LION GLOBAL INVESTORS

FOR PROFESSIONAL INVESTORS ONLY

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VIEWPOINT*PLUS*

A brighter future for Asia in 2015

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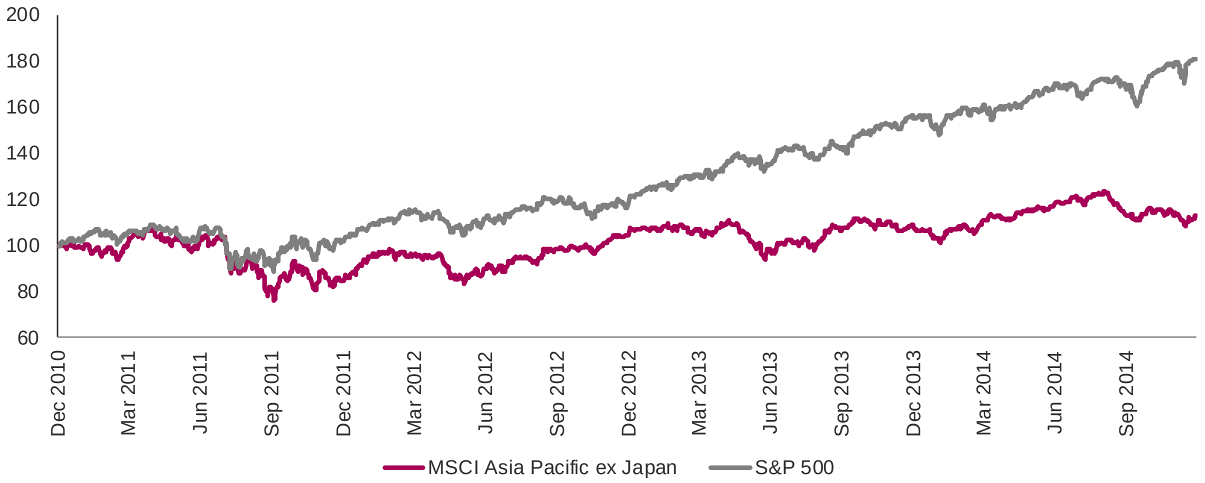
Key points:

- **Asia is in a sweet spot of fundamental catalysts (lower oil prices and structural reforms), mispriced earnings, and a favourable point in the market cycle**
- **Risks come from prolonged oil weakness causing instability in vulnerable economies and companies**
- **The next 12 months will provide an attractive entry point for long-term investors seeking exposure to Asian equities**

Over 2011 to 2014, markets in Asia have lagged the US, with the MSCI Asia Pacific ex Japan return of 13%, lagging the S&P 500 return of 79% (in USD terms) as shown in Chart 1.

Chart 1: Asia lagged the US



Source: Lion Global Investors, Bloomberg

While the three catalysts form a strong basis for Asian equities to rerate, we remain watchful of the risks that could derail the upgrade.

Catalyst 1: lower oil prices

Falling oil prices transfer wealth from oil producers to oil consumers. Oil producers, in particular those with high production costs and stretched reserves, will be most heavily affected. Economies such as Venezuela, Nigeria and Russia fall into this group. Oil consumers, including the United States, the European Union, and Japan stand to benefit from lower oil prices. Asian economies tend to be importers of energy, and lower oil prices will benefit economies including Singapore, Hong Kong, and India, while hurting net energy exporters such as Malaysia.

Consequently, most Asian companies stand to benefit from lower oil prices. Lower input costs should lift profit margins of energy consuming companies, which should translate into higher corporate earnings. On a macro level, Asian economies also benefit from improved trade and fiscal positions.

Behind the weakness in oil is a combination of oversupply and weak demand. Globally, demand for oil remains weak especially in China and Europe, as shown in Table 1.

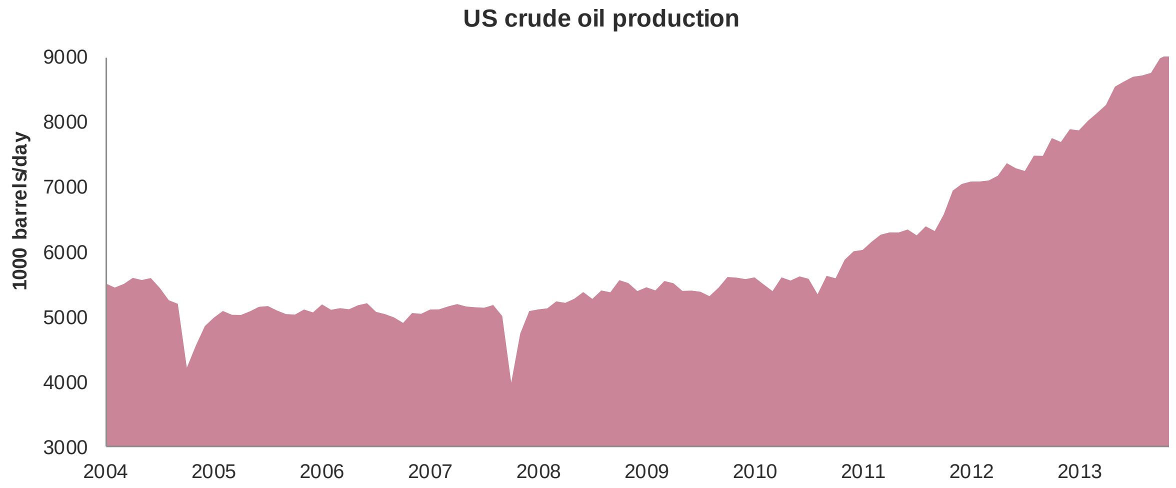
Table 1: Oil demand remains weak

Oil demand (million barrels/day)	2011	2012	2013	2014F
Europe	14.3	13.8	13.6	13.5
China	9.4	9.8	10.1	10.3

Source: Macquarie Capital (USA) IEA, December 2014

On the other hand, the rapid growth of US oil production (Chart 2) and the recovery in oil production from Libya and Iraq have resulted in a supply demand imbalance. Saudi Arabia, the largest producer in OPEC (Organization of the Petroleum Exporting Countries), was able to maintain fairly stable oil prices in the past few years as the swing supplier. However, at its 27 November 2014 meeting, OPEC decided to maintain oil production at 30 million barrels per day as Saudi Arabia sought to maintain its market share and undermine the profitability of US shale producers.

Chart 2: Rise of US oil production



Source: Bloomberg, 31 October 2014

Catalyst 2: structural reforms

The political leadership in Asia's three largest economies – China, India and Indonesia – has embarked on structural reforms to increase competitiveness.

Cutting red tape and simplifying labour regulations will enhance the ease of doing business in India, while faster government decision making and reforms should lead to accelerating growth this year. In China, the deliberate slowdown in growth will lead to more balanced and sustainable growth in the future. Reforms will quicken in SOEs (state owned enterprises) while capacity cuts in upstream industries will eliminate excess capacity. Indonesia has taken advantage of the lower oil price to end fuel subsidies, enabling the government to channel more funds into much-needed infrastructure development.

We are cognisant that reforms in Asia are laborious and setbacks are to be expected. However, we are convinced that these countries are moving in the right direction with their reforms.

Catalyst 3: repressed earnings upgrades

As mentioned previously, US equities have outperformed Asian equities over the past four years. The main reason is the anaemic earnings growth of Asian companies. Despite Asia's stronger GDP (gross domestic product) growth versus the US, earnings growth of Asian listed companies have been lacklustre.

In the long run, earnings growth will mirror GDP growth. Based on yearly earnings growth, MSCI Asia Pacific ex Japan markets grew at a faster pace than the US in 2014 (Chart 3). Market performance in 2014, however, has lagged – the S&P 500 returned 14.2% against the MSCI Asia Pacific ex Japan return of 3.8% in USD terms. In addition, consensus forecasts 8.9% earnings growth this year for Asian markets, which is higher than the 8.1% for US. While Asian earnings have been consistently downgraded in the past four years, we believe the slow earnings growth in 2011 and 2012 are largely over.

Chart 3: Earnings growth in Asia catches up

Source: ThomsonOne Analytics, Lion Global Investors, as at 31 December 2014

Lower oil price, structural reforms and low earnings growth base effect will provide the tailwind needed to propel Asian earnings back into the attention of the market, which would support a sustained rally in Asian equity markets. However, we remain mindful of the risks that could derail a rally in Asian markets.

Risks: what could derail our view on Asia?

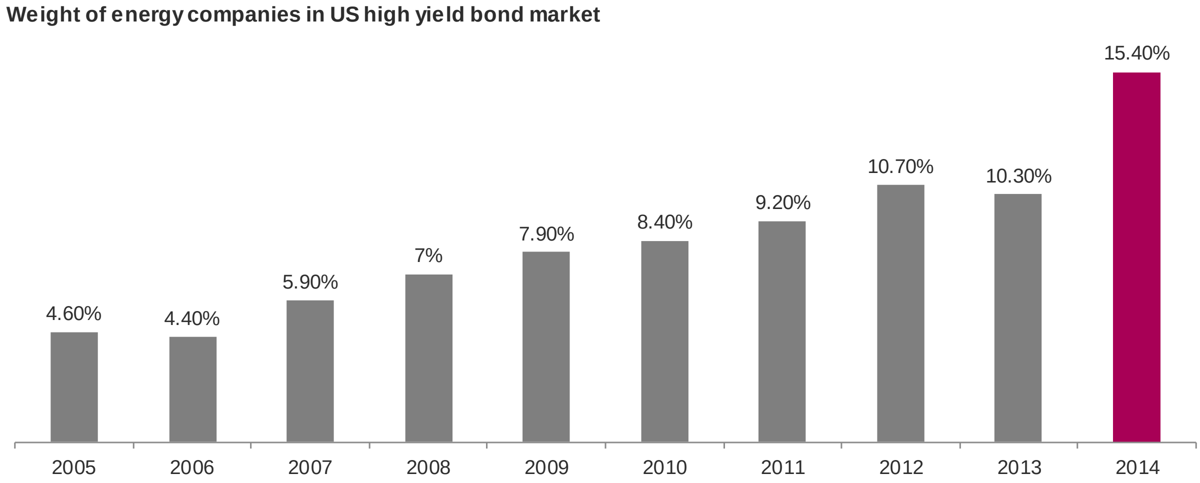
Ironically, a longer and deeper protracted fall in oil prices could be negative for Asian markets. The benefits of low oil prices are felt by consumers across many countries while the pain is concentrated in a few countries. As such, tail risks increase exponentially if oil price stay low for a prolonged period. Among the tail risks, three stand out.

Firstly, while the wealthy core of OPEC membership – Saudi Arabia, Kuwait, Qatar, and the United Arab Emirates – are able to buffer lower oil prices with their hefty reserves, other poorer OPEC members are less likely to be able to weather low oil prices for as long, which could lead to cuts in transfer programs, reduce support from their local populations, and as we've seen in recent years, possible regime change.

Secondly, in Russia, a combination of sustained weak oil prices and sanctions would stress Russian reserves. Already, Russia has spent around US$90 billion of its currency reserves, equivalent to 4.5% of its GDP (gross domestic product), in defence of the ruble. Should financial stress destabilise Russia, this would impact the already weak Eurozone economies and more importantly risk appetite of investors.

Thirdly, prolonged weak oil price could lead to an increase in default among energy and energy-related companies, especially in the US high yield bond markets, where energy companies have increasingly turned to for financing (Chart 4).

Chart 4: Energy companies a rising weight in high-yield debt market



Source: Barclays U.S. Corporate High Yield Bond Index. columns represent year-end values except 2014, which is as of 17 October 2014.

However, the greatest fear is that prolonged oil price decline could precipitate unexpected turmoil or volatility in capital markets due to reduced capital flows to emerging markets. We continue to monitor the situation closely for the emergence of such risks.

Despite the risks, the outlook for Asia remains bright.

Asia's time to shine

From a technical standpoint, markets rarely rally in a straight line, and over five-year periods, the US and Asia have shown a tendency to rally alternately – US equities tend to rally as Asian equities decline, and vice versa.

If history rhymes, Asian equity underperformance over 2011-2014 may be coming to an end and we could expect to see Asian markets outperforming the US in 2015 or 2016 (Table 3).

Table 2: Five-year market returns

Market return	1996-2000	2001-2005	2006-2010	2011-2014
S&P 500	131.8%	2.7%	12.0%	79.1%
MSCI Asia Pacific ex Japan	-24.3%	111.6%	86.7%	13.1%
Outperformer	S&P 500	MSCI Asia Pacific ex Japan	MSCI Asia Pacific ex Japan	S&P 500

Source: Bloomberg, Lion Global Investors, in USD terms dividends reinvested.

Our central scenario is that oil price will remain weak and the recovery would be very gradual but we do not expect to see oil price staying below US$45 per barrel for an extended period of time.

Behind this view is our belief that global growth, while anaemic, will not contract. Oil prices may stay low in the near term due to seasonal demand factors but supply destruction and a recovery in oil demand due to low oil prices will result in oil prices moving away from a prolonged period of weakness.

Asian markets are thus placed in a sweet spot of fundamental catalysts (lower oil prices and structural reforms), mispriced earnings (repressed earnings and potential recovery not reflected in market returns) and a favourable point in the market cycle (over the next five years).

While we do not seek to time the market, we hold that **the next 12 months will provide an attractive entry point for long-term investors seeking exposure to Asian equities**. However, stock picking remains key and Lion Global Investors combines bottom-up stock picking and top-down awareness in delivering long-term market outperformance.

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