CLSA ASIA-PACIFIC MARKETS GREED & FEAR

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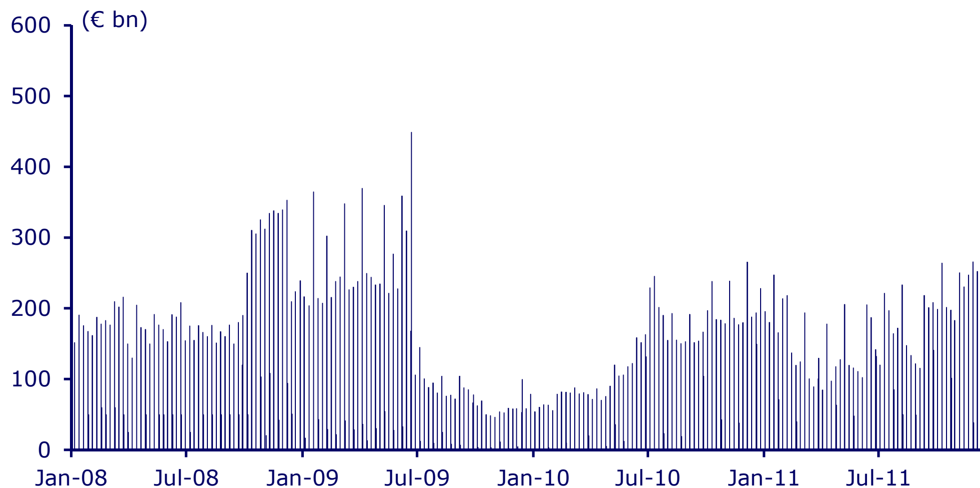
Bank junkies

Jakarta

If the ECB has not been doing enough to monetise according to many its critics, it is going out of its way to help the banks. It is this liquidity provision which is the prime reason why markets have calmed down of late, not the half-baked "Merkozy Plan" for a "fiscal pact". The news yesterday that 523 euro area banks have borrowed €489bn for three years from the ECB should help European banks through their massive bond refinancing schedule in coming months, though it should be noted that nearly €300bn of this amount will be absorbed meeting maturing loans. Meanwhile, the level of demand for the ECB's three year money is, of course, a symptom of European banks' general stress levels.

Figure 1

ECB main and long-term refinancing operations (euro lending to banks)



Note: Latest data for 21 December include €489bn 3-year loans and €30bn 3-month loans. Source: ECB

The other issue is whether the banks will use this facility to buy lots of Eurozone sovereign debt, as the hyper active Nicholas Sarkozy seems to expect. While there will doubtless be some buying of short term government paper, *GREED & fear* doubts the banks will behave in such a manner so long as these banks have not been nationalised and taken over by governments. The reason is that, for now at least, these banks are still in the private sector. The interest of their shareholders, which increasingly includes senior employees on deferred equity linked remuneration, is to deleverage rather than to take on new risky lending. It is also not to be diluted by raising equity at current distressed prices. Of course, if banks are nationalised down the road, as is quite possible, then coercing them to buy their respective government bonds becomes much more likely, a form of financial "suppression" long discussed by CLSA's legendary investment guru Russell Napier.

The other point is that the ECB's expanded funding of the banks will simply ensure that the Eurozone sovereign debt crisis, and the related European banking crisis, become ever more intertwined. A good article on the weaving and dodging going on to help European banks without calling it a "bailout" was published in yesterday's *Wall Street Journal* ("*Bank Aid: Just don't call it a bailout*", 21 December 2011).

In the meantime, *GREED & fear* would still advise investors to use any rebound in the S&P500 to the 200-day moving average as an opportunity to reduce exposure further to risk assets. The 200-day moving average is now 1260. While the decline in activity can partly be explained by the time of the year, the dramatic collapse in trading volumes in recent weeks is also an indication of the damage done by the relentless volatility. Thus, Asia ex-Japan stock market

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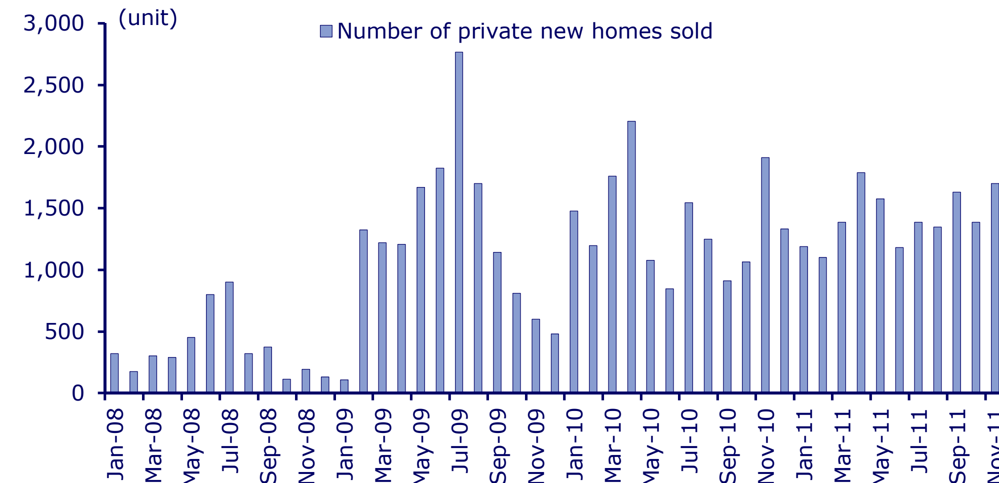
average daily trading volume has fallen from US$27bn in early November to US$20bn in the past two weeks (see Figure 2). *GREED & fear* would also advise investors to continue to bet against the euro. As is only to be expected of a former employee of a famous investment bank, Mario Draghi has already shown himself to be a far more flexible fellow than his predecessor, and he will be cutting interest rates again as soon as he believes he can get away with it.

Figure 2
Asia ex-Japan stock market average daily turnover

Note: 10-day moving average. Source: Bloomberg, CLSA Asia-Pacific Markets

Returning to the theme of financial suppression, Asia saw an example of suppression of late with Singapore's decision earlier this month to impose a draconian 10% additional buyer's stamp duty (ABSD) on foreign purchases of residential property. Since the residential property market in Singapore was already correcting as a result of rising supply and a succession of previous anti speculation measures, this latest measure was virtually akin to kicking someone in the head who is already lying prostrate on the ground. This is why the Real Estate Developers' Association of Singapore did not welcome the decision arguing that the local property market had long ceased to be speculative. As a result of the latest measure, CLSA's Singapore property analyst, Chin Hong Pang, now forecasts a 10% decline in residential property prices next year and a 35% decline in private new home sales (see CLSA research *News muncher: Singapore property – A surprise move*, 8 December 2011).

Figure 3
Singapore number of private new homes sold (excluding executive condos)



Source: URA, CLSA Asia-Pacific Markets

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Singapore has a history of "pro cyclical" policies towards property in terms of exacerbating a market move that is already under way. Still the latest measure is so extreme that it raises the issue of another motive. In *GREED & fear*'s view that motive can be best explained by reports in the Singapore press that this latest measure was the brainchild of the Monetary Authority of Singapore (see *Straits Times* article "*Property curbs nothing to do with speculation*", 9 December 2011), and was prompted by concerns about capital inflows and soaring asset prices ultimately destabilising the local economy. In this respect, the MAS is aware, correctly, that Singapore faces a Swiss like risk of being swamped by capital inflows in a situation of acute global risk aversion. As someone who has long been telling investors to own Singapore dollars, *GREED & fear* cannot deny that there is such a risk. *GREED & fear* still likes the Singapore dollar but is less enthusiastic than previously given the entirely arbitrary nature of this latest announcement.

Meanwhile, it is possible that there may also be a populist angle given that the focus on foreigners may sell politically. On this point the 10% additional stamp duty is only levied on foreigners whereas there is a 3% additional stamp duty on locals and so-called PRs buying their third and second residential property respectively. Remember in the recent general election held in May, the long ruling PAP received its lowest percentage of the popular vote since independence in 1965. Still Singapore will have to be very careful about any retreat from its single minded and thus far supremely successful focus on the recruitment of "foreign talent" in recent years. This is because the foreign talent is, frankly, at the margin what makes the place.

In Jakarta this week it is remarkable to note that Indonesia is on the cusp of securing yet another year of relative outperformance in the context of an Asia Pacific ex-Japan benchmark. This means it will have outperformed for eight of the past ten years. Thus, the MSCI Indonesia has risen by 3.7% in US dollar terms so far in 2011 and is up 1,145% over the past ten years. By contrast, the MSCI AC Asia Pacific ex-Japan fell by 17.8% in 2011 and is up 136% since the end of 2001 (see Figure 4).

Figure 4

MSCI Indonesia relative to MSCI AC Asia Pacific ex-Japan

Source: Datastream, CLSA Asia-Pacific Markets

This continuing outperformance is also why Indonesia now has the highest valuation in the Asia ex-Japan context based on stocks covered by CLSA. The CLSA Indonesia universe of 42 stocks under coverage trades at 13x 2012 earnings and 3x forecast 2012 book.

The above data would suggest that a lot of good news must be in the price. While this is true to an extent, it is also the case that Indonesia's premium rating is still in *GREED & fear*'s view justified by the highest return-on-equity (RoE) in the region and also by the highest net interest margins (NIM) in terms of the banking sector. The CLSA Indonesia universe has a forecast RoE

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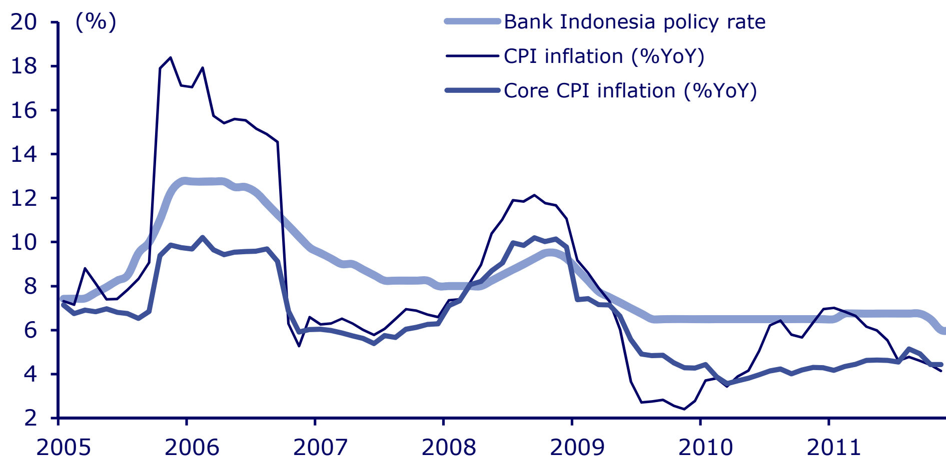
of 25% for 2012, while commercial banks' NIM is running at 6%. The net gearing of the CLSA Indonesia sector also remains healthy at 13%, as does the dividend payout ratio at 38%.

The continuing outperformance is also explained by the fact that Bank Indonesia resumed monetary easing during the past quarter, cutting its policy rate by a larger than expected 75bp to 6%. Citing the weakening external environment, the central bank decided it had room to ease given that headline CPI inflation has eased from 7.02% YoY in January to 4.15% in November while core CPI inflation has also eased from 5.15% in August to 4.44% in November (see Figure 5). The continuing benign inflation is in part the consequence of the rupiah, which has been one of Asia's most stable currencies this year helped by the strong fiscal position with an estimated fiscal deficit this year of only 1.5% of GDP. Total public sector debt also remains low at only 25% of GDP.

Figure 5

Bank Indonesia policy rate and CPI inflation

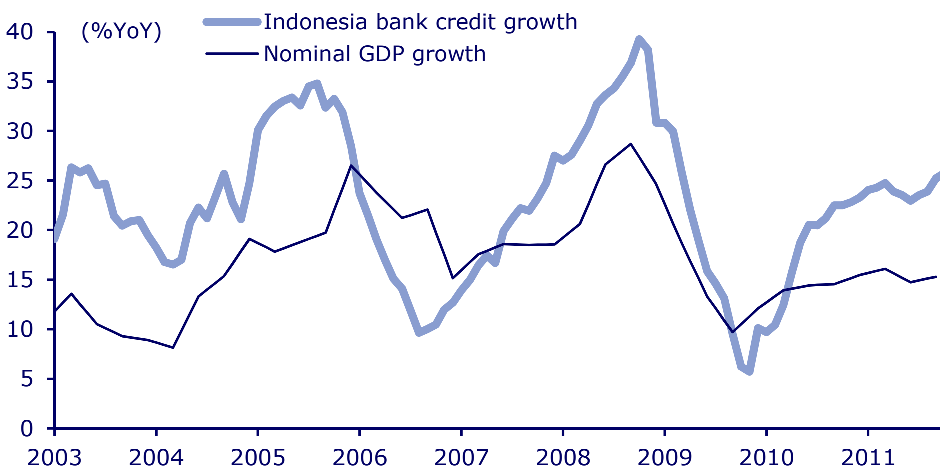


Source: CEIC Data, Bank Indonesia

The conservative fiscal stance is another reason why the central bank has felt comfortable resuming easing. Still to *GREED & fear* the long-term investment case would probably have been helped if the Indonesian central bank had displayed more caution. After all credit growth is running at 25.8% YoY, well above nominal GDP growth of 15.3% YoY, and has been running at an average of eight percentage points above nominal GDP growth since 2Q10 (see Figure 6). Still this does not mean that Indonesia is about to blow up, with CLSA's economics team forecasting credit growth of 17.5% in 2012 in the context of forecast real GDP growth of 6%.

Figure 6

Indonesia bank credit growth and nominal GDP growth



Source: CEIC Data, CLSA Asia-Pacific Markets

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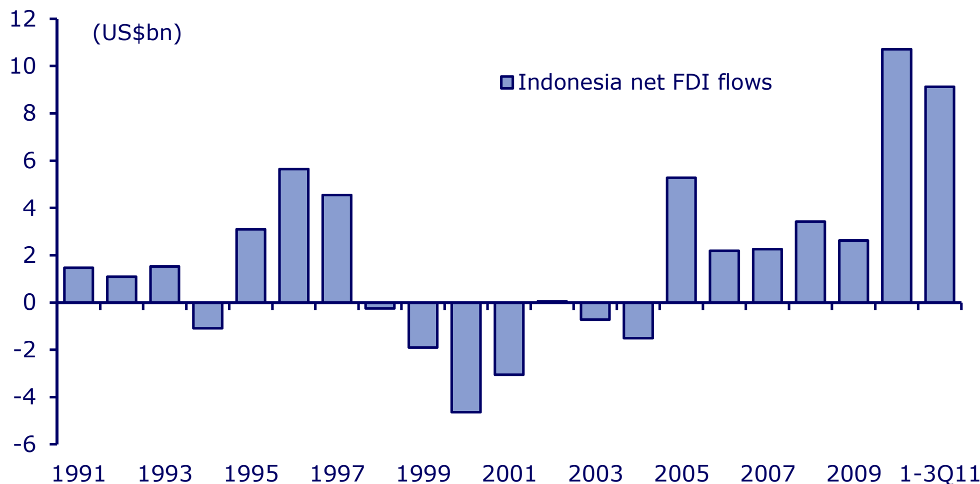
Growth should continue to be driven not only by consumption but also by an accelerating investment cycle. Indonesia now has the second highest investment to GDP ratio in Asia after China, running at 32% of nominal GDP (see Figure 7). However, unlike China there are as yet no worries about excess investment given the obvious deficiencies in infrastructure. This is why after protracted delay it is encouraging to *GREED & fear* that a land clearance law was finally passed by parliament last week. This should be followed by the passage of a so-called implementing regulation in 2012 which, hopefully, means land acquisition should commence in 2013/2014. Last week also saw another long anticipated event with the upgrade of Indonesia's sovereign debt to investment grade status by Fitch Ratings. This will mean cheaper borrowing costs around.

Figure 7
Indonesia gross fixed capital formation as % of nominal GDP

Source: CEIC Data

A further positive has been growing evidence of foreign direct investment across a variety of sectors, be it mining, auto or consumer, where multinationals have been attracted back by the improving story. Thus, net FDI rose by 41% YoY to US$9.1bn in the first three quarters of 2011 (see Figure 8). The one potential drawback here is that the rising FDI poses growing competition for dominant incumbents. An example is Procter & Gamble which is building its first factory, having pulled out of the country during the Asian Crisis. This has prompted an increase in capex at Unilever, one of the dominant incumbents.

Figure 8
Indonesia net FDI flows



Source: CEIC Data

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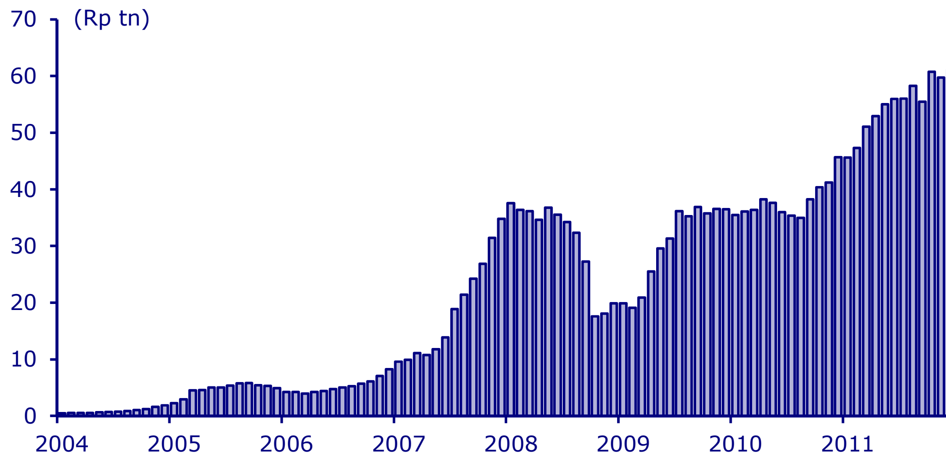
The positive domestic momentum also explains why Indonesia has not succumbed as severely as other Asian markets have to on-going bouts of Euroland-related risk aversion. This is because domestic investors have remained buyers. Local equity mutual funds have continued to see inflows this quarter and throughout 2011. Thus, domestic stock mutual funds' total assets have risen by Rp4.9tn so far this quarter and by Rp14.5tn so far this year to total Rp61.1tn. (see Figure 9). This has proved an important support whenever foreigners sell, most particularly as foreign ownership is still high at an estimated 35% at the end of November.

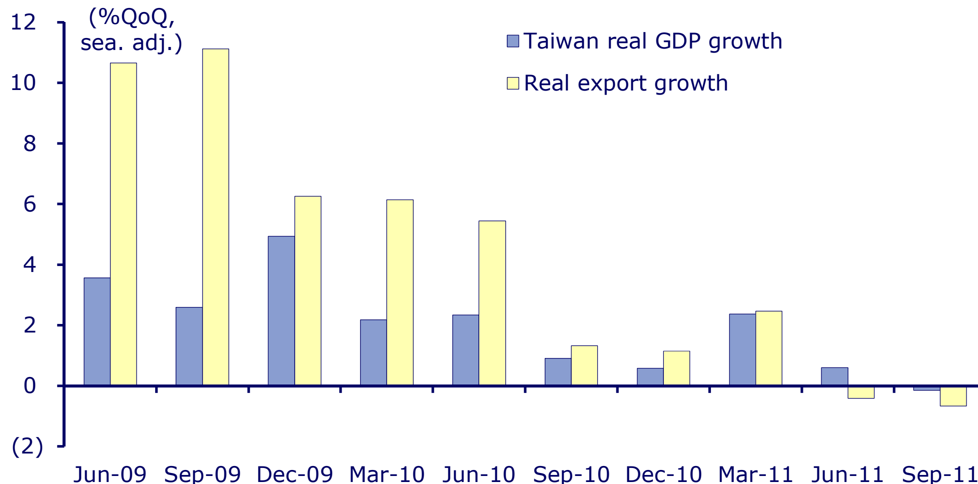
Figure 9
Indonesia domestic stock mutual funds' total assets



Source: BAPEPAM

GREED & fear will, therefore, maintain for now the longstanding overweight in Indonesia in the relative-return portfolio. Meanwhile, it is an irony worth noting, given Europe's fiscal problems, that one reason for Indonesia's fiscal virtue is the government's failure to spend money. On this point, the headline in yesterday's *Jakarta Post* was "*SBY laments lack of spending*"! Land clearance has been one issue here. But another is officialdom's growing fear of the Corruption Eradication Commission (KPK).

Figure 10
Taiwan real GDP growth and real export growth



Note: Seasonally adjusted quarter-on-quarter growth. Source: CEIC Data

One casualty of the ongoing risk aversion caused by the continuing Eurozone crisis has been the lack of the usual pre-election rally in Taiwan. In Taipei at the end of last week for the first time in 15 months, *GREED & fear* was struck by the extremely negative sentiment. This has been primarily driven by growing evidence of an economic slowdown partly driven by

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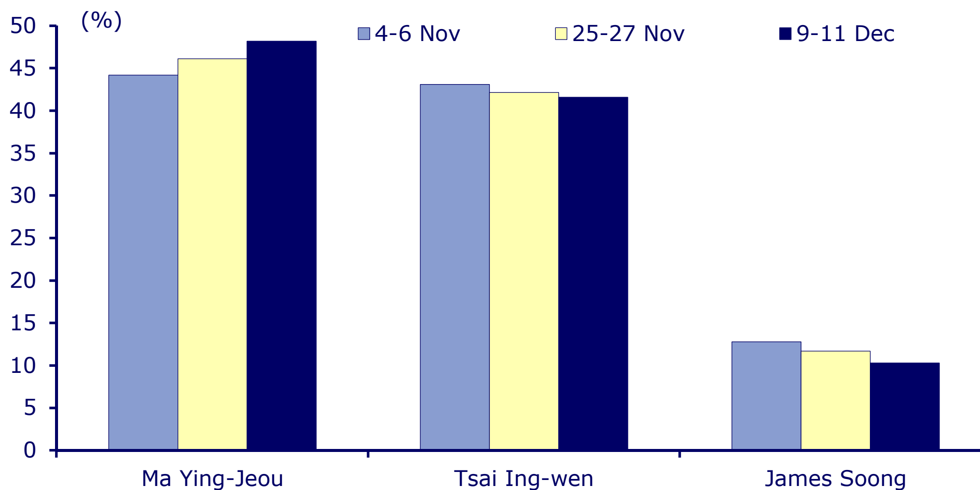
weakening external demand. Thus, Taiwan real GDP fell by a seasonally adjusted 0.1%QoQ in 3Q11 with real exports down 0.7%QoQ (see Figure 10). But the mood has also not been helped by a far closer presidential election race than previously expected. This has been primarily because of the successfully moderate stance adopted by the DPP opposition candidate Tsai Ing-wen.

With three weeks left before the 14 January presidential and legislative polls, the most recent CLSA-commissioned poll conducted on 9-11 December shows KMT's presidential candidate Ma Ying-jeou with a seven percentage point lead over Tsai (see CLSA research *Taiwan elections – KMT extends its lead*, 15 December 2011). This should mean a KMT victory, as currently anticipated by CLSA's recently returned head of Taiwan research, Peter Sutton. Still it is also worth noting that the first CLSA poll, conducted on 4-6 November, showed a very even race with Ma leading Tsai by only one percentage point (see Figure 11).

Figure 11
Opinion polls on 14 January 2012 Taiwan presidential election



Note: Re-estimated results reflecting underlying true intentions. CLSA commissioned polls conducted by Gallup MRC Taiwan Ltd.
Source: CLSA Asia-Pacific Markets. Gallup Market Research Corp, Taiwan

So the bottom line is that the election remains close. The two key issues will be the level of the turnout (the higher the better for the KMT), and the attitude of the swing voters, estimated at about 20% of the total electorate of 18m. The reasons why President Ma should in *GREED & fear*'s view ultimately prevail are, first, that the economic relationship with China has improved significantly under his watch (witness direct flights and ECFA); and, second, that his government has successfully stolen many of the DPP's more populist policies designed to counter growing concerns about wealth distribution and unaffordable property prices. Examples are the recent introduction of a luxury tax and talk of moving to an annual property tax system that would be levied on real market prices rather than the present system that levies tax on a price only about one third or less of the real market price. On this point, the Legislative Yuan passed a bill last week to establish a reporting system based on actual transaction prices (see CLSA research *Taiwan Property – Temporary relief*, 14 December 2011).

If such policies are politically popular, the potential emergence of a real holding tax on residential property poses a major long term threat to Taiwan's elevated residential property values. This is because of the large percentage of vacant units as revealed in the decennial census data. Thus, the vacancy rate in Greater Taipei rose to 19.1% in 2010, up from 15.9% in 2000 and 13.6% in 1990 (see Figure 12).

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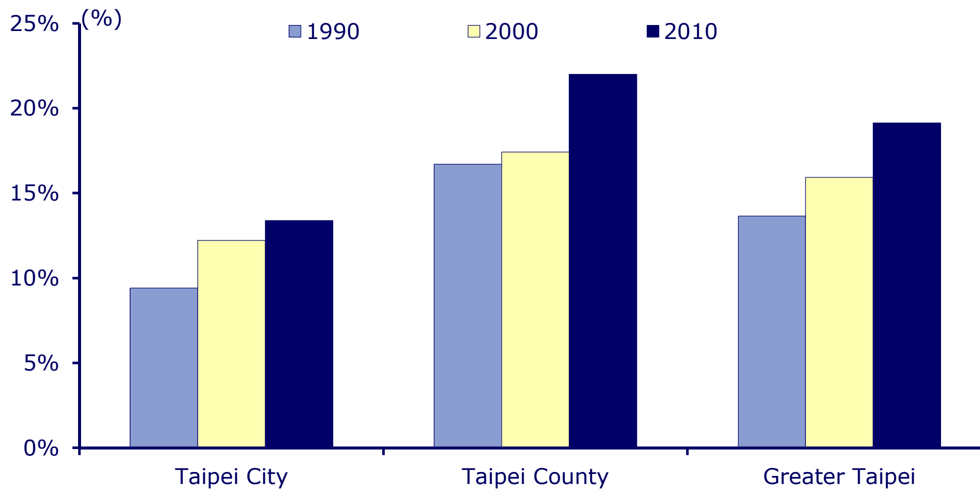
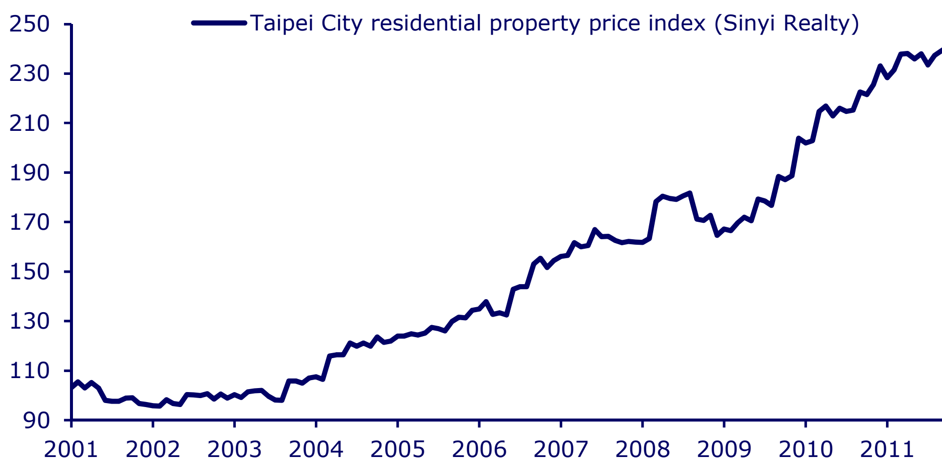
Figure 12
Taipei residential property vacancy rate



Source: Government census

The cultural desire in Taiwan to keep accumulating property, along with improving cross-Strait relations, explains the 152% appreciation in residential property prices in Taipei City over the past ten years (see Figure 13). This has contrasted favourably with the desultory return from the stock market, and the Taiwanese retail investors' disappointing experience with structured finance products. Still there are now looming downside risks for Taiwan property. For the current high values (US$20,000/sqm in high-end projects in Taipei City) stand in stark contrast with the large vacant supply. On top of this should be added ugly demographics and, so far, a complete lack of demand from mainland Chinese or other foreigners. Rather demand at the top end in recent years has been driven by Taiwanese businessmen based in China taking advantage of the arrival of direct flights. It is also the case that investment demand, which accounts for over 40% of total transactions in the Greater Taipei housing market, will certainly decelerate significantly if the cross-Strait relationship cools.

Figure 13
Taipei City home price index



Source: Sinyi Realty

Clearly, the cross-Strait relations should continue to improve if the KMT wins. Still if the DPP pulls off a surprise victory, the "Capital Links" story will go on hold for awhile. There is unlikely to be a complete disaster since the DPP, under its current leader, has significantly moderated its previous stance. Thus, while refusing to acknowledge the "one-China" principle, Tsai has said that, if elected, her administration will not revoke agreements made under ECFA.

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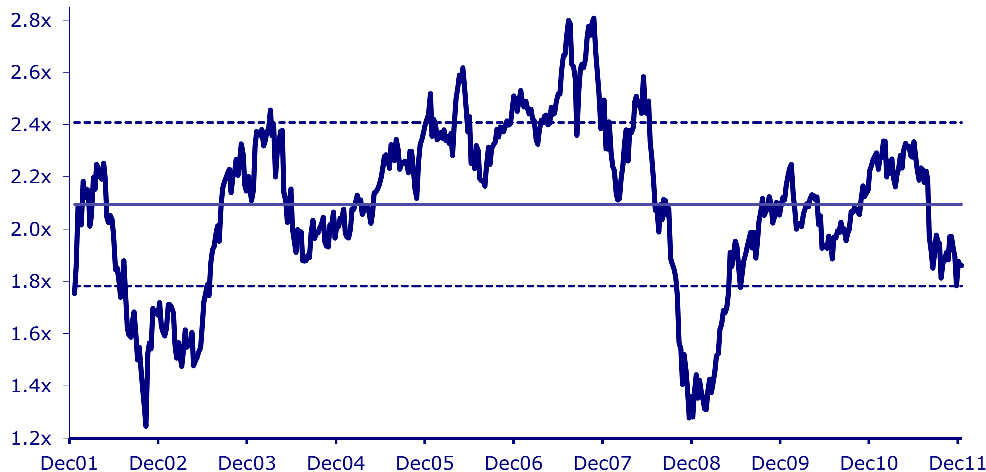
From a valuation perspective, the Taiwan market is relatively cheap, though well above the trough valuations seen in late 2008 in terms of trailing price to book. Thus, CLSA's universe of 84 Taiwan companies under coverage trades on 1.8x trailing price-to-book, compared with a 10-year average of 2.1x and a trough valuation of 1.3x reached in late 2008 (see Figure 14). There is clearly a risk of such a re-test, with the downside momentum likely to be accelerated from a stock market perspective if there is a negative political shock.

Still with the DPP and KMT both seeking to occupy the middle ground, the politics of identity matters less in Taiwan than it used to. Much more critical is the continuing reality of a Japanese-style neo-deflationary malaise where Taiwan is now at risk of no longer seeing the benefit of the one area where it has not followed the Japanese example in recent years. That is rising property prices.

Figure 14
CLSA Taiwan universe trailing price-to-book



Source: CLSA evaluator

Finally, to complete a rather bearish picture, CLSA's new Taipei based banking analyst Dexter Hsu has just come out with a sell rating on the three major banks, Chinatrust, Mega and First Financial (see CLSA research *Taiwan Banks – Unfavourable environment*, 16 December 2011). Hsu argues that the sequential slowdown in exports should not only increase asset quality risks but also lead to a revenue crunch. He believes provisions could rise over the next two years, with credit exposure to the Dram sector representing a key risk. Loan growth is expected to slow to 3.9% in 2012 and 3.6% in 2013 from an estimated 8.9% this year.

For all of the above reasons, *GREED & fear* will reduce the weighting in Taiwan in the Asia Pacific ex-Japan relative-return portfolio by a further two percentage points to a small underweight (see Figure 15). *GREED & fear* would have added more to Korea but given the death of Kim Jong-il it is probably prudent to monitor the "eerie silence" in North Korea for a while, though the base case must be status quo. So by a process of elimination *GREED & fear* will add to Australia by reducing the longstanding underweight in Australian financials from zero to three percentage points since there is a limit to how much many portfolios can be overweight Asean given liquidity issues. It also appears to be the case that Australian banks' wholesale funding has become easier in recent months because they are not perceived as geared to Eurozone risk. Hong Kong will also be reduced by one percentage point.

Finally, a few changes will also be made in the Japanese long-only portfolio this week. The investments in drugstore operators Sugi and Tsuruha will be increased by two percentage points each (see Figure 16). The money will be raised by removing Fast Retailing. A four percentage point investment will also be initiated in potential casino play, Sega Sammy, a maker of gaming equipment. This will be paid for by reducing the existing investments in

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Suzuki Motor and Sumitomo Metal Mining by two percentage points each. The investment case for Sega Sammy can be found in a just published research report by CLSA's Tokyo-based analyst, Nanako Imazu (*Sega Sammy – Window of opportunity*, 14 December 2011).

Figure 15
CLSA Asia Pacific ex-Japan asset allocation

	MSCI AC Asia Pacific ex-Japan weightings 21-Dec-11	CLSA recommended weightings 22-Dec-11	Mismatch from current benchmark
Australia	26.0%	9.0%	-17.0%
China	18.1%	23.0%	4.9%
Hong Kong	8.2%	7.0%	-1.2%
India	6.4%	6.0%	-0.4%
Indonesia	3.0%	8.0%	5.0%
Korea	15.5%	15.0%	-0.5%
Malaysia	3.5%	8.0%	4.5%
New Zealand	0.3%	0.0%	-0.3%
Philippines	0.8%	6.0%	5.2%
Singapore	5.0%	4.0%	-1.0%
Taiwan	11.0%	10.0%	-1.0%
Thailand	2.0%	4.0%	2.0%
Total	100.0%	100.0%	--

Source: CLSA Asia-Pacific Markets

Figure 16
Japan absolute-return long-only thematic portfolio

Theme	Weight (%)	Stocks	Description	Weight (%)
Trading	16	Mitsubishi Corp	general trading company	6
		Mitsui & Co	general trading company	5
		Sumitomo Corp	general trading company	5
Real Estate	21	Mitsubishi Estate	real estate company	10
		Mitsui Fudosan	real estate company	5
		Daito Trust Construction	property developer	6
Exporters	20	Suzuki Motor	automaker	4
		Canon	office equipment maker	4
		Fanuc	industrial robot maker	5
		Isuzu Motors	truck maker	3
		Yamaha Motor	motorcycle maker	4
Machinery	4	Keyence	optical-sensor maker	4
Gold mining	4	Sumitomo Metal Mining	gold & non-ferrous metal miner	4
Consumer	25	Asahi Breweries	beer producer	5
		Japan Tobacco	cigarette maker	6
		Sugi Holdings	drugstore operator	5
		Tsuruha Holdings	drugstore operator	5
		Sega Sammy	gaming equipment maker	4
Airport	3	Japan Airport Terminal	Haneda airport operator	3
Telecoms	7	Softbank	mobile operator	7

Source: CLSA Asia-Pacific Markets

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Key to CLSA investment rankings: BUY = Expected to outperform the local market by >10%; **O-PF** = Expected to outperform the local marketby 0-10%; **U-PF** = Expected to underperform the local market by 0-10%; **SELL** = Expected to underperform the local market by >10%. Performance is defined as 12-month total return (including dividends).

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