

Picking the stars

Among emerging markets in Asia, China and Indonesia are well poised for 2015

BY MARK MATTHEWS

ONE question that I am often asked is if emerging markets or the developed markets in Asia are good to invest in. This question is surprisingly hard to answer, given the great diversity that exists between Asian countries where few commonalities can be found. This diversity is far greater among emerging markets, for example countries such as Saudi Arabia and South Africa which are commodity-based economies, compared with Thailand or even China which are more labour-based markets.

Given this scenario, perhaps a more relevant question should then be: "Which emerging market(s) do you like?"

My short answer would be that China, as well as Indonesia, are both well poised for 2015.

It is commonly believed that GDP (gross domestic product) growth correlates with stock market performance. In the case of China, this is true to a certain extent but an interesting argument to this perceived correlation would be this – if GDP growth is indeed a key determinant of stock market performance, then China's stock market should have been the best in the world since 2009. It is in fact among the worst performing.

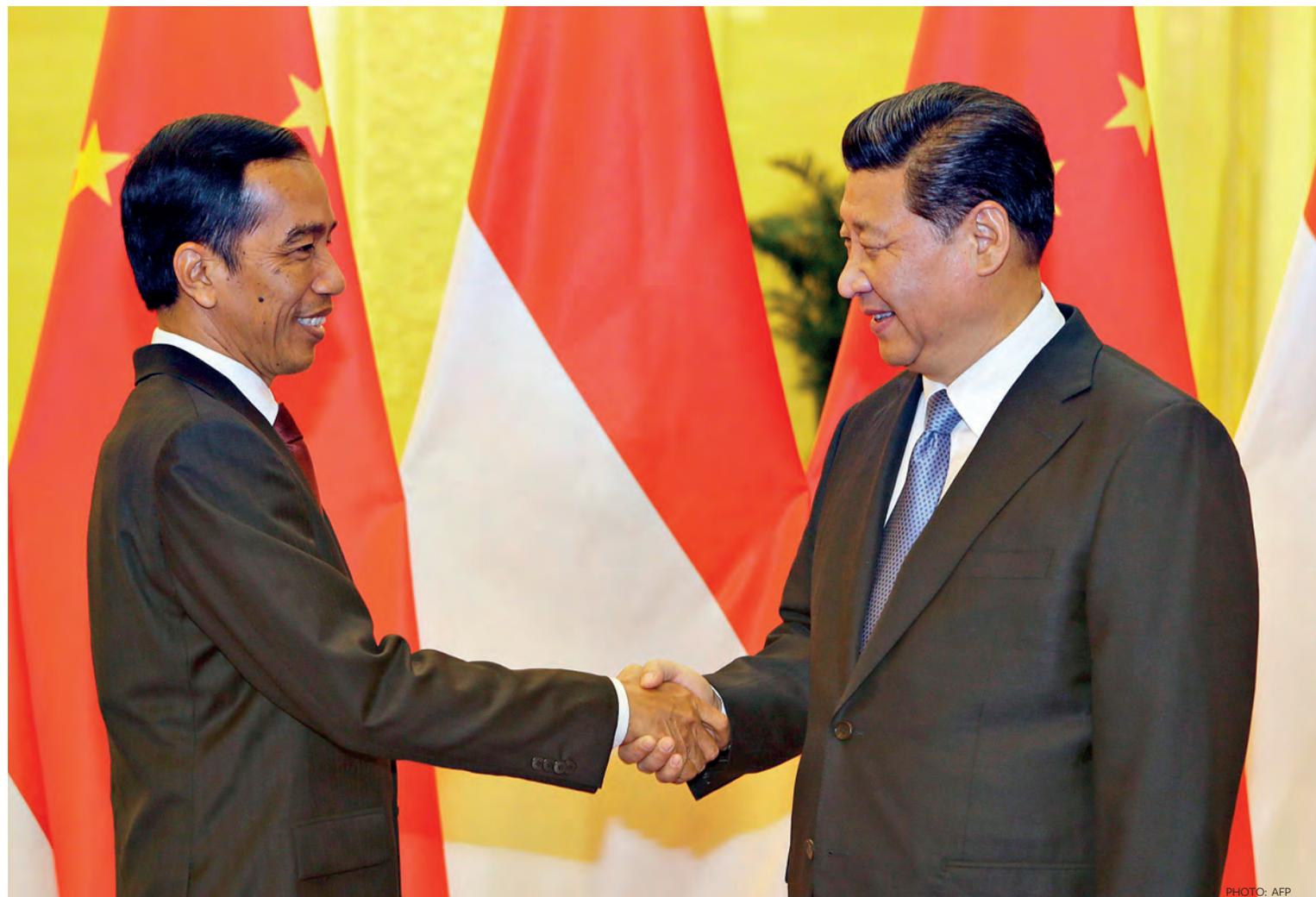
Last year, the Chinese economy showed clear signs of deceleration, and yet the Shanghai Composite Index rose almost 50 per cent. There are several reasons for this, and they all revolve around the country's new leadership.

The Chinese government's crack-down on corruption and focus on "quality over quantity" means that China is on track to become a better-run place, on both governmental and corporate levels.

There is also a clear inverse correlation between corruption and GDP per capita. This holds true for all economies and not just China's. Given China's large population and burgeoning middle class, a less corrupt economy has big implications on the cash flow of companies. And ultimately it is cash flow, and not GDP growth, which drives share prices higher.

Chinese stocks remain cheap at less than 10x price-to-earnings. While local retail investors are noticing the move in the stock market and have started buying Chinese equities, they still only account for a very small percentage of the market's trading volume.

Then there are foreign investors to consider. With over US\$2 trillion funds tracking the MSCI and FTSE, the launch of the Shanghai-Hong Kong Stock Connect programme removes many obstacles that previously prevented A-share inclusion in global indices. At some point, in 2015 or at the latest by 2016, they will need to be included in these indices, which means up



FOR THE BETTER

Indonesia President Joko Widodo (left) with China President Xi Jinping. The Chinese government's crack-down on corruption and focus on 'quality over quantity' means that China is on track to become a better-run place. Indonesia is similarly experiencing a major catalyst for change with the new and ambitious government now in place

to US\$50 billion of passive funds buying into A-shares. One, however, should also not confuse slower growth with zero growth.

In 2009, China's GDP grew by 9.2 per cent, and it added Turkey to its GDP (US\$785 billion). In 2015, China should grow around 7 per cent, but it is adding Indonesia to its GDP (US\$880 billion). That is because the base is much bigger this year than it was in 2009, more economic dollars are produced, even though the growth rate is lower.

Closer to home, Indonesia is similarly experiencing a major catalyst for change with the new and ambitious government now in place. President Joko Widodo's government is working to overcome two key handicaps for the country: infrastructure and government bureaucracy.

Despite his minority government in parliament and strong opposition from members of the establishment which made it look like he lacked the power to do anything, two events that happened in December 2014 seem to have dispelled some naysayers.

The first is an obvious rift in the coun-

try's largest party, the Golkar party, which had never been in opposition prior to the current government. Its absence from incumbency is a major hurdle to Mr Joko. Now, with the party split between reformists and non-reformists, it is likely the reformists will join the government, tipping it into a majority in parliament.

The second, and also the more contentious of the two, is the removal of the petrol subsidy as announced on New Year's Eve. The fuel subsidy which was expected to be 276 trillion rupiah (S\$29.18 billion) in 2015 will be reduced to just 25 trillion rupiah instead. Money allocated to the fuel subsidy can be spent on more productive and long-neglected areas such as healthcare, education and infrastructure instead; with the budget for infrastructure set to double this year over last year.

With Mr Joko's consolidation of political and economic power, we expect that the MSCI Indonesia is due for its next phase of growth. This is consistent with the stock market's good performance last year, outperforming the MSCI World Index after Mr Joko came into power. Taking into ac-

count an equity risk premium which is now near its five-year and 10-year averages, this implies a fairly-valued Indonesian equity market.

That being said, earnings per share (EPS) growth should accelerate from here on out, considering the government benefits from lower energy prices, allowing it the resources to launch infrastructure projects after being budget-positive. In addition, the expansion in money supply is positive for economic growth, corporate profit margins are widening and the country's export industry exposure is tilted towards that of recovering economies (specifically India, Japan and the US).

As Mr Joko is outperforming expectations both politically and fiscally, Indonesia's economy is poised to strengthen this year. The market is cheaper than India and has strong earnings growth potential. The currency may weaken further, but this weakness should be more than offset by capital appreciation in stocks this year. ▣

Mark Matthews is Head Research Asia, Julius Baer