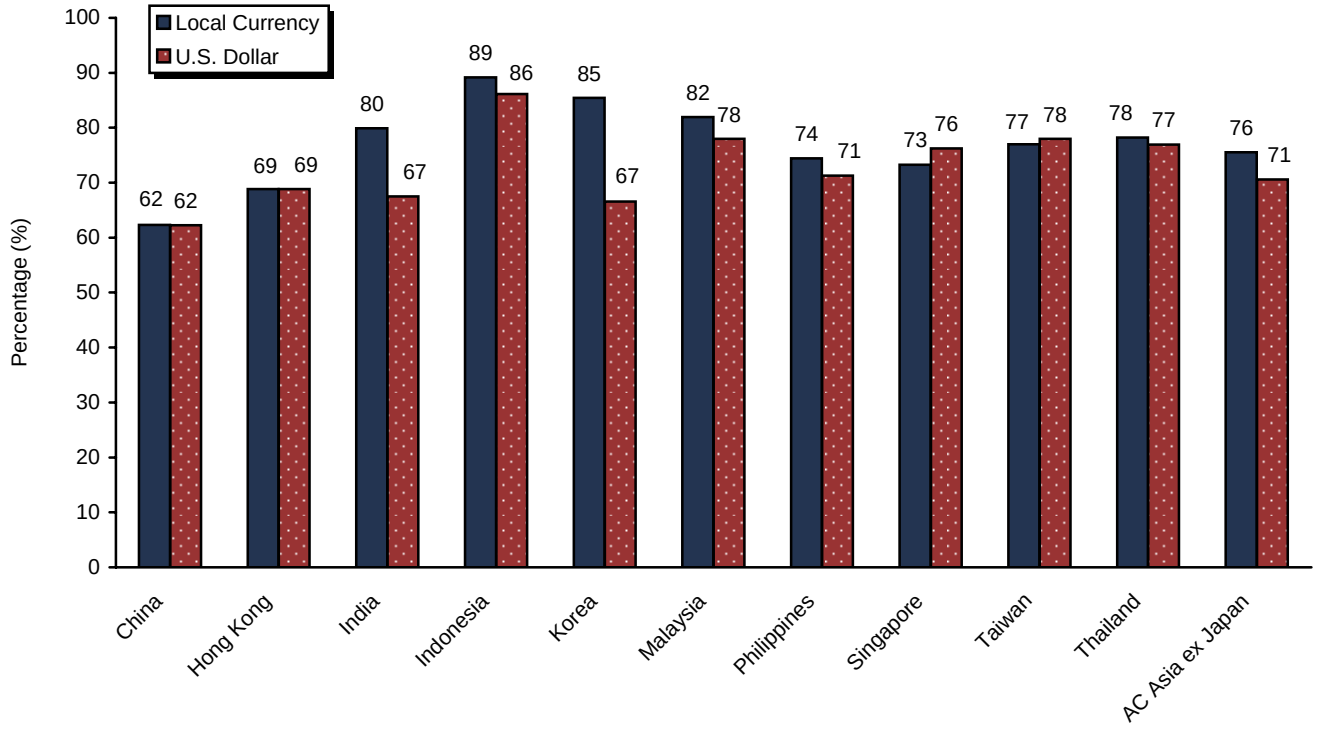
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Data are based on monthly total returns in local currency for each region.

Exhibit 22

Asia ex Japan Market Declines and Subsequent Rallies



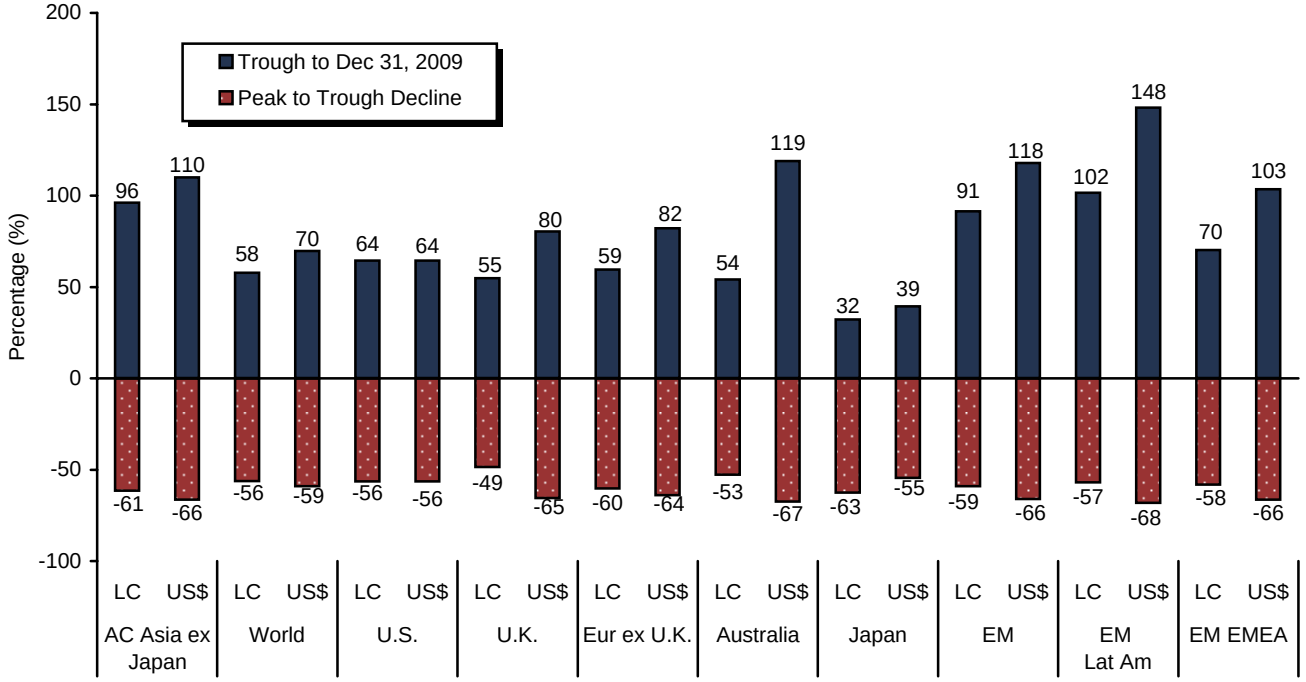
December 31, 2009 Level as a Percentage of Previous Peak



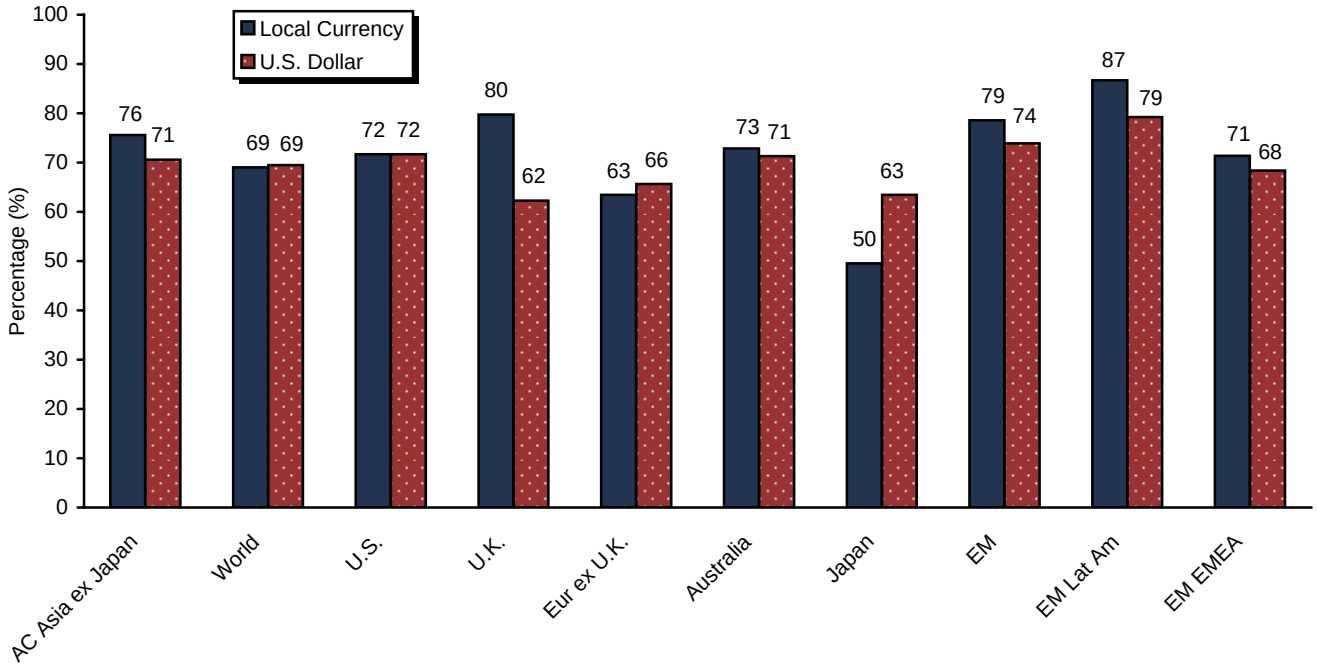
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Peak and trough dates are based on each individual region's peak and trough. The bottom graph shows the percentage of the previous peak level that has been recovered. For example, a 50% decline would require a 100% rally to return to peak level.

Exhibit 23

Global Market Declines and Subsequent Rallies



December 31, 2009 Level as a Percentage of Previous Peak

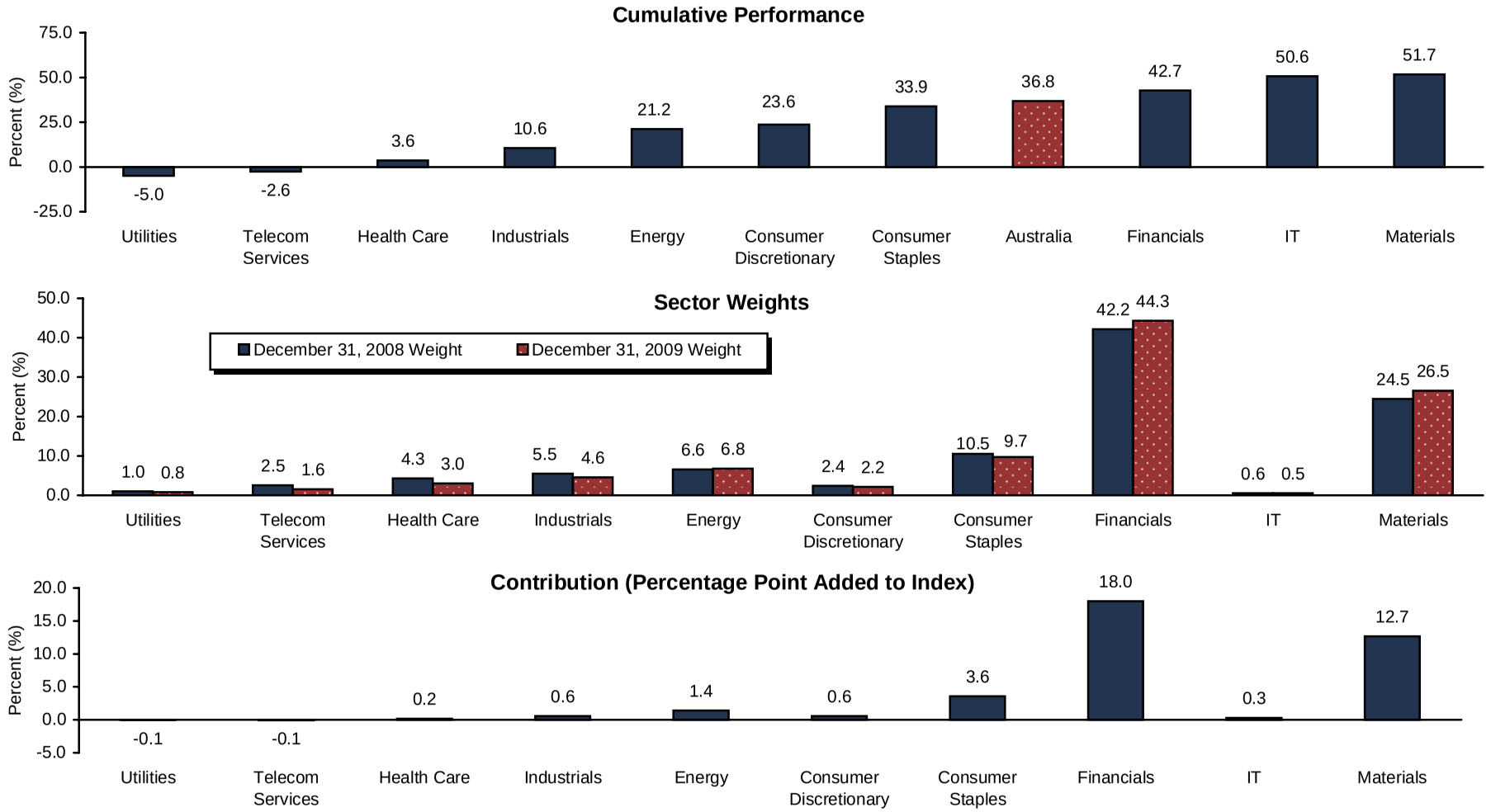


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Peak and trough dates are based on each individual region's peak and trough. The bottom graph shows the percentage of the previous peak level that has been recovered to date. For example, a 50% decline would require a 100% rally to return to peak level.

Exhibit 24

Performance Attribution for MSCI Australia Index

December 31, 2008 – December 31, 2009

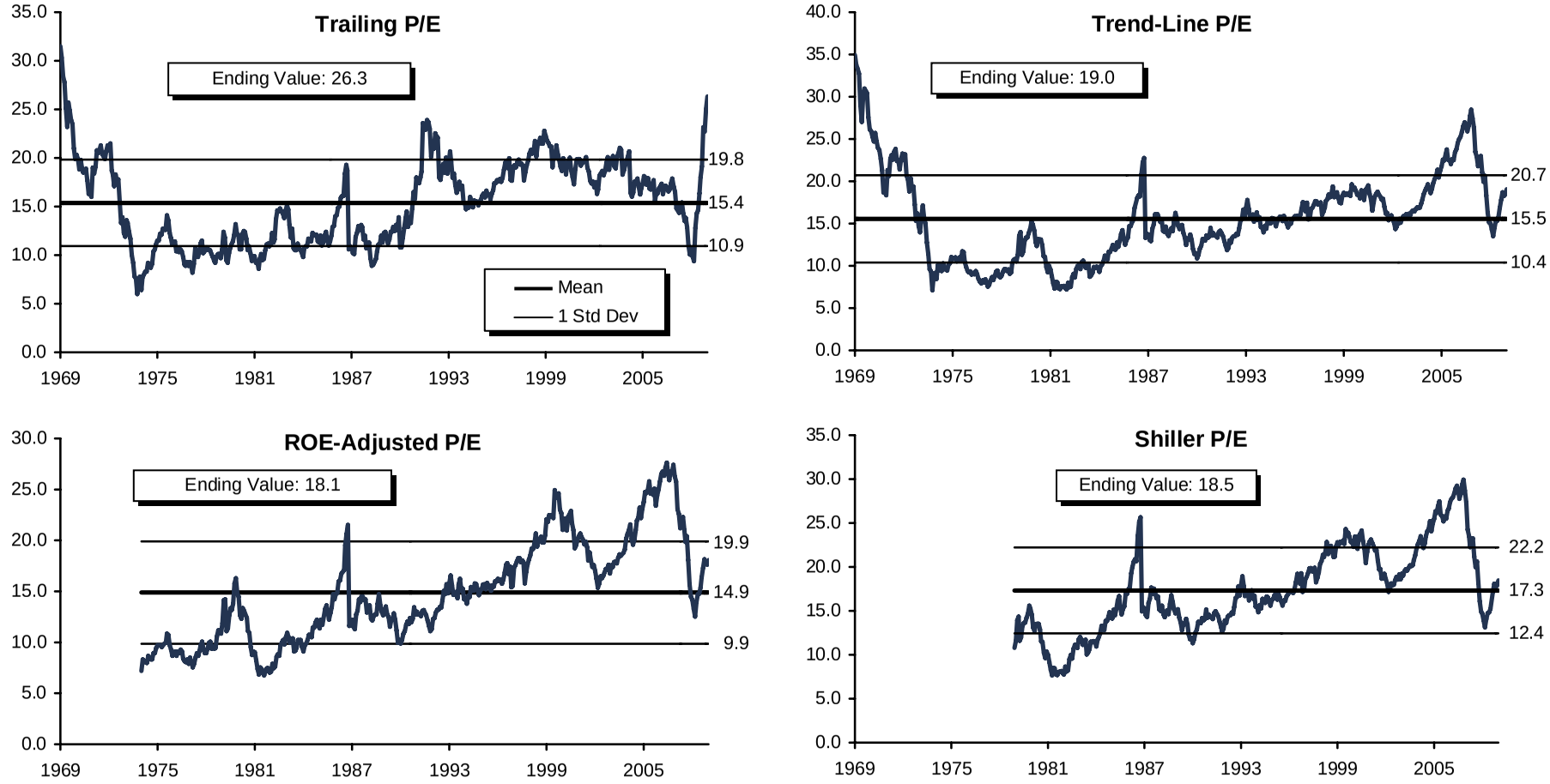


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Contribution represents the sector's percentage point addition to the MSCI Australia Index return of 36.8%. Sector contributions are calculated by multiplying the sector's December 31, 2008, weight by its cumulative local currency return from December 31, 2008, to December 31, 2009. Percentages may not total due to rounding. Performance is measured by net total returns in local currency.

Exhibit 25

MSCI Australia Price-Earnings Valuations

December 31, 1969 – December 31, 2009

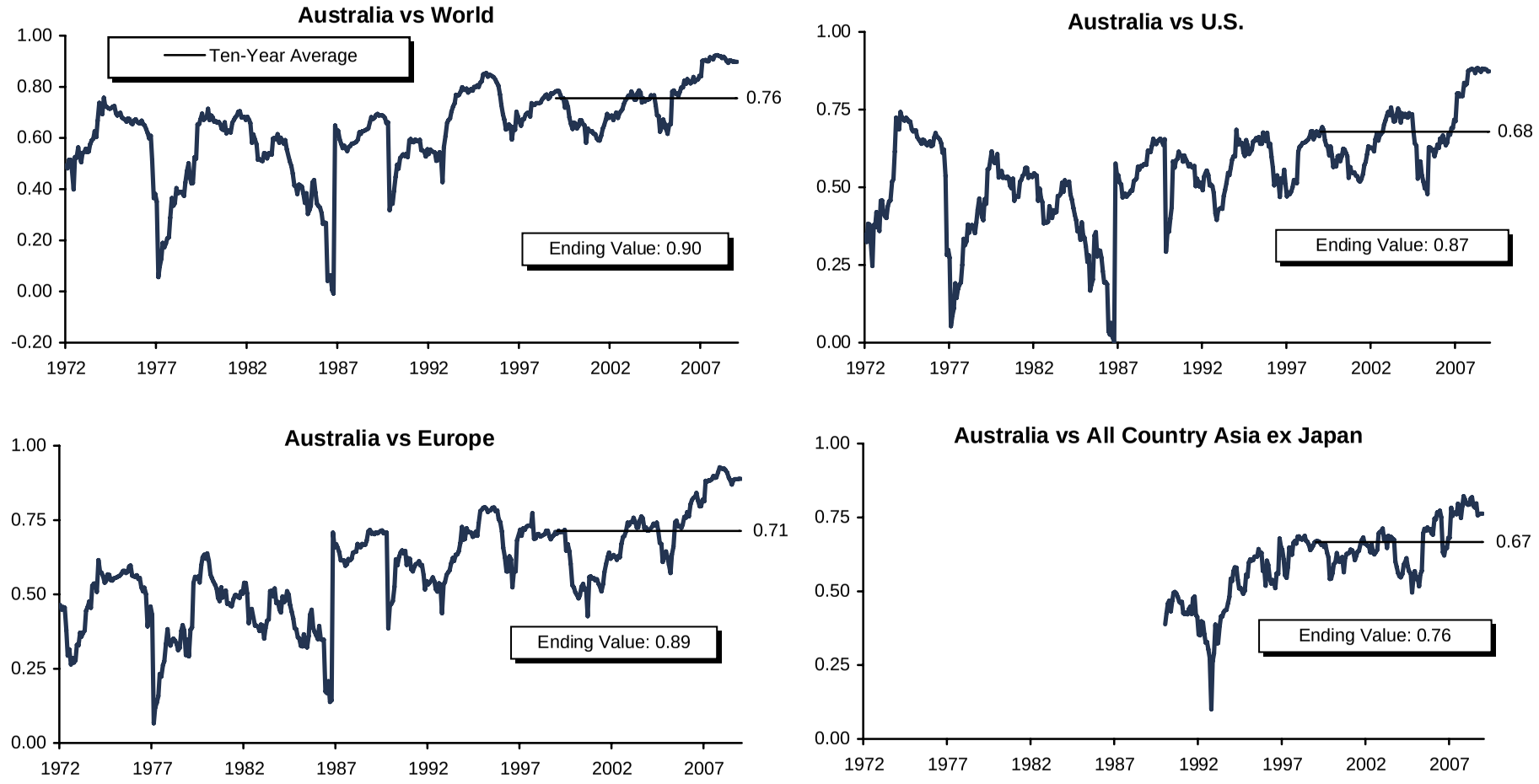


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranites.
Notes: The return on equity (ROE)–adjusted P/E ratio is the current trailing price-earnings (P/E) ratio multiplied by the ratio of the current level of ROE to its historical norm. Shiller P/E is calculated by dividing the current price level by the ten-year average of real (inflation-adjusted) earnings per share. Trend-line P/E ratios compare current stock prices to the level of earnings predicted by long-term real earnings growth based on a simple linear regression. Earnings are deflated using Australia CPI data as of September 30, 2009. Data for ROE-adjusted P/E and Shiller P/E begin December 31, 1974, and November 30, 1979, respectively.

Exhibit 26

Australian Equities Rolling 36-Month Correlations

December 31, 1972 – December 31, 2009



Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Data are based on monthly total returns in local currency for each region. Data for MSCI All Country Asia ex Japan begin on December 31, 1990.