Investment Strategy

Equity Strategy

Investment Strategy | Asia-Pacific
18 December 2008

Asia Equity Year Ahead 2009

Merrill Lynch

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Recuperation & recovery in 2009

2008 was not the Year of the Bull in Asia. Equities are on course for their largest loss in over 20 years and the market cap of the MSCI Asia-Pac index has been reduced by $1.9 trillion. 2009 should be a better, recuperative year.

MSCI Asia Pacific index forecast trading range of 200-350

The classic post boom & bust trading pattern in equity markets is sideways within a very large trading range. Asian 2009 upside is constrained by the weak global growth, the downside protected by excess pessimism and cheap valuation.

Asia is cheap; but any EPS recovery will be very shallow

Asia is trading at its cheapest level in 20 years; but EPS recovery will be way more shallow than consensus forecasts, in our view. EPS rising from $26 to $32 in the next 24 months is inconsistent with ML Macro prediction of an "L-shaped" recovery in Asian growth.

OECD, inventories, credit drives Asian inflection points

A rally in Asian equities is already underway and bear market rallies of 25-50% should be expected. The sustainability of the current rally requires a recovery in the OECD lead indicator, Asian inventories & credit markets in H1.

Asia "best of breed" likely to outperform in 2009

Next year promises to be a stock-pickers paradise once volatility and correlation abates. We forecast outperformance from Asia's "best of breed" stocks (Table 2).

Asia consumer should outperform in 2009

Chinese consumption as % GDP is at a huge secular inflection point. Asian consumer less constrained by debt, has high savings and is well-supported by monetary and fiscal policy. Consumer names should outperform: play it via staples in China and telecom in India.

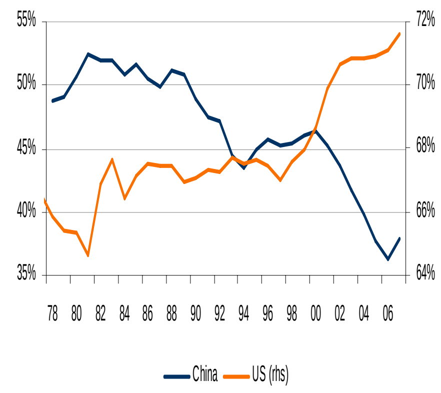
China over India; Korea over Taiwan

Cash-rich China is embarking on a secular uptrend versus an Indian corporate sector dependent on foreign capital; we believe Korean equities are a better contrarian position than the Taiwanese tech sector.

Our Asia country strategists are…

Overweight telecom in Japan, China, India, Korea, Taiwan, Australia and Singapore; overweight banks in India, Australia and Hong Kong but underweight in China and Singapore; underweight real estate in Hong Kong, Singapore, China and Australia; underweight tech and cyclicals in most countries. See Table 3 for our Asia sector preferences and themes for 2009.

Chart 1: Consumption (% of GDP) - China vs US



Source: Merrill Lynch estimates, Global Insight

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The Year of the Bull

2008 was not the "Year of the Bull" in Asia. The MSCI Asia-Pacific index, which excludes Japan, is on course for a 60% drop in 2008, the worst annual return in over twenty years. Market capitalization tumbled by a mighty $1.9 trillion in 2008, a figure equivalent to the combined GDP of India, Singapore & Taiwan.

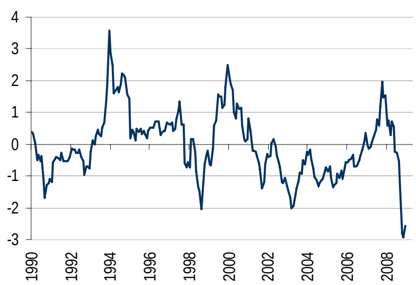
2009 should be a much better year. Here's why.

Asian equities in a big, fat trading range

We're cautiously optimistic on Asian equities in 2009. That said the classic post boom & bust trading pattern in equity markets is sideways:

- MSCI Asia-Pacific index floor should be around 200: downside protected by high cash levels, cheap valuations and likely H1 trough in lead indicators
- MSCI Asia-Pacific index ceiling should be around 350: upside constrained by weak global growth and the inability of EPS to surprise on upside.

Chart 2: Merrill Lynch Asia ex-Jap composite valuation measure, number of SDs from avg



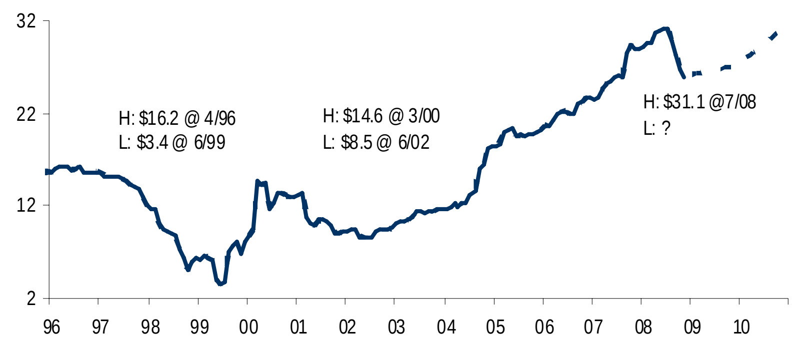
Source: DataStream, (the Merrill Lynch Asian composite valuation measure of trailing PE, PB, PC and DY is currently close to 3 standard deviations below its average)

Asia cheap, but EPS recovery will be shallow

Asian equities are cheap. This time last year, ML's Asia Composite Valuation Index was trading two standard deviations above trend. Today it's trading three standard deviations below trend. Book value for MSCI Asia-Pac index is around 170. Investors notably baulked at taking Asian equities below that level recently.

But consensus EPS numbers for Asian companies remain lofty and we believe must fall further. Compare how EPS vanished in the Asia crisis and fell 40% in the last recession with the consensus forecast for Asian EPS in the next 24 months (Chart 3). A decline from $31 to $26 and a recovery to $27 by end-2009 and $32 by end-2010 is inconsistent with ML Economics outlook of a quick deep recession followed by a shallow L-shaped recovery. Global real GDP of 1.1% is forecast to be the weakest since 1982 and TJ Bond and team are forecasting a recessionary 5.1% pace of growth in Asia.

Chart 3: EPS of MSCI All Country Asia, excluding Japan – history & 09-10 consensus



Source: Merrill Lynch estimates, MSCI, IBES

Watch OECD lead indicator, inventories & credit

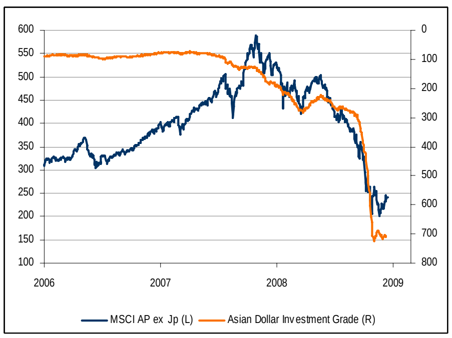
But while the macro says prepare for a grim recessionary year, the 60% decline in equity prices goes some way to discounting such a brutal backdrop. Asian equities basically go up and down with global growth expectations (Chart 3), so the key for Asian investors as always is the OECD lead indicator. If policy stimulus can engineer a recovery in the lead indicator in early 2009, then expect a smart rebound in Asia equities in the first half of 2009.

Table 1: What Asian equities correlate with

	Last year	Long term	Change
MSCI AC World	0.89	0.68	0.20
S&P 500	0.61	0.46	0.15
MSCI JAPAN	0.91	0.55	0.35
MSCI AC EUROPE	0.88	0.63	0.25
MSCI EM	0.95	0.85	0.10
VIX	-0.62	-0.34	-0.28
Yen	-0.40	0.06	-0.45
Euro	0.54	0.10	0.44
CRB	0.37	0.20	0.17
WTI Oil	0.52	0.13	0.38
Gold	0.27	0.18	0.09
BDI	0.21	0.07	0.14
US 10 yr	-0.31	-0.13	-0.18
3m Libor Spread	-0.05	-0.09	0.04
Asia inventories/sales#	-0.91	-0.55	-0.36
OECD lead indicator	0.44	0.36	0.08
US employment	0.67	0.05	0.62

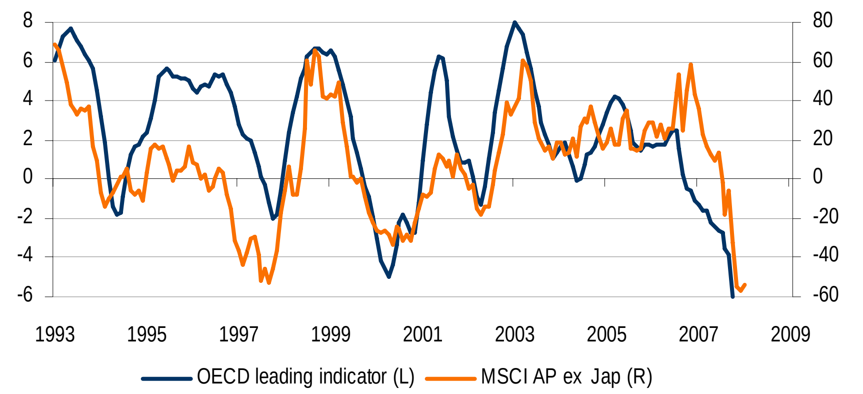
Source: DataStream, Merrill Lynch, # Using ratios from Japan and Korea

Chart 5: MSCI Asia-Pac (ex Jap) and Asia investment grade bond yield spreads (bps)



Source: DataStream, Merrill Lynch

Chart 4: OECD leading indicator and MSCI Asia Pacific ex-Japan*



Source: DataStream, Merrill Lynch, * 6m annualized change for OECD, % YoY for MSCI AP ex Jap

Indeed a bear market rally in Asian equity markets is well underway in late 2008. Two further confirmation signals we look for to sustain the rally in early 2009 would be a decline in Asian inventories and a decline in Asian credit spreads.

On inventories…

- The relationship between manufacturing shipments and inventories in Asia has a very good correlation with stock market prices (see Table 1)
- The bad news is inventories are currently rising very sharply relative to sales, at the fastest pace in almost 30 years in Korea and fastest pace in over 10 years in Japan, helping explain the recent plunge in equity prices
- But as some postponed deliveries will get reordered and any sign that inventories are down in Q1 should cause equities to rally further

On credit…

- Asian credit spreads began to widen in July 2007, slightly ahead of the October 2007 peak in Asian equity prices (Chart 5); investment grade spreads are trading at +700bps extremes, which discounts a default scenario worse than in the Asian Crisis according to credit analyst Michele Barlow
- If the recent decline in CDS spreads in Korea, China and India can be followed by a +100-200bps narrowing of Asian investment grade spreads then this would be consistent with a rally in MSCI Asia Pac up toward our ceiling target of 350

Best of Breed = Best 2009 Theme

A big, fat trading range for Asian equity markets can still generate great returns for investors. Volatility caused a big jump in the correlation between Asian stocks to 90% in 2008, up from its historical average of 68%, making active outperformance very difficult.

A key ML call for 2009 is a peak in volatility, which would cause lower stock correlations and create a stock pickers paradise.

Table 2: Asia Best of Breed

Company	Bloomberg Ticker	ML Ticker	Country
China Shenhua-H	1088 HK	CUAEF	China
Ping An Insura-H	2318 HK	PIAIF	China
Baidu.com-ADR	BIDU US	BIDU	China
China Mobile	941 HK	CHLKF	China
Bharat Heavy	BHEL IN	BHHEF	India
Larsen & Toubro	LT IN	LTOUF	India
Wipro	WPRO IN	WIPRF	India
Bharti	BHARTI IN	BHTIF	India
NTPC Ltd	NATP IN	NTHPF	India
Samsung F&M	000810 KS	SZVZF	S. Korea
Taiwan Semi	2330 TT	TSMWF	Taiwan

Source: Merrill Lynch GEM Equity Strategy

Note Best of Breed was the best equity strategy during the 1990s Japanese trading range. Companies with the best balance sheets, the best managements and the best products massively outperformed. We're not predicting such a long bear market in Asia. But the markets are likely to separate the men from the boys in coming quarters. One way to outperform in a world of scarce growth is to own a basket of large cap Asian stocks biased toward domestic demand where earnings growth is healthy, management is raising RoE and the balance sheet is solid. Our recent screen for such Asian stocks yielded the list shown in Table 2

Secular consumer names should outperform

Both secular and cyclical forces should conspire to make Asia consumer names continue their 2008 outperformance of external-demand plays:

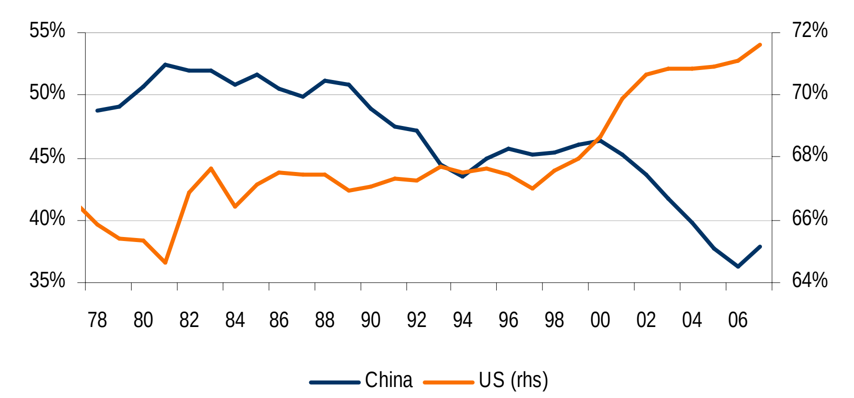
- China consumption as % GDP is at a huge secular inflection; China may be the only large economy with a rising share of consumption in the next 10 years

- More generally Asian economic growth is shifting from external to domestic demand. The Asian consumer is less constrained by debt, has high savings and will be well-supported by monetary and fiscal policy. Note that consumer staples, discretionary and health care account for just 12% of market cap, versus 35% in the US.

- Lower commodity prices, lower inflation and lower interest rates in 2009 are also a bullish combination for Asian domestic demand themes.

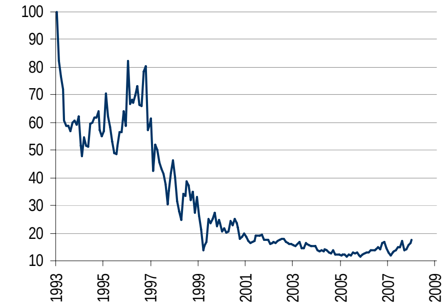
David Cui and Jyoti Jaipuria, our respective heads of China and India strategy like staples in China and telecom in India as the best way to play the Asia consumer theme in 2009.

Chart 6: Consumption as % of GDP – China vs. US



Source: Merrill Lynch estimates, Global Insight

Chart 7: MSCI China vs. India in USD terms



Source: DataStream

China over India; Korea over Taiwan

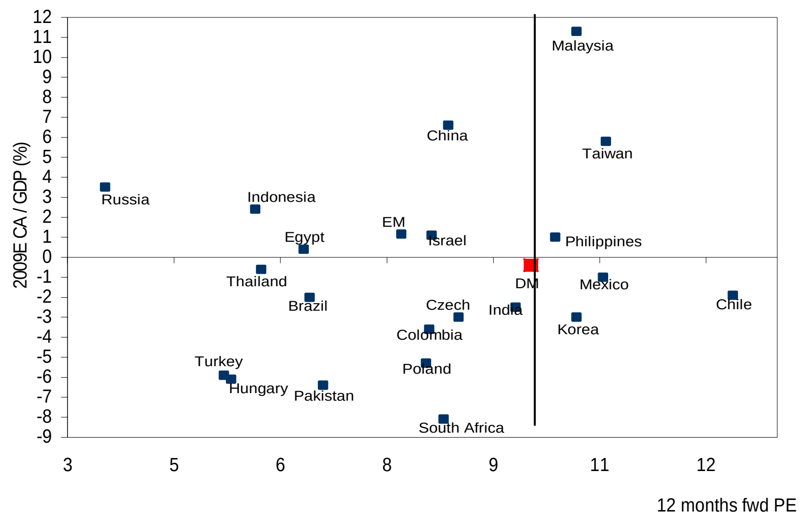
- China outperformed India in 2008, but this follows years of underperformance (Chart 7); the secular trend is reversing as China will be one of the few economies on the planet deregulating in coming years

- China equity positives: trades at a discount to developed markets; has enormous excess savings as shown by its massive current account surplus (Chart 8); growth slowdown means big policy stimulus and local equity markets more sensitive to liquidity than growth; stable exchange rate; consumer unconstrained by debt; the economy is unconstrained by banks

- India equity negatives: political uncertainty in run up to summer 2009 elections; regional earnings slowdown relatively bad news for markets with bulky EPS estimates (India EPS numbers look tougher to hit than the China numbers, e.g. Indian banks forecast 18% EPS in '09 versus 10% in China); India much more dependent on foreign capital for corporate funding

- Korea is the most contrarian "long" in Asia according to ML's Fund Manager Survey; foreign ownership is very low; economy will be weak but we believe the decline in the Korean won is over; Taiwanese tech exports are likely to plunge from -10% to -50% in coming months due to the US economy; over 50% of the Taiwanese equity market remains technology

Chart 8: Current account versus 12m forward PE



Source: Merrill Lynch calculations, EIU, IBES, Thomson Datastream

What our Asia strategists like

Our country strategy heads suggest the following sector weightings for Asia:

- Overweight telecom in Japan, China, India, Korea, Taiwan, Australia and Singapore

- Overweight banks in India, Australia and Hong Kong but underweight in China and Singapore

- Underweight real estate in Hong Kong, Singapore, China and Australia

- Underweight tech and cyclicals in most countries

Table 3: Asia sector preferences and themes for 2009

Country	Country strategy head	ML sector view	Themes for next year
Japan	Kikuchi Masatoshi	OW tels, transport, utilities UW non-bank fins, electronics, chemicals	Deflation benefits specialty retailers, global infrastructure, social welfare
China	David Cui	OW Tels, con. staples, railway construction UW steel, materials, banks, property	Consumption to hold up more than other sectors. Railroad construction to benefit from stimulus Overall FAI growth to slow; asset price deflation. Avoid FAI related and leveraged sectors
India	Jyoti Jaipuria	OW tels, pharma, banks UW metals, software, real estate	Stocks lower in 1H on slow economy, collapsing earnings, election uncertainty. Better 2H with easing interest rates and expectations of improved outlook for 2010
Australia	Kerry Duce	OW tels, beverages, banks UW retail, REITS, mining	Starting March, shift from defensives/banks to hard assets (gold, energy,construction) as fiscal and monetary stimulus flows through and inventory liquidation cycle bases.
Korea	Bryan Song	OW tels, insurance UW chemicals, shipbuilding, construction	Defensive names such as telcos (better for wireless vs fixed line) and insurance, but fiscal & monetary stimulus major drivers in 2H. Avoid cyclicals until signs of global economic recovery
Taiwan	Sophia Cheng	OW banks, telecoms UW tech, cyclicals	Closer relationship with China will spur cross-border investment, cut in inheritance tax will bring Taiwanese money back onshore
Hong Kong	Mark Matthews	OW banks, consumer discretionary UW property	Deflation benefits bonds over equities, hurts property. China stimulus helps Hong Kong longer term in better Pearl River Delta linkages
Singapore	Melvyn Boey	OW tels UW properties, banks	Cash-rich companies with global footprints will emerge stronger as they take away global market share

Source: Merrill Lynch

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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