Finding value in Asian equities

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Was the de-rating of Asian stocks justified?

Over the past 10 years, Asian markets have tended to trade at a discount to their OECD global peers. The question is: Given that Asian equity markets already started from a cheap valuation standpoint, were they de-rated further or did they hold their valuations? The latest data reveals that Asian share prices are some 45% under-valued compared to their earnings index.

The original reasons provided for investing in Asia back in the early 1990s remain firmly intact. These include:

- Superior growth rate relative to developed markets;
- Attractive demographics;
- A highly-educated labour pool;
- Underdeveloped markets relative to their economies' purchasing power;
- High savings rates (versus developed markets), and;
- Unsurpassed cost competitiveness.

China is one of the key drivers of growth in the region. China's extraordinary strong economic growth is not just an export story: It has been boosted by the rising trend of domestic demand as more affluent Chinese citizens own their homes and are buying cars, mobile phones and other modern consumer goods and services. The consumption boom is stimulated by the demographic composition of the region. When young people join the workforce, they earn and spend a large part of that income on durable goods which have a high income and money-multiplier effect, contribute to tax receipts, lessen the government budget deficit, etc. In brief, they help the economic machine work at a greater capacity than it would otherwise.

This favourable demographic trend is likely to underwrite a sustainable domestic demand trend of about 4% to 5% per annum in the region. That is much higher than the rate of 1% to 2% per annum in mature OECD countries. Unlike the past, the forecast high nominal economic growth in Asia is also likely to translate into high earnings growth, as Asian companies have been more profit and cash-flow focused after the 1997-98 Asian crisis.

Asian markets are also supported by strong liquidity. The "loan to deposit ratios" in the region suggest that lending has slowed significantly. The lack of lending (i.e. lack of borrowing) results in an excessive amount of liquidity in the banking system. Contributing factors include reduced corporate CAPEX spending as firms become more watchful of their cash flows, and individuals becoming more conservative due to the lack of employment opportunities and income growth. Consequently, there is plenty of money available for investment in financial markets. Compare a Hong Kong bank deposit yield of 0.25% versus a dividend yield of 6.5% for Hang Seng Bank.

Management, particularly in corporate governance, is not the strongest competitive advantage Asia possesses. However, governance is improving, as witnessed by greater share repurchases and dividend increases.

Finally, the valuation characteristics of the region are compelling. Currently, the Asian equity risk premium is even higher than at the depths of the Asian crisis of 1997-98, or even 9/11. This is another way of stating

UNLIKE THE PAST, THE FORECAST HIGH NOMINAL ECONOMIC GROWTH IN ASIA IS ALSO LIKELY TO TRANSLATE INTO HIGH EARNINGS GROWTH.

that risk aversion towards Asian equities is extremely high and future corporate cash flows are being discounted by an abnormally high and punitive discount rate. Additionally, in the past there have been times when the Asian return on equity (ROE) was comparable to that of the U.S. When this happened, the Asian price/book ratio tended to trade in line with that of the U.S. or even at a premium. Currently, trading at a 2% discount to the U.S. ROE (i.e. 10% versus 12%), Asian markets' price/book ratio is at nearly at a 50% discount to that of the U.S. The trailing and prospective P/Es have similar discounts.

These characteristics offer something attractive for value or growth managers, and the recent de-coupling and out-performance of Western markets suggest momentum managers should be interested as well. ▪