

Asian Market Outlook for 2007

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We are positive on the outlook for most Asian markets on a 12 month view. Domestic fundamentals are generally very strong and valuations – while on the higher end of trading ranges established over the past few years – are (with a couple of notable exceptions) not especially stretched. We believe, however, that in the near term there is a growing risk of a correction as market participants take some risk off the table following recent sharp gains and there is some re-assessment of the sustainability of the current “goldilocks” environment in the US.

Asia faces a number of cyclical headwinds as we move into 2007. Although there are widely divergent views on whether the US economy will have a hard or soft landing, most lead indicators point to slower US growth in the next few quarters. US housing market activity has slowed sharply and in some areas prices are now declining. The fall in energy prices and bond yields has given some near term respite to debt-laden US consumers, but there is little disagreement among economists that US domestic demand will weaken in 2007. Non-US growth is currently holding up well and may fare better than it has in the past when the US economy has slowed, but lead economic indicators for Japan, Europe and China also point to weaker growth in 2007.

Historically, most Asian stock markets have acted as high beta plays on global growth, generally outperforming during periods of strong industrial demand and underperforming during periods of weak growth. As global growth slows, the combination of weaker external demand and reduced pricing power tends to pressure company earnings, and reduced risk appetite tends to compress price-earnings multiples. Based on the growth outlook outlined above, even if a worst case scenario of a hard landing in the US is avoided, Asian markets are likely to go through a period of turmoil.

There are arguments for why this time may be different. One of the arguments is that growing domestic demand in Asia will compensate for slower

external growth, allowing Asian economies and markets to reduce their dependence on US and European cycles. While the argument sounds good in theory, we feel that in practice it does not hold up. With a few notable exceptions, most countries in Asia have small open economies that remain highly dependent on trade value-added to generate growth. Savings rates generally remain high, consumption low, and investment - the key driver of business cycles in Asia - remains highly correlated to external demand. While increased global integration (particularly in manufacturing) has benefited Asia, it has also bound the region even more tightly to the global industrial cycle. Except for some of the larger economies, such as China and India, exports remain the primary engine of growth and will likely remain so for the foreseeable future.

Another argument for why Asia may be able to de-link from US and European demand is that rising intra-regional trade will fill the export gap. The problem with this argument is that most intraregional trade is related to the global integration of the manufacturing process rather than a new source of final demand - as indicated by the continued high correlation between intraregional trade and US and European import demand.

China demand has been growing - particularly for key raw materials - however, the strong correlation between Asia's exports to China and OECD import demand indicates that China's final demand for manufactured goods has not yet reached a stage where it is able to compensate for weaker demand in non-Asian markets.

While the global cyclical environment is not favourable for Asian markets, there are a number of domestic factors that should help to offset the potential blow from slower global growth.

In many important ways, most – though not all - Asian economies present a mirror image of the US economy. Current account surpluses are large, savings rates are high, fiscal accounts are healthy,

debt levels are low, property affordability ratios are manageable and financial systems are flush with cash. Even in the event of a worst case scenario of a sharp slowdown in US economic growth, in most countries policy-makers have the flexibility to cut interest rates, allow exchange rates to ease and boost fiscal spending. Strong corporate and household balance sheets, healthy banking systems, and unstretched equity market and property valuations indicate that private sectors in most countries are also in a strong position to weather a cyclical slowdown.

Based on our view that global growth will slow this year, it is likely that at some point in the next few months, Asian markets will go through a period of volatility and potentially fall quite sharply as investors re-assess the earnings outlook and global risk appetite recedes. During this period more defensive markets and sectors should outperform, but it is unlikely that any will emerge completely unscathed. However, if our central view is correct, and the US economy avoids recession and European and Japanese growth slows only modestly, the correction in Asian markets should be relatively short-lived as strong domestic fundamentals reassert themselves and long term investors return to the market.

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