Q3 2014 Market Spotlight

Morningstar Investment Management Asia Limited

The Global Picture

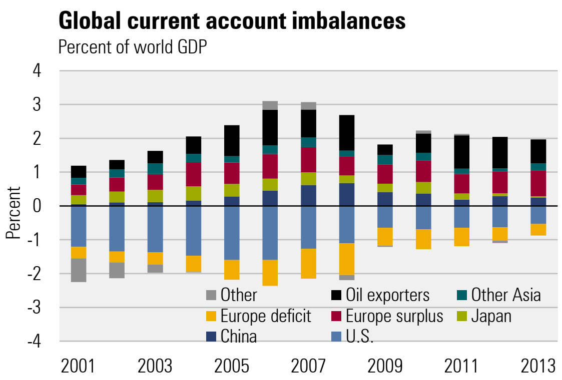
The recovery goes on, but more slowly than we expected it to do. Since January, most analysts have trimmed growth forecasts for 2014, primarily because of one-off events, especially in Q1. The second half was expected to bring stronger growth, but Q3 failed to deliver. In fact, growth last quarter turned lower and more uneven. Based on Q3 surveys, commodity prices, plus monthly data on real activity, the economy sped up only in North America, while slowing in most other regions, including China and Europe.

Cyclical and secular forces are pulling the levers, often in opposite directions. The business cycle recovery quickly lifted sentiment and narrowed risk premiums worldwide in the second half of 2009 and during 2010, then vanished in 2011 as the eurozone slipped into recession and China slid toward lower growth. Now the cyclical component powers Europe's economy, right as it loses oomph in the U.S.

Second, there's the financial cycle. The U.S. was until recently in "active deleveraging," or a decline of nominal debt balances. That phase is over in the U.S., but continues in Europe. Narrowing current account imbalances (see **Figure 1**) after the crisis has sapped global demand.

Secular adjustment, the third force shaping today's economy, will likely stay with us for years. Adverse demographics and a long-running productivity slowdown have lowered the neutral rates of growth, real interest, and inflation. In parallel, the profit share—the slice of national income earned by capital owners—has crept up over time, changing the distribution of income between capital and labor. And because businesses are reluctant to invest, that redistribution has lowered aggregate desired spending.

Figure 1



Source: IMF's World Economic Outlook, October 2014, Figure 4.1.

The upshot: Unless recent technological advances lift productivity, advanced economies will either experience a credit-powered reflation, or slide toward a (depressing) stagnation of real incomes. Results may vary by country.

In Q4 disinflationary forces dominate. One driver is oil prices. In Japan and the eurozone, lower inflation will persist unless the euro and yen depreciate further. In China, the U.S., and the U.K., inflation remains within safe bounds, and commodity prices, wage growth, job market slack, and exchange rates suggest minimal price changes over the next six months.

We don't expect the Fed will tighten rates for at least another six months, although a number of risks might change that view. One risk is that the job market improves faster than it has recently, or that wages start rising faster than inflation. On the other hand, if monetary policy in the rest of the world lags the Fed's, the dollar would appreciate further, pushing inflation down and postponing the Fed's own rate hikes.

We've already seen some of that. Because monetary tightening is expected sooner in Washington than in Frankfurt or Tokyo, the dollar has appreciated against the euro, which now trades at levels of early 2013. The Japanese yen has fallen too, dropping again toward the end of October, and is now around 2007 values.

Other, external factors might derail monetary policy. If China had a financial crisis, Europe re-entered recession, or commodity prices slumped, the Fed might put off the first interest rate hike, or even consider further easing. That easing might bring temporary relief, at the cost of further inflating market valuations, which we believe are already lofty.

In the U.K., the mildly good run continues, even as Europe falters. U.K. GDP grew 0.7% in Q3, barely slower than the 0.9% pace in Q2. Lower growth probably lies ahead, as business sentiment and the housing market have moderated. Both core and headline inflation have fallen, reducing the odds that a rate hike is coming anytime soon. M

SPOTLIGHT ON EMERGING MARKETS

The emerging markets outlook might be darkening. On one hand, gradually improving demand from advanced economies would lift exports. On the other, Chinese growth is unlikely to pick up. In fact, China might miss its official goal of 7.5% growth in 2014. More importantly, we expect a gradual decline in growth to the 4% to 5% range over five years, which will continue to weigh on commodity producers in South America and Africa, as well as on trade-driven Asia-Pacific. The slower-than-expected recovery in the eurozone is a drag for Eastern Europe (including Russia).

Financial inflows and spreads suggested until recently that investors still favored emerging markets. But earnings won't outpace the sluggish growth of GDP and trade. Plus, sentiment has soured quickly during recent fits of volatility. EM equities might rise if inflation turns out lower than we expect in the U.S., leading the Fed to put off interest-rate hikes.

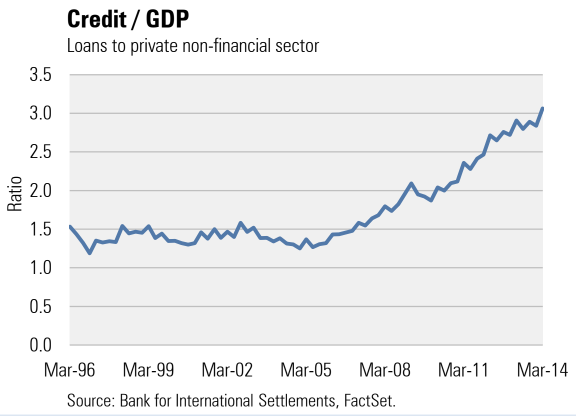
Recent elections in some EM countries won't be panaceas. For example, **Brazil** has made little effort to reform since being named part of the Fragile Five by Morgan Stanley in May 2013. Its results from recent years underscore this weakness, so the re-election of incumbent Dilma Rousseff isn't encouraging.

Brazil's external deficit hasn't budged, at almost 4% of GDP; the fiscal gap has only grown larger. As a commodity exporter, Brazil is vulnerable to China's slowdown. Household debt is a top concern: The credit-to-GDP ratio has gone up by 60 percentage points in 10 years, and the debt service ratio has grown to 22% (see **Figure 2**). Coupled with an overvalued housing market and the high leverage of domestic banks, the risk of a financial crisis is clear.

The administration has done nothing to cut the deficit, despite a recent credit downgrade by S&P. The central bank has one hand tied. If it doesn't raise rates, it risks even higher inflation; if it does, it could trigger defaults.

Meanwhile, Narendra Modi, **India**'s new prime minister, also has his hands full. Consumer price inflation plunged to 6.5% in September, from 7.8% in August, on the back of lower food prices, and wholesale inflation hit a five-year low of 2.4% (from 3.7%). In a recent statement the central bank assured that the 8% target is within reach by January, however, it will likely miss its January 2016 goal of 6%.

Figure 2. Brazil's Debt Service Ratio



Source: Bank for International Settlements, FactSet.

Output news has been less rosy. Industrial production was up just 0.4% in August, year on year. The manufacturing Purchasing Managers Index shows further weakness in September, whereas the overall output index suggests growth picked up only slightly in Q3.

Indonesia's foreign currency reserves took a big hit from mid-2011 through mid-2013, but since have recovered, reaching an all-time maximum in August 2014. That reflects a narrower external deficit, from a peak 4.5% in 2013, to a forecast 3.5% in 2014.

President-elect Joko Widodo, who took office in October, is expected to boost public investment, while phasing out oil subsidies, which have played a major role in keeping the fiscal gap high. While lower fuel subsidies will help the government balance its books, it will stoke higher inflation—the subsidized price of fuel is about $2 per liter, much lower than the market price. The 2015 inflation forecast has risen past 6%, despite the central bank's target range of 3.5 to 5.5%.

The central bank has stayed pat since November of last year, as it balances the risk of higher current account deficits with that of higher inflation.

All in all, Indonesia is more resilient now to financial outflows and interest rate hikes than it was a year ago.

A Look at Local Markets

While Asia-Pacific regional benchmarks sank in the third quarter, some markets surged ahead. In particular, China and Japan snapped back from weak Q2 performance, while India and Thailand continued their winning ways.

China A shares jumped nearly 16% in the most recent quarter, after a weak first half of 2014 (see **Figure 3**). The latest rally comes ahead of the announced Hu-Gang Tong, or Shanghai-Hong Kong Stock Connect program, which is designed to further open trading of A shares to international investors, after about a decade of limited availability to qualified investors. The move could stem Chinese stocks' years-long slide if outside investors buy into it. But China's long-term economic growth story might not be as compelling to investors as it has been in the past, as growth continues to slow. We see further slowing ahead, ushering in an age when 4% to 5% growth will be the norm, which might crimp investors' zeal for Chinese stocks. However, officials continue to have a variety of economic stimulus at the ready, which could support stock prices in the medium term.

Figure 3: Selection of equity benchmark performance

Country/Region	Index Name	Q3	Q2	YTD	1-Year
Asia-Pacific	DJ Asia/Pacific TR USD	-2.72	6.56	2.24	4.49
Asia-Pacific	MSCI AC Asia Pacific GR USD	-2.78	6.34	1.69	4.03
China	MSCI China A GR CNY	15.95	1.93	10.14	6.86
Hong Kong	Hang Seng HSI TR HKD	0.20	6.86	2.20	4.45
India	S&P BSE SENSEX India INR	4.79	13.52	25.79	37.41
Japan	Nikkei 225 Average TR JPY	7.36	2.39	0.84	13.78
Korea	MSCI Korea GR KRW	-3.28	1.13	-3.29	-1.20
Malaysia	FTSE Bursa Malaysia KLCI TR MYR	-1.03	2.75	1.34	7.48
Singapore	FTSE/SGX STI TR SGD	1.78	3.40	6.28	6.69
Taiwan	MSCI Taiwan GR TWD	-1.19	8.21	10.46	16.16
Thailand	MSCI Thailand GR THB	7.62	7.82	23.13	15.86

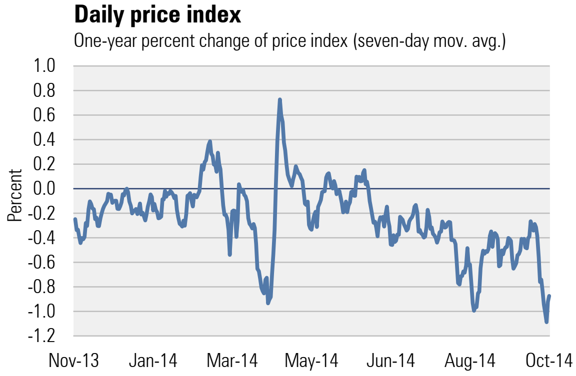
Source: Morningstar Direct. All periods as of 30 September 2014, except Q2 (1 April to 30 June 2014).

Japanese stocks also rose sharply in the quarter, up 7.36% over June 30, moving year-to-date performance just barely into positive territory. However, the Nikkei leapt another 7% into early November after the Bank of Japan surprised markets with new bond- and stock ETF-buying programs, further depreciating the yen.

This may ease deflationary pressures somewhat. Inflation is ostensibly at its highest level since the 1990s. But after factoring out the April tax hike, the headline number is just 1.3%. An index of often-purchased items, from supermarket scanner data, shows that deflation for groceries deepened in September (see **Figure 4**).

Japan's reflation could be in danger because wages are barely rising. In August cash earnings for regular employees, excluding bonuses, rose just 1.4% from a year before; excluding bonuses, the rise was just 0.7%. That's in spite of historically low unemployment (3.7%), and the ratio of job offers to job seekers is the highest in 20 years. Wages don't rise even as the job market gets tighter.

Figure 4



Source: UTokyo Daily Price Project.

Regionwide stock indexes hedged to U.S. dollars fell 2.72% (the Dow Jones Asia/Pacific index) and 2.78% (the MSCI All-Country Asia Pacific index. Markets in Korea, Taiwan, and Malaysia all contributed on the downside, as measured in local currency, while Hong Kong stocks approximately broke even at 0.20%.

For the nine months ended Sept. 30, Asia-Pacific stocks in USD together increased about 2%; Korea led losers at -3.29%, measured in won. All single-country returns here are measured in local currency terms.

In India, stocks rose 4.79% in Q3, a paltry increase next to Q2's 13.52% rise but well ahead of the regionwide increase for the quarter. Investors continue to buy India's reform story under newly elected Prime Minister Narendra Modi, as stocks have outpaced the regional index by more than 23 percentage points year to date. As we've said previously, there's likely some irrational exuberance here, as Mr. Modi still faces the task of reining in spending while keeping growth alive.

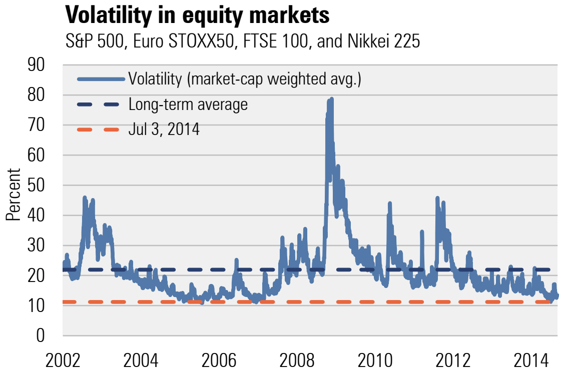
Meanwhile, Thailand is the only country in the region to come close to India's stock performance so far in 2014. Thai stocks rose 23.13% in the year-to-date period, with Q3 returns of 7.62%, nearly even with the 7.82% in Q2.

The increases have come in a year filled with political crisis, including a military coup in May, weak exports and tourism, and declining economic projections. But inflation remaining in check has allowed Thailand's central bank to maintain its policy rate at 2% since the last cut in March.

Are stock investors too complacent?

Volatility had slumped to multi-year lows before October's market swings (see **Figure 5**).

Figure 5



Source: BIS' Quarterly Review, Sep. 2014, Graph 6.

Calm reigned across a wide array of asset classes. Also, credit spreads for high-yield corporate bonds and for emerging-markets fixed income were historically low. True, this October equities fell and risk perceptions flared up, presumptively due to weak data from Germany, doubts about Greece, falling oil prices, and a mishmash of hazy threats ranging from Iraq to Ebola. Of course, markets rebounded and volatility plunged toward the end of the month.

Are markets too complacent? Investors may be mistaking low volatility for low risk, when in fact the opposite is true. Low volatility and narrow spreads are signs of high risk-taking—as put concisely by Claudio Borio, head of the Monetary and Economic Department at the Bank for International Settlements.

Low volatility is partly explained by monetary policy. Central banks have reassured the public that they'll keep monetary policy loose for quite some time. Despite these half-promises, monetary policy will likely diverge across regions. On one side, the Federal Reserve and the Bank of England will start tightening soon, however timidly; on the other, the European Central Bank and the Bank of Japan probably will hold out, or even ease further.