



C A M B R I D G E A S S O C I A T E S L L C

GLOBAL MARKET COMMENTARY

DECOUPLING?

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Decoupling?

While Asian equities have their own unique characteristics, investors have long believed that Asian markets are affected by what takes place in the United States. Indeed, the fact that Asian equity markets, fueled by concerns of a U.S.-led slowdown, sold off more sharply than did U.S. markets during May and June seemed to lend credence to the economic bromide that when “the United States sneezes, Asia catches cold.” Likewise, as U.S. equities have rallied from their June market lows, Asian equities have outperformed their U.S. counterparts, notwithstanding a military coup in Thailand, and North Korea’s missile launches and nuclear testing.

However, the conclusion that Asia is as or more tied to the United States compared with previous years becomes less certain if one considers economic growth in the two regions. Although U.S. growth has slowed sharply over the past two quarters, Asia has barely skipped a beat, with both industrial production and exports growing briskly. Indeed, according to both Goldman Sachs and Morgan Stanley, the tight correlation between U.S. and Asian industrial production has weakened over the past ten years. While in our opinion it is premature to conclude that the U.S., let alone global, economy has absorbed the full impact of the downturn in U.S. house prices, a number of factors suggest that Asia is in fact moving away from its *economic* reliance on the United States and may be better positioned than in the past to withstand any communicable diseases from across the Pacific. At the same time, given that the region is not immune to a sharp slowdown in global growth, investors first need to understand what exposures are currently reflected in the region’s equity markets.

Taking a Closer Look at Asian Equity Markets

As we have recently discussed,¹ the case for increasing strategic allocations to Asian equities rests on the broadening and deepening of capital markets across the region, the portfolio diversification benefits provided by Asian equities (as evidenced in their relatively low historical correlations with U.S. equities), and reasonable valuations, particularly in light of the region’s growth potential.

Given the availability of information on the Japanese market and the fact that its equity market both dominates the region (accounting for 58% of the broad MSCI All Country Asia Pacific Index of developed and emerging equities) and has historically shown much lower correlations with the U.S. market than has the rest of Asia, we will focus our discussion on Asia ex Japan equities.²

Table A provides a breakdown of the AC Asia Pacific ex Japan Index, both by country and sector. From a country perspective, it is important to recognize that (outside of Japan) *individual* Asian equity

¹ Please see *Investing in Asia* (2006) and our November 2005 Global Market Commentary: *Increasing Strategic Equity Allocations to Asia*.

² Based on rolling 36-month local currency total returns, the MSCI Japan Index currently displays a 54% correlation with the AC Asian Pacific ex Japan Index, and only a 37% correlation with the MSCI USA Index, compared to a 77% correlation between the AC Asia Pacific ex Japan Index and the MSCI USA.

markets tend to be highly concentrated and contain large sector bets.³ Asia ex Japan equities are dominated by Australian, Korean, and Taiwanese shares, which together account for 60% of the region's market capitalization, double their percentage of regional GDP. In contrast, Asian equity exposure is tilted away from the China and India growth stories, as their capital markets remain underdeveloped. China, for example, accounts for nearly 40% of regional GDP but only 10% of Asia's market cap.

Despite the country concentrations, Asia ex Japan as a whole is broadly diversified across economic sectors. Asia ex Japan sector exposure is reasonably comparable to that of other major equity regions (the United States, Japan, and Europe), although with clear overweights in the materials and financial sectors and an underweight in health care, which accounts for only 1.5% of equity market capitalization, compared to 9.3% for the AC World (Tables B and C). While Asia is reputed to be a "cyclical play," Asian equities actually have comparable, if not less, exposure to cyclical sectors than other major equity regions. Asia has notably less exposure to consumer discretionary and energy stocks, while its exposure to industrials is consistent with that of the rest of the world. Asia's major "cyclical" overweights are in the information technology (IT) and materials sectors; however, Asia's IT sector weight is slightly less than that of U.S. equities. Asia also has smaller equity exposure to industrials than do the United States and Japan.

A More Independent Asia?

Although the diversification benefits provided by Asian equities, together with reasonable valuations and the Asian growth story, make an allocation to Asian equities attractive, investors should also be aware that the region's fortunes (and, by extension, the fortunes of its capital markets) are tied in part to those of the United States. Asia has historically been heavily dependent on the United States due to the latter's role in providing foreign capital and buying exports. The "Asian Crisis" of 1997-98 was due in part to—and exacerbated by—reliance on short-term capital inflows and the fact that many Asian countries had pegged their currencies to the US\$.

However, Asian economies have since put their financial houses in order, with most economies sporting current account surpluses, huge foreign currency reserves, improved government finances, lower external debt burdens, and for most economies, floating exchange rates. Table D put this into perspective. Financially, Asia is in much sounder shape than it was ten years ago. Indeed, Asia is now a net exporter, not importer, of capital. Should the region encounter rough economic seas, many countries have ample currency reserves on which to lean into the wind.

This shift in economic fundamentals has given Asia increased independence from U.S. monetary policy. According to the International Monetary Fund (IMF), since the Fed began tightening the average spread of Asian policy rates over U.S. rates has *declined* 240 basis points and is now essentially zero, while Morgan Stanley points out that most Asian short-term rates and bond yields trade at a discount to those of the United States. In the past, Asian economies would move largely in step with U.S. monetary policy to

³ Please see our January 2005 to June 2005 Global Market Commentaries, which are a series of primers on the Asian markets.

maintain currency pegs and offer competitive interest rates to attract foreign inflows. The current “de-linking” from U.S. monetary policy largely reflects floating exchange rates and strong balance of payment surpluses, as well as low domestic inflation pressures. It could even be argued that the financial relationship between the United States and Asia has been turned on its head, with the United States now highly dependent upon Asian capital inflows to support its massive current account deficit. Most Asian economies now have considerably greater freedom to loosen monetary and fiscal policy to stimulate domestic growth should the global economic environment sour.

Asia also seems to be less reliant than before on U.S. external demand. The U.S. share of Asian exports (excluding Japan) fell from over 25% in the late 1980s to roughly 22% in 1998 and just 17% in 2005, only slightly larger than Europe’s 16% share. Meanwhile, intra-Asian trade has grown from roughly 25% to 43% of exports over the same period.⁴ Exports to China accounted for 30% of intra-Asian exports in 2005, up from 15% in 1990.

Yet intra-Asian trade data are admittedly murky, with a substantial amount of intra-Asian trade representing “re-exports” destined for third markets, making it difficult to pin-point how much of the flow in goods between Asian economies (especially to China) is not simply an intermediate step in the production chain. Yet even if we dismiss all intra-Asian trade figures as reflecting re-exports (highly unlikely), the U.S. share of Asian exports has still declined over the years from roughly 35% in the late 1990s to 30% today. These numbers suggest that Asia is becoming economically more integrated and less reliant upon the United States and other sources of external demand.

A more self-sufficient Asia should be reflected at some point in a shift from externally led to domestic-led growth. However, while private consumption has been growing across Asia, with savings rates falling in many countries, exports and investment have grown even faster, causing consumption as a share of GDP to fall across most of the region, and especially in China. According to the IMF, private consumption is expected to grow 7.8% in 2006 and 8.4% in 2007, while investment and exports are estimated to grow 13.2% and 17.6%, respectively, in 2006 and 11.8% and 16.7% in 2007. So despite growing consumption, exports (whether to regional or external nations) will remain a significant driver of recent growth. The extent to which domestic consumption holds up in the face of weakening export demand will be the key gauge of how resilient Asian economies have become.

Conclusion

Asian economies have made great strides in improving economic fundamentals by reducing dependency on foreign capital and broadening trade exposure away from the United States, with the region in a much stronger position to withstand external shocks than nine years ago. Yet Asia still seems reliant on export-led growth, and therefore geared to the global economic cycle. Should U.S. growth falter, but demand from Europe, Japan, and elsewhere remain supportive, Asian economies would certainly have greater

⁴ It should be noted, however, that intra-Asian exports breached 40% of total Asian exports during 1995-97, in the run-up to the Asian financial crisis, after which intra-Asian exports declined sharply before rising again over 2000-05.

immunity to U.S. economic illness than has been the case in the past. However, in the event that U.S. *and global* demand were to suffer (a likely scenario), Asian economies would likely fall ill as well, although Asia's more robust macro-health argues that the region should be better positioned to withstand the blow.

Still, correlations with U.S. and global equity markets remain high. Should investors abruptly change their outlook for the global economy, Asian equity markets will likely be hit again as they were in the spring, potentially falling harder than the U.S. markets. However, we view any substantial pull back in Asian markets as a buying opportunity, consistent with our long-term view of building a strategic overweight in Asian equities.

Table A

MSCI ALL COUNTRY ASIA PACIFIC EX JAPAN SECTOR AND COUNTRY ALLOCATIONS

As of September 30, 2006

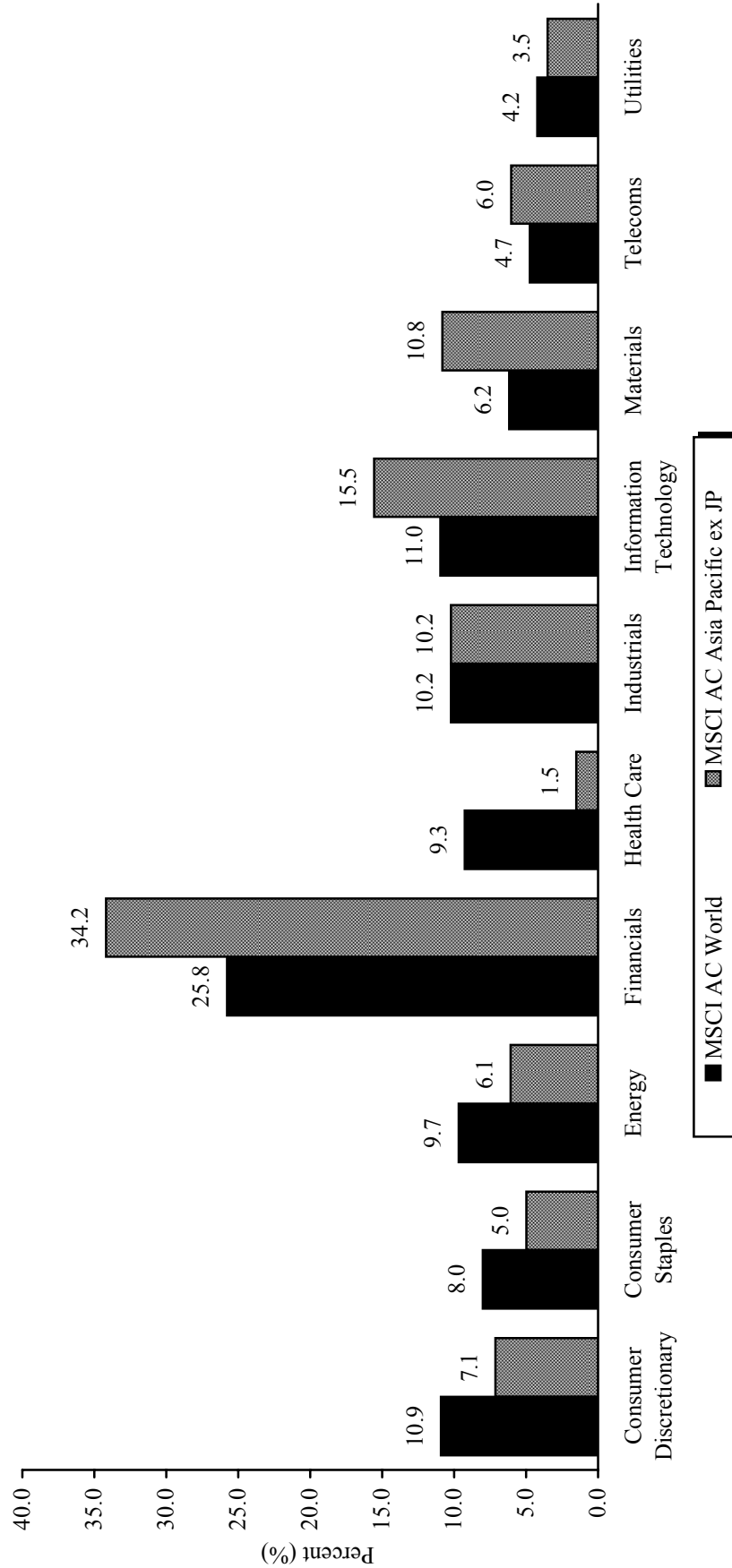
| Sector | Hong Kong | | India | | Indonesia | | Korea | | Malaysia | | New Zealand | | Pakistan | | Philippines | | Singapore | | Taiwan | | Thailand | |
|----------------------------|-------------|-------------|-------------|-----------|-----------|-------------|-------|----------|----------|-------------|-------------|----------|----------|-------------|-------------|-----------|-----------|--------|--------|----------|----------|--|
| | Australia | China | India | Indonesia | Indonesia | Korea | Korea | Malaysia | Malaysia | New Zealand | New Zealand | Pakistan | Pakistan | Philippines | Philippines | Singapore | Singapore | Taiwan | Taiwan | Thailand | Thailand | |
| Consumer Discretionary | 18.2 | 6.1 | 15.6 | 7.0 | 2.1 | 30.3 | 5.3 | 5.3 | 2.3 | 2.3 | 0.1 | 0.6 | 5.8 | 5.8 | 5.9 | 0.9 | | | | | | |
| Consumer Staples | 47.7 | 3.8 | -- | 10.7 | 2.4 | 22.7 | 6.7 | 6.7 | -- | -- | -- | 0.4 | 1.4 | 1.4 | 3.2 | 1.1 | | | | | | |
| Energy | 23.3 | 36.8 | -- | 17.7 | 1.3 | 8.4 | 0.7 | 0.7 | -- | -- | 0.7 | 0.1 | 0.3 | 0.3 | 2.9 | 7.7 | | | | | | |
| Financials | 43.1 | 7.5 | 15.0 | 3.8 | 1.4 | 9.9 | 2.4 | 2.4 | 0.2 | 0.2 | 0.3 | 0.8 | 7.2 | 7.2 | 7.0 | 1.5 | | | | | | |
| Health Care | 59.9 | -- | -- | 24.1 | 2.2 | 5.8 | -- | -- | 4.6 | 4.6 | -- | -- | 3.4 | 3.4 | -- | -- | | | | | | |
| Industrials | 22.5 | 10.1 | 14.6 | 6.2 | 0.7 | 23.2 | 5.2 | 5.2 | 0.6 | 0.6 | -- | -- | 11.3 | 11.3 | 4.6 | 1.0 | | | | | | |
| Information Technology | 0.8 | 1.6 | 3.1 | 9.1 | -- | 34.7 | 0.1 | 0.1 | -- | -- | -- | -- | 1.2 | 1.2 | 49.1 | 0.2 | | | | | | |
| Materials | 60.0 | 5.1 | -- | 4.6 | 0.8 | 12.2 | 0.1 | 0.1 | 1.2 | 1.2 | 0.4 | -- | -- | -- | 13.7 | 1.9 | | | | | | |
| Telecommunication Services | 4.8 | 33.2 | 4.0 | 5.1 | 8.8 | 14.6 | 3.5 | 3.5 | 4.6 | 4.6 | 0.3 | 2.5 | 9.1 | 9.1 | 7.3 | 2.1 | | | | | | |
| Utilities | 13.7 | 10.2 | 38.9 | 4.9 | 3.4 | 14.3 | 9.6 | 9.6 | 2.5 | 2.5 | 0.5 | 0.6 | -- | -- | -- | 1.6 | | | | | | |
| Country Weight (%) | 30.4 | 9.6 | 9.8 | 6.8 | 1.6 | 17.7 | 2.7 | 2.7 | 0.9 | 0.9 | 0.2 | 0.5 | 4.9 | 4.9 | 13.2 | 1.6 | | | | | | |
| Number of Constituents | 88 | 81 | 42 | 68 | 24 | 92 | 60 | 60 | 12 | 12 | 15 | 17 | 38 | 38 | 104 | 41 | | | | | | |

Sources: Factset Research Systems and Morgan Stanley Capital International. MSCI data provided "as is" without any expressed or implied warranties.

Notes: Percentages may not total due to rounding. Country sector weights refer to each country's share of the index's sector exposure. The bolded data indicate the country with the largest sector allocation.

Table B
MSCI ALL COUNTRY WORLD AND MSCI ALL COUNTRY ASIA PACIFIC EX JAPAN
SECTOR ALLOCATIONS

As of September 30, 2006



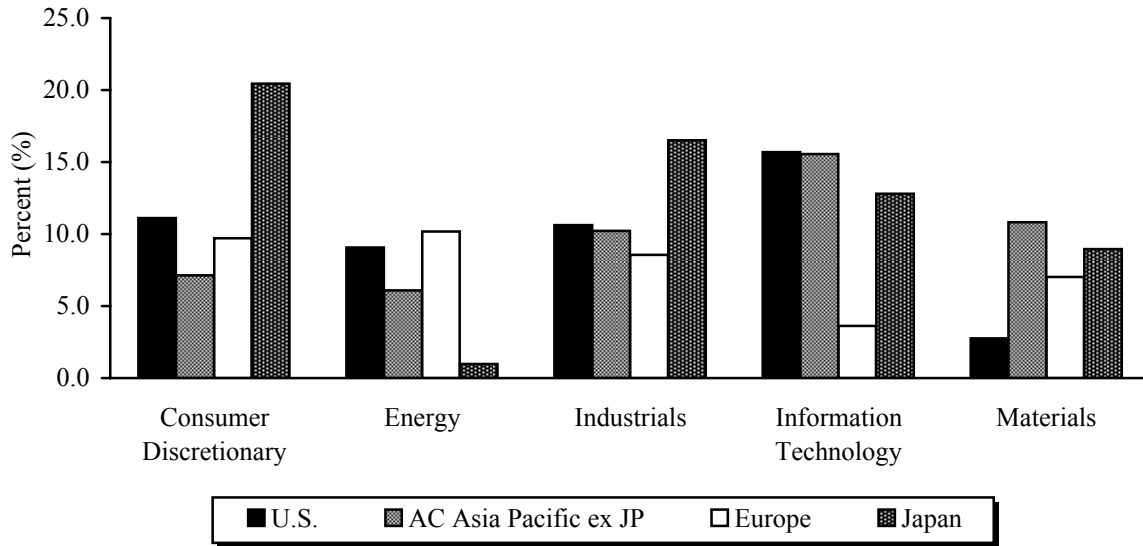
Sources: Factset Research Systems and Morgan Stanley Capital International. MSCI data provided "as is" without any expressed or implied warranties.

Note: Percentages may not total due to rounding.

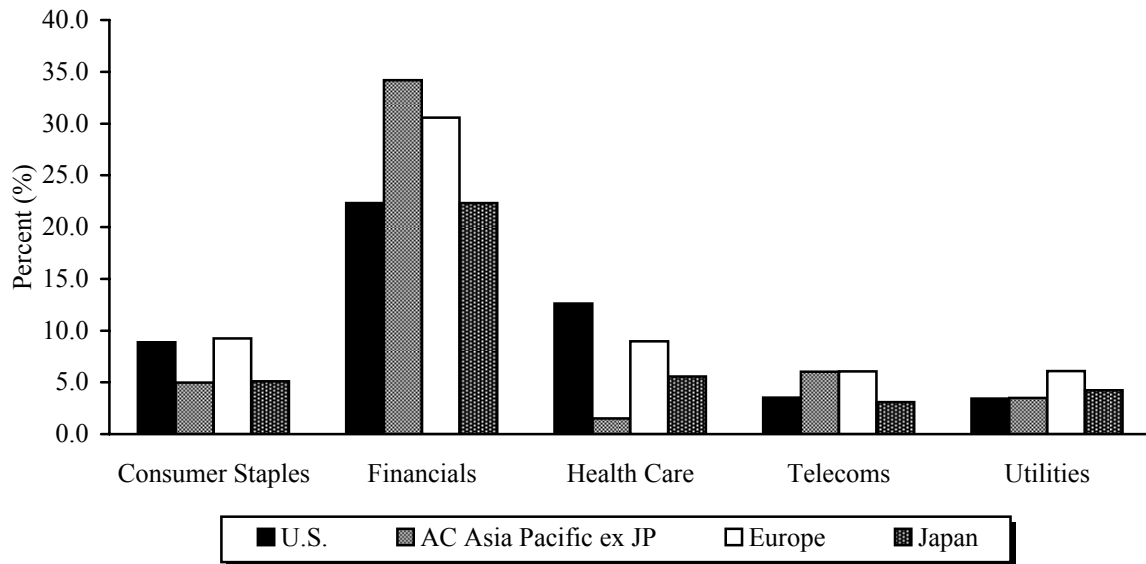
Table C
MSCI GLOBAL EQUITY MARKET SECTOR ALLOCATIONS

As of September 30, 2006

Cyclical Sectors



Non-Cyclical Sectors



Sources: Factset Research Systems and Morgan Stanley Capital International. MSCI data provided "as is" without any expressed or implied warranties.

Note: Percentages may not total due to rounding.

Table D
SELECT FISCAL INDICATORS

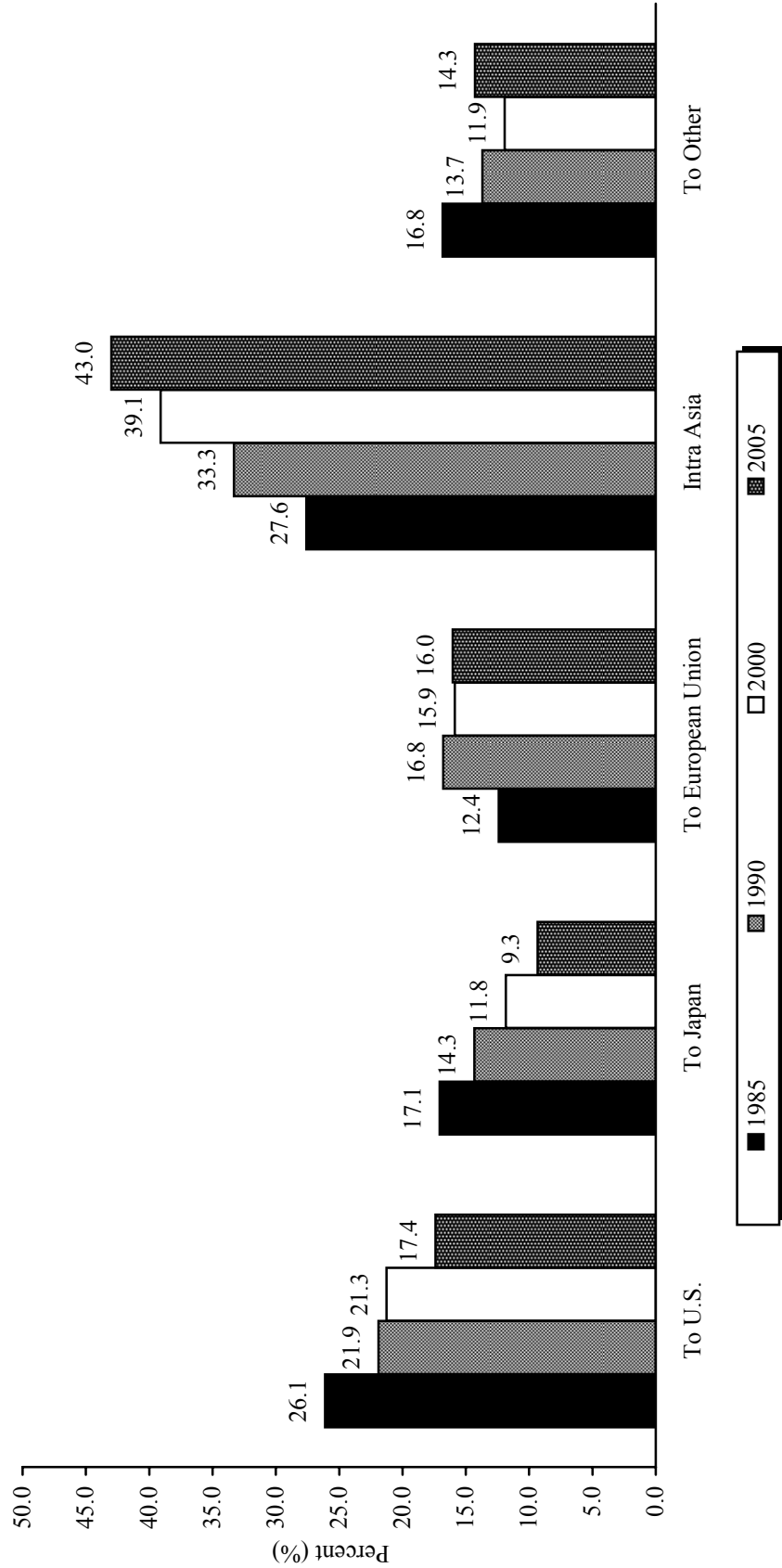
| Country | Current Account as % of GDP | | Foreign Currency Reserves (US\$ Mil) | | External Debt as % of Exports | | Govt Deficit/Surplus as % of GDP | |
|-----------------|--------------------------------|------|---|---------|----------------------------------|-------|-------------------------------------|-------|
| | 1997 | 2005 | 1997 | 2005 | 1997 | 2005 | 2000 | 2005 |
| Hong Kong | -4.4 | 11.4 | 92,804 | 124,244 | --- | --- | -0.6 | 1.0 |
| Korea | -1.6 | 2.1 | 19,710 | 209,968 | 120.0 | 65.3 | 1.1 | 2.1 |
| Singapore | 15.5 | 28.5 | 70,883 | 115,334 | --- | --- | 7.9 | 6.0 |
| Taiwan | 2.3 | 4.7 | 83,502 | 253,290 | --- | 43.8 | -4.5 | -2.4 |
| China | 3.6 | 7.2 | 139,890 | 818,872 | --- | --- | -3.1 | -1.2 |
| India | -0.7 | -1.5 | 24,324 | 131,018 | --- | --- | -5.6 | -4.1 |
| Indonesia | -1.6 | 0.3 | 16,088 | 32,774 | 250.3 | 155.9 | -1.1 | -1.1* |
| Malaysia | -5.9 | 15.2 | 20,013 | 69,377 | 55.6 | 36.8 | -5.7 | -3.8 |
| The Philippines | -5.2 | 2.4 | 7,178 | 15,800 | 170.3 | 131.5 | -4.0 | -2.7 |
| Thailand | -2.1 | -2.1 | 25,697 | 50,502 | 159.9 | 47.3 | -2.2 | 0.1* |

Sources: Asian Development Bank, International Monetary Fund, World Economic Outlook Database, and Thomson Datastream.

Notes: Percentages may not total due to rounding. A dash (---) indicates data are currently unavailable.

* Data as of 2004.

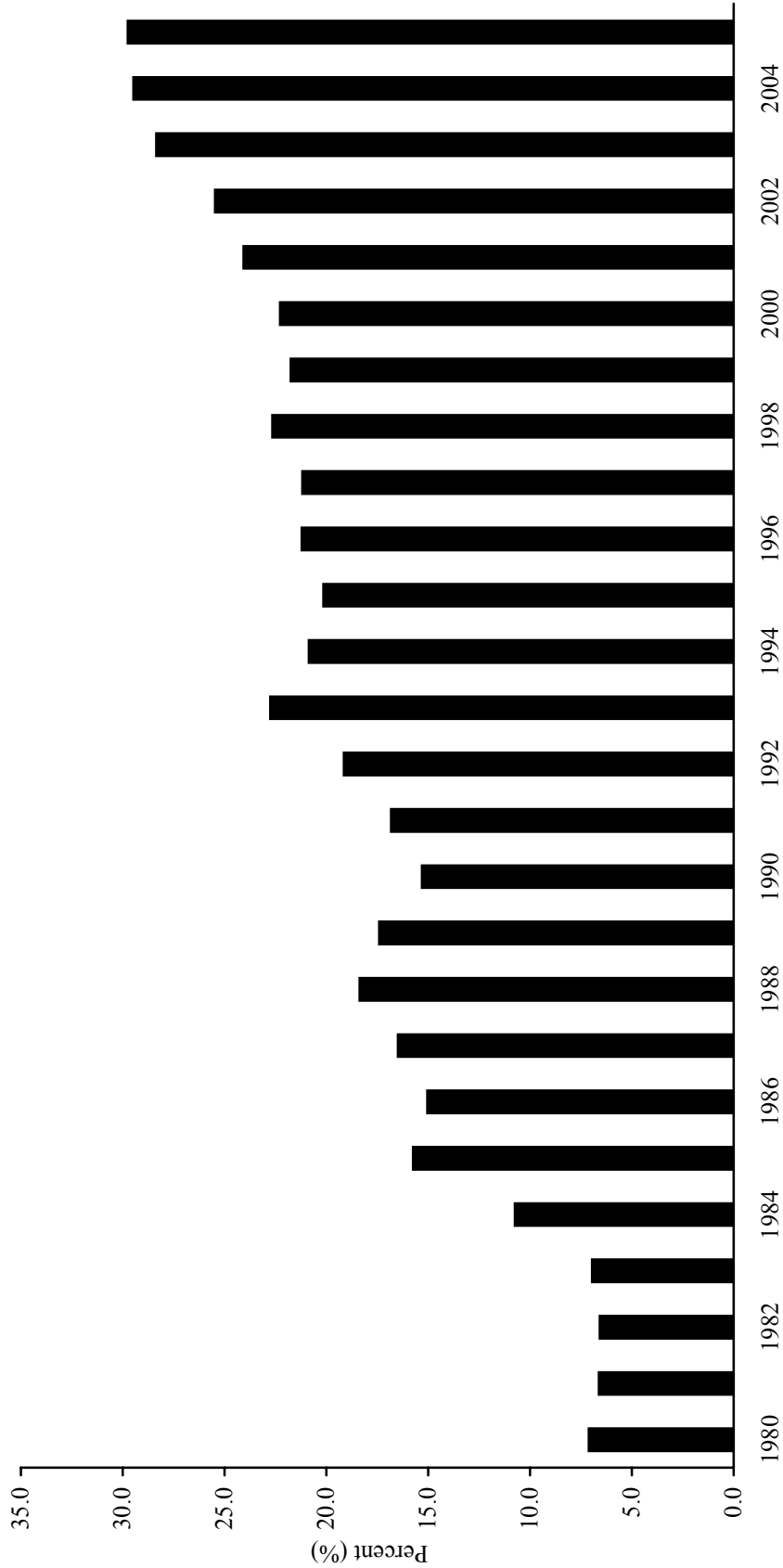
Table E
ASIAN EXPORTS
1985-2005
Percent of Total Exports



Sources: IMF Direction of Trade Statistics and Thomson Datastream.

Notes: Percentages may not total due to rounding. Intra-Asia exports exclude Japan.

Table F
ASIAN EXPORTS TO CHINA AS PERCENT OF INTRA-ASIAN EXPORTS
1980-2005



Sources: IMF Direction of Trade Statistics and Thomson Datastream.

Notes: Percentages may not total due to rounding. Intra-Asia exports exclude Japan.