Q4 2014 Market Spotlight

Morningstar Investment Management Asia Limited

Economic Outlook

The consensus can be dead wrong. For example, most economists expected a bear market for bonds in 2014. Instead, long-term yields fell across major currencies. Troubled European sovereigns were no exception. Italy closed 2014 borrowing five-year money for less than 1%, down from 2.7% a year earlier.

To be fair, some consensus forecasts were right. The Federal Reserve tapered asset purchases and eventually shelved quantitative easing. The dollar rose. It was a year of sluggish growth, globally. China stayed on course for a soft landing. Fiscal headwinds did ease. Japanese headline inflation accelerated, even if only thanks to the consumption tax. Commodity prices didn't rise. Globally, inflation was lower than it's been in decades. The eurozone's recovery was indeed slow and uneven—Spain, however, surprised on the upside, and Italy and France disappointed.

But the mainstream was caught out on many fronts, besides interest rates. The Bank of Japan launched another wave of asset purchases. The Bank of England didn't raise interest rates, despite signals to the contrary in 2013. U.S. unemployment fell below 6%, and oil prices below $60. Russia took a bite out of Ukraine. The Fragile Five made it to December, however Brazil lost "its" World Cup in a crushing defeat to Germany.

Some global economic themes to watch for in 2015 include:

- U.S. monetary policy will diverge from those of the eurozone and Japan in 2015 and probably into 2016. But the Federal Reserve may start raising rates later than the consensus expects, and tightening may be smaller in 2015 than the market thinks.
- Despite the sharp appreciation of the U.S. dollar, further rises are probable.
- Cheaper oil has lowered the market's projections in the short term. Growth expectations, on the other hand, have risen for most mature economies. A rebound in the price of oil is likely in 2015, but new supply from unconventional oil sources has depressed the long-term baseline price. (See more in "Spotlight" below.)
- Headline inflation will shortly turn negative in many advanced economies, prompting some economists to worry about a deflationary spiral. But deflation is unlikely in economies with fiat money and excess bank reserves.
- A Greek exit from the eurozone is more likely than ever. Markets appear too complacent.

Closer to home, Japanese Prime Minister Shinzo Abe won the December election, and his Liberal Democratic Party and its (much smaller) Komeito coalition partner kept their two-thirds majority. Despite a turnout of just over half the electorate, the incumbent's victory has been interpreted as an endorsement to Abenomics—a mix of monetary easing, fiscal stimulus, and structural reform.

On the tails of this victory, Abe announced a JPY 3.5 trillion fiscal package aimed at lifting growth, the third stimulus program since he launched his tripod of policies over two years ago. (The first two, in January 2013 and April 2014, were worth JPY 10.3 trillion and JPY 5.5 trillion.) In addition, in the short term the administration is likely to push ahead with initiatives such as corporate tax cuts and the restart of nuclear plants.

The spending program might raise the deficit, but most economists are betting that Japan will grow faster in 2015 than in 2014, which will boost tax revenues. The forecast for the government balance in fiscal year 2015-16 has thus slipped over the past month.

Falling oil prices continue to undo the inflationary effects of the cheaper yen. Core inflation, excluding the effect of the consumption tax rise in April, is just 0.7%. Wages and inflation expectations have failed to pick up, which doesn't bode well for inflation in 2015.

China

Two headwinds held back China during 2014. One was Beijing's attempt to rebalance the economy and contain a runaway shadow financial sector. The second one was the cooling off of the property sector. Both contributed to keep real GDP growth at 7.4% in 2014.

The home stretch of 2014 saw signs of weakness. Industrial production expanded 7.2% from a year before in November, less than the 7.7% posted in October. The average output purchasing manager index fell from Q3 to Q4. The composite index declined quarter-to-quarter, for manufacturing; for services, however, it rose a little.

We expect Beijing to announce a growth target between 6.5% and 7%, somewhat below the consensus forecast of 7%.

Fixed investment spending has tempered, from annual rates of 25% in 2010 to close to 15% now. The latter is still too high, but policymakers believe in a gradual approach to rebalancing, so we don't expect a collapse. If necessary, the government will roll out new stimulus measures to support investment and keep overall growth close to 7%. A modest example of policy support was the cut by the People's Bank of China of its benchmark rates in November. That was the first such move since July 2012.

India

2014 for India was another letdown year, as the economy probably grew close to 5.5%, just one percentage point more than in 2012 and far below the near-10% pace achieved from 2005 to 2008, and in 2010-2011. While that pace isn't likely sustainable in the long term, a cyclical return to something closer to 7% should be possible.

The first quarter of 2015 should see a growth spurt, thanks to lower oil prices—India is one of the world's largest importers. Consumers will benefit from cheaper oil through lower retail prices. In addition, the Reserve Bank of India can afford to lower interest rates (as it did this month) because inflation has dropped.

Inflation dropped to a record low 4.4% in November and, although it bounced to 5% in December, it's still at multiyear lows. Wholesale price inflation is essentially zero, and could well turn negative in January. Provided that price pressures stay low, further cuts should bring the key repo rate down to at least 7%, if not lower.

The pace of reform seems to have picked up in late 2014. The Modi administration took advantage of cheaper oil to scrap diesel subsidies, while also increasing prices for natural gas. The change should improve the fiscal balance or re-route resources to more important uses, such as public infrastructure. The government also lifted limits on foreign investment in a few sectors, and sent a bill to parliament for a national goods and services tax, replacing the panoply of state taxes. With no state elections until November, Modi should be able to pursue contentious reforms for the next few months. K

SPOTLIGHT ON OIL PRICES

From February 2011 until June 2014, Brent crude oil traded below $90 on exactly three days. As of July, only two of 49 forecasters polled by *The Wall Street Journal* expected oil to fall below $90 by year-end. An ever-growing population, plus ever-shrinking oil reserves, supposedly made $50 oil a nostalgia item. Or so we thought. In the last trimester of 2014 the price sank to $55.

In the short term lower prices benefit oil-importing countries, a category which happens to include the five largest economies in the world: the U.S., European Union, China, Japan, and India. Together they account for two thirds of the world's gross domestic product (in nominal terms, at market exchange rates), and half the population.

A $10 fall in the price of oil is a transfer $325 billion a year from oil producers to consumers. If the average price in 2015 were $70, $30 lower than in 2014, the gift would amount to 1.2% of world GDP.

When oil prices fall, the winners are largely households in rich countries. They are many and spendthrift. The losers are few: the governments of oil-producing countries and companies. They're also less constrained by current income than consumers, so won't immediately cut investment, dividends, etc. Overall, then, cheaper oil lifts global spending—for now.

However, there's a catch. Consumer prices track the cost of black gold in the short term. Persistently low oil prices mean that U.S. inflation might fall below zero shortly. The eurozone in December was already in technical deflation.

For oil exporters, the effects of cheaper oil are of course negative. Income, profits, and fiscal revenue will all decline, but to different degrees, depending on how hooked an economy is on oil. For example, energy makes up 70% of Russia's exports, 25% of its output, and 50% of government revenues. Cheap oil, consequently, is wreaking havoc in there. By contrast, Norway's net exports of oil and gas amount to just 10% of GDP, and 29% of the government's receipts. Its massive sovereign wealth fund (almost $900 billion) should help soften the blow.

Most major producers outside North America run a fiscal deficit if the price goes below $100, according to data from the International Monetary Fund and *The Financial Times*. Some of them—Algeria, Iraq, Iran, Libya, Nigeria, and Venezuela—don't balance their budgets unless the stuff is trading above $100 (Russia is in that group as well). Cheaper oil will mean less revenue, tighter budgets, and currency depreciation—wherever the exchange rate is not fixed. In addition, if inflation expectations are not well anchored, higher inflation is likely.

Why are prices falling? Plentiful supply is the most important reason. As oil prices increased in the mid-2000s, energy companies found it profitable to extract oil from shale formations. Crude production in the U.S. alone jumped from about 5 million barrels a day (mbd) in 2008 to 9 million now, out of a worldwide total of 75 million. The U.S. is on track to overtake Saudi Arabia as the world's top producer and is already No. 1 when ethanol and other liquid fuels are included.

Until recently the extra oil from the U.S. and Canada had a muted effect. The boom coincided with disruptions in the supply from Libya, Iraq, and Iran. That took about 3 million barrels of daily production off the market. But in 2014 things changed. Libya's output, for instance, according to OPEC's Monthly Oil Market Report, increased by 400,000 barrels a day since the summer. That led to OPEC's total production rising to 30.3 mbd in the third quarter of 2014 from 29.8 mbd in the first quarter.

In November, as excess oil kept piling up, Saudi Arabia announced it wouldn't scale back production. As the only major producer with spare capacity, it can steer world prices, while everybody else acts as a price-taker.

Wall Street estimates that most shale projects in the U.S. turn a profit at $60 a barrel. That means many wells were losing money in early 2015. Companies should pull back on drilling, putting a floor under oil prices, at least in theory.

But this is not the case in practice. Oil companies sign contracts that give them the right to drill on a plot of land for a certain period. If they don't drill, they must compensate the lessor, and the right to drill expires. In the short term, after the contract is awarded, drilling makes sense even below the "breakeven price."

Production, then, won't necessarily slow down, even if new drilling does. Canadian oil sands projects can turn a profit for even longer. Tar sands are more like mining than oil drilling: They require large initial investments, after which they can keep producing oil for years, at low marginal cost.

Even over the long run prices might not recover all the way to $100 a barrel, for several reasons. First, technology is lowering the cost of squeezing tight oil out of the ground. Second, disruptions in the Middle East will return, eventually. In fact, one could argue that low oil prices might lead to more disruptions, if OPEC producers have to cut public expenditures and trigger social unrest. Third, at $60 a barrel Saudi Arabia would run a fiscal deficit of 14% in 2015, according to Moody's. How long can Riyadh afford it?

The supply surge is one story. But on the other hand, analysts worry that the price of oil has fallen because of weaker demand. Instead of raising disposable income for consumers, cheaper oil is a harbinger of slower growth. But where's the evidence of this slowdown?

Copper, nickel, and iron ore prices have all dropped over the past six months. The same is true of wheat, sugar, cotton, and soybeans. Widespread price declines strongly suggest that global forces, not just commodity-specific effects, are at play.

A different explanation, however, for decreasing commodities prices is that U.S. real interest rates are expected to go up. The Fed is now patiently awaiting the right time to start tightening. Past bouts of rising real rates have coincided with sinking commodities prices.

Others point at forecast surveys to explain lower oil prices. Forecasters have been marking down GDP projections, bringing down the world's expected growth 0.3 points in 2015. In particular, economists have in mind the structural slowdown in China, the lackluster recovery in the eurozone, a Russian rumble, and the failure that is Abenomics. Pessimism is further amplified because negative scenarios get a lot of press.

But real-time gauges of activity, such as the composite purchasing managers index, don't show a major decline. The problem with the demand hypothesis is that it's mostly in the realm of the expected, not the actual. Oil supply has actually gone up, but whether China will slow down in 2015 remains to be seen.

To be sure, the supply and demand interpretations are not at odds. Oil prices may be responding to a recent surge in supply. Cheaper oil is raising growth now, but it's not enough to offset macroeconomic forces that are expected to depress demand in the medium term. If the pessimism is overdone, plus oil supply stays up, prices could recover. K

A Look at Local Markets

Retail investors piled into China A shares in Q4, boosting Shanghai stocks 36.68% in the quarter. A share prices jumped 20.6% in December alone, a volatile month in which stocks on one day lost more than 5%.

The jump in China A shares in Q4 brought the annual increase for 2014 to 50.53% (see **Figure 1**), an incredible figure as China's economy continues to slow. Increases were driven by renewed optimism, the influx of some new capital via the Shanghai-Hong Kong Connect program, and the absence of investment alternatives for Chinese retail investors. But the Shanghai market made the jump to light speed following an unexpected interest rate cut on Nov. 21.

The Hang Seng, meanwhile, significantly trailed its mainland counterpart, returning just 3.21% in the quarter and 5.48% in the year.

Figure 1: Selection of equity benchmark performance

Equity Index Returns for Select Asian Markets

Country/Region	Index Name	Q4	Q3	1-Year	3-Year
Asia-Pacific	DJ Asia/Pacific TR USD	-1.72	-2.72	0.48	8.18
Asia-Pacific	MSCI AC Asia Pacific GR USD	-1.37	-2.78	0.29	11.69
China	MSCI China A GR CNY	36.68	15.95	50.53	14.05
Hong Kong	Hang Seng HSI TR HKD	3.21	0.20	5.48	12.09
India	S&P BSE SENSEX India INR	3.26	4.79	29.89	9.53
Japan	Nikkei 225 Average TR JPY	8.05	7.36	8.95	9.61
Korea	MSCI Korea GR KRW	-3.83	-3.28	-6.99	17.05
Malaysia	FTSE Bursa Malaysia KLCI TR MYR	-3.91	-1.03	-2.62	12.73
Singapore	FTSE/SGX STI TR SGD	3.14	1.78	9.62	21.18
Taiwan	MSCI Taiwan GR TWD	5.65	-1.19	16.69	29.69
Thailand	MSCI Thailand GR THB	-5.00	7.62	16.98	2.55

Source: Morningstar Direct. All periods as of 31 December 2014, except Q3 (1 July to 30 September 2014).

In India, stocks earned a respectable 3.26% in the quarter, bringing the total return for 2014 to a robust 29.89%. India has surpassed China as the world's fastest-growing economy, and it's tempting to believe that global investors drove stock prices higher once Narendra Modi took over as prime minister in May.

However, data do not bear this out. Foreign investors bought a net INR 971 billion ($15.6 billion) worth of India's stocks in 2014, down from INR 1.13 trillion in 2013 and about INR 1.28 trillion in 2012. Where global investors did buy in to India in 2014 was its debt market, where they put approximately INR 1.59 trillion to work, well ahead of prior years.

Whether foreign investors will jump on the India stock bandwagon in a greater way in 2015 is a tough call, as an expected rate cut and lower oil prices should support higher growth, while a rate rise in the U.S may cause investors to curb emerging markets bets.

Japanese stocks started the quarter on the wrong foot, giving up the gains from Q3 before surging again for a quarterly rise of 8.05%. The last-quarter surge brought the advance for the year to a similarly sized 8.95%.

But while domestic individual investors were snapping up stocks in China and India in 2014, the opposite was occurring in Japan, as retail investors sold off a net $3.6 billion.

A number of other forces supported higher stocks in Q4, however, including the BoJ's increase of its quantitative easing program and a broadening of it into risk assets, the delay of the second increase to the consumption tax increase to April 2017, and the rollout of a JPY 3.5 trillion stimulus plan in late December. Also, the JPY 127 trillion Government Pension Investment Fund announced in October that it had increased its allocation to stocks to about half of all assets, up from about one fourth previously.

Thai stocks, after jumping 7.62% in Q3, slipped 5% in Q4, as increasingly sluggish economic data tested the country's "Teflon Thailand" moniker.

Regionwide stock indexes hedged to U.S. dollars fell 1.72% (the Dow Jones Asia/Pacific index) and 1.37% (the MSCI All-Country Asia Pacific index). Markets in Korea, Malaysia, and Thailand contributed on the downside, as measured in local currency.

For the year, Asia-Pacific stocks in USD together approximately broke even; Korea led losers at -6.99%, measured in won, while China led winners, as previously stated. All single-country returns here are measured in local currency terms.