MACQUARIE INVESTMENT MANAGEMENT

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Asian equity markets – primed for investment

SUMMARY

Investing in Asia over the last 12 months has not been without its own set of challenges, but continues to be a region we strongly believe deserves greater attention. In our view, Asia ex Japan is primed for investment as it remains one of the fastest growing regions, even with the highly publicised slowdown in China. The MSCI Asia ex Japan Index posted returns of 22.7% for the calendar year to December 2012 and we believe it looks set to perform well over the next year. Below we detail the key markets within the region and the variance in drivers and investment opportunities.

CHINA - OVERWEIGHT

MSCI China Index returned 23.1%. For most of 2012, investors and market commentators were worried about a 'hard landing scenario' in China – where property prices would collapse, non-performing loans would soar and banks would become insolvent and growth dipped as a result. In the second half of 2012, industrial production gradually recovered, consumer discretionary spending was robust and the Chinese continued their love affair with property and hard assets.

Economy: Ongoing stresses in Europe and the US dragged on exports early in 2012, bottoming in the third quarter and recorded accelerations in October and November. Infrastructure is one of the principle drivers of growth and is historically around twice nominal GDP growth. In 2012, infrastructure spending occurred later in the year than expected as local governments and businessmen waited for policy directions at the completion of the 18th Party Congress. Political shuffling now complete, outgoing President Hu Jintao promised optimism commenting on New Year's Eve that efforts will be stepped up "to promote strong, sustainable and balanced growth in the world economy."

Outlook: Recent positive PMI, industrial production numbers and nominal retail sales figures continue to surprise. Signs are clear for recovery to gain momentum.

THAILAND - OVERWEIGHT, MINDFUL OF POLITICAL UNCERTAINTY AND MONARCHY SITUATION

MSCI Thailand returned 38.5%. You only need to travel to Bangkok and count the number of high-end condos for sale and number of Ferraris on Sukhumvit Road to gauge the strength of the market. But this is all too familiar for anyone that dares to remember 1997.

Economy: Some answers to the optimism found in the Bank of Thailand's loosening stance, leaving policy rates low at 2.75%. A combination of innovative fiscal policies put in place by the Prime Minister Shinawatra sent the boom into overdrive. Tax re-imbursement for 'first car scheme', minimal daily wage increase from 200 Baht to 300 Baht and the controversial government rice pledging scheme have played their part for full employment and ongoing economic growth forecasts.

Outlook: Be cautious on valuation, trading well above its 10-year price earnings.

SOUTH KOREA - UNDERWEIGHT

MSCI Korea returned 19.6%.

Economy: Despite a number of policy measures, including July and October rate cuts, the economy still has yet to see signs of a concrete recovery. This sets a damp economic backdrop for incoming leader, Park Geun-hye, the daughter of Park Chung-hee, whose authoritarian rule ran from 1961 to 1979. Her stunning victory in the presidential election in December aroused huge interest both inside and outside South Korea

Outlook: We see competitiveness fading against Asian neighbours.

PHILIPPINES - OVERWEIGHT

MSCI Philippines returned 47.6% - the best performing Asian index.

Economy: GDP growth has exceeded market expectations and is likely to hit top range of their official target of 6%. Growth has been driven by robust overseas remittances, increased infrastructure and consumer spending coupled with benign inflation and a low interest rate environment, encouraging consumer spending. Of note are the Public Private Partnership programs, which are being gradually rolled out demonstrating political commitment to improve infrastructure and investment confidence.

Outlook: Good economic outlook led by strong domestic consumption. Policy makers need to monitor inflation pressures from upbeat domestic demand, which could be boosted by election spending and wage demands.

SINGAPORE - UNDERWEIGHT

MSCI Singapore returned 33.4%.

Economy: For 2012, the economy is estimated to have grown by 1.2%, slightly below the Ministry of Trade's growth forecast of around 1.5%. Weakness in the manufacturing and export sectors continued to weigh down on the economy.

Outlook: Growth expectations are muted with the country entering a slower phase of growth. Inflation pressures likely to remain above the Monetary Authority's comfort level due to supply constraints.

INDIA - NEUTRAL WEIGHT, WARY OF TRANSPARENCY

MSCI India returned 27.3%. Recent policy announcement by the government and expectation of easing monetary policy has lifted market sentiment.

Economy: The economy remained sluggish throughout 2012 as GDP growth decelerated further from 6.5% in the prior year to 5.5% in the current year. Inflation remained stubbornly high (8%) throughout the year with some signs of moderation in recent months.

Outlook: : We expect GDP growth to recover to 6-7% with easing inflation, rate cuts by the central bank and an enabling policy environment. Recent policy action has raised hopes that it is committed to economic reforms and arresting the downturn in growth.

MALAYSIA – UNDERWEIGHT, BETTER OPPORTUNITIES IN OTHER ASEAN

MSCI Malaysia returned 14.1%. High stock valuations, upcoming elections and slow earnings growth limited gains in stock market.

Economy: The economy remained robust growing at 5.2% for the year and inflation remained tamed under 2%. Strong growth has been fuelled by domestic demand due to low unemployment and enhanced incomes from government handouts ahead of the presidential election.

Outlook: There is risk of current ruling government coming to power with reduced majority and not being able to deliver on reform agenda.

TAIWAN - UNDERWEIGHT TO NEUTRAL

MSCI Taiwan returned 18.6%. Being significantly exposed to the tech supply chain means the index follows the quarterly trend and rumours of consumer electronics.

Economy: GDP numbers fell due to heavy reliance on exports and weak domestic consumption. The economy deteriorated further when the government downgraded forecasts from 3.85% to 1.15% on worsening global economy.

Outlook: GDP is thought to have troughed in 3Q12 at 0.98%. |GDP is forecasted to grow 3.15% in 2013 and we expect to opportunistically look to accumulate.

INDONESIA - NEUTRAL WEIGHT, COST PRESSURES AND INCREASING POLITICAL RISKS

MSCI Indonesia returned 4.8% (10.75% in INR terms). Domestic consumption was robust as the wealth effect continued to benefit Consumer Discretionary companies with an overall sector performance of 52%. Other outperformers included Industrials at 60.6%, where manufacturing remained strong as foreign companies relocate to a manufacturing base on cheaper land and wages. But market valuations are getting expensive.

Economy: GDP growth remains strong at 6.0-6.5%. Concern is on inflation due to higher energy costs. As fuel is subsidised, potential for fiscal constraints may limit its ability to contain inflation should oil prices increase. CPI should be around the 4.5% level however this has led to reduced ability of loosening monetary policy.

Outlook: Lack of infrastructure, growing cost pressures and an election in 2014 may see policies that favour certain sectors.

HONG KONG – OVERWEIGHT, BUY QUALITY NAMES AND VALUE

MSCI Hong Kong returned 27.7% with property developers and energy companies posting the best performance. Global investors returned to the Hong Kong market in the fourth quarter as signs of Chinese economic recovery became more apparent.

Economy: As an externally oriented economy, Hong Kong's economic growth decelerated to around 1% for the majority of 2012 due to the weak European and US economies. However, Hong Kong is regarded as a China proxy and as such the economy experienced strong inflows on positive economic news flow from China. Rising wages from tight labour market and wealth effect from asset prices increase has created robust domestic spending.

Outlook: Although we expect economic growth will remain subdued, we expect the equity market to perform well as the Hong Kong equity market offers the best exposure to Chinese economic recovery.

CONCLUSION

We believe that investing in Asia ex Japan equities provides investors with an opportunity to benefit from one of the strongest growing global regions. Our experience over the last 12 months has reiterated to us that it is a diverse region with exposures across all sectors. Return drivers differ widely across the region so it is important to assess each country individually. Internal consumption continues to develop so reliance on global demand is falling, and it is critical to have firsthand knowledge of the region to successfully invest.

We are confident that the region will continue to grow over the next 12 months and believe that it is primed for investment.

Note: Index returns referenced in this paper are quoted in USD terms for the 12 month period ending 31 December 2012. Past performance is not necessarily indicative of future performance.

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