The Issues

March 2011

MXFEJ AS BELLWETHER ON GLOBAL RISKS?

The usual high, positive correlation between the S&P 500 and MSCI Far East ex Japan (MXFEJ) indexes has broken down since the end of 2010 (Chart 1), with the former in a rally and the latter in a correction. Of late, investment banks in Asia have been touting an "out of emerging equities into developed markets" theme (which suggests there is more time to run). But is this true? This month we will examine the underlying drivers of these indexes' divergence in performance and the likely outlook.

Fund Outflows in Perspective: Asia ex Japan Markets vs. US$20.6 Billion into U.S. Equity Funds (January 2011)

Has there been a substantial shift in fund flows out of Asia ex Japan? Not really. Tables 1 and 2 show a $4.5 billion outflow YTD in 2011 vs. a $76 billion net inflow in 2010 in Asia ex Japan, a small amount that suggests normal profit-taking to lock in some of the sharp gains of 2010. Thus, any idea of theme-driven fund outflows from Asia ex Japan due to portfolio rebalancing is jumping the gun. Furthermore, the relative size of inflows into U.S. equity funds strongly indicates U.S. investors have been buying their own home market.

International Equity Fund Flows (to 2/16/2011)

Table 1

(USDm)	1 week	4 weeks	Ytd
GEM	(3,158)	(11,536)	(8,407)
Asia ex Japan	(1,987)	(5,744)	(4,478)
Latin America	(460)	(1,400)	(496)
EMEA	159	147	1,581
International	2,513	7,786	13,414
Pacific	(146)	(476)	(263)
Japan	747	2,244	3,172
Western Europe	2,335	5,203	5,798

Source: EPFR vs. >US$76 bn net inflow in 2010

Foreign Net Buying in Asian Bourses (to 2/18/2011)

Table 2

(USDm)	Korea	Taiwan	Japan	India	Thailand	Indonesia
1 week'	(46)	(680)	n/a	108	476	274
2 weeks	(2,058)	(2,134)	4,720	(352)	110	278
4 weeks	(2,508)	(826)	5,598	(756)	71	406
Since 2009	42,898	26,779	29,133	45,659	3,039	3,817

Source: Bloomberg. Profit taking by locals

MXFEJ as a Leading Barometer for Global Trends in Risk Aversion

Divergences between the MXFEJ and the S&P are nothing new (Chart 1). They have occurred a number of times and have *always* eventually reverted to being in sync. The key question is: whether the MXFEJ moves back up in sync with the S&P in a bull market (as in "A" in Chart 1), or if the S&P finally follows the MXFEJ into a meaningful correction or, at worst, a bear run (represented by "B" in Chart 1).

The former case (A) is market noise, i.e., shorter-term profit-taking, after which a bull run typically resumes. Of concern is case (B): the fall of the MXFEJ being a forewarning of a global rise in risk aversion which, in the end, drives all markets down. Two past examples are: 1) the MXFEJ declined in April 2008, the S&P finally gave way by August 2008, which was followed by a nasty global bear market the rest of the year; and 2) the MXFEJ corrected in April 2010 on jitters over the eurozone's sovereign debt crisis, and the S&P continued to rally until the dollar surged (as the euro plunged), rekindling fears of a double-dip in the U.S. The S&P then corrected well into May.

Worthy of note is how the MXFEJ leads in subsequent market recoveries. Near the end of the 2008 financial crisis, the MXFEJ started base building in October 2008, while the S&P did not hit bottom until March 2009 ("C" in Chart 1). And in June 2010, with the dissipation of contagion risks in the eurozone, the MXFEJ resumed its rally, while double-dip concerns drove the correction in the S&P until August 2010 (see "D" in Chart 1).

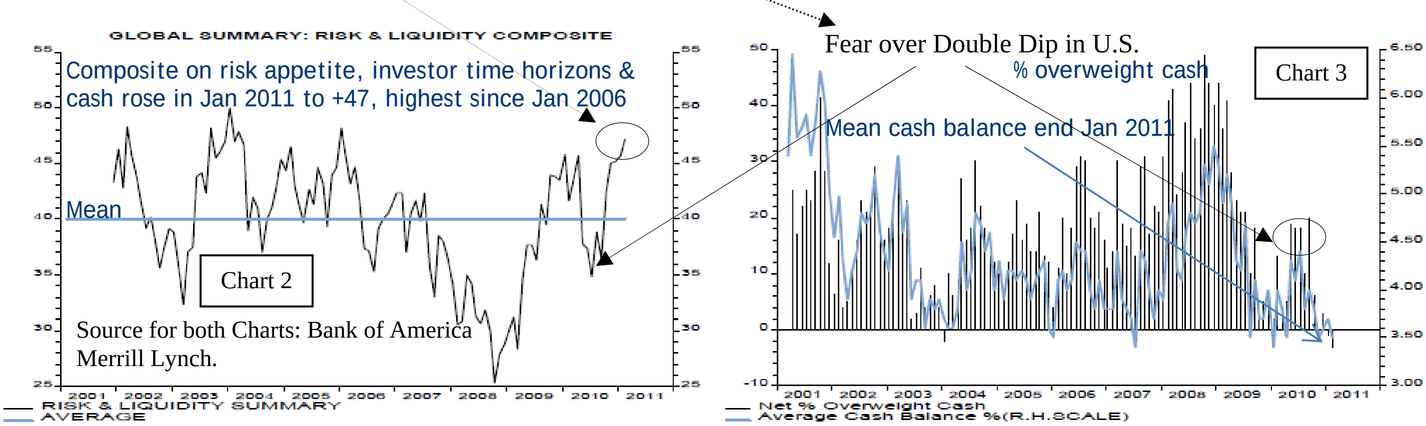
Locals in Asia, with decades of economic progress behind them, thanks to the U.S. Fed's money printing, now have ample savings to drive domestic consumption and investment. Thus, even in the worst of times for the global economy, much of Asia is still growing. The confidence factor of Asia locals on future prospects for their home economies is much higher than the average global investor's. That is why local investors provided the buying that ended bear market runs in Asian bourses, e.g., end 2008 and April/May 2010, while most global funds were still sellers.

Economies in Asia Pacific ex Japan (e.g., China, Korea and Taiwan) are significant global exporters, and China's demand is the key driver at the margin on commodity prices. Smart global money recognizes these aspects. These funds are the first to buy Asia ex Japan equities on signs of a turnaround in the fortunes of the global economy, and the first to exit on signs of rising risk. Many local investors in Asia are the momentum type, hence, the accentuated rise and falls of MXFEJ.

Records from mid-2008 to the present show the MXFEJ as the first to correct (on signs of trouble) and also the first to bottom and then lead in a subsequent rebound. The evidence shows it to be a more sensitive barometer of shifts in global risk aversion trends than the traditional bellwether Dow Jones or the S&P of past decades.

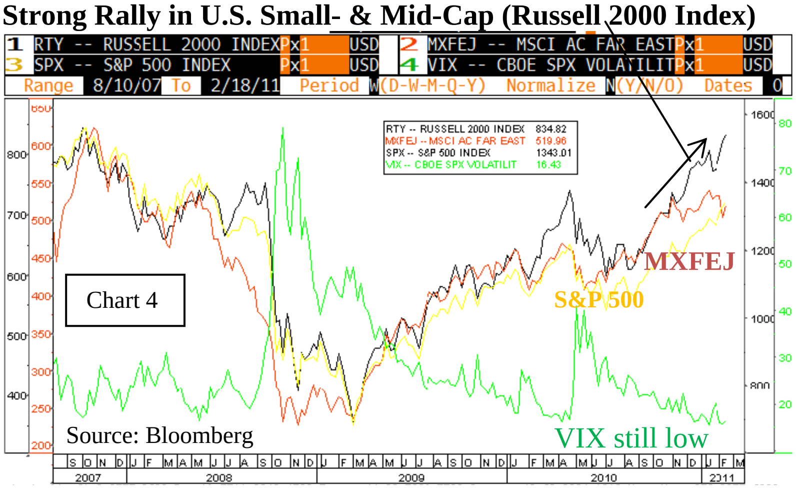
The Recent Situation—High Risk Appetite among Global Funds and in U.S. Equities

For much of 2H10 global funds and U.S. investors, concerned with the U.S. economy, were underweighted in the U.S. and held high levels of cash with a low risk appetite (Bank of America Merrill Lynch survey: Charts 2 and 3). That market sentiment has reversed 180 degrees since October 2010. By January 2011, the risk appetite composite among global fund managers had scored the highest reading since January 2006 (Chart 2). The trend rise in risk appetite is what's driving U.S. equities higher, not fund outflows from emerging markets to the "safe havens" of developed markets, as suggested by a number of investment banks.

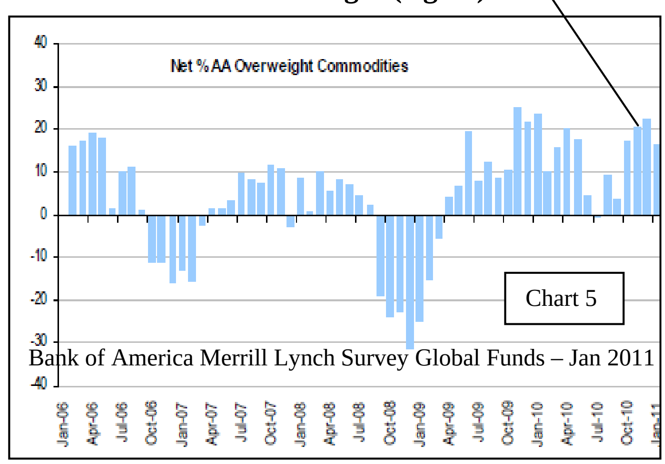


Other risk aversion readings, e.g., the volatility index VIX (Chart 4), the strong outperformance of U.S. smaller-cap stocks, and the move by global funds back into commodities (Chart 5) all point to high risk appetites and bullish expectations. The S&P 500 has witnessed one of its longest uninterrupted up trends from end October 2010 to the onset of recent events in Libya.

Strong Rally in U.S. Small- & Mid-Cap (Russell 2000 Index)



Global Funds Net Overweight (Again) in Commodities



Are Developed Markets Really Safe Havens?

The U.S., the largest economy, was once the growth engine of the global economy, and Wall Street was the bellwether of the global stock market scene. Since the 1970s, we have heard the saying, "When Wall Street sneezes, Asia catches a cold." When conditioned by historical experience, it takes reprogramming for ingrained behavior to change. Many investors still regard major developed economies, led by the U.S., by virtue of their size and diversity, to be more insulated from global events, and their stock markets to be safe havens, while emerging markets are riskier. But are they really?

The last few major financial crises with global seismic impacts—the IT bubble of 2000, the 2008-09 financial meltdown (of the shadow banking sector) and the 2010 eurozone sovereign debt crisis—all owe their origins to the developed world. Thus, the perceived safe haven status of developed markets is illusory.

The Signal from the Decline in MXFEJ—Rising Inflation Risks Globally

The current increase in global inflation risks from rising food prices, and now oil, actually reflects unfinished adjustments to years of money printing, led by the U.S. Fed (and, since 2009, by China). Why are food prices rising? Most cite the weather. Others talk about the U.S. government's policy on ethanol, with one-third of the corn crop diverted from the food chain. A few would mention financial speculators who are buying commodities and agricultural land. But a key culprit is demand shock—a rise in demand for food, oil and other commodities from the boom in emerging economies (led by China), thanks to years of global easy money. There is also a social by-product of easy money—a widening of the gap between the haves and the have-nots—a universal phenomenon in varying shades.

The rise of geo-political instability in the Middle East is driven by the same global trends. In this region, rising food costs have acted as a catalyst to release the anger of the long-deprived have-nots. This unstable social eruption is likely to linger. Perhaps a spike in oil prices will do the job avoided by most governments (and their money printing presses)—as the final destructor of demand. We don't know. But all markets are interlinked in a global world, and the current high risk appetite posture of global funds and investors in U.S. equities is looking increasingly out of place against the global backdrop of rising instability.

Outlook and Our Investment Policy

Oil Import Bill in Asia as % of GDP

As % GDP	Fuel Net Import	Fuel Net Export
Korea	7.0	
Thailand	6.7	
Taiwan	4.0	
Singapore	4.0	
Philippines	3.0	
China	2.3	
Malaysia		7.0
Indonesia		0.5

(Source: GSI Estimates)

Current inflation rates (ex the oil factor) will not derail growth in Asia ex Japan economies because wage inflation is low (aside from China). The business cycles of most Asian economies are on the up phase but not overheating. Governments, backed by strong current accounts, will resort to policies of strengthening their currencies and subsidies (e.g., for the poor) to cushion higher imported food costs.

Stock market corrections in Asia were due to shorter-term profit-taking. At current levels, valuations are again enticing, and the buying power of locals can fuel another up-leg. This is particularly true in Taiwan and Malaysia, where the public sectors can be expected to pursue populist policies conducive to growth to pave the way for upcoming elections. Without the oil factor, we would now be reinvesting our cash.

However, oil has changed the overall equation. Expenditures on oil in the U.S. are about 4% of GDP (Asia data, in Table 3). Each $20 rise in the price of oil will cost the U.S. another US$140 billion in energy, or almost 1% of GDP. Since overall GDP growth in the U.S. is low, a surge in oil prices could easily threaten a double dip. In this sense, the U.S. is more vulnerable to oil prices than most Asian economies (all of which have the cushion of higher GDP growth rates). A surge in oil could finally tip Wall Street into joining the MXFEJ in correction mode.

Nobody can forecast what may transpire in the Middle East. The only known is the unknown, and we can only wait and see. At present our funds are ~24% in cash with 5% invested in oil services-related shares. These, plus other defensive sectors such as gas distribution, medical and pharmaceuticals, environment, gold-related and high dividend-yield stocks, compose over 40% of the fund's portfolio, so we are already positioned defensively.

Should the oil situation stabilize, we can redeploy our cash within a day. However, if the oil situation worsens, we will have no hesitation in taking our cash position substantially higher, also in very short order. Events will eventually stabilize, and when that comes, we would expect MXFEJ to rally first, as lead indicator of dissipating uncertainties over the global economy.

The Net Asset Values GSI Asian Capital Growth—US$27.54 & the Long Short Fund—US$25.13 (Mar 3, 2011)