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Q2 2014 ASIAN EQUITIES OUTLOOK
KEEPING A CLOSE EYE ON CURRENCIES

At a Glance:

* U.S. Fed tapering and worries about a possible interest rate hike are key concerns this quarter.
* An interest rate hike would mean devaluation in property and would particularly hurt cities with high property prices such as Hong Kong, Singapore or Beijing.
* Given their recent experience with currency crises, we believe Indonesia and India are best prepared in the region to deal with currency depreciation.
* We remain cautious on Chinese equities given concern about overcapacity and non-performing loans but are buying selectively in sectors such as tourism, Internet and IPP.
* Japanese equities have been disappointing so far this year but we remain upbeat that consumer spending will increase and help boost the economy as companies raise salaries.

Pressure on Emerging Markets Currencies

Emerging markets U.S. monetary tapering and worries about an earlier-than-expected interest rate hike by the U.S. Federal Reserve continue to be top concerns for Asian investors. There were an interest rate scare earlier this year that interest rates may rise sooner rather than later when new Fed chairwoman Janet Yellen last month, in her first press conference, rattled markets by making comments suggesting that an interest rate hike might come in as soon as six months. She subsequently assured market watchers that the Fed intends to keep interest rates low, pointing to a still-weak U.S. job market.

So far, concerns haven't caused a sell-off in Asian equities but tapering and a rate hike spell weakness for emerging market currencies. After years of steady appreciation, China's renminbi is now down about 2% year to date. Currency depreciation is good for exports but also increases costs. These are valid concerns but we believe Asia will hold up well given its previous experience with currency crises. Two countries in particular, Indonesia and India, have an advantage, in our opinion.

A Fed interest rate hike not only but also risks devaluation in the property sector. Cities with high property prices such as Hong Kong, Singapore, Mumbai, Shanghai and Beijing are vulnerable to a property price correction, which would affect wealth and consumption. China is struggling to reform its property sector, but it remains to be seen how reform progresses. Thus far, we are seeing some moderate changes but we believe policies need to be changed more drastically to be effective.

Regional Standouts Indonesia and India

No stranger to currency crises, Indonesia and India have already gone through currency depreciation pains last year in mini crises. Both countries were seeing their current account deficits widening and investors pulled funds from the bond and equities markets. But Indonesia and India raised interest rates and are now better positioned and a lot healthier than other emerging markets. The Jakarta stock market has been a top performer this year and Indonesia's rupiah is up about 7%. Similarly, India's rupee has been gaining strength, now nearing an 8-month high, after dropping sharply last year, causing high inflation. India's current account fell to just 1% of GDP in the fourth quarter 2013. Investors have been returning to Indian equities, buoyed by optimism that of a closely-followed general election could usher business-friendly Narendra Modi into office.

Cautious on China

Elsewhere in Asia, currency concerns are making us cautious. China's currency, the renminbi, has been one of the steadiest trades in recent years, but those days are coming to a close. The yuan has taken a big beating in recent months and is down 2% year to date. We anticipate the yuan will continue to face stress as the U.S. rebounds and export-driven countries weaken their currencies in order to make their exports more attractive. We don't expect much FDI into China because there is already a great deal of overcapacity.

The other big concern about China is credit. About 10 years ago, GDP growth and credit growth were about equal, at about 12% to 15% each. Now GDP growth has slowed to about 7.5% while loan growth is nearly triple that at about 20%. The power of credit has been reduced dramatically. China is accumulating more debt to GDP and we expect it will soon reach 300% if the current pace continues. Given this environment, we are treading carefully in China, buying selectively using a bottom-up approach.

Sectors we like include tourism and branded goods, both of which are getting a big boost from China's growing middle class. We also like IPP due falling coal prices and interest rates. Bank lending rates are coming down in China as the number of financing choices and vehicles is increasing, a development that should greatly benefit IPP companies. We see plenty of upside to valuations in the industry. We also remain bullish on China's nascent Internet sector, which has a low correlation to macro policy. A recent sell-off in Chinese Internet stocks, sparked by concerns about a worldwide tech bubble, makes for a more attractive entry point. Our main concern about China's Internet sector is regulation. The Chinese government needs to do more to be supportive and to foster innovation. Recent headlines that Chinese regulators are pulling putting a tight limit on online third-party payment accounts are not promising. We hope that policies that help facilitate private enterprise growth will follow.

Higher Salaries in Japan

Japanese equities have been disappointing year to date – the Nikkei is down more than 11% year to date – but we remain optimistic about the longer-term outlook. There is solid profit growth and cash flow at companies such as Toyota and Honda, which are now starting to talk about raising salaries. Higher salaries and more jobs should stimulate consumer spending. The big challenge to consumer spending are discussions regarding introducing a new consumption tax. We believe that while the tax is a legitimate concern, higher income and more jobs will nonetheless help boost the economy and boost to spending.

Source: Bloomberg is the source for all data in this document as 16 April unless otherwise specified

Arthur Kwong
Head of Asia Pacific Equities
BNP Paribas Investment Partners

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* BNP Paribas Investment Partners Asia Limited, 30/F Three Exchange Square, 8 Connaught Place, Central, Hong Kong.

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