Monthly outlook – January

Eastern promise – yield reality

Without Asia, there would be only a tortuous recovery from the crisis

Asia is the most populous continent, counting more than 4 billion inhabitants, or more than 60% of the Earth's population. It is not only in this respect that it leads the world however, as if we narrow our definition of Asia to exclude Japan, then it is a continent that is emerging from the global economic crisis considerably more rapidly than any other region. Even more encouraging is the fact that in the meantime Asia has outgrown its initial export-driven growth model. We may be witness in the coming years to a sort of paradigm shift, where, for the first time since the Asian crisis of 1997, internal demand in the region (particularly in the Chinese market) may take over as the key driver of Asian growth. The latest prognoses envisage annual GDP growth in the region of 8.4% this year, and 8.2% in 2011. By comparison, the developed world – and even the developing world – lags far behind, having seen respective rates of GDP growth of around 2% and 6.6% in 2009, and looking ahead to expected annual growth figures of 2.2% and 6.4%, respectively, in 2010. With expected GDP growth of 10.5% this year and 9.8% in 2011, China is indisputably the driving force in the region. Is there anything that could stop this steamroller?

To find an answer to this question, it's worth casting an eye back two years in time. In April 2008, Jim Rogers – the multi-millionaire investment guru who pensioned himself off in 1980 at the age of 38 – declared that "China's economic advance is all but unstoppable." In Rogers' opinion, though a possible civil war in China might have appalling consequences, even an event of this kind (which shows very little chance of happening at present) would only produce a temporary setback. Just as from a serious epidemic or other crisis, China would emerge from all this and keep marching forward. Rogers' words appear to be borne out in the 9.6% expansion in the Chinese economy in 2008, followed by growth of "only" 8.5% in 2009 – and, as if this were not already a world record amidst an economic crisis, this year the country may well re-enter the realm of double-digit growth.

The one thing that might yet bring the Red Dragon to its knees would be a significant crisis in water management. Few people realize that Northern China is struggling with a huge freshwater supply problem. Naturally the country is trying to combat this as best it can, but if the issue is not resolved, or if a remedy is not found in good time, then China may yet crumble. The situation is similar in Northern India, except that there it's even more critical. Water shortages in numerous parts of the world are already throwing up issues of security policy. While yesterday's wars were fought for territory, energy sources now lie at the focus of conflicts and the wars of tomorrow are likely to be fought over water. By re-regulating rivers that originate on the Tibetan Plateau, Beijing is substantially reducing supplies of drinking water in the countries of Southern and Southeast Asia. While China attempts to alleviate the increasingly serious water shortage at home by diverting rivers and building reservoirs, the supply of water reaching India and the other states in the region is dwindling. It is conceivable that in order to preserve stability and peace in the region, international agreements might be urgently needed to standardize rules pertaining to the diversion of watercourses.

Setting aside for a moment the problem of water, we must see that an economy like that of China – which is growing at an average annual rate of over 10%, which holds the world's largest foreign currency reserves (more than USD 2,000 billion), and which has an emerging new middle class that will soon become the most populous section of society – signifies "the future" for investors and enterprises with a global outlook. Moreover, the financial market is developing in China as well. Following a government resolution of 2008, the Chinese stock market regulatory authorities (having delayed the launch due to the ongoing financial crisis) have at last approved the trading of index futures.

The change announced in recent days creates the opportunity for opening long-awaited geographical arbitrage positions, as under hitherto valid conditions (the lack of free movement of capital between Hong Kong and Shanghai) there are significant discrepancies in the prices of a number of companies traded on both cities' bourses (although, interestingly, convergence has occurred in the case of banks), and these discrepancies are expected to decrease in the long term.

There is another China in the Asian continent, however, which lags some 20 years behind and whose name is perhaps unsurprising: India. Here, after the 6.5% GDP growth produced in the year of crisis of 2009, an expansion of 8% may be expected in 2010, and 8.2% in 2011. Economic fundamentals in the second most populous country on Earth (where every sixth person is an Indian) are showing substantial improvement, while economic and trade relations with China are constantly strengthening. Urbanization in India today has accelerated to an astonishing degree, while average income per capita has reached the level where there is already an appreciable increase in demand for durable goods.

In the light of all the above, it is worthwhile for investors to cast an observant eye on AEGON Fund Management's Asia fund, to be revamped from February 2010. Amid an already favourable outlook, the investment policy of the AEGON Asia Equity Fund of Funds will be changed from 1 February with a view to securing a yet higher yield. The Fund will receive a new composite benchmark, the composition of which will be: 75% MSCI AC Far East ex Japan Index + 15% MSCI India Index + 10% ZMAX Index.

From the aforementioned date onwards, Japan, which was earlier included in the reference index, will be removed. Its place will be taken by India, a country about which the Fund Manager takes a far more positive view given that it promises a much greater expected rate of GDP growth and yield potential than the sharply receding land of the rising sun has shown in recent times. Although Japan is setting off on a path of renewed growth after its dramatic -5.4% fall in GDP in 2009 (an economic decline virtually unknown since the Second World War), its real GDP growth – expected at a mere 1.3% in 2010 and 1.7% in 2011 – will still fall far short of the region's average.

According to the new composite benchmark of the revamped AEGON Asia Fund, the primary targets will be China, Hong Kong, Indonesia, South Korea, Malaysia, the Philippines, Singapore, Taiwan, Thailand and India. Accordingly, the Fund will concentrate entirely on the developing Asian region, thereby offering a substantially higher yield potential to both its present and future investors. Taking advantage of the above-mentioned arbitrage opportunity, the Fund Manager will also undertake a 3% exposure in the AEGON Asia Equity Fund of Funds by selecting individual equities that can be expected to show changes in price in this direction. We have selected the current seven stocks (e.g. PetroChina Co. Ltd. and Jiangxi Copper Co. Ltd.) from among 30 companies. Provided outperformance by the chosen securities is achieved, we can be expected to further expand our position.

Although, as can be seen from the above, the benchmark is changing, the approach remains successful as before. Just as previously, the Fund Manager will take a very active approach to selecting among the aforementioned countries and will constantly adjust the relative weight represented by each country within the portfolio in accordance with our market expectations. We will also continue our earlier, highly successful practice of including ‘off-benchmark’ investments (i.e. investments falling outside the reference index) in the region, which, just as in the past, could prove highly favourable going forward. In addition, we will continue to make dynamic alterations to the Fund’s equity exposure (a greater equity exposure if the approach is bullish, and a lower exposure if it is bearish, with an accompanying more defensive Fund strategy).

Real GDP growth (%) Fact and forecast

	2009	2010	2011
Asia/Pacific	3,2	6,9	6,8
Japan	-5,4	1,3	1,7
Australia	1,0	2,8	3,2
Asia ex Japan, Australia	5,5	8,4	8,2
China	8,5	10,5	9,8
Hong Kong	-2,6	5,6	4,4
India	6,5	8,0	8,2
Indonesia	4,6	5,9	6,2
Malaysia	-2,2	4,5	5,2
Philippines	1,0	5,5	6,0
Singapore	-2,0	5,5	5,5
South Korea	0,0	5,5	4,0
Taiwan	-3,0	4,8	5,2
Thailand	-3,0	3,0	5,0
Vietnam	5,1	6,5	6,6
Global	-0,9	4,2	4,2
Developed	-3,4	2,0	2,2
Emerging Markets	2,0	6,6	6,4
Hungary	-6,9	-1,5	2,0

Source: Nomura

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