Asia – Still a Compelling Value

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At first blush, there's a fire sale going on in the Asian emerging market. Excluding Japan, Asian stocks are trading at 11.6 times trailing earnings. That's dirt-cheap compared to buying into the S&P 500 - U.S. stocks are moving for almost 14 times trailing earnings, as of mid-January, 2012.

The bargain-basement valuations are even more apparent, though, when you add a bit of historical perspective: The MSCI Asia Pacific (ex-Japan) is trading at lows not seen since the 2008 credit crisis - and significantly below where they stood even at their worst moments, in the thick of the Asian financial crisis of 1997, when things were so bad that global financial markets had to move to organize a bailout.

A look at historical price-to-book ratios - a measure of a stock's price compared to the liquidation value of its assets - confirms the assessment: The MSCI Asia Pacific ex-Japan is trading at around 1.6 times book value. And compared to their American counterparts, Asian companies are sporting comparatively little leverage fluff. Balance sheets are generally strong throughout the region, although some investors have concerns about the willingness of Chinese banks to fairly and fully disclose their balance sheets and embrace transparency.

A Monetary Tailwind

China is still the 800-pound gorilla in the Asian markets - and that's showing no sign of changing. China's incredible urbanization and rapid growth of a middle class of skilled laborers, bureaucrats and bourgeoisie over the course of the last generation has generated a surge in consumer demand. This demand, in turn, drives demand both for goods and services produced in China itself and imported from elsewhere in the Asian region. This, of course, leads to tremendous opportunity for China's neighbors all around the Pacific Rim. The rising tide of China, thus far, has been lifting all the boats around it.

The Chinese transformation has been so marked, though, and so profound, that it's brought with it concerns of inflation. Most prominently, of course, migrant workers and emerging wealthy Chinese have bid up luxury real estate prices in some areas to bubble levels. The price of shelter in Beijing and Shanghai was bid up to 35 percent and 30 percent of disposable income per capita, by the end of 2010. And a combination of bad weather, which has impacted the harvest for several seasons, and increased demand for more expensive - and resource intensive -

foods such as pork and poultry has led to widely reported pressure on food prices. Food prices in China had actually increased by some 8.8% overall over 2011.

Until recently, the Chinese central bank has been tapping its foot on the break pedal to rein in growth to more sustainable levels, and put a damper on inflationary pressures. With some success, as it turns out - at least by emerging market standards: The Chinese National Bureau of Statistics reported that year-over-year inflation numbers had been falling for four consecutive months, coming into the end of 2011, with a fall from 5.5 percent annualized in October to 4.2 percent in November and 4.1 percent in December - bringing the Chinese inflation rate to the lowest point in some 15 months. The Chinese Consumer Price Index actually fell by 0.2 percent in November. The moderating inflation numbers gave planners much more flexibility to promote more accommodative policies.

As a result, toward the end of 2011, the Chinese Central Bank reversed course, easing bank reserve requirements to free up lending amidst signs that the bubble in luxury real estate in major urban centers was showing signs of deflating. Meanwhile, China has also been aggressively developing its inland 'second and third-tier' cities to take the pressure off of the mega-cities on the coast and facilitate the immense logistical challenge of feeding so many people in one area.

Agnes Deng, portfolio manager of the Greater China Fund, Inc., stated in a recent interview that "inflation and policy risk has started to moderate in China, while the government's pro-growth policies should make smaller and medium-sized companies... deserving of renewed interest going into 2012."

She further stated that she had been increasing holdings in consumer-oriented businesses in China, as well as well as information technology - capitalizing on the potential and momentum for increased market penetration for these goods and services into the Chinese middle class.

If China is able to continue pursuing its accommodative monetary policy, it bodes well both for Chinese consumption, and for the Asian region as a whole. It also makes the attractive valuations in the region look that much better.

More on the China Housing Bubble

In one sense, the Chinese housing bubble appears very much localized to the luxury markets in major cities. These are the properties that experienced the biggest run-ups. They were also the first to collapse in the latter part of 2011. But looking at housing prices nationwide, housing prices for the average Chinese as a percentage of income have actually fallen in the last ten years. However, one does have to take into account the skewing effect of having so much of the national income concentrated along the coasts. There could well be more downside to come in the Chinese housing market. But remember that the Chinese don't leverage nearly as much as American homebuyers: It is common for families to pay cash for houses there. A 20 percent decline that would cause substantial dislocation for Americans leveraged 9-to-1 in a house is much less problematic for a Chinese family with little or no debt on the house.

Meanwhile, while the financial media has been fixated on the mounting troubles in Europe and potential downgrades of European sovereign debt (downgrades that actually came to fruition for a number of European countries in January of 2012), Fitch actually boosted its rating for Indonesia to BBB-. This is the first time Indonesia has had an investment-grade rating since the 1997 crisis.

Growth Outlook

Khiem Do, portfolio manager of The Asia Pacific Fund, Inc., remains bullish on Asian stocks in general. He is projecting that China will continue on a steady growth pace of about 8 to 9 percent in 2012, and the Asian region ex-Japan will hum steadily along at a growth clip of about 7 percent. Globally, Barings analysts are projecting 2012 growth rates throughout the global emerging markets at 5.1 percent.

In each of these cases, Asian economic growth is set to dwarf economic growth in Europe and the U.S. Do's analysts are projecting growth rates in the U.S. of about 1.3 percent. Europe may well fall into a sharp recession, with a contraction of about 0.5 percent for 2012. The impact of European recessions on Asia has historically been small - China's local export markets are expanding strongly. The Chinese consumer is boosting demand for imports as well, moderating account balance surpluses.

Returns

Asian emerging market returns were disappointing in 2011. The MSCI Asia Ex-Japan index gave up double digit losses - and these losses were reflected in actively-managed equity funds across the board (however, Deng and Do each lost less than their theoretical benchmarks). Arguably, though, there was little fundamental basis for the price declines. Asian growth continues apace, and risks of a Chinese hard-landing were arguably declining during the fall, even as markets were punishing Asian shares.

This was mostly sentiment, according to Aberdeen Capital Management: Institutional investors were nervous about Europe - and therefore throttled back on risk across the board.i There was no major fundamental deterioration in Asia during that time frame. This is not to say that risks don't remain. They are always present, and uncertainty is always with us. But on the fundamentals, the emerging Asia markets remain strong and attractively valued, compared with equities elsewhere in the world.

i Aberdeen Capital Management: Annual Report to Shareholders; October 2011 ■