Why Asia Matters: When East Meets West

Executive Summary

- Asian debt offers attractive risk-adjusted returns for investors looking to diversify into a neighbourhood of relative strength.
- Asia's outperformance, if sustained, will result in a more level economic playing field with developed countries than in prior decades.
- In tandem with its growing influence in world financial markets, China will become less of a producer and more of a consumer in the global economy.
- One key risk to the constructive outlook on Asia is a "weaker for longer" growth pulse for developed countries.
- While the beneficial impact on Asian assets' price valuations may be temporarily obfuscated by exogenous forces, Asia is well positioned to deploy its financial resources to ring-fence the market contagion.

The term "Shangri-La" never fails to evoke imagery of Oriental mysticism. Originating from English author James Hilton's 1933 novel *Lost Horizon*, Shangri-La was the fictional Tibetan monastery bearing utopia-like qualities, where four Westerners sought refuge after a plane crash-landing. While geographically isolated and immune to the sociopolitical turbulence then prevailing in the outside world, Shangri-La nevertheless drew heavily, in a material sense, from the world around it. Within its grounds were contemporary features, including central heating and a grand piano, as well as bathtubs from Akron, Ohio.

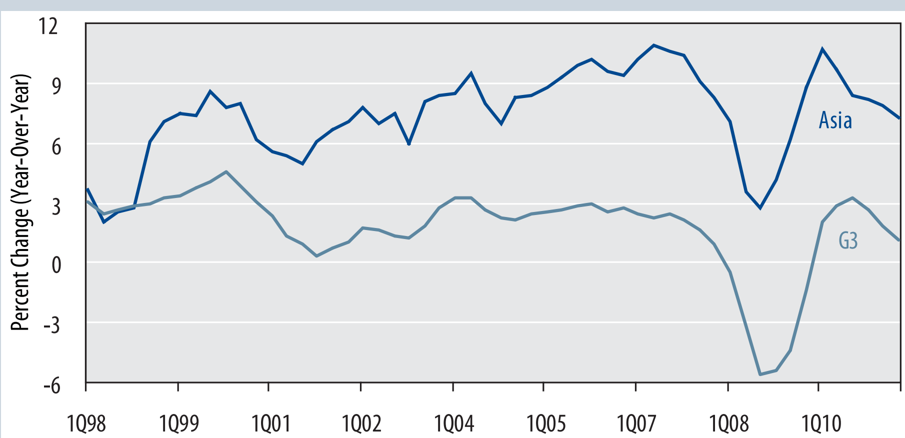
Conceptually, Shangri-La can be used as a thematic framework for analysing current economic issues in emerging Asia in at least three ways. First, its geographical isolation is analogous to the current topic of the decoupling of Asia's growth from the developed world. Second, amidst the Western pessimism of the 1930s, Shangri-La's appeal hints at a degree of East-West levelling. Third, its modern facilities can be interpreted as an innate penchant for consumption, underscoring the scope for rebalancing Asia's growth strategy.

Decoupling, in Alpha Terms

To be sure, decoupling does not imply immunity, particularly so, given increased economic and market interactions globally. As a case in point, China's World Trade Organization (WTO) membership, which began in 2001, has had a positive catalytic effect in spurring global flows. World trade in 2010 was 2.5 times its level a decade ago, amounting to around half of world GDP, up from just one-third in the 1990s.

It follows that Asia's economic cycle remains tightly correlated with that of the developed countries (Exhibit 1). Post-Lehman Brothers, the region's GDP growth displayed an uncharacteristically immediate and steep slippage of more than four percentage points in the first quarter of 2009 to reach a decade-low of 2.7% year-over-year (YoY). Recent market worries over the soft patch in the Chinese purchasing managers index (PMI), occurring amid global growth fears,

Exhibit 1
Asia-G3 GDP Growth: Mind the Gap



Source: JP Morgan

can be viewed as a tacit acknowledgement of the continued sensitivity of Asia's growth to G3 demand. Simply put, Asia is not yet in a position to influence world growth in a "beta" sense.

Nevertheless, one might argue for a broader definition of decoupling, citing as evidence Asia's consistent outperformance in GDP growth vis-à-vis developed nations. Since 2000, Asian economies have outpaced G3 countries by an average of six percentage points. Significantly, this "alpha" has widened over time, from five percentage points, on average, in 2000–2006 to nearly eight percentage points in the post-Lehman years.

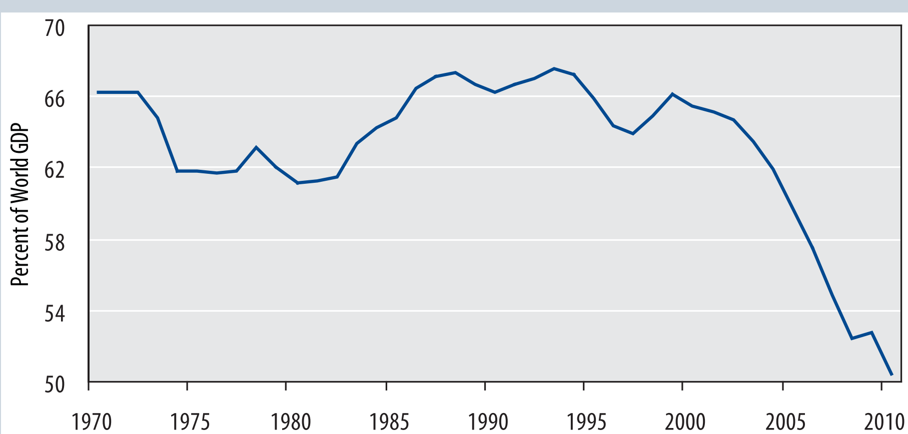
Factors underpinning the resulting superior GDP growth outturns in Asia have been well advertised. In the years following the region's own financial turmoil in 1997–1998, we have witnessed strict adherence to macroeconomic discipline as a linchpin of development strategies. In contrast to the pre-crisis experience, many Asian countries now demonstrate a time-tested respect for fiscal responsibility and central bank autonomy. At the same time, the build-up in external surpluses has meant that many Asian countries are now key exporters of capital to the rest of the world. Recent news headlines underscore the pivotal role that China now plays in global debt markets.

Levelling the Playing Field

In contrast, developed countries are now being forced to deal with the fallout from fiscal profligacy. The sovereign rating trajectories have mirrored the divergence in the fundamental trends between Asian and developed economies. Year-to-date (YTD), seven developed nations (Greece, Ireland, Italy, Japan, Portugal, Spain and the US) have received a combined total of 29 rating downgrades—and no upgrades—from Moody's, S&P and Fitch. Eight countries (Belgium, Greece, Ireland, Italy, Japan, Portugal, Spain and the US) remain on negative outlook, suggesting the possibility of more negative actions over the next 12 months. So far this year in Asia, the ratings of three countries (Indonesia, the Philippines and Sri Lanka) have been upgraded, with four countries (China, Hong Kong, Indonesia and Sri Lanka) currently on positive outlook.

Asia's outperformance, if sustained, will reinforce the evolving paradigm shift in the world economic order. Over time, the dominance of industrial countries is likely to whittle down, leading to a playing field that is more level than in prior decades. Strikingly, the G7 share of world GDP has fallen markedly to an all-time low of 50.5% currently, from roughly two-thirds throughout most of the past four decades (Exhibit 2). No wonder that global economic groupings are becoming more inclusive, with the larger Asian and emerging market (EM) countries positioned to play a more active role.

Exhibit 2
G7 Is Now Less Dominant Than in the Past



Source: World Bank

Rebalancing Demand

Admittedly, a more level playing field for Asia comes with a price tag, particularly for China. In tandem with its growing influence in global financial markets, China will become less of a producer and more of a consumer in the global economy. Chinese officials have expressed their commitment to a reorientation of the growth strategy toward domestic consumption. While such a policy would contribute to more sustainable world growth, it also ultimately will serve the country's self-interest. In all likelihood, this process could quicken as the sovereign debt-induced hit to aggregate demand in industrial economies reduces the effectiveness of China's export-leaning growth strategy.

Measured as a ratio to GDP, household consumption in China has been declining steadily to less than 40%, or about half that of the US; this has mirrored a decline in the share of national income coming from labour, given the dominance of capital-intensive industries. Given aging demographics, the lack of a social safety net serves to encourage precautionary savings. Consumption-boosting measures (in the form of fiscal reforms and exchange rate appreciation) are likely to be instrumental in rebalancing China's economic structure and sustaining growth over the longer term.

There are tentative signs suggesting that domestic consumption is slowly becoming a larger part of the Chinese GDP equation. China has taken center stage on key consumer goods, including iPads, cellular phones and autos. This trend has reflected a confluence of factors, including rapid urbanisation, a growing middle class and an observed shift in spending habits among the young.

Investment Implications

One key risk to the constructive outlook on Asia is a "weaker for longer" growth pulse for developed countries. The beneficial impact on Asian assets' price valuations may be temporarily obfuscated by exogenous forces. Nevertheless, from a strategic perspective, we believe that Asian debt offers attractive risk-adjusted returns for investors looking to diversify into a neighbourhood of relative strength. In the event of an economic shock emanating from the developed world, Asia is well positioned to deploy its financial resources to ring-fence the market contagion.

In Asian FX, we maintain a structural long position, favouring the lower-beta Chinese yuan and Singapore dollar. The role of currency appreciation in bolstering households' purchasing power interweaves with the need to reorient the region's growth strategy. The vulnerability to generalised risk aversion dampens our enthusiasm for higher-beta currencies. Still, we hold a medium-term constructive view on the South Korean won (given sharp gains in manufacturing competitiveness against Japan) and the Indonesian rupiah (given the central bank's move to strengthen the currency in an effort to fight inflation).

An increasingly blurred divide between developed and developing markets underpins Western Asset's conviction to invest in Asian local-currency bonds. In periods of broad market stress, investment-grade government debt stands to benefit from its safe-haven status with domestic investors. We see value in taking strategic exposure to countries with good prospects for rating upgrades, such as Indonesia. While Indonesia bonds are susceptible to a technical pullback due to increased foreign participation, potential demand from crossover investors should ameliorate this risk.

On the hard-currency side, the overhang of new supply is likely to rein in near-term performance. The valuation of high-yield USD-denominated sovereign bonds—those of the Philippines, for example—is comparatively tight, although such bonds have held up well amid external uncertainty. Global investors looking for opportunities to diversify their US-dollar credit exposure can consider scaling into debt issued by quasi-sovereign corporates and banks. Current market conditions create temporary price dislocations that present switch opportunities to select high-grade credits on a cash-credit default swap (CDS) basis.