

Asian Equities: Not for the Fainthearted

- The short-term case for buying east Asian equities is strengthening. Selling pressure is approaching a climax, suggesting that currency stabilization and lower interest rates are not too far off. With the Asian asset class having lost over 50% in US\$ terms since June 1997, the short-term upside for investors is significant.
- Beyond the three-month horizon, however, risks are large and unquantifiable. The first of these risks is external. Once China, Japan and Latin America begin to suffer from South East Asia's super competitive currencies, pressure for a new round of depreciation could mount. This pressure could be enhanced if a rising US trade deficit unleashes protectionism.
- The second risk is that the downtrend in corporate earnings will be much deeper and longer than currently expected. In that event, the Asian financial crisis could resemble that of the US in 1929-32 or Japan since 1990, rather than Mexico circa 1994.
- The third risk is that of policy mistakes and mounting social unrest. Having grown accustomed to super-charged growth and rising employment, Asian governments will find austerity and unemployment difficult to deal with.
- There is a real possibility that one or more of these scenarios will materialize as the economic crisis worsens. Investors should therefore continue to closely monitor devaluation pressures outside the region, and the course of credit, corporate earnings and politics inside it.

Time for Bottom Fishing?

Since June 1997, developing Asia equity markets have lost over 50% of their value in US\$ terms. For some markets, such as Thailand and Korea, this comes at the tail end of a longer decline which began as early as 1994. Measured from their respective peaks, individual markets have shed anywhere between 38% and 95% in US\$ terms, with Asia as a whole falling 60% (Table 1).

In our *Emerging Markets Strategist's* fax reports of the past few weeks, we wrote that the *financial* crisis in Asia may be reaching a temporary pause, and that this presented investors with a short-term buying opportunity. The recent bounceback in some of the region's currency and equity markets could mark the beginning of this process.

The likely trigger for such upside is a reversal of investors' sentiment. Over the past few months, there has been an increasing effort on the part of western governments, international organizations, transnational banks and the governments of the region to restore confidence. The global risk of an Asian meltdown is now better appreciated, and there is growing sense that the industrial countries will act as a "lender of last resort" in order to prevent such a meltdown from happening.

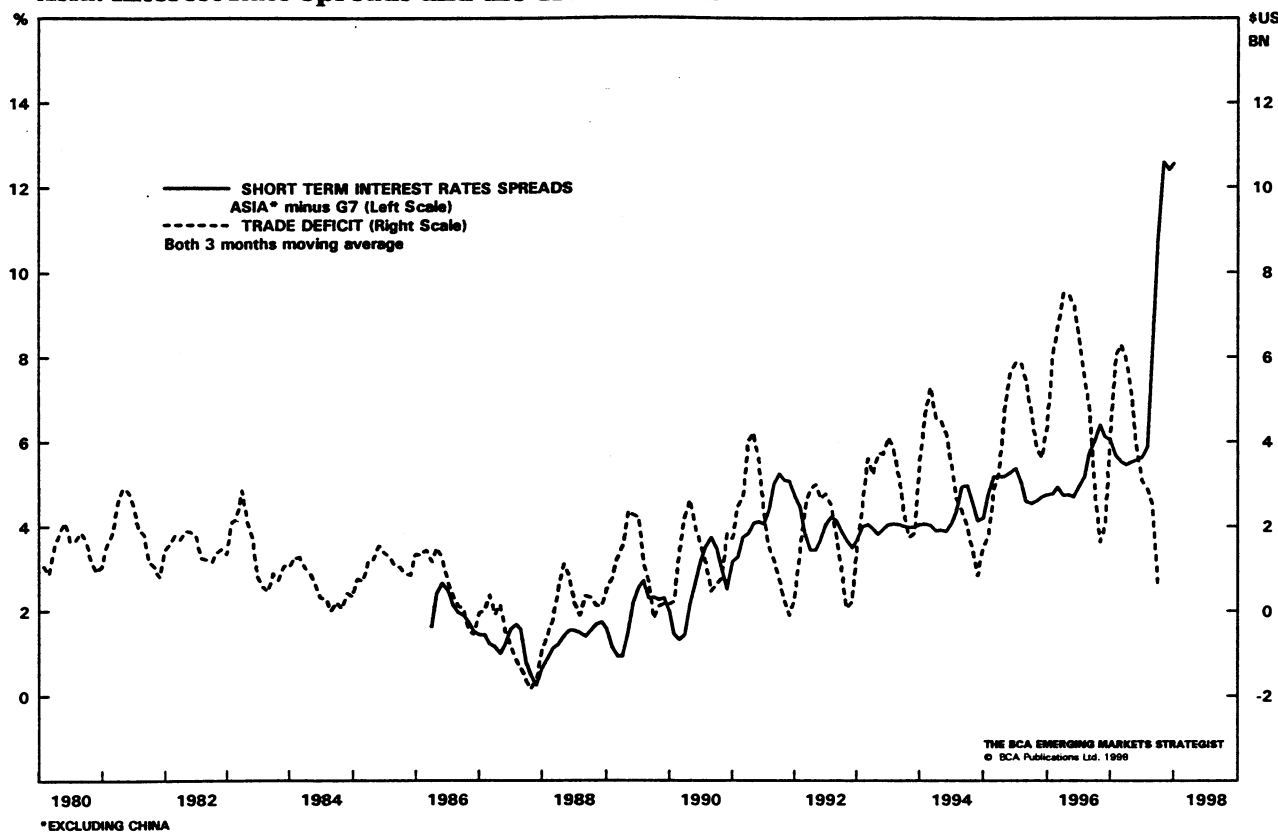
Once investors begin to believe that the worst of the financial crisis is over, the likely consequence will be a reversal of sentiment, with highly bullish implications for equity markets.

As illustrated in Chart 1, the growth of Asia's trade deficit over the past decade meant that its short term interest rates had to rise relative to the G7 so as to attract enough capital inflow.

Table 1
Asia's Market Declines (US\$)

Market	Peak	% Chg. From Peak
China (All-B)	Aug 1997	-46.8
Hong Kong (MSCI)	Aug 1997	-48.2
India (IFC global)	Sep 1994	-45.9
Indonesia (IFC global)	Feb 1997	-95.1
Korea (IFC global)	Oct 1994	-84.5
Malaysia (IFC global)	Feb 1997	-81.6
Pakistan (IFC global)	Mar 1994	-52.5
Philippines (IFC global)	Jul 1996	-74.9
Singapore (MSCI)	Feb 1996	-53.2
Taiwan (IFC global)	Jul 1997	-37.7
Thailand (IFC global)	Jan 1994	-91.6
ASIA (IFC global)	Sep 1994	-59.7

Chart 1
Asia: Interest Rate Spreads and the Trade Deficit



This positive relationship has now been broken. From the middle of 1997 onward, interest rate spreads have widened dramatically against a sharp *contraction* in the trade deficit.

The principal question for investors is whether and when this divergence will begin to close.

Over the next few months, the trade deficit is likely to turn into surplus, as Asia's slowdown dampens imports, while its competitive currencies fuel exports. In addition, debt rescheduling packages and international assistance should help stem the hemorrhage on the capital account – both directly, as well as indirectly by restoring some confidence.

The combined effect of these two processes will be to ease much of the downward pressure on the region's currencies. And once currencies begin to stabilize, interest rates spreads should start narrowing.

In that event, equity investors stand to benefit doubly – first from a large injection of liquidity into financial markets, and secondly, from appreciating (or at least stabilizing) exchange rates. *Given the depressed levels of the region's*

stock markets, the positive effect on stock prices could be very large.

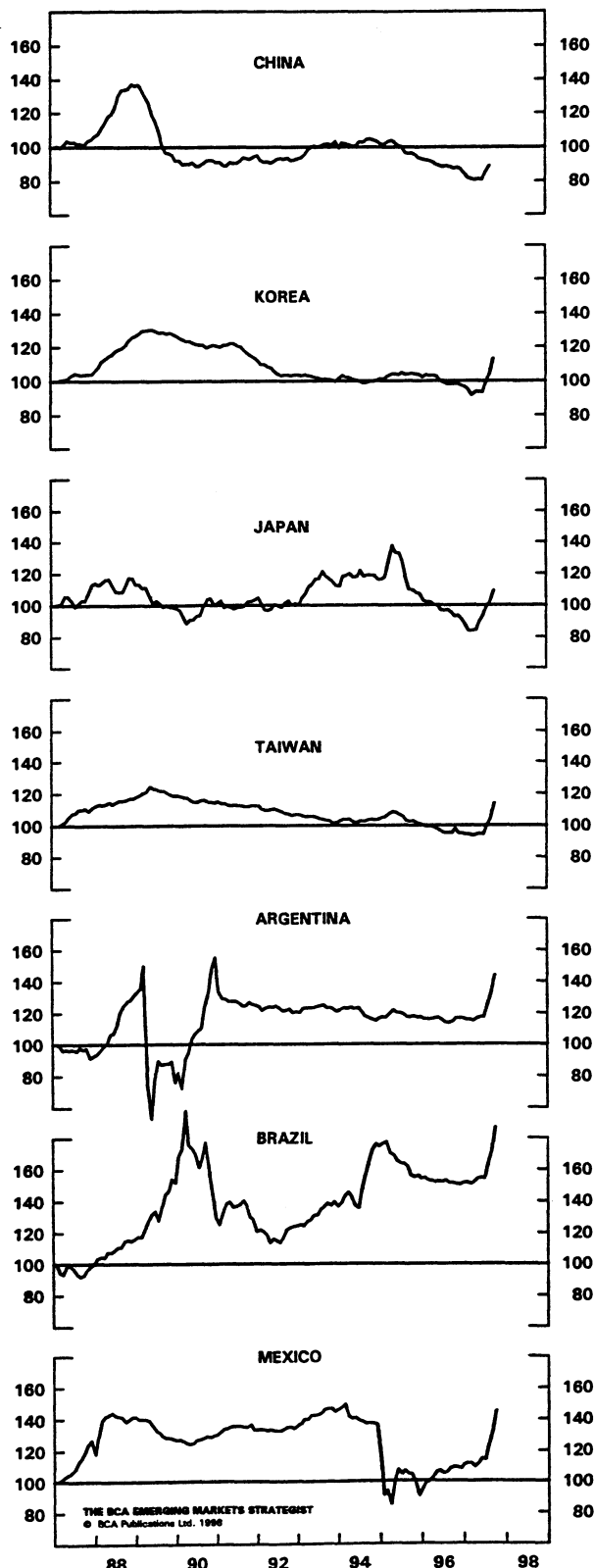
The bigger question, however, particularly for long-term investors, is what happens next? Even if equities stage a strong comeback, does this mark the beginning of a *sustained* bull run? Or will markets revert back to a trading range? Worse still, could this be simply a false start, to be followed by further declines?

The international nature of the crisis, both in and outside the region, makes its dynamics complicated, so the eventual outcome is highly uncertain. Investors could nevertheless benefit from focusing on three main risks: (1) currency contagion, (2) the profit downtrend, and (3) social instability and policy mistakes.

The Currency Meltdown: Is It Over?

The first risk is that currencies fail to stabilize. The main reason for this risk is that devaluation cannot be a solution for all countries: it solves the problem in one country only by passing it to others.

Chart 2
Real Effective Exchange Rates
Relative to ASEAN 4 (ASEAN 4=100)



ASEAN 4: INDONESIA, MALAYSIA, PHILIPPINES
 AND THAILAND

Indeed, even in Asia itself the cycle of devaluation has affected some countries much more than others. As illustrated in Chart 2, the devaluation by the ASEAN countries has made other currencies in the region – primarily those of Korea, Taiwan and Japan – look more “expensive” (or less “cheap”) than before.

The impact on Latin America has been even greater. Relative to ASEAN, the Brazilian real effective exchange rate has appreciated by as much as 80% over the past ten years, followed by the Mexican peso (45% relative appreciation) and the Argentine peso (43% relative appreciation).

Unless the ASEAN currencies *appreciate significantly* – a rather remote possibility – the risk of currency contagion elsewhere in the developing world will remain significant for the foreseeable future.¹

Paradoxically, a recovery of Asian exports could create further devaluation pressures in the region. The Japanese economy is too weak to absorb Asia’s export growth, so much of it will have to go to the western economies, particularly the US, with negative implications for their own external balances. Our sister publication, the *International Bank Credit Analyst*, estimates that the US could see its current account deficit rise to \$200-250 bn, up from \$160 bn currently.² The result should be downward pressure on the \$US/Yen, and possibly rising protectionism – both of which are bearish for the Asian currencies.

Finally, the recent widening of interest rate spreads is at least partly justified by the region’s reduced investment grade. Asia’s risk premium is now much higher than before, and its invisible deficit – primarily the cost of servicing its foreign debt – has widened due to sharply depreciated currencies (South-East Asia’s ratio of external debt to GDP has doubled to 90%, up from 45% in mid-1997). As long as this remains the case, interest rate spreads could stay high, even if the trade balance swings into surplus and the capital outflow stabilizes.

¹ For a fuller discussion of devaluation risks in Latin America, see “The Day After: What If Latin America Devalues?” *The BCA Emerging Markets Strategist*, December, 1997. For copies, please contact our circulation department (Tel: 514-499-9550; e-mail: circ@bcapub.com).

² See, “Will the Asian Crisis Mean Mushrooming Trade Imbalances?”, *The International Bank Credit Analyst*, January, 1998.

The Question of Earnings

The second major risk for investors is that the downturn in corporate earnings turns out to be deeper and longer than presently expected.

Many observers, including some of our own publications, have on a number of occasions compared the current Asian situation with the Mexican crisis of 1994-5.³ Despite some similarities, the *resolution* of the two crises may prove different, and one key reason is profits. The recovery of the Mexican equity market since 1995 proved sustainable largely because corporate earnings managed to stage a relatively quick comeback. *This is unlikely to be the case in Asia.*

Before turning to the reasons for this bearish outlook, it is instructive to contemplate the possible consequences of an earnings meltdown.

Lessons for the U.S. and Japan

In a regular business cycle, profits follow a rather predictable pattern, whose regularities are fairly well understood. For this reason, investors often "see through the cycle," focusing on the *trend* of earnings, rather than on their volatility. The situation is different during a period of sharp structural change, such as the Great Depression in the US of the 1930s, or the burst of the Japanese bubble in 1990. The reason is that unlike the typical downswing, a period of structural change is a "singular" event: neither its outcome nor its timing can be predicted with any certainty. Under such conditions, the *trend itself* becomes highly uncertain, which in turn forces investors to look not through the cycle, but very much *at* the cycle.

This kind of behavior is evident from the experience of both the US and Japan. As illustrated in Chart 3 on page 14, during the 1929-1932 bear phase, as well in the subsequent period of revival, US equities followed closely the underlying trends of production and corporate earnings (the latter correlation is somewhat weaker only because earnings data for the period are available on quarterly rather than monthly basis).

A similarly tight link with earnings fundamentals is exhibited by the Japanese experience. As illustrated in Chart 4 on page 14, equity prices

failed to recover until profits finally turned up in 1995. The market's recent downturn is again associated, at least partly, with growing apprehension about a pending collapse of growth and profit.

Although the present Asian episode is still too young to draw definite parallels with the US and Japan, the significance of profits seems evident (Chart 5 on page 14). In fact, here the earnings down-cycle has been a leading indicator, *preceding* the stock market crash by several months.

The lesson from this comparison is twofold:

- First, in time of *systemic distress*, investors' eyes are fixed on the real economy; and
- Secondly, in the presence of great uncertainty, confidence is not fully restored until there is hard evidence that earnings *are indeed finding a bottom.*

Asia is presently going through a period of profound structural change, with clear symptoms of systemic distress. Within a single year, it has turned from a "miracle" to a pending disaster. This is a very a profound change which cannot fail to have a *lasting* impact on investors sentiment. And as the Japanese case painfully illustrates, the longer the economy lingers, the *less* forward-looking investors become. The implication is that unless the Asian economies stage a quick comeback – which now seems increasingly unlikely – investors will want to see hard evidence *before* putting their money back in.

The risk that the Asian equity crisis turns out to be deeper and longer than Mexico's suggests the need for extreme caution. The magnitude of the potential downside is illustrated in Chart 6 on page 15, where we compare the Asian equity crisis with that of the US following the 1929 market crash, and with Japan after its 1990 market collapse (indices expressed in US\$). Three observations are worth noting:

- First, a major bear market does not end quickly. The US bear phase lasted more than two years (September 1929 – June 1932), pushing prices down by 85%. In Japan, the downturn continued for more than five years (December 1989 – June 1995), erasing 76% of the market value in US\$ terms – and even that may not be the end of the story.

³ See "Gauging the Impact of Asia's Turbulence: Lessons From Mexico in 1995," Special Report No. 9, *The BCA Global Investment Strategist*, January 5, 1998.

Chart 3
U.S. Equities and the Real Economy: 1929-1959

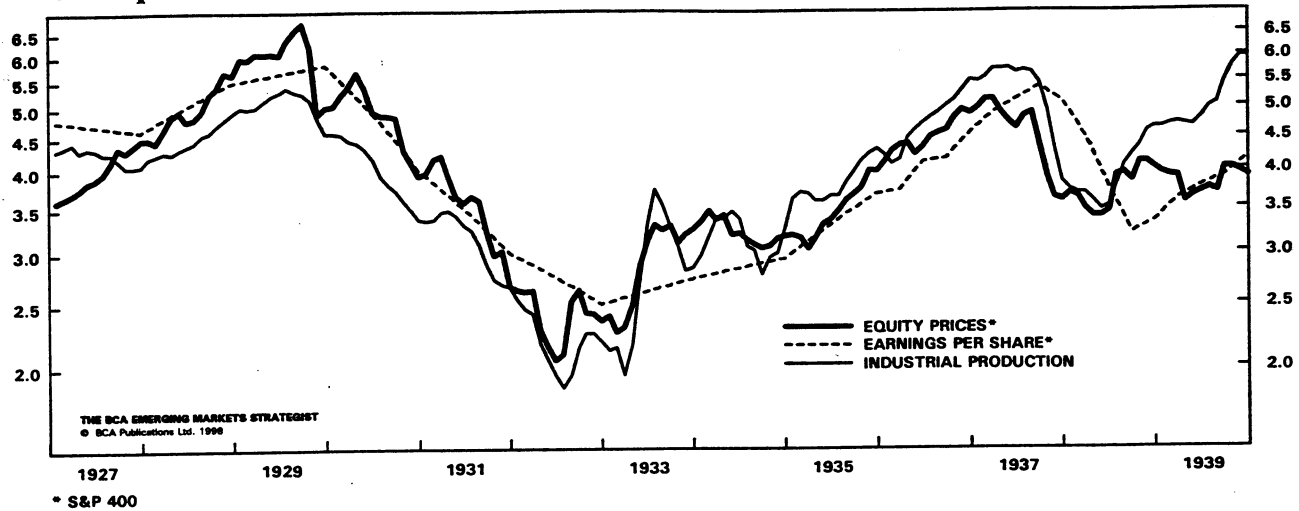


Chart 4
Japanese Equities and Earnings: 1987-1998

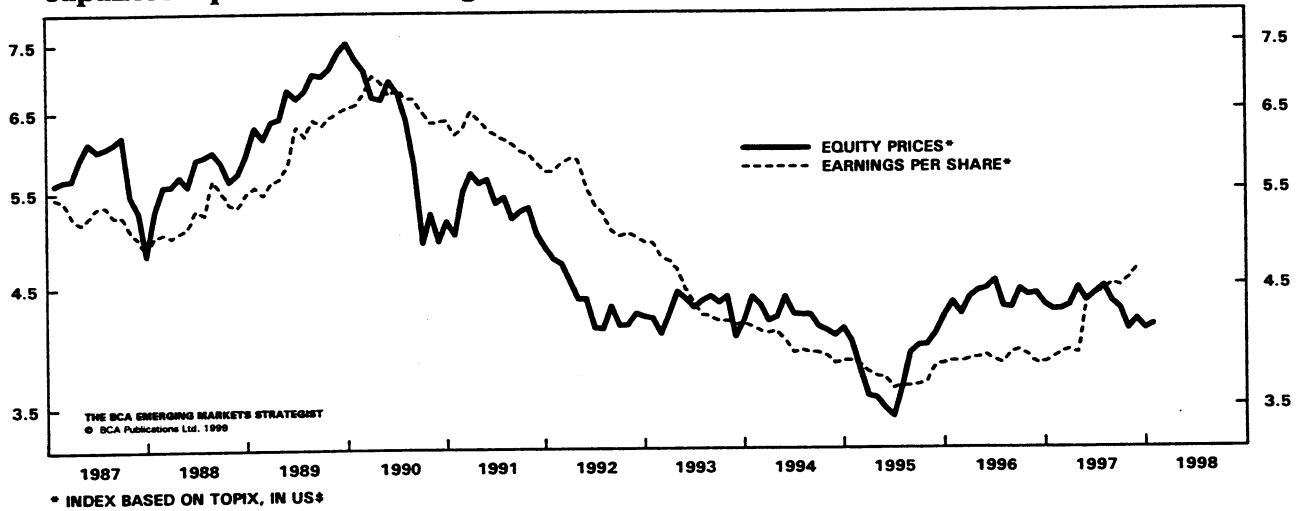


Chart 5
Asian Equities and Earnings: 1995-1998

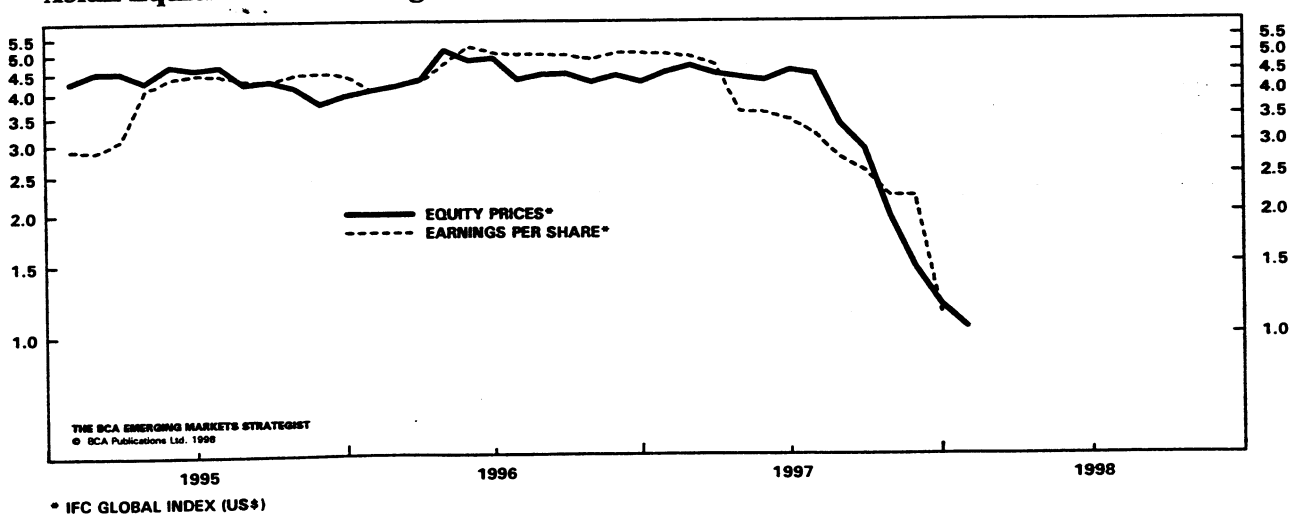
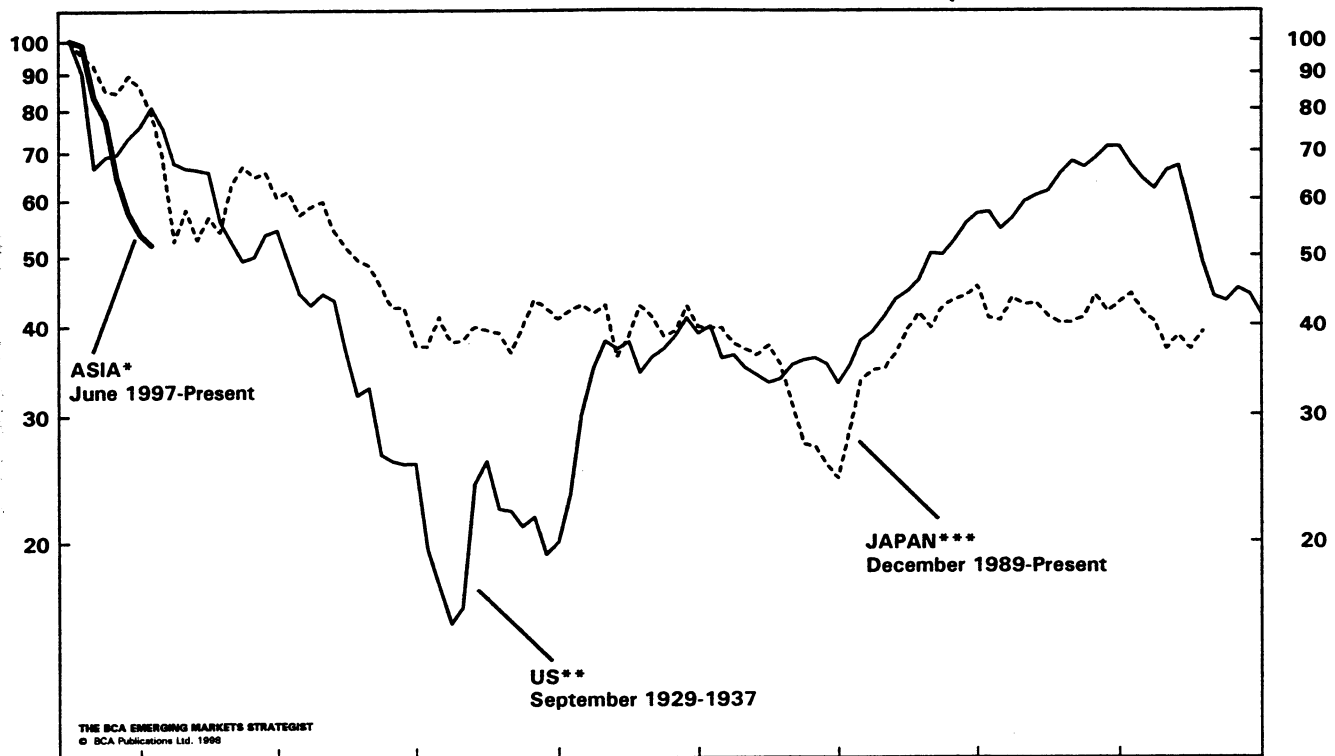


Chart 6
Great Market Downturns



Feature Article

NOTE: ALL PRICES EXPRESSED IN US\$

*IFC GLOBAL
**S&P400
***TOPIX

- Secondly, a premature entry into a major bear market can prove highly costly. A US investor buying the S&P400 index in December 1930, after it had already dropped 51% from its peak, lost 69% in the following 18 months; if he held onto his shares, his capital would have recovered only by November 1935, five years after he bought in. Similarly, a foreign investor buying the Japanese Topix index in July 1992, after the market had already given up 63% of its value in US\$ terms, would have still ended up losing 35% by the time the market bottomed in 1995, four and a half years later.
- Thirdly, the decline in Asian equities, *taken as an asset class*, is still relatively moderate by the standards of “deflation-like” crises. Since June 1997, which we date as the beginning of the crisis, the *average* drop in equity prices has been “only” 50% in US\$ terms. Moreover, the crisis is merely a few months old – far shorter than the US and Japanese ones. The potential downside in the region is therefore still significant.

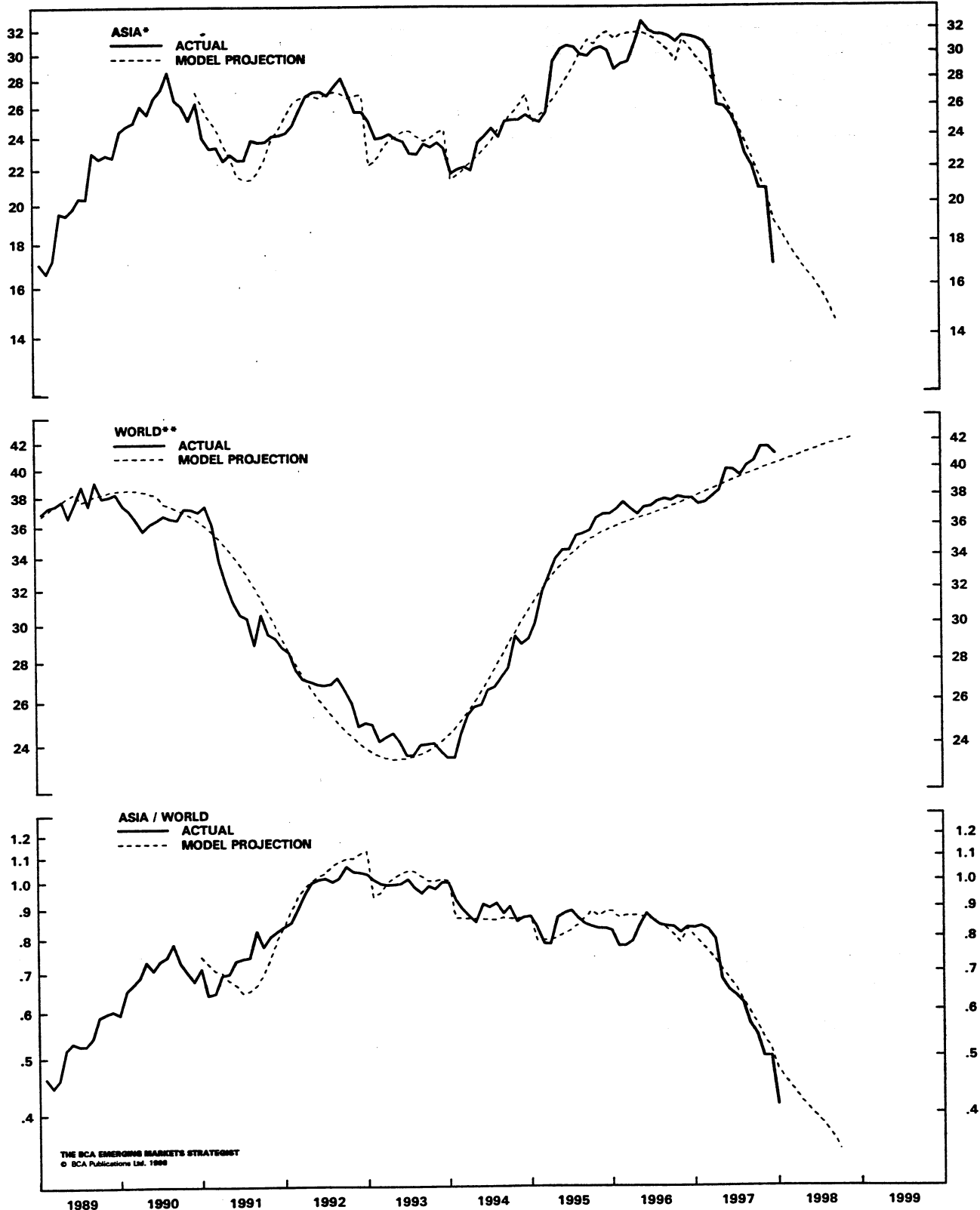
The question, of course, is *whether this risk will materialize*, and the answer depends a lot on what happens to earnings.

The Bad News: How Much More To Go?

The medium-term outlook for Asian profits is negative. Based on our proprietary models, Chart 7 on page 16 provides earnings projections for developing Asia, as well as for the world as a whole (data are expressed in inflation-adjusted US\$).⁴ According to these projections, Asian earnings per share could face declines of 20% or more over the course of 1998 (top panel). World earnings per share, on the other hand, are likely to move sideways

⁴ The underlying models and approach are described in two Special Reports of *The BCA Emerging Markets Strategist*: “Back to Basics: Earnings Growth and the Relative Performance of Emerging Markets” (June 26, 1997), and “Emerging Markets Earnings: The ‘Good’, the ‘Bad’ and the ‘Ugly’” (November 10, 1997).

Chart 7
Real Earnings Per Share: Asia vs. the World



THE BCA EMERGING MARKETS STRATEGIST
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NOTE: EARNINGS PER SHARE ARE EXPRESSED IN US\$ AND DEFLATED BY US CPI
 * IFC GLOBAL
 ** MORGAN STANLEY CAPITAL INTERNATIONAL

(second panel). Relative to the world benchmark, therefore, Asian earnings per share should fall another 20% from current levels, as illustrated in the bottom panel. (These projections assume exchange rates remain at current levels.)

Unfortunately, 1998 is unlikely to be the end of the story. With reported profits lagging the economy, it is only in 1999 that Asia's present economic carnage, rising interest rates, and heavier foreign debt services will be fully reflected in corporate bottom lines. Thus, even in the best-case scenario, with the Asian economies troughing by the end of 1998, corporate earnings are unlikely to recover before the end of 1999, at the earliest. Under a more realistic scenario, with the economic downturn lingering for two or more years, the earnings downturn will be even deeper.

How Much is in the Price?

Assuming exchange rates stabilize at current levels, Asian equity markets appear to have discounted much of the bad news for 1998, and possibly more. The rationale is illustrated in Chart 8 on page 18, where we contrast Asia's IFC global index with Morgan Stanley's world index.

The top panel of the chart expresses Asia's equity prices and earnings per share relative to the world average. In both cases, a rise indicates that Asia is outperforming, a decline that it is under-performing. The bottom panel depicts the Asia premium/discount. This index is computed on the basis of the series in the top panel, and shows how much more or less investors are willing to pay for 1 US\$ of Asian earnings relative to 1 US\$ of world earnings.⁵

Based on these data, Asian earnings are currently trading at a 20% discount to world markets – close to their record depth in 1992. Does this mean that Asia has been oversold? The answer is yes, but only with respect to trailing earnings. If we instead look on *projected* earnings, the picture is rather different.

Note that Asia's current financial turmoil is only the boiling stage of a process which has been brewing for some time:

⁵ For instance, in September 1994, the relative price index was 1.18, against a relative earnings index of 0.91. The ratio of the two indices was 1.3, representing a 30% premium. This same result can be obtained by dividing Asia's P/E by the world P/E, subtracting one and multiplying by 100.

- First, the chart shows that investors have begun discounting the "Asian miracle" long before the current crisis. Sentiment toward these markets, as illustrated by the premium/discount index in the bottom panel, has fallen gradually from a premium of 120% in 1989, to a discount of 20% presently.
- Secondly, the gradual deterioration of sentiment has been confirmed by Asia's earnings under-performance. As illustrated in Chart 7, during the early 1990s this under-performance came because Asian earnings per share *rose more slowly* than world earnings. But since 1996, Asian earnings per share were *actually falling* against a rising world trend.

Equities therefore face strong headwinds from *both* falling earnings and collapsing sentiment.

Although it is impossible to tell at what point these trends begin to reverse, given the depth of the Asian crisis, it is hard to see a *sustained* recovery of sentiment without a clear reversal of the earnings trend. According to our models, Asian earnings are likely to continue underperforming for the rest of the year (as indicated by dotted line in the top panel of Chart 8 on page 18). And if the region's economies weaken further, the process has even more room to run.

Based on these earnings predictions, Asian equities face an uphill battle. The thick dotted line at the bottom of Chart 8 on page 18 projects what will happen to the Asian premium/discount if relative earnings move down according to our models while relative equity prices remain unchanged. It suggests that under these conditions, Asian equities will be able to outperform only if their discount narrows to less than 5%, down from 20% currently.

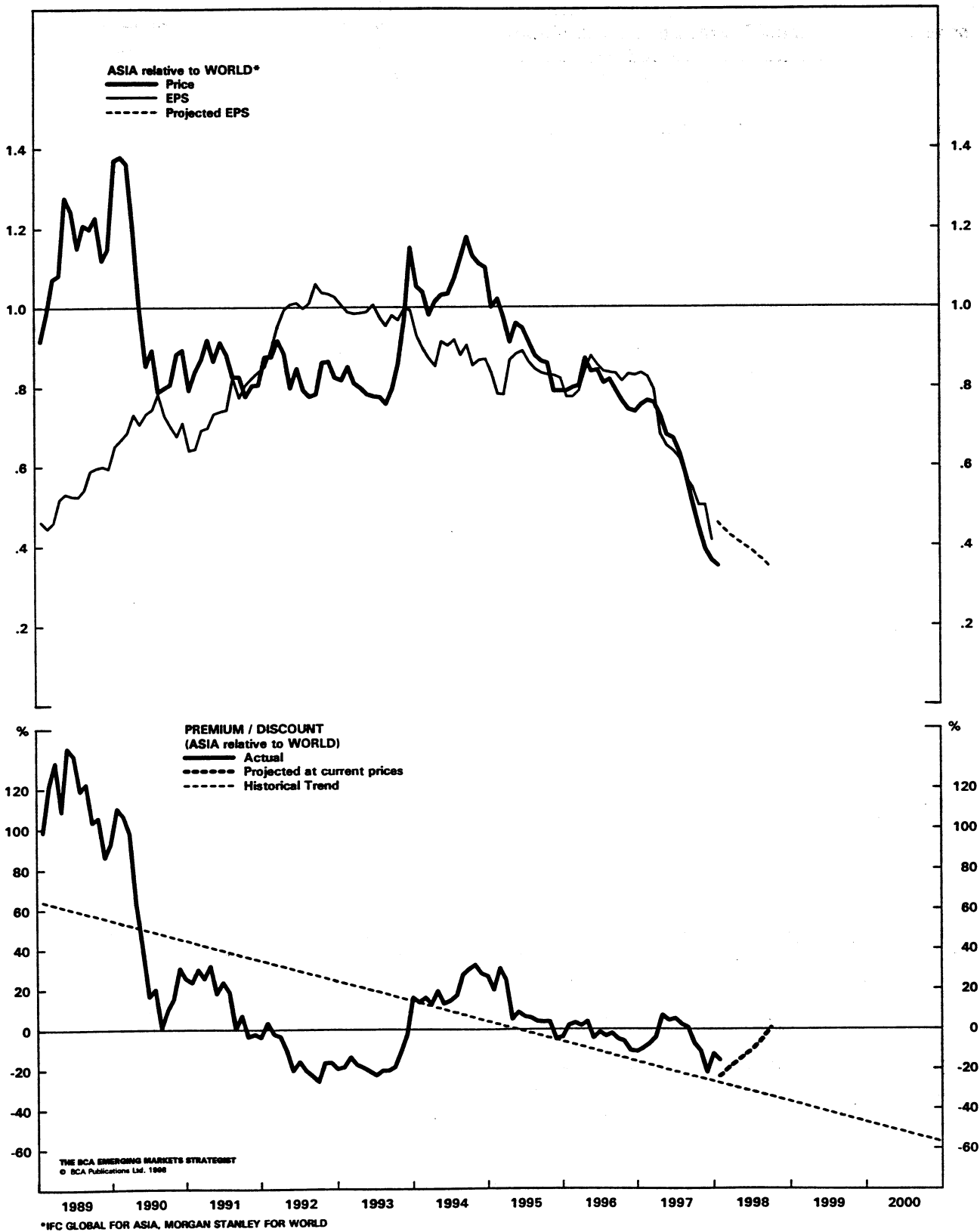
In other words, in order to outperform, Asia needs to see a *very large improvement* in investors' sentiment – this at a time when earnings are *heading down*, both absolutely as well as relatively.

The probability of such a scenario actually happening seems low. Of course, events such as announcements of a debt rescheduling package or a major policy shift could boost sentiment quite sharply, but the question is *for how long*. As the Asian earnings grind continues, deteriorating valuations are likely to put continuous downward pressure on sentiment.

Chart 8

The Asian Outlook: How Much Is in the Price?

Feature Article



Policy Mistakes and Social Unrest

The third risk is that despite all good intentions, policy mistakes end up undermining rather boosting confidence, and that this could be further aggravated by bursts of social unrest.

At a general level, there is still wide disagreement on the proper remedy for the Asian crisis. The IMF is imposing austerity requirements which have been traditionally aimed at stabilizing over-heated economies, with bloated government deficits. The root of Asia's crisis, however, is largely the consequence of excess investment. Much of Asia's capacity has been built to service export markets, and this capacity has now grown far beyond what can be absorbed by foreign demand. Asia needs more, not less demand, which means that the IMF medicine of fiscal and monetary *tightening* may end up making a bad situation worse.

Things could be complicated further by the eruption of social unrest. Many of the region's economies have experienced close to two decades of rising employment and wages. This pattern has now been broken by a combination of mass layoffs, wage reductions and rising prices of basic necessities. The result could be an explosive social cocktail, with highly uncertain consequences.

A related risk comes from the structural aspect of the IMF programs – namely the requirement that countries implement deep market reforms. This is particularly problematic in places such as Korea, where the entire matrix of relationships between the *chaebol* (conglomerates) and government is coming under assault. A different but equally destabilizing situation exists in Indonesia, where structural reforms challenge president Suharto's massive control over the country's corporate sector.

The big issue here is not that there are intimate ties between politics and business, for such ties are common in many other regions. It is rather that these ties *will have to change radically and rapidly*, and that *there is no external authority to impose such changes*.

Finally, although the global risks of an Asian meltdown are now better appreciated, the bailout could still be botched. The main problem is that the world lacks a clear "hegemon," such as Britain in the nineteenth century, or the US until the 1970s. This means that there is no evident "lender of last resort," and that any assistance

package to Asia needs to be coordinated among numerous and often reluctant players. Given the magnitude of the problem in Asia, particularly if trouble spreads to Japan, China, or Taiwan, there is a real risk that even with the best intentions rescue packages may end up being too little, too late. (Clinton's deepening legal problems could create a power vacuum, thus strengthening the "isolationist" Congress, and undermine the US ability to act.)

Investment Conclusions

After dropping by over 50% in US\$ terms, Asian equities offer a short-term buying opportunity for investors who can stomach the risk. The main upside comes from the external accounts. As the trade deficit turns into surplus, and provided that Asia's debt problems are being effectively addressed through debt rescheduling and aid packages, confidence could be restored, leading to sharply falling interest rates, some currency appreciation, and a reversal of investors' sentiment.

However, for long-term investors risks remain uncomfortably high and unquantifiable. The first danger is that the currency will fail to stabilize, either because of contagion in China, Japan, Taiwan, Latin America or elsewhere in the developing world, or due to growing protectionism in the western economies.

The second risk is that the earnings downtrend proves to be much steeper and longer than anticipated. Our own view is that profits should not begin to recover before 1999 at the earliest. If that turns out to be the case, investors' sentiment could take a serious blow, failing to recover until *after* profits have marked a clear bottom.

The third risk is that policy makers in and outside the region will err in their remedies, or drag their feet in implementing them, and that rising social tensions will increase political uncertainty.

These risks suggest that long-term investors should not raise their exposure to Asia for the time being. Only as some of these concerns begin to dissipate, will a broader entry into the market become warranted.

Jonathan Nitzan
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