



China's slowdown, if well managed, will be an important driver for Asia

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The Debate

Recent growth story pushes Asia ex Japan onto the global stage

Region has had major impact on world economy in recent months, with China driving demand for commodities

This week's Conjecture, hosted by James Tew, head of Client services at S&P, focuses on Asia ex Japan. Taking part in the debate were Andrea McNee,

chief investment officer at Resolution Asset Management, and Mark Williams, manager of the F&C Pacific Growth fund.

What have been the key drivers in the Asian region over the past six months?

Mark Williams (MW): The world in general has been largely influenced by Asia over the past six months to a year. A lot of that has been to do with China's growth and it is an inescapable fact that China is becoming a far greater influence on the world both politically and economically. China's demand for commodi-

ties and other basic materials at this stage in the cycle has been one of the biggest driving factors. That has spilled over into the emergence of a Chinese middle class and a huge increase in discretionary consumer spending.

India has also been a huge influence because of the size of its economy. We have seen the emergence or dominance of India as an outsourcing centre for services while there has been huge infrastructure spending around the economy. Those two factors have been the main drivers and the other Asian countries have been unable to escape that influence.

What do you think the key drivers will be for the next six months or so?

Andrea McNee (AM): China is obviously important and I believe its slowdown, if well managed, will be an important driver for Asia. That said, one of the greater influences at the moment is the US economy. The decoupling argument is trying to be made for Asia but if the US economy slows, that will still have an influence on the region. How Asia copes with that and how domestic demand holds up in that environment will also be a key driver.

How important are geopolitical events?

AM: The coup in Thailand is interesting because initially the reaction in the market place was to buy on the dip. It is actually more complex than that and it is going to take a while for the proper democratic process to unfold in Thailand.

That makes us cautious on the country right now. North Korea is an impossible situation to analyse. It has always been a threat and continues to be so and we just have to hope diplomacy and sanctions will work.

MW: Both these issues are significant. The North Korean question has been outstanding for quite a long time and the South Korean market trades at a discount partly because of that.

However, it needs to be man-



aged and the worst thing is for an arms race to develop within Asia. That is perfectly possible but ultimately we are positive there will not be any of the horrific end scenarios that are potential with any sort of warfare. As long as there is not any actual conflict we think the impact on economic growth will be limited.

These geopolitical events have to be seen as a negative but, at the same time, they will not become the dominant negative they are in overall political terms.

Are places like China and India going to supplant the demand America has created?

AM: We are expecting a soft landing in the US meaning we expect growth to fall from about 3.5% in 2006 to 2.5% in 2007. Asia is still a big exporter to the US so, if we do get a US consumer slowdown, that will have an impact on Asia's export growth.

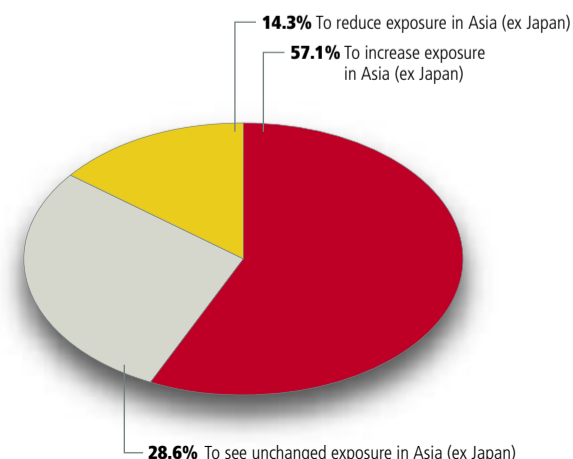
Asia's export growth so far this year has held up incredibly well but we are expecting that to soften. We expect GDP numbers for Asia to come down but not significantly. We predict a pretty positive environment for Asia and that growth should still be around 4% for the region.

MW: That a large amount of Asia's growth is based around exporting to the developed world is inescapable. If you look at it on a country basis, Hong Kong sends 16% of its exports to the US, China and India and India sends approximately 21% there. None of those can escape from a US slowdown in demand.

We are hopeful there will be a soft landing in the US but the risks of a hard landing are obviously there, especially as there has been a fall in housing prices.

Within Asia you can find pockets of domestic demand and can arrange portfolios so they are

OVER THE NEXT THREE MONTHS DO YOU EXPECT:



Source: Conjecture



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not badly hit. I feel Asia will weather this better than a lot of the other regions in the world. That is why, on a relative basis, I would still remain very positive on Asia for the next year of even 10 years. You have to bear in mind that if America catches a cold it does affect the rest of the world and you can't get away from that fact.

What is influencing stock selection at the moment?

AM: Where we have been playing domestic demand we have been doing so through China's property sector.

We bought into Chinese property in the summer. At that stage, people were becoming extremely concerned about overheating in China and clearly there were some measures that came out to dampen that which were specifically targeted at the property sector.

Share prices fell quite dramatically and valuations started to look attractive, trading at 40% to 50% discounts to NAV.

We have been playing the consumption theme by buying into those stocks and it has been beneficial as the stocks are now trading at around 20% discount to NAV. We are still quite optimistic on the property sector in China and are also positive on Hong Kong and Singapore from that perspective.

Again the focus would be on property and banks, if you expect the US economy to slow and US interest rates to fall, it would be supportive of domestic liquidity in Hong Kong and the property sector.

Are there other important sectors?

MW: In our top 10 holdings we have also got BHP and a lot of China's demand, due to its infrastructure needs, are going to be a big driver of the resources sector.

Jiangxi Copper, a copper refiner, is one of our big holdings that also plays into China's ongoing development and domestic demand. We have also been playing Indonesia and the Philippines with about 6% of the portfolio in the former.

We recently bought Astra, which is a big beneficiary of the increase in motor vehicle sales there. Indonesia is one of the few countries in the region to be seeing a fall in interest rates forecast to the year end.

Are you prepared to take on the additional volatility involved in investing directly in these countries?

AM: When people buy our funds they obviously expect us to be investing in the Asia Pacific region. There are 800 stocks for us to choose from and we only need to own 60 so we feel there is more than enough choice within the Asian region.

Do you consider Australia to be part of the Asia ex Japan region?

MW: When people invest in Asia they are looking for the real Asian growth story, which does not necessarily encompass a large proportion of the Australian domestic market.

Our approach has been to allow ourselves the flexibility to take that exposure should we want to, though we are not forced into it. At the moment we have about 7% or 8% in Australia but that is entirely commodities based because we are very positive on the overall growth story.

That said, the one time I would want significant exposure to Australia would be if I was very negative on the Asian region. Then it would typically act as a defensive market because approximately 6% of its exports are to the US.

In light of this, how important is it for a fund to have a benchmark?

MW: The main reason we do not have a benchmark is to allow ourselves flexibility, particularly with areas such as Australia, to increase our exposure significantly when we think it is a reasonable or profitable thing to do.

At the moment, we are relatively positive about growth in the rest of Asia so we do not want to have a large exposure.

If we were to choose an index and manage our funds against a particular index, then we would have to make a choice as to whether or not we were going to be including Australia. We would end up being tied to that to a degree that we probably would not want to.

Some countries in the region have not invested in their infrastructure. Do you think that will restrain growth?

MW: I think of this in two ways. To start with, when the infrastructure is being put in place it is a big boost to growth. Somewhere like India, which has a massive road programme in place called the Golden Quadrilateral, is going to be a benefit.

Once that infrastructure is in place the country will end up with the ability to export and use it, or bring produce to market when it is still fresh rather than seeing

the wastage. To some degree it is a positive then.

However, if you look at India and its potential as a manufacturing base, it is largely disadvantaged by its lack of infrastructure and its inability to actually get products to the end consumer.

Likewise in Indonesia, labour costs are now probably lower than China's if you look at them on an average basis.

People still find it more expensive to manufacture on a per unit basis in Indonesia for a lot of goods as they do not actually have the infrastructure support to be able to transport these goods around the country to a large degree.

What will happen to the dollar over the coming months and what is the likely impact on the Asian markets?

AM: We take a lead from our fixed interest team on the currencies and their view would be that the US economy will slow down, interest rates will get cut so the US dollar will fall.

In that case we would see that as being beneficial for the region, considering the soft landing scenario and not a recession scenario in the States. In particular, we think it would be very positive for Hong Kong.

In terms of currencies within the region, we are not really seeing huge amounts of currency strength.

What is your current view of market-cap biases in the region?

AM: We look at our portfolios very much on a country basis then we pick best stocks within that country so we do not have a size bias at all.

That said, we did have a rea-

sonable overweight position in the first quarter of this year to small caps. We monitored it and cut it back as we became a bit more worried about the overall outlook for Asia over the summer.

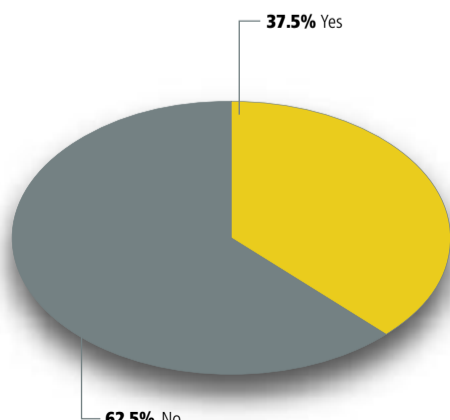
So the portfolio would have shifted more into larger cap at that point in time and it still does have that bias to more mid and large rather than small cap.

We look at each company on its own fundamentals and look at the expected total return we can achieve from that.

THE NEXT GREAT DEBATE

Next week's Conjecture is on Boutiques featuring Close Investments' Stuart Alexander and Jonathan Polin of Resolution. For more information go to www.conjecture.co.uk

DO YOU CONSIDER AUSTRALIA TO BE ASIA (EX JAPAN)?



Source: Conjecture