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# ASIAN MARKET COMMENTARY

# RATIONAL EXUBERANCE

December 2006

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## Rational Exuberance

The MSCI Asia Pacific Index returned a healthy 15% in 2006 (16.8% in US$). This represents a combination of relatively anemic returns in Japan, which accounts for approximately 55.1% of the region's market capitalization, and very strong returns elsewhere in the region. Small-cap stocks performed particularly poor in Japan and very well elsewhere in the region. Returns reflected strong earnings, high global liquidity, and investor confidence in the Asian growth story. Central to the growth story are the Chinese and Indian economies, which are marked by cheap labor, enormous infrastructure needs, and deepening ties with multinational corporations. Sustained U.S. demand and the continuing commodities boom have also supported individual markets (e.g., Australia, Indonesia, and the Philippines) in the Asia Pacific. These positive factors helped the region weather both a sharp global market downturn in the spring and assorted political and geopolitical uncertainties throughout the year. Moreover, the strength of most local currencies against the U.S. dollar (Table A) boosted the returns of unhedged US$-based investors substantially.

Despite the fact that most of the region's stock indices have recently hit record or multiyear highs, strong earnings growth caused the price-earnings (P/E) multiple to fall from 19.5 at the close of 2005 to 18.8 as of December 31, 2006 (below the historical averages) while the return on equity (ROE) increased from 11.0 to 11.9. While valuations are generally attractive, there are notable exceptions in particularly hot markets such as China and India. Further, there are important risks that could interrupt the growth trajectory, such as whether the Chinese economy can avoid overheating, Japanese domestic demand picks up, earnings continue to grow in the region's developed markets outside of Japan, and country and regional tensions are held in check. Asian markets also are subject to the vagaries of the U.S. economy, as was demonstrated from May through July when returns were negative due to fears of a U.S.-led economic slowdown. While these risks remain, the Asian growth story provides compelling long-term opportunities.[1] Within Asia, Japan currently represents the best opportunity given both its fundamentals and relatively attractive valuations.

## Emerging Markets Asia—Investors Buy Into the Growth Story

The MSCI Emerging Markets Asia Index's 27.7% return (33.2% in US$) marked its fourth consecutive year of strong performance. All nine constituent markets, save Thailand (-1.6%), had positive annual returns in local currency terms, while in U.S. dollar terms every market, save Pakistan (3.6%), posted double-digit returns for the year. Among markets tracked by MSCI, China was the best performer both in local currency and U.S. dollar terms (83.4% and 82.9%, respectively) thanks not only to a booming economy but also to the reform and reopening of the Chinese domestic initial public offering (IPO) market and the listing of blue-chip Chinese firms. Two huge bank IPOs, the Bank of China in June and the Industrial and Commercial Bank of China (the world's largest IPO ever) in October, underscored the huge investor interest in China. However, by the close of 2006, Chinese equity valuations have become stretched, with the P/E

[1] Please see our recent papers, *Increasing Strategic Equity Allocations to Asia* (November 2005) and *Investing in Asia* (2006).

ratio on the stocks in the MSCI China Index at 21, up 72% from the close of 2005, while the ROE has fallen to 15.5 from 16.8.

Likewise, MSCI Indonesia, whose stock index hit a record high, saw its P/E ratio jump by 62% to 19.5 and its ROE fall to 22.5 (from 25.6). Indonesia's return of 74.8% (59.8% in *rupiah*) was the second highest among countries in the MSCI All Country World Index in U.S. dollar terms and third highest in local currency terms. By contrast, although the Korean Kospi hit a record high, MSCI Korea returns (4.1%) were low by global standards with the market, as in Japan, seeming to take a breather after delivering outsized returns (54.3%) in 2005. Still, MSCI Korea returned 13.2% in U.S. dollar terms and valuations remained low as the P/E multiple fell from 12.3 to 11.4 during 2006.

India was one of the world's great success stories, with investors responding in part to recent China-esque GDP growth of about 9.2%. After its sharp market drop in the late spring the Sensex Index rose more than 54% over the next six months. MSCI India returned 48.5% in 2006, besting its stellar 42.4% return in 2005. However, by the end of 2006 the P/E ratio of stocks in the MSCI India Index had reached 22.9, its highest monthly level since April and well above that of other emerging Asian markets, signaling that investors seeking India exposure should be cautious. Moreover, India's 1% dividend yield (DY) rate is the world's second lowest.

Asian markets shrugged off some potentially destabilizing political events in 2006. MSCI Taiwan returned 20% even though the country's leadership was embroiled in a political corruption scandal for much of the year, culminating in the trial of First Lady Wu Shu-chen in December. North Korea's missile launch and subsequent nuclear test, meanwhile, had little effect on markets. Ditto for political controversy and a September military coup in Thailand, though a different result ensued when the government attempted to intervene in the markets with capital controls.

While one can argue that investors' general imperviousness to these signs of instability means that they are not properly pricing risk, investors may in fact be making a calculated bet that the region's economic fundamentals are stronger than ever before, while local governments have become more responsive to market forces. Thus in December, when the Thai central bank, concerned about the rise in the *baht*, sought to penalize foreign investors seeking to repatriate short-term investments it was immediately forced to back off (at least with respect to stocks) after The Stock Exchange of Thailand dropped 14.8% in one day. From a broader perspective, Asian nations' financial positions have improved significantly since the Asian financial crisis, as they hold much more foreign reserves than in 1997 and are far less exposed to US$-denominated debt.

Going forward, attention will continue to center on Chinese and Indian growth, continued capital market reforms, and demand in the region and elsewhere for South Korean and Taiwanese manufactured goods. An artificially weak *yuan* may adversely affect other export-driven markets in the region whose currencies are strengthening against the U.S. dollar, making their products relatively more expensive in the U.S. market. Greater Chinese willingness to let the *yuan* appreciate—despite the potentially negative effect on domestic Chinese employment—would ease this threat, as well as reduce the possibility of a protectionist backlash in the United States that could hurt growth not only in Asia, but across the globe.

We consider emerging Asian stocks as a whole to be fairly valued although there is, of course, a wide divergence in valuations within the region. While emerging Asian stocks still trade at a discount to other emerging markets based on most metrics, it should be noted that they trade at a slight premium based on P/Es, which has widened over the last year. However, an emerging Asia P/E of 15.8 remains well under its historical average of 20.8. Relatively high Asian P/E multiples may also reflect the fact that Asian markets are less commodity (i.e., cyclically) driven than many emerging markets outside the region. The ROE of 14.8 for Asian stocks, meanwhile, although well above its historical average of 10.2, is still low compared to both emerging and developed markets.

**Pacific ex Japan 2006—Solid Performance**

The MSCI Pacific ex Japan Index boasted the strongest local currency performance in 2006 among developed regions, returning 24.8% (32% in US$). Stock indices in all four constituent markets—Australia, Singapore, Hong Kong, and New Zealand—hit record highs late in the year. Hong Kong (30.7%) has reaped the rewards of being the preferred market for Chinese IPOs while Singapore's success was spurred by 7.6% GDP growth in the fourth quarter. New Zealand (12.6%) lagged other developed markets and earnings did not keep pace with stock price increases; the P/E multiple of stocks in the MSCI New Zealand Index rose to 19.9 from 15.1, while the ROE fell to 15.9 from 20.2.

Looking ahead to 2007, the continuation of the China growth story is particularly important to the developed Pacific nations ex Japan as Hong Kong (0.71) and Australia (0.65) are both highly correlated with the Chinese market.[2] Also, Australia, the largest Asian-Pacific capital market aside from Japan, is overwhelmingly reliant upon financials and materials and would obviously be hit hard by a slowdown in either of these sectors.

Other than with respect to DYs, Pacific ex Japan valuations are above their historical means. This is particularly true in the case of ROE, which is now 14.8, 1.7 standard deviations above its historical average of 11.3, but still lower than those of other developed markets. The P/E multiple of 17.5 is high by world standards, but less than that in the United States or Japan. While the normalized P/E on an ROE-adjusted basis (23.0)[3] is significantly higher, earnings may have more room to run, particularly given that Pacific ex Japan stocks are directly tied to the emerging Asian growth story and there is more room for improvement in ROEs. Furthermore, despite somewhat high P/Es, consensus expectations remain moderate, calling for earnings growth of 5.4% for the region and perhaps even negative growth in Hong Kong and Singapore.

[2] These are five-year correlations between the relevant MSCI country indices. Both correlations are substantially higher than the ten-year figures, suggesting the increased importance of the Chinese economy to Hong Kong and Australia.

[3] The ROE-adjusted P/E is derived by multiplying the P/E based on trailing 12-month earnings by the ratio of the current ROE to its long-term average, such that a relatively high current ROE increases the ROE-adjusted P/E and vice versa.

Finally, investors should find some protection in the form of a 3.3% DY, which is well above that available in other developed markets.

**Japan—Moving Sideways**

Japan, which posted the highest return among developed markets in 2005 in local currency terms, performed quite poorly in 2006. The MSCI Japan Index's 7.3% (6.2% in US$) return was easily the worst among developed countries both in local currency and in U.S. dollar terms and is deceiving since the return was due largely to strong performance in December. Although both health care and utilities delivered returns of approximately 30% in 2006, these sectors combined represent only 10.4% of the index. Meanwhile, extremely poor performance on the part of small-cap stocks (represented in the Topix Small Index, Topix Second Section, and Mothers Index) made broader Japan equity plays a much worse proposition.

The Japanese market has stagnated despite the fact that GDP growth has been in the 2.0% range and the country is enjoying its longest postwar economic recovery. Another positive sign is the small but steady rise in consumer prices, which led the Bank of Japan to scrap its quantitative easing policy in March and then, in July, to raise interest rates above zero for the first time in nearly six years. Land prices have also increased after a 14-year decline, capital expenditures are forecast to expand by their highest rate in 16 years, and business confidence is up.

Still, given the MSCI Japan Index's 44.6% return in 2005, it is perhaps not surprising that the Japanese market cooled down significantly in 2006. We continue to believe that the Japanese market is poised for further growth (indeed consensus expectations are for a 14.7% increase in earnings) and that valuations are very reasonable (Table C). Thanks to record corporate profits the P/E multiple for stocks in MSCI Japan dropped from 23.7 at the end of 2005 to 21.2. This is well below the historical average of 47.2 though still high relative to those of other developed markets. While the market ROE (9.8%) is at high levels on a historical basis, it is low relative to that of other developed markets both on an absolute basis and compared to normative ROEs of roughly 12% to 14% for developed markets. Japanese corporations have become much more responsive to investor pressure to increase returns than they once were, suggesting that further ROE improvement is likely. After normalizing P/Es for ROE cyclicality, the P/E ratio is also well under its long-term mean (Table D). Meanwhile, the price-book ratio (2.1) is low relative to that of other markets while the price-cash earnings (10.2) ratio is in line with global norms.

Favorable valuations aside, the strength of the Japanese market in 2007 is likely to hinge on the answers to such questions as (1) will Japanese corporate profits and dividends continue to hit record levels? (2) will Japanese companies become more accountable to shareholders? (3) what economic policies will the three-month old Abe government adopt? (4) what will be the outcome of the Upper House elections in July? and (5) will Japanese consumption pick up, weaning the economy from its heavy reliance on U.S. and Chinese growth and on a weak yen?

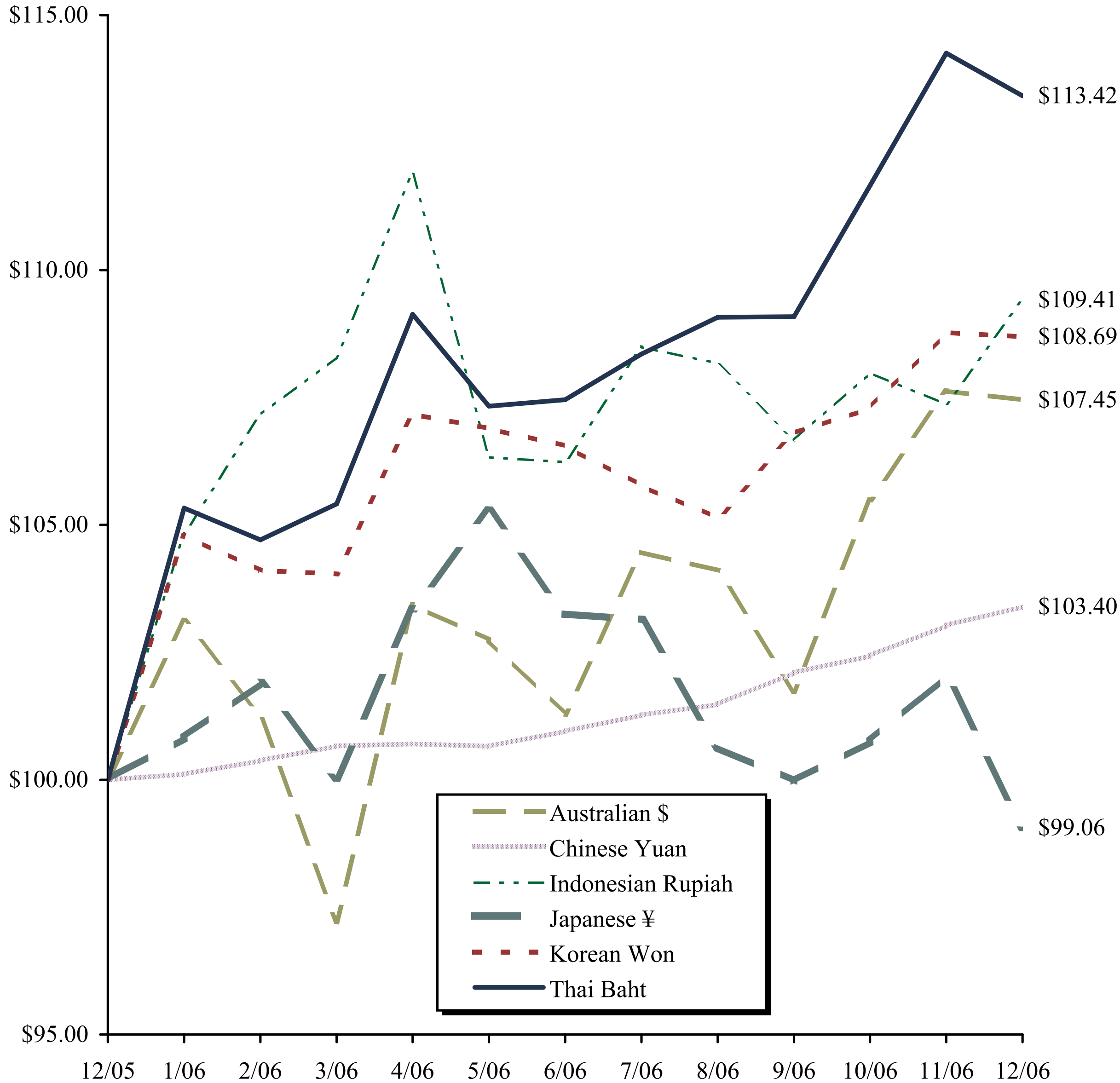
Although these questions are all important ones and create short-term uncertainties, we believe that Japan is in the midst of a secular recovery. This recovery follows a bear market that lasted well over a decade. As a result, despite four years of strong performance, Japanese equities remain far below their late 1980s peaks and valuations remain reasonable. We continue to believe that Japan's underlying strengths make it the preferred centerpiece of an Asian investment strategy in the current market environment. And while a short-term setback is always possible during a recovery this should not dissuade investors in for the long haul. Likewise, the Asian growth story provides a compelling long-term rationale for investing in the Asia Pacific ex Japan markets, despite the potential for short-term bumps on the road.

**Table A**

**SELECTED ASIAN CURRENCIES VERSUS THE U.S. DOLLAR**

**January 1, 2006 - December 31, 2006**

**Cumulative Wealth Index**
**(December 31, 2005 = $100)**




Source: Thomson Datastream.

Note: Currency appreciation is measured by how many U.S. dollars are needed to buy a hypothetical unit of a foreign currency—e.g., as of December 31, 2006 it would have taken $113.42 to purchase a unit of Thai *baht* that could have been purchased for $100.00 on December 31, 2005.

## Table B

### MSCI PACIFIC EX JAPAN PRICE-EARNINGS RATIOS

### December 31, 1984 - December 31, 2006


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

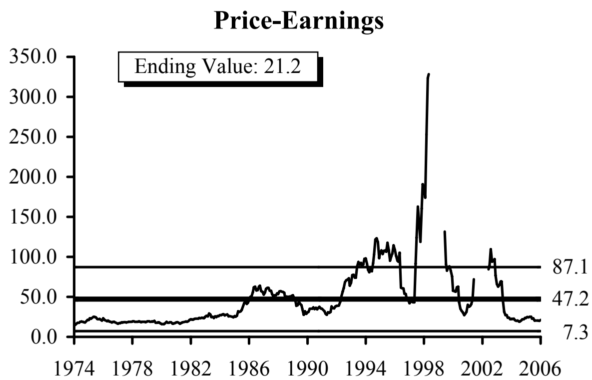
Notes: Return on equity (ROE) is calculated by dividing the index's price-book ratio by its price-earnings (P/E) ratio. The ROE-adjusted P/E ratio is the current P/E based on trailing 12-month earnings multiplied by the ratio of the current ROE to the historical average ROE of 11.3. Graph represents monthly data through December 31, 2006.

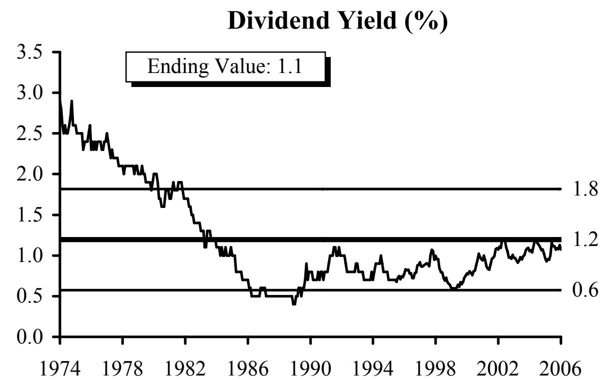
## Table C

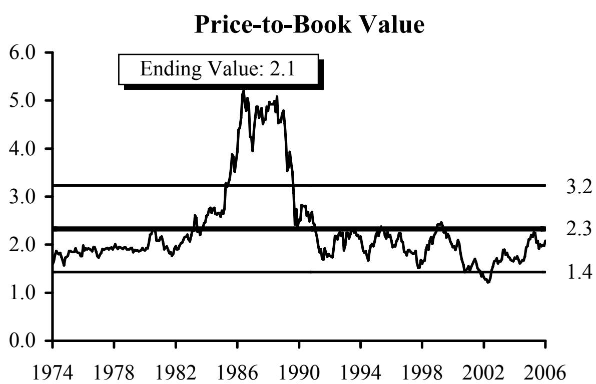
## GLOBAL EQUITY MARKET VALUATIONS

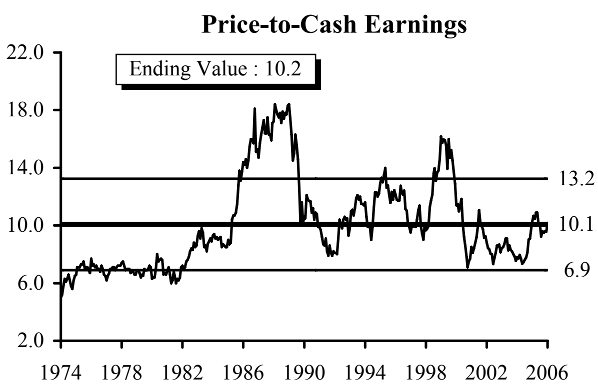
### MSCI Japan Index

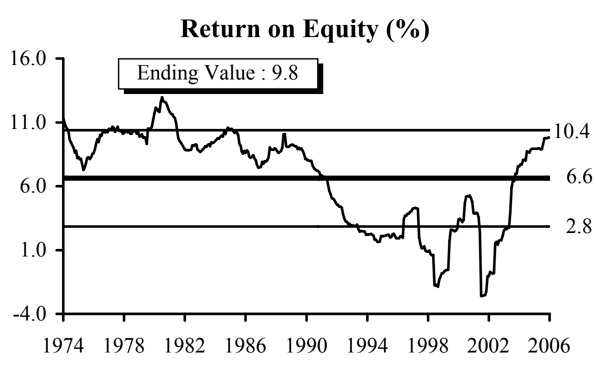
### December 31, 1974 - December 31, 2006





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

Notes: Return on equity is calculated by dividing the index's price-book ratio by its price-earnings (P/E) ratio. Gaps in the P/E graph represent periods for which negative P/Es have been removed.
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## Table D

### MSCI JAPAN ROE-ADJUSTED PRICE-EARNINGS RATIOS

**December 31, 1974 - December 31, 2006**


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

Notes: Return on equity (ROE) is calculated by dividing the index's price-book ratio by its price-earnings (P/E) ratio. The ROE-adjusted P/E ratio is the current P/E based on trailing 12-month earnings multiplied by the ratio of the current ROE to the historical average ROE of 6.6. Graph represents monthly data through December 31, 2006.