

## Asia's Economic and Financial Market Landscape – 2002

A year ago this week, **DSGAsia** was officially launched as an independent company. We distributed a report on the company's performance in our last mail-shot of 2001 but for those of you who had already disappeared or disengaged by then, we would like to offer again our thanks for your support<sup>1</sup> in our debut year and inform you that we have decided to cease actively marketing our services to new customers.

A year ago this week, **DSGAsia** was officially launched as an independent company

Our opening offering in January 2001 carried the title above minus one. In the course of presenting our roadmap for this year, we thought it appropriate to build in a review of our themes and calls during the last. In this we are carrying on a tradition we hope we have established over many years for generally honest hindsight and maintaining ownership for our views – both right and wrong. Of course, if after reading this missive you do not believe us, all of the seventy or so articles we published last year, not to mention our ever-funky charting resource, can be found on our website at <http://www.dsgasia.com>. Full access is available to all **DSGAsia** clients so if you have not applied for a username and password, hit the return button and we will set you up pronto.

We start with a review of our themes and calls during 2001

Our big picture call last year was that global growth would slow to near zero by the second half of 2001. We had already predicted in mid-1999 that Japan was heading into recession and we subsequently said that we expected the US to join them. Why? Because we thought the damage had already been done by the lagged effect of far tighter global liquidity conditions and the tech bust, and although we expected Greenspan to cut and cut, previous credit excesses, investment overhangs and subsequent balance sheet repair would result in a sputtering transmission mechanism of liquidity to the real economy.

Our big picture call was that global growth would slow to near zero by the second half of 2001

Accordingly, we also started the year extremely nervous of equity markets where although we saw the scope for a near term relief rally as Big Al swung into action, we thought that monetary easing would not be enough to offset a deteriorating profits environment. How right we were but subsequently, we were too early in believing that Asian markets would start to discount the worst by mid-year. Although we remained resolutely bearish on the US corporate earnings outlook (indeed we still have major problems with analysts medium term expectations), we believed that Asian numbers were far nearer the mark and that the region's domestic liquidity build

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<sup>1</sup> In fact, post turkey, I am now wearing it....



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would start to win out. Nevertheless, the lack of ability of US analysts to discount and Asian production and export numbers coming in even weaker than had been expected, all served to keep local cash piles on the defensive.

The natural outcome of our bearish growth views, when combined with our secular disinflation beliefs, was that Asian central bankers were overly tight and accordingly would ease aggressively both through the rates and currency markets.<sup>2</sup> Inflation did indeed surprise on the downside most everywhere and central banks did their stuff as expected. Long USD/short local currency strategies, and positioning for local yield compression paid off handsomely over the course of the year.

We believed Asian central bankers would ease aggressively both through the rates and currency markets

Also as expected, and contrary to market consensus, current account surpluses remained high and even widened in some cases as analysts failed to build in the consequences of moribund investment growth into their models. The feedback loop through building foreign exchange reserves – locals, unlike in 1997-98 stayed put in their own banking systems this time round – aided our rates compression story and will ultimately be highly domestic equity supportive in our opinion. With investment remaining sluggish throughout next year, and banking systems unwilling or unable to lend to corporate sectors which in any case continue to deleverage, current account surpluses will once again be strong and domestic household liquidity will build further still.

But unlike in 1997-98 locals stayed put in their own banking systems

We will return to our country specific FX/rates and equity views in greater detail a little later but first, what of the big picture prospects for 2002? We reproduce below our favourite charts of OECD narrow and broad free liquidity illustrating their impacts on equity markets and, with a lag, real economic activity. Turning to the broad measure first, in contrast to this time last year, the runes say activity is going to pick up. Nothing spectacular. Money multipliers will continue to function sub-potentially since balance sheets are still undergoing repair, any meaningful recovery in CAPEX is most likely a 2003 story (though its rate of decline is already moderating and thus its subtraction from GDP growth should consequentially diminish), and the US consumer will be in savings rebuild mode. Our hunch remains that the strongest quarterly growth in the US could be seen earlier than many expect due to base compression but that this will soon run out of steam as we move into H2.

The runes say OECD activity is going to pick up in 2002. Nothing spectacular though

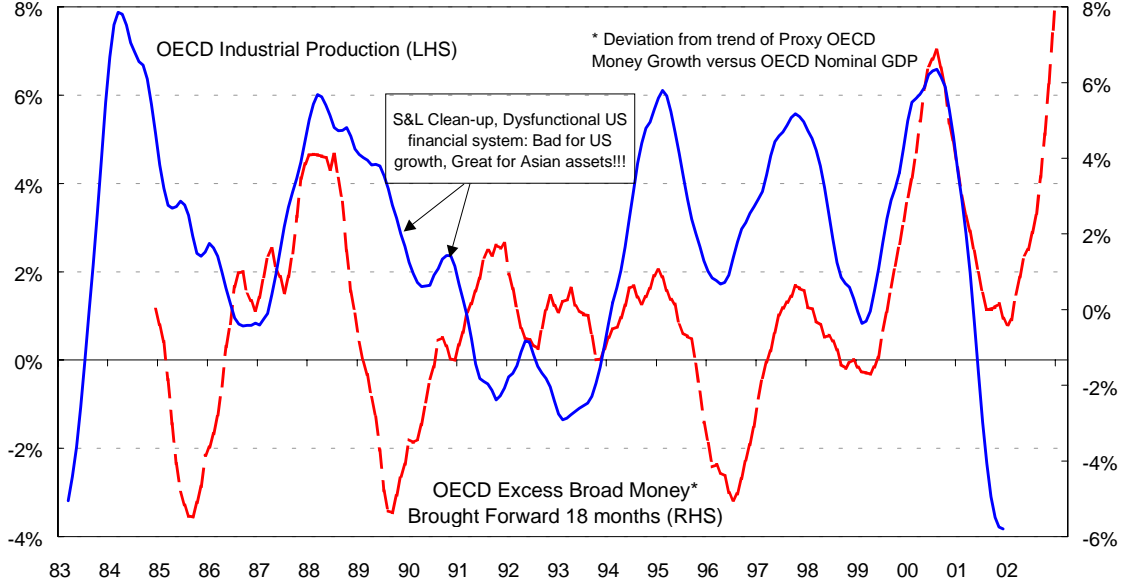
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<sup>2</sup> See for example “Asian Interest Rates - How Low Can You Go?”, February 5<sup>th</sup> 2001 and “The Price is Right - Disinflation Versus Deflation”, April 17<sup>th</sup> 2001.

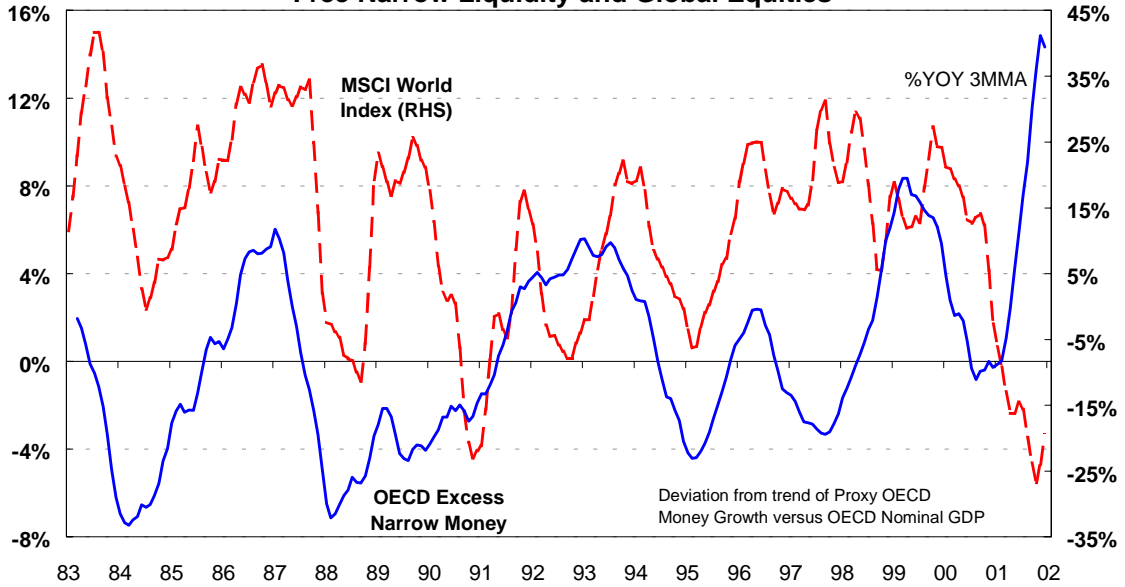


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## Free Broad Liquidity Leads Economic Activity



## Free Narrow Liquidity and Global Equities



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We suspect that the Fed Chairman shares some of our scepticism over the V-shaped recovery. The economy was facing major challenges even before September 11<sup>th</sup> and although the events provided all manner of excuses to all manner of people, we do not think the path of rates would have been very much different had the WTC remained unmolested. Moreover, Greenspan's previous behaviour does not suggest that he is one to aggressively take back easings until he is convinced they are truly working; you may recall that after taking rates down to 3% in late 1992, he did not start to raise the Fed Funds rate again until early 1994. Hence if we are correct in this assessment, the recent sell-off at the long end has got ahead of itself and bonds could rally mildly again. We would stress *mildly* since unless one believes that the economy is going to take a further major nosedive from here, we are unlikely to retest the early November lows seen in yields.<sup>3</sup>

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In a similar vein, we also believe equity markets are pricing in too much good news. In this sort of landscape, we expect corporate earnings – allowing for accounting rinky-dinks – to continue to disappoint. Unlike Asian firms that have spent the past four years paying down debt, America's companies occupied much of this period issuing debt to buy back equity, and this becomes more problematic to service in a low nominal growth environment. Moreover, although capacity and technology-related factors will continue to cap consumer prices, input prices may see some strength implying further margin compression. All of the above suggest that the US markets are going to have a problem progressing much further from current levels despite the abundance of free liquidity sloshing about globally (hence we expect the disconnect between the two lines on the narrow liquidity chart to continue as was the case in the early 1990s). However, we believe that Asia will provide a willing home for some of this surplus cash in a regional environment of *stronger* than expected growth and *improving* profitability.

US bond and equity markets are ahead of themselves

We will not go overboard on the strong growth bit since in many ways, the rebound we are looking for is predicated on the same sort of low base effect that will drive the US. It is just that the degree of compression – throughout almost all the region including notably Japan – has been even more severe. Unlike in 1999-2000 though, where growth was almost entirely externally

Asia will provide an environment of stronger than expected growth and improving profitability

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<sup>3</sup> This has implications for the housing market since it suggests we are at or near the end of the REFI boom and thus the ability for American households to continue to extract further equity from their properties to maintain current levels of consumption is likely to become more constrained.



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(and arguably externally-bubble) driven, we are now further down the line in the aforementioned deleveraging process while with a few exceptions, financial sector clean-ups are more complete. Furthermore, consumption has been pretty firm across the board – *volumes* have still managed to grow even in the most suicidal places such as Hong Kong and Taiwan – which is evidence that households have viewed the current downturn as more of a cyclical event as opposed to the major shock to permanent income that was the Asian financial crisis. Hence, should growth rates indeed start to stabilise over the coming two quarters, and with this stabilisation fears of job insecurity diminish, then one should expect to see an improvement in risk appetites reflected in accelerations in consumer expenditure and switches out of bonds and bank deposits into stocks and real estate.

In the early stage of such a process, portfolios will likely benefit from a higher 'crap quotient' – the brokerages, penny stocks and the like that the retail punters will pile into – but in our opinion, the real kicker for the foreign money that could subsequently follow will be the most un-Asian experience of earnings growth outstripping nominal GDP expansion.

For once we could see earnings growth outstripping nominal GDP expansion

It is well documented that a dollar invested in Asian stock markets in 1990 would have struggled to be worth a dollar today. Similarly, most Asian currencies can hardly be considered to have been great stores of value. Some have tried to argue that this has been evidence of huge inefficiency but if one accepts the premise that the price of stocks should reflect the expectation of future income streams then Asian markets have been far from irrational.

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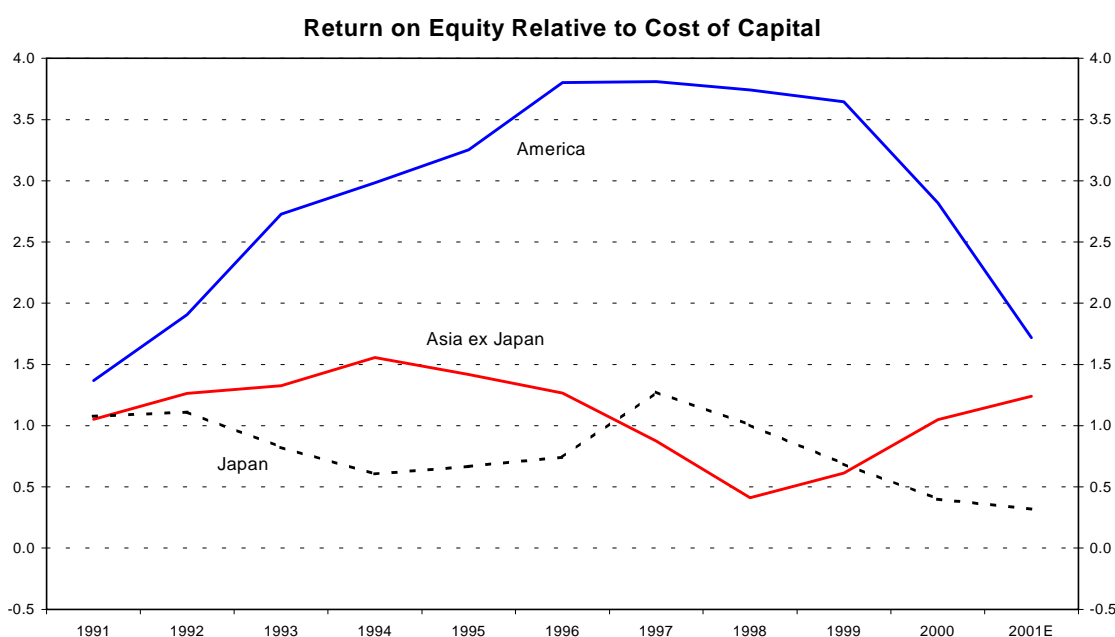
In 1996, while an indentured economist at the great house of Warburg, I co-authored an article with Danny Truell entitled "The Myth of Asian Profitability". In this piece, we explored the reasons for the huge divergence seen between corporate profit and GDP growth in many countries in the region and concluded that despite all the cheerleading of Asian analysts and officials, Asia's lousy performance as an equity investment over time accurately reflected investors more sober assessments of the returns delivered by local companies. From a macro basis, our conclusion was that the profit share in GDP – in marked contrast to the experience of America over the same time period – was accruing more to the household sector in the form of unit labour cost growth outstripping the ability of companies to raise prices. From a micro basis, we examined trends in return on equity and concluded that worryingly few companies were being successful in delivering returns in excess of their cost of capital. It was on a combination

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of this piece plus an assessment that many Asian currencies were becoming seriously overvalued, that we based our “get the hell out of the region” call.



Five years on, we honestly now believe that the trend is reversing. Unlike 1997, Asian currencies are generally hyper-competitive while nominal interest rates are at record lows throughout much of the region. Moreover, despite the savageness of the region's slowdown, returns on equity (ROE) relative to the cost of capital have held up well (see the chart above), which implies that structurally, Asian companies are starting to work their balance sheets and cashflow more efficiently.<sup>4 5</sup> Indeed as we wrote back in June:

**Asian companies are finally starting to work their balance sheets and cashflow more efficiently**

<sup>4</sup> The chart we have constructed is based on our own (and market) crude estimates for price-earnings and price-book value ratios relative (in most cases) to prime borrowing costs. We are in the process of collating more robust series of numbers for (amongst other variables) returns on equity, returns on total capital employed and weighted average costs of capital with a view to presenting a more detailed analysis of this issue in due course. But for now, we believe that the rough data that we are employing more than amply illustrate the general trend.

<sup>5</sup> You may wonder why a 'macro' shop is devoting its resources to more micro issues. The answer is that we have always believed that trading markets based on pure macro factors



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“[W]ith working capital and other funding far less free-flowing than in the past, investment plans have been scaled back, production has been rapidly reined in, and inventories have been kept far better under control than has been the historic norm. The result has been that headline growth has slowed far more sharply than in previous cyclical downturns (the Asian financial crisis was no pure cyclical event) but it also implies that the output response to any upturn will be abrupt on the upside. The days are no more when the majority of companies can continue to keep on merrily producing and investing on the view that the state will ensure that the cash continues to flow from the banking system. This is not to say that there is no inventory overhang to be worked off but demand vagaries, not stock adjustments, will increasingly define the near-term cyclical trajectory going forward.”<sup>6</sup>

What has forced such changes? At the margin, market regulation is being tightened and greater transparency and best practice is being introduced which is not to say that many of the region's companies and officials would not go back to their old ways of doing business if they had the choice but rather, the resources and barriers to entry that would support such a choice are considerably less available than before. Again as we wrote back in June: “[T]he confluent forces of a) the shift from state-mandated debt financing to market-mandated equity financing, b) limitations on fiscal largesse which preclude universal corporate support programmes, c) the infiltration of external best practice as foreigners have wormed their way into hitherto domestic reserves, and d) the cartel-busting nature of the new economy, all imply that Asian returns on capital are embarking on a secular up-trend even as those in America appear to have peaked.”

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The contrast with the US could not be more stark. As we have noted in the past, ROE peaked in the US in 1996 at 24.5% and has been on a general downtrend ever since. All manner of accounting tricks managed to inflate stated (as opposed to cash) earnings up until 2001 but just as Asia discovered in 1997 (Asia ex Japan's ROE peaked at 16% in 1994 by the way), as soon as asset markets stop rising (let alone fall), such bean counting prestidigitation tends to impact horribly in reverse. This then leaves

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tends to work only at times of major cyclical turning points – 1997-98, 2000-01, etc. – and that in interim periods, the drivers are far more eclectic. In other words, just as in 1999, when we decided to take the year off, we rather suspect that by the second half of 2002, the macro trades will be well set and our customers might start to question even more closely exactly what it is they are paying for.

<sup>6</sup> See “The Mercantilist's Lament”, June 28<sup>th</sup> 2001.



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companies with the choice of seeing their earnings collapse (which they can do little about first up) or cutting their input costs.

Asia's experience has been generally a 'European' one. With labour relatively hard to shed, cost reductions have been mainly garnered via debt reduction, less investment (especially of the peripheral sort) and other efficiency gains such as better working capital management. America has spent the past decade paring its costs back to the bone, which means that labour force reduction is the only major source of immediate savings. For sure, we have yet to see deleveraging and CAPEX will remain subdued but the ability to extract major, secular improvements in ROE from here, and as a result grow cash earnings at the sorts of rates that the markets are still factoring in, could be mighty difficult.

All in all therefore, our betting would be that although we are unlikely to see Asian returns on capital reaching the levels achieved in America any time soon, the relative rate of improvement, combined with magnificent liquidity conditions, favours regional equity markets in a manner not seen in a decade. In fact, it almost reminds me of why I decided to come out here in the first place!<sup>7</sup>

What can go wrong with this rosy scenario? Quite a lot naturally. Wildcards include US equities having another major swoon and killing off any signs of renewed confidence, Japan going into meltdown mode and taking global bond markets with it,<sup>8</sup> Argentina's default setting off a round of "me too" abrogations, and all manner of nasty geo-political events which might be out there. One could position investments for such scenarios of course, though whether one can physically hold on to or realise the gains in the resulting new world order might be a moot point. We prefer – for a variety of reasons, not all economic – to avoid having such doomsday scenarios as our base case.

So on the assumption that the world as we know it is not going to end in 2002, how should one be positioned within an Asian context? Our general biases are to be long equities, neutral fixed income markets and neutral to slightly short the US dollar relative to certain local currencies. However, within the region, the biases are by no means uniform.

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<sup>7</sup> Well one of the reasons. We will not go into some of the others in a family publication.

<sup>8</sup> See "Japan - Compromised or Compromising?", December 17<sup>th</sup> 2001 for our latest views on this subject.



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Beginning with Japan, we had a good record last year with our Yen and JGB calls and a slightly more spotty copybook with regards equities. We correctly called the equity market bounce early in 2001 but were too slow to cut the trade as it became clearer that a) markets were still going to be 'surprised' by economic weakness and b) Koizumi failed to deliver at the pace that many had hoped for. Thereafter, we avoided directional bets but recommended selling collars to position for a market breakout either way.<sup>9</sup> As for FX/rates, we maintained the view that the Yen (and JGBs) was not going to weaken significantly, riding the move up to 118 nicely before recommending going long USD/JPY, as well as long KRW/JPY in late September. Our position as we enter 2002 is that Koizumi's reform process is still just about on the rails and that we could get both another short-term financial sector fix and a positive growth surprise in the first half of this year. It is probably too early right now but we would be to be looking to close out JPY shorts and positioning for a sharp, yet ultimately unsustainable, equity spike. The good news for the rest of the region is that we do not believe the system is about to implode any time soon and in the absence of such an eventuality Japan has little scope to cause major damage.

The good news for the rest of the region is that we do not believe Japan is about to implode any time soon

Without doubt our worst call last year was to be far, far too early in calling for a bottom in Taiwan. Although we again read the FX/rates markets well, the perception that the CBC was behind the curve when combined with an unimpressive political showing that at times seemed disturbingly Japanese, did nothing to support investor confidence against a horrible external backdrop. We continue to believe that the worries about the country's future (leaving aside the forcible reunification scenario) are overdone. Some of the policy sclerosis could be easing, the banks *are* fixable albeit action needs to occur sooner than later, and finally, one should never bet against the flexibility of Taiwan (and Hong Kong for that matter) to adapt. It should never be forgotten that both have a natural resource that is lacking elsewhere in the region – the ability of entrepreneurial populations to change their countries bottom up, irrespective of the competence (or lack of) of their leaders.

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<sup>9</sup> In fact, our general theoretical strategy – it has little to do with macro – is more long/short since we believe that micro reform continues apace despite the incompetence of the government and the bureaucracy. Although one can make the same sort of argument across much of the region, it has been interesting that the strategy has performed far better in Japan than elsewhere. This is probably less a reflection of the relative quality of the investment professionals and more a reflection of the lack of liquidity, additional trading restrictions and higher volatility of the markets in non-Japan Asia.



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In the SAR, it is difficult to believe that a re-elected Tung Chee Hwa – we know we are going out on a limb on this call – will be any worse than last time around. Indeed, on immigration and cross border policies at least, we are cautiously optimistic that the authorities are starting to get it and may even do something vaguely helpful in the next six months or so. Ultimately, we believe that in both Taiwan and Hong Kong, as soon as a glimmer of external recovery starts to appear, locals will at the very least be forced to cover their shorts and in the SAR, this could also translate into a more buoyant property market. Short covering appears to be happening already in Taiwan and if our global assumptions are realised, we feel that the two will be amongst the region's best performers. Oh, and by the way, no change in the peg.

**We believe Taiwan and Hong Kong will adapt irrespective of their governments**

The macro story for Korea may be as good as that for Taiwan into a global upturn but it seems a far more crowded trade. This is not to say that one is going to lose money in Korea. Even though we remain sceptical that we are embarking on a major tech recovery, for Asia's more IT-commodity producers, even 10% volume growth in an environment of more stable pricing will deliver a major turnaround in export growth.<sup>10</sup> This will benefit almost everyone in the region but we suspect that the monetary authorities in Korea and Singapore will be the first two to start tightening. In Korea we expect this to come more through the interest rate markets as the long end has started to price recently. Unless the JPY really motors up again against the USD, we feel the authorities will be reluctant to allow too weak a USD/KRW. Moreover, Korea's more broad domestic economy argues that rates are the more effective monetary policy tool and even though CAPEX should remain weak (by Korean standards at least – never underestimate the potential for the *chaebol* to start making stupid investments again given the chance), domestic consumption growth is already far stronger than in most other places.<sup>11</sup>

**The monetary authorities in Korea and Singapore will be the first two to start tightening**

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<sup>10</sup> To balance our Taiwan *mea (nostro? – Romanus aeunt domicus) culpa*, in hindsight, our USD1 DRAM call in April was one of our better efforts.

<sup>11</sup> We were banging on about how a lower investment rate and the new economy would massively enhance consumer choice long before it became fashionable. Although many consumption stocks have already seen major re-ratings, some are now reaching a market capitalisation that puts them on the radar screens of the mutual fund complexes. Weight of money pushing up hitherto small-caps may be a recurrent investment theme this year.



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In Singapore, any tightening will come through the currency which as we pointed out a couple of weeks ago, is trading far too weak relative to the MAS' normal reference points. In essence, we believe that some of the added insurance we thought the authorities were going to buy in late August will be taken back into the early part of 2002. Two other factors could also help the SGD and Singapore equities. First, we believe that the government is serious about delivering major cuts in the costs of doing business which should start to become more apparent as we near the May budget. And second, we believe that the MYR is going to come increasingly under *revaluation* pressures. We were in a minority all year in believing the Ringgit peg was not going to go and we now believe that blind prejudice as much as anything is causing analysts and money managers to overlook the major turnaround seen in the country's balance of payments since Dr Mahathir started to clean shop in mid 2001. The MYR is unlikely to be allowed to float upwards but the effect will be a massive liquidity build and a local equity market that should fly.

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Elsewhere in ASEAN, we are far less sanguine. For sure, the PITs markets could have a bounce along with everyone else, but our structural call, based as much as anything on poor quality political leadership that is making the "China cleans up at the grouping's expense" call self-fulfilling, remains in place. Throughout 2001 we maintained our avoid local equities and long USD biases – an aberration aside with a long IDR call in September which was followed by a series of reflexive foot-shooting incidents – and conceptually, we would retain these into 2002. Nevertheless, with balance of payments positions likely to show some improvement across the region, local currencies could be relatively stable near-term while in the Philippines and especially Indonesia, there is still scope for rates compression. Not for the faint hearted though.

The MYR is going to come increasingly under *revaluation* pressures

Finally India and China where the usual disconnects between macro and micro were apparent as ever. Like many others, we assumed at the outset of the year that India might be a relatively defensive play given its tiny external sector. Fat chance. Although software players taking a mauling should have been predictable, politics and financial market scandals dominated market direction. Being next door to Pakistan did little to help either.

In India and China, the usual disconnects between macro and micro were apparent as ever

In China, for what it is worth, we called the B-share spike early in the year though we seriously doubt whether any foreign players participated, aside from those who had been stuck in these generally appalling companies and used the opportunity to sell with gratitude and alacrity. We remain highly impressed with the central leadership's efforts to push ahead with wide-

We remain highly impressed with the Chinese leadership's efforts to push ahead with wide-ranging reform



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ranging reform – banking sector, SOE, capital and property markets, etc. – and see little immediate challenge to the economy's resilience. Nevertheless, we would once again re-iterate our long held views that China is not one economy. Headline numbers hide a wide range of income disparities and now WTO accession is done and dusted, the real bargaining begins. As for the RMB, talk of a major appreciation misses the point that although the private industrial sector could live with a significantly stronger currency, it would be further agony for an agricultural sector that is already receiving ever-increasing levels of handouts. We may get some further band widening but any float will be an extremely dirty one.

China will most likely deliver on its WTO promises over time but foreigners will likely be disappointed with both the pace of delivery and the returns they garner. The one area where we do see potential for major profits is the energy exploration and extraction sector. The general experience has been that foreigners only make significant amounts of money in China when they can offer technologies that the locals cannot easily backward engineer and replicate. Even before September 11<sup>th</sup>, we had been discussing the implications for the sector of the Shanghai declaration where Russia and China (plus a posse of 'stans) decided to put aside territorial disputes (for now) in order to develop new energy fields. Post those events, the Americans are also on board about helping exploit alternative sources. Over the next few years, we see considerable potential for commodity prices to rise relative to selling prices in the shops. Our long Aussie dollar call set out in our 4<sup>th</sup> June piece, "Digger's Revenge", has trod water ever since. We expect it to still come good.

Remain long Aussie

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