Strategy In-Depth

4 March 2007 | 8 pages

Asia Equity Strategy

Trend or Bust?

- **Momentum style investing has now outperformed value by 33 months** – This is not only the longest period but also the strongest period of outperformance of momo vs. value. Three conditions lead to momo outperforming. Ample liquidity, low volatility and stable growth forecasts. Doubt has crept into each of these. When that occurs, value outperfoms. Markets most at risk: China and India.

- **Since 2003 Asian markets have moved up in a wave pattern** – These waves have broken twice before. In 2004 when markets were 32% above trend and again in 2006 when the market was 28% above trend. Prior to the sell-off, we traded 24% above trend. The market will revert to trend. If the trend holds, take risk. If the trend does not hold, we have regime change.

- **STAR recommends we take little risk** – STAR for some time has suggested the region is no longer cheap but momentum/technical factors were still positive. As of February 15, this was no longer the case.

- **Asia ex has been cheaper on P/BV 90% of the time** – Based on P/BV, Asia ex is now more than 1 sd above mean. We are not yet at the average of the prior blow off (3.2 times P/BV) but clearly are no longer cheap. The most expensive markets based on P/BV are China, India, Indonesia and Singapore.

- **Down Jan with above average valuation has in 75% of cases led to a down Q1** – And 75% of cases for the full year. Markets most vulnerable are Thailand, China, Korea and Hong Kong.

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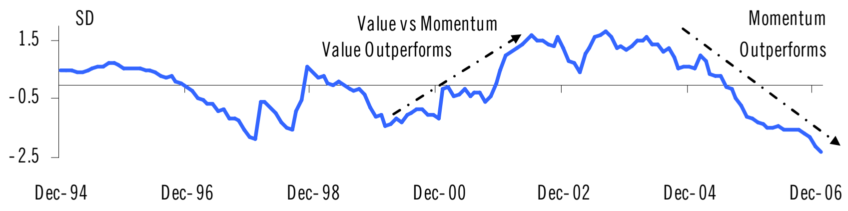
Value vs Momentum Performance since 1994



Source: Citigroup Investment Research

See Appendix A-1 for Analyst Certification and important disclosures.

[1]Citigroup Global Markets Asia

What to think about the market?

Asia ex moves up in waves. The market gets overbought, the wave crashes back to trend and we move higher. Back in 2004, the market was 33% above trend before we had a reversal. In 2006 we were 28% above trend. On February 16 we were 24% above trend.

Figure 1. MSCI AC Far East ex Japan 24% Above Trend on Feb 16

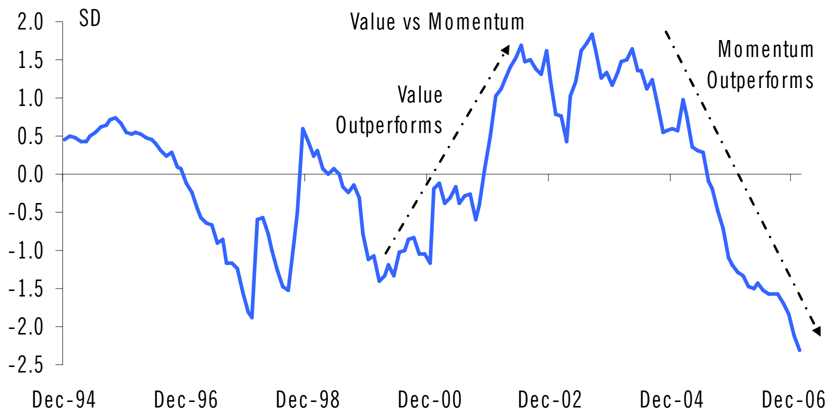
Source: Bloomberg, Citigroup Investment Research

So, we are going back to trend, the white line. If this holds take on risk; if we break below, hold on to your nose!

Goodbye Momo; Hello Value

Momo has had a phenomenal run. Momo always does well when liquidity is ample – it is getting less so, volatility is low – no longer the case and 3rd when growth forecasts are stable-post the durable goods data this is questionable. China, Singapore, Malaysia, Indonesia and India are all momo.

Figure 2. Value vs Momentum Performance since 1994



Source: Citigroup Investment Research

Most Markets Trading At Peak P/BVs

On P/BV, China has been cheaper 96% of the time since 1995, India in 93% since 1990, Indo 95%, Singapore 98% and the region in 90%. Clearly we are no longer Value. So we are vulnerable to changes in sentiment. The main complaint about using P/BV is that ROE remains high. This is true with ROE of 14%. However, markets lead and at previous peaks ROE was high too, see 2000, and yet markets still declined.

Figure 3. P/BV by Asian Markets

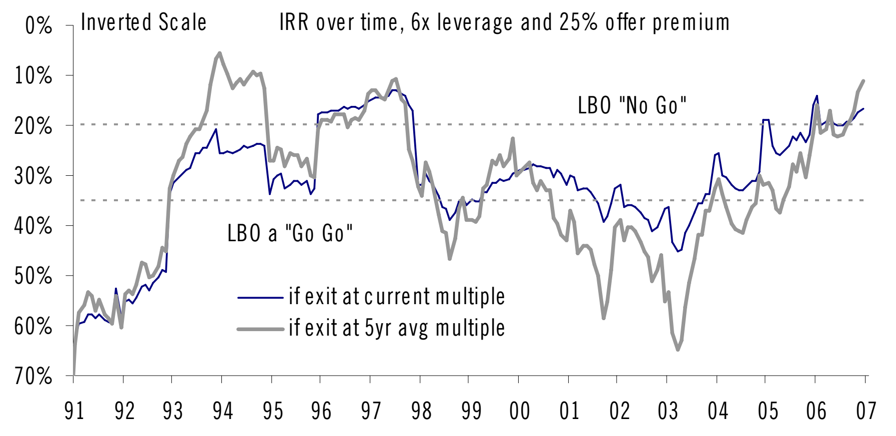
	Ch	HK	India	Id	Kr	My	Ph	Sg	Tw	Th	AxJ
Current P/BV	3.2	2.1	5.3	4.2	1.8	2.6	3.1	2.4	2.2	1.9	2.4
% of time > current PBV	2%	13%	6%	4%	4%	30%	22%	1%	65%	64%	9%
% of time < current PBV	96%	84%	93%	95%	95%	69%	76%	98%	33%	34%	90%
% of time at current PBV (+/-1%)	1%	3%	1%	1%	1%	1%	1%	1%	2%	2%	0.5%
Data since Jan 90 except for China (Nov 95)											
No. of months > current PBV	3	26	12	9	9	62	46	2	133	132	19
No. of months < current PBV	131	173	192	195	195	142	157	201	68	70	186
No. of months at current PBV (+/-1%)	2	7	2	2	2	2	3	3	5	4	1

Source: MSCI, Citigroup Investment Research

LBO IRRs are too low and uninteresting

We have built a LBO meter to show the likelihood of LBOs over time under different interest rate environments. Here is how we do it. We consider the non-financial constituents in MSCI Asia ex Japan as a single company, "The Asia Inc.", and sum up the financial data for each of them to build monthly time series. We then use the reported sales revenue, EBITDA, depreciation and amortization and capex for the next five years to calculate the implied free cash flow. For each month we use the U.S. BAA corporate bond yield at that point in time to compute the interest expense of the deal debt. Again, we stick to our LBO assumptions earlier, i.e., pay a 25% premium to take out the Inc. and the deal takes place at 6x leverage.

Figure 4. LBO IRRs are too low and uninteresting



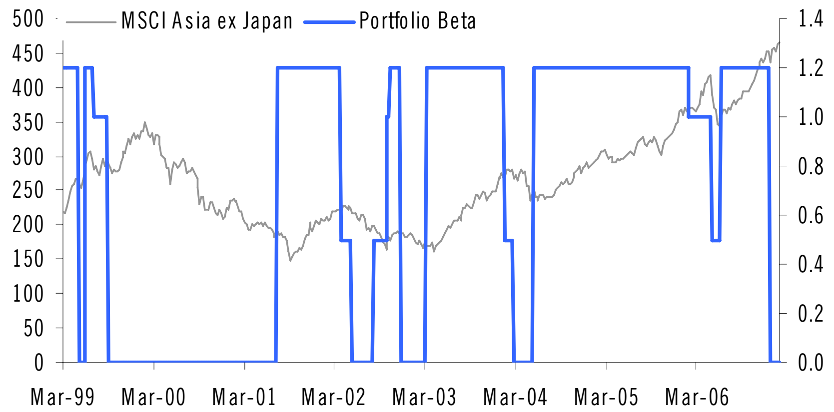
Source: Citigroup Investment Research

Currently based on in price equals out price LBO, IRRs are just 17% – too low. If you sell the business in 5 years based on the 5-year average EV/EBITDA the IRR drops to 11%, clearly very low and uninteresting, i.e., valuations are too high. Not only are IRRs low based on the "exit at the 5-year average" but they have only been high once before, in 1993, and since then markets have benefited from lower rates. Also note the LBO investor owns the business, has leveraged the balance sheet to "his/her" best advantage and still IRRs are below the sweet spot. As minority investors, we only have a ticket to ride, we don't own the business.

STAR model went to Zero Beta

STAR model went to zero beta. Why, because technicals have deteriorated on top of poor valuations, hence the move to risk reduction. We have highlighted the concerns signaled by STAR some 3 weeks ago.

Figure 5. STAR model went to zero beta



Source: Citigroup Investment Research

Figure 6. STAR expects 3-month return of -2.8%

STAR Component	**15-Feb-07**
1. Fundamentals	
Contribution to Expected Return	-2.9%
MSCI Asia ex JP Dividend Yield	2.13%
MSCI Asia ex JP 12-month Forward P/E	14.5
2. Cash Calls and Short-term Momentum	
Contribution to Expected Return	0.0%
Cash Calls/M3 (6-month MA)	0.29%
Momentum (5D-20D Moving Average)	Positive
3. Technicals	
Contribution to Expected Return	0.0%
MSCI Asia ex JP Advance/Decline Ratio	1.1
MSCI Asia ex JP %New Highs-%New Lows	6.9%
4. Sentiment	
Contribution to Expected Return	0.0%
Put/Call Implied Volatility	0.88
5. US Dollar Strength	
Contribution to Expected Return	0.0%
DXY Index %YoY	-7.3%
STAR Expected 3-month Return	-2.8%

Source: Citigroup Investment Research

January and P/BV as a predictor of the rest of the year

A down January with above average P/BV has led to a down Q1 in 75% of occurrences. Ditto for the full year. The reason why January has predictive power is that it is indicative of global fund flows. When these are poor, investors may feel less comfortable about the state of the global, hence Asian, economies. Historically, the strongest return period for Asian markets has been December to February. So a poor January contains significant information.

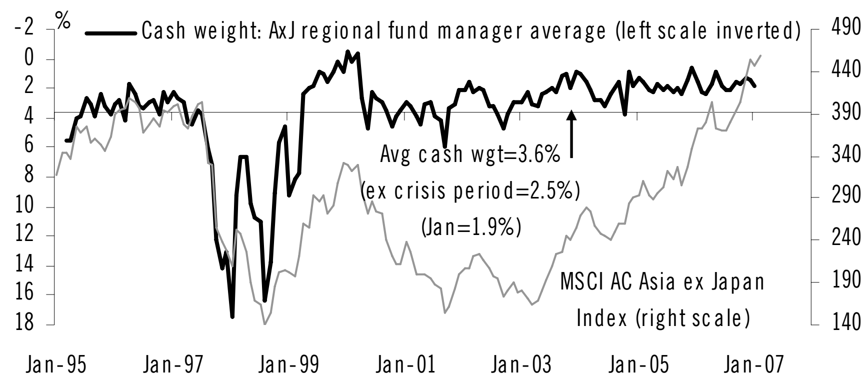
Figure 7. P/BV as a predictor of the rest of the year

	Current P/BV > Average	Down Jan and P/BV > Avg Occurrences	% of time having negative period performance 1Q	1H	1Y
MSCI AC Asia ex JP	x	4	75.0	50.0	75.0
China	x	6	100.0	66.7	66.7
Hong Kong	x	5	80.0	40.0	60.0
India	x	4	100.0	75.0	25.0
Indonesia	x	2	100.0	50.0	50.0
Korea	x	3	66.7	100.0	66.7
Malaysia	x	3	33.3	33.3	33.3
Philippines	x	3	100.0	100.0	100.0
Singapore	x	3	100.0	66.7	33.3
Taiwan		2	50.0	50.0	50.0
Thailand		4	100.0	50.0	100.0

Source: MSCI, Citigroup Investment Research

*Regional and country indices starts from 1988, China from 1993 due to data availability.

Figure 8. Cash levels at 0.5 sd below ex crisis mean at 1.9%



Source: Emerging Portfolio Fund Research, Citigroup Investment Research

Appendix A-1

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We, Chris W Leung, CFA, Markus Rosgen and Elaine Chu, research analysts and the authors of this report, hereby certify that all of the views expressed in this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

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