What effect do foreign crises have on SE Asia?

Paul Gambles, Managing Director

The closer you think you are, the less you'll actually see

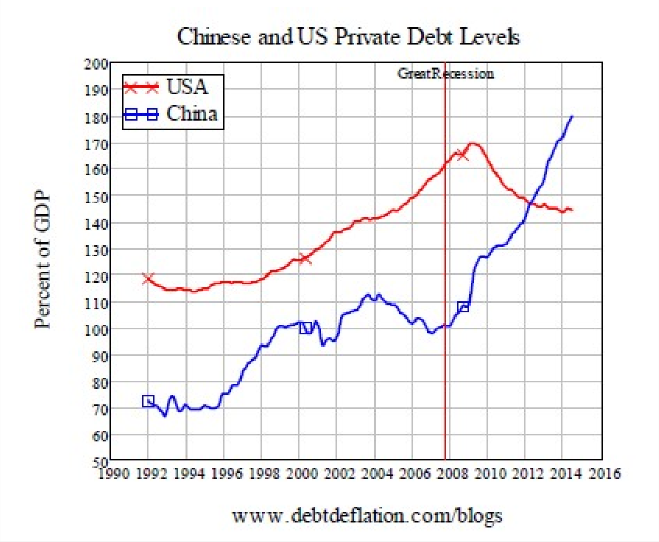
– *Now You See Me, Summit Entertainment (2013)*

By 1911, The Great Lafayette was such a renowned illusionist that when an oriental lantern from the set caught fire during a performance, the audience thought it was part of the act. In fact the fire destroyed the stage and killed Lafayette along with two of his assistants.[1]

In recent weeks, it has seemed to me that an illusionary trick has been taking place. Whilst everyone was concentrating on events in Athens and Frankfurt, the Chinese stock market was crashing before our eyes.

A global shock

For a 3-week period in late June and early July, the Shanghai and Shenzhen stock exchanges plummeted with share values dropping by a third. Whilst few foreign investors were directly exposed to these markets[2] - only 1.5% of Chinese shares are owned by foreigners – it is impacting the global economy. After all, China is the world's second largest economy: some 2¼ times greater than third-placed Japan. Added to that, it's also first-placed USA's main export and import partner, representing 7.6% of America's export market and just under 20% of its imports.[3]



This had been coming: as I pointed out in an Update in June,[4] China has long appeared to be on the way towards Japanese-style debt deflation (see chart), as the

[1] http://www.scotsman.com/news/the-magician-whose-greatest-illusion-was-death-1-465747

[2] http://edition.cnn.com/2015/07/08/asia/china-stocks-explainer/

[3] US Census Bureau

[4] *China flatters to deceive… and it's a worrying deception*, MBMG IA Update, June 2015, http://www.mbmg-investment.com/in-the-media/inthemedia/49

government attempts to artificially boost demand by making borrowing cheaper for the debt-addicted private sector.

In fact, the stock market crash wasn't as rapid as it may have appeared. Between 12th July 2012 and 9th July 2015, the two Chinese markets lost an estimated USD 3.25 trillion in value.[5] Put into context, the Greek state owes international creditors around USD 237 billion[6] - some 12 times less (although of course it's not so much Greece's debt per se that has ever concerned me, so much as the wider ramifications of the failure of the inane self-serving Euro project).

Cede or impose control: it makes little difference

I've felt for a while that ASEAN currencies are susceptible in any kind of global economic, liquidity or capital market crisis; such as those that are very much on the horizon, despite short term attempts to kick cans further down respective roads, in China and Greece.

While a politicians' compromise may have been reached to keep Greece in the Eurozone for now, I wouldn't rule out a return to the Drachma in the not-so-distant future. A full-blown Euro exit would exert further downward pressure on Southeast Asian currencies, as any flight to safety by investors would favour the US Dollar. We appear to have returned to the situation I previously outlined, where the world is in a risk-on pro-Dollar/risk-off pro-Euro *et al* cycle. Beyond this, such discrimination as there is tends to favour those currencies with apparently attractive short-term prospects such as the Sterling, without looking at deeper fundamentals. Maybe the interest-rate-increase corner, into which we expect the Fed to have trapped themselves before the year end, will lead to some reappraisal of this.

In contrast to Greece's total lack of control over economic policy,[7] the Chinese government thinks it's in complete charge. The government has gone all-out to limit the effects of the crash, cutting interest rates, halting scheduled IPOs, threatening to arrest short sellers and allowing speculators use their houses as collateral for marginal loans.[8] Whether this constitutes assistance or interference is a matter of debate. Word is that the government will keep throwing ever more kitchen sinks at the problem until the markets behave more the way it wants them to. However, what Beijing doesn't seem to realise is that even with all that power to control markets, it is merely papering over the cracks. The fundamental problem that many governments – not only China – are failing to recognise is that private debt is so elevated as to pose an impediment to sustainable growth.[9]

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[5] *ibid*

[6] http://www.reuters.com/article/2015/06/28/us-eurozone-greece-debt-factbox-idUSKCN0P80XW2015062

[7] Euro Summit SN 4070/15, 12th July 2015 http://www.telegraph.co.uk/finance/economics/11736779/Greece-is-being-treated-like-a-hostile-occupied-state.html

[8] http://www.forbes.com/sites/jessecolombo/2015/07/19/is-chinas-stock-market-crash-over/

[9] *China flatters to deceive… and it's a worrying deception*, MBMG IA Update, June 2015, http://www.mbmg-investment.com/in-the-media/inthemedia/49

ASEAN currency impact

Against this backdrop, a positive resolution to either or both of the Greek and Chinese issues would be expected to boost pro-cyclical 'risk-on' currencies like the Baht, Rupiah, Peso or Ringgit.

The Thai Baht has suffered disproportionately to most neighbours over varying terms – falling by 14% against the Malay currency from this time last year to April 2015 (see chart); although it bounced strongly off those lows, before giving back most but not all of that bounce. It's also had a rough few weeks against the likes of the Peso as well.

Source: XE.com

Source: XE.com

In Malaysia, specific local factors, such as the recent financial scandal[10] are more likely to generate relative direction versus the Baht; but with Peso and Rupiah it seems that markets are paying greater heed to Thailand's weaker growth outlook.

This is a very short-term perspective – greater current account challenges remain for both the archipelago nations than for Thailand.

Whilst I remain concerned about Thai growth, I can see much better fundamentals here and I think these will have a medium to long-term effect that is more significant than the short-term growth forecast differentials. This is particularly because I feel all three countries may miss their revised official growth targets to the downside, a problem that would have a greater impact on countries where growth is a key determinant in currency valuation.

James Sullivan of Coram remains a believer in the longer term ASEAN growth story and sees ASEAN assets as offering less distorted medium term valuations than in developed economies that are more divorced from fundamental realities: [11]

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[10] http://www.forbes.com/sites/riskmap/2015/07/21/a-scandal-in-malaysia-spurs-credibility-crisis/

[11] All markets are equal, but some markets are more equal than others – Client note by James Sullivan of Coram Asset Management

The vast majority, if not all major stock markets, have been huge beneficiaries of loose monetary policy. Without QE led policy, I have little doubt markets would still be far below their previous peaks.

Three primary reasons have made equities the least worst asset class:–

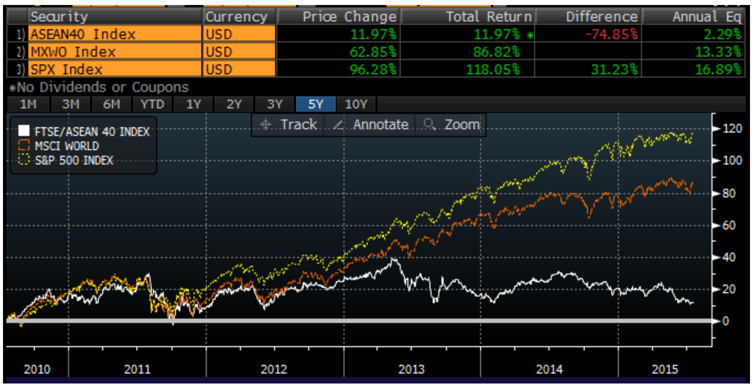
1) Currency debasement has supported corporate earnings

2) Cheap liquidity has been in abundance

3) Negative real rates

…QE has been wide reaching, and reached parts of the market that other policy measures couldn't reach. However, when one observes some of the extremities, there are clear laggards. The Emerging Markets have been left behind, and drilling down, few more so than the Association of South East Asian Nations – the ASEAN region…

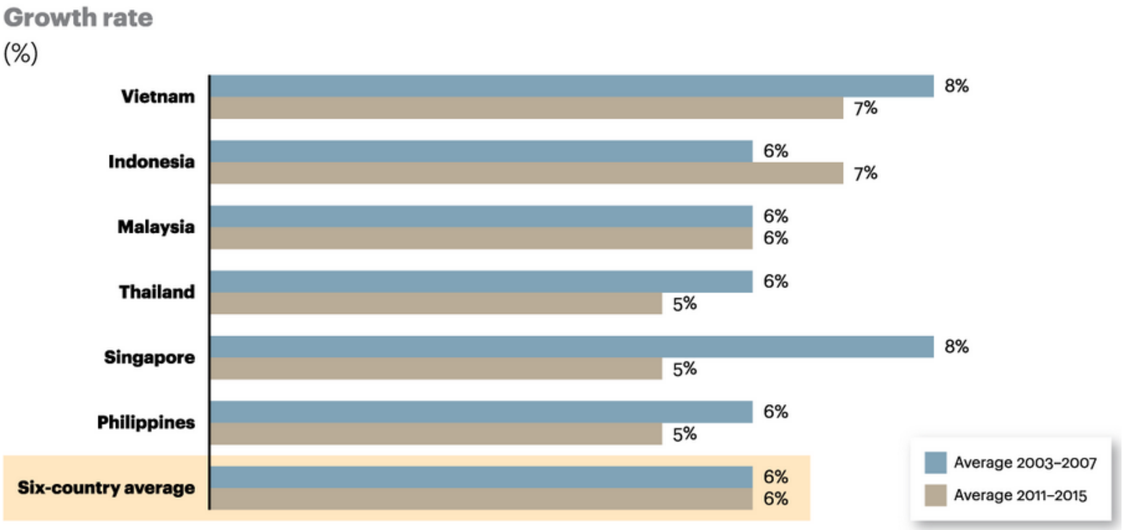
The FTSE ASEAN index is up 12% over 5 years, compared to the MSCI World Index and the S&P which are up 87% and 118% respectively:



Source: Coram Asset Management

Sullivan goes on to summarise the medium term attractions of ASEAN:

The unification of the 10 member states, higher growth rates, a younger population, modest debt to GDP ratios and 'undervalued' currencies all add up to a quite enticing investment opportunity. Not without risk and potential volatility, but with a medium term outlook, it appears to offer something rather exciting. Certainly something different from the rather saturated safe(r) haven developed markets...



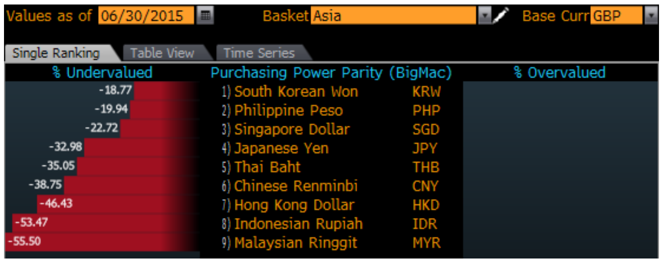
Note: ASEAN is the Association of Southeast Asian Nations; percentages are rounded.
Source: Organisation for Economic Co-operation and Development (OECD) Development Centre's medium-term projection framework in the *Southeast Asian Economic Outlook 2010*

From a UK perspective the relative attractions are apparent, especially as Sullivan shares my views that the UK economy and currency are on very thin ice because of the extreme levels of private debt, the ever more fragile housing bubble and the record current account deficit:

> When we then consider the UK current account deficit is the greatest since records began, surely as part of a multi asset portfolio we should be diversifying our currency exposure also?
>
> ...It isn't without risk - both equity and currency risk is apparent - but when we consider Sterling is a multiyear high (5 plus years) against the Singapore Dollar, the Malaysian Ringgit, the Indonesia Rupiah and strong against the Baht and Peso, the currencies themselves offer something different…However, the consequence of a $9 trillion carry trade unwind...remains the most unpalatable risk.

Sullivan is particularly drawn to my own main proxy for Thai Baht base portfolios, the Singapore Dollar, noting that even by such unscientific metrics as The Economist's *Big Mac Index*[12] (fast becoming the only part of that increasingly political polemic that's worth reading regularly), SGD is 23% undervalued as the following Bloomberg PPP data also highlights:

[12] http://www.economist.com/content/big-mac-index



Source: Coram Asset Management

All this means that, because of exchange rates, there may come an opportunity to buy reasonably-priced Thai assets at an effective discount. That said, I've long felt that the Baht could fall below 36 to the US Dollar in any relatively major global (or China-generated) crisis and below 39 to USD 1 in an extreme case.

Thus, notwithstanding that the Euro has the life expectancy of a pre-Thanksgiving turkey, that Sterling appears to be overvalued against just about anything, that China is likely to weigh around the necks of ASEAN and indeed Asian currencies like a dead albatross and that Baht looks like good medium to long term value relative to Peso, Ringgit & Rupiah, whether there is an attractive general opportunity in Thai assets right now really depends far more on events in Athens and Shanghai than in Bangkok. However conditions still appear to be favourable to more value-driven, opportunistic, absolute return style managers although in Thailand, as indeed elsewhere, they remain a very small minority.

For further information, please contact us by e-mail on info@mbmg-investment.com or call +66 2 665 2536.

Paul Gambles has completed CFA level 1 and is licensed by the SEC as both a Securities Fundamental Investment Analyst and an Investment Planner.