

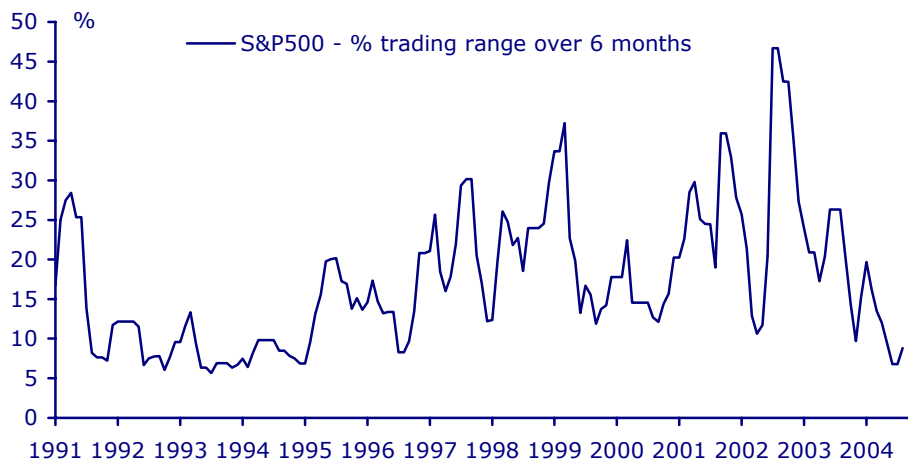
Argy sans bargy

Singapore

Wall Street has of late rallied back into its trading range of recent months. Talk of a break down to the downside has for now been put on hold while hopes are again, naturally, rising of a break out to the upside. As the financial markets head out of the holiday season into the autumn the chances grow of a decisive break one way or another. Still for now the remarkable feature of 2004 is the lack of volatility in the major stock market averages. The S&P500 is seeing the narrowest trading range since 1994 (see Figure 1). The foreign exchange markets have also been dull with the major action being in the bond market. Even then, the 10-year Treasury bond yield began the year at 4.25% and is now only 4.26%. Still a lot of blood and guts has been spewed by leveraged bond investors in the intervening period. Deflationists were blown up in the inflation scare of the second quarter. But bond bears were then caught out by the unexpected slowdown in economic momentum which has occurred so far this quarter.

Figure 1

S&P500 – rolling 6-months % trading range



Note: % from 6-month low to 6-month high. Source: Datastream, CLSA Asia-Pacific Markets

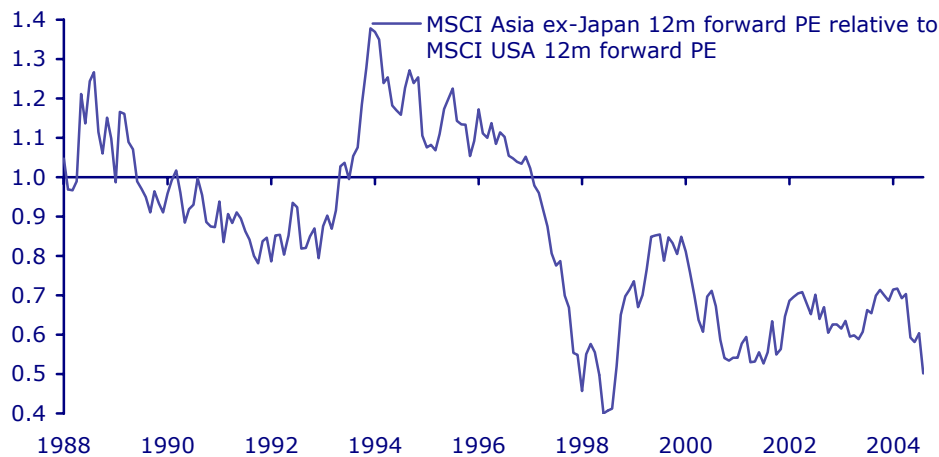
The net result of the above is that there has been no clear trend. For talking heads on the sell side such as *GREED & fear* this pattern has some compensation. For as long as markets remain trendless, no one can be right, and no one can be wrong, and everybody keeps getting paid. But the reality is that, with the explosion in hedge funds, the financial services industry's business model is now geared into volatility. And for hedge funds, trendless markets are very hard places to make money. In this context *GREED & fear* views the recent pattern of market behaviour as a natural corrective process required to purge some of the obvious excesses out of the hedge fund universe. The excesses are there because of the boom in prime broking which has dramatically lowered the barriers of entry into the absolute-return business, a process which will surely lead to a reduction in fees charged as hedge fund returns inevitably disappoint. The hedge fund phenomenon will survive but the best time to start an Asian hedge fund was five, if not ten years ago, when the pioneers had the field to themselves.

Speaking of ten years ago, the fact that the volatility of the S&P500 is the lowest since 1994 is also worth noting since many people this year have been comparing the present monetary tightening cycle with what occurred that year in terms of stock market action. Then the US stock market trod water for 12 months and only began to rally shortly before the end of the tightening cycle while more high beta emerging stocks corrected quite sharply during the course of Fed tightening. Will history repeat itself? *GREED & fear* remains sceptical. The view here is that there are two important differences between then and now. The first is that valuation parameters are very different. Back in 1994 American equities were comparatively

cheap while emerging stocks were comparatively expensive, most particularly Asian ones. At the beginning of 1994, the MSCI EMF index and the MSCI AC Asia ex-Japan index were trading at 21x and 20x 12-month forward earnings respectively, compared with 14x for the MSCI USA index. The second difference is the pace of Federal Reserve tightening. There is clearly a growing desire within the Fed to put monetary policy back on neutral in terms of a more normalised yield. But *GREED & fear* continues to believe that the pace of monetary tightening will run well short of even present reduced expectations. Money markets are still expecting a further 50bps interest rate hike by the end of this year and another 100bps in 2005.

Figure 2

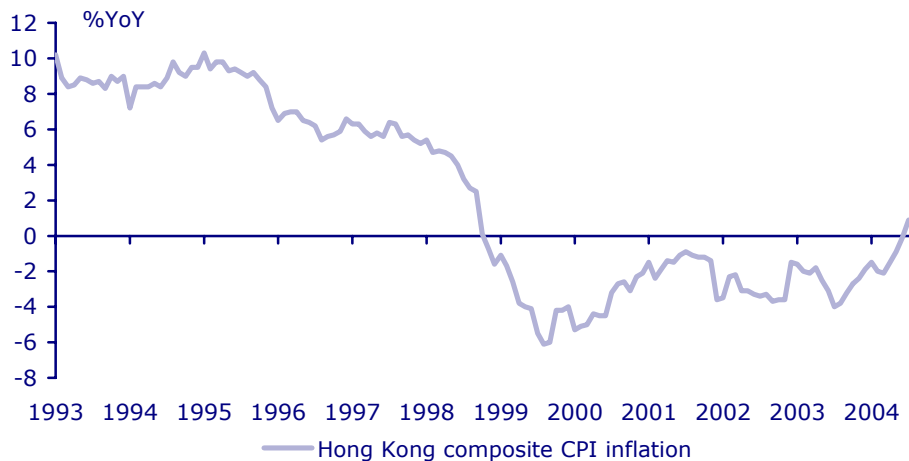
MSCI Asia ex-Japan 12m forward PE relative to MSCI USA



Source: I/B/E/S

Figure 3

Hong Kong composite CPI inflation



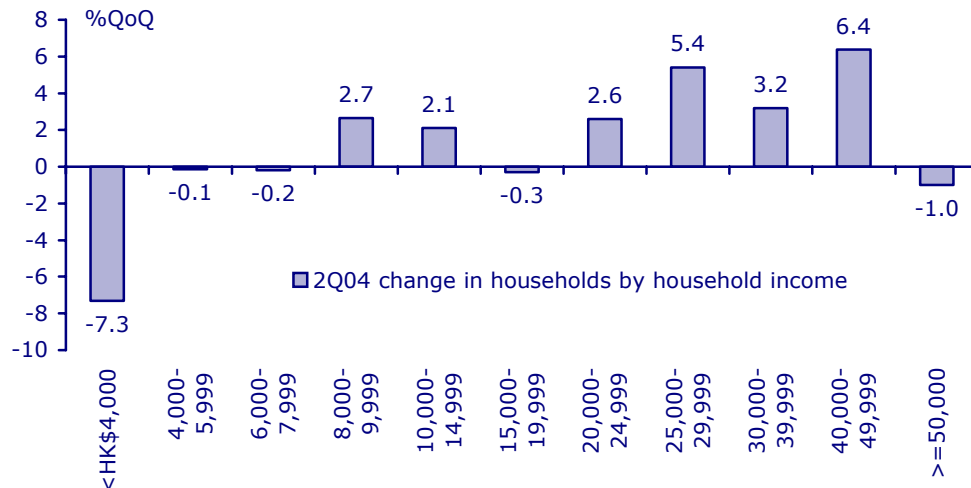
Source: CEIC Data

Within Asia the mood in Hong Kong this week has been buoyed by confirmation that the economy has moved definitively out of deflation. The composite consumer price index rose by 0.9% YoY in July, the first increase since October 1998 (see Figure 3). This was expected but confirmation in the actual data certainly does no harm. The key issue going forward will be the future trend in income growth, which is beginning to look encouraging. Median monthly household income rose by 2.7% QoQ in 2Q04 to HK\$15,400 after staying flat for four consecutive quarters. More encouraging still is that the number of higher income households increased in 2Q04 while the number of low income households decreased (see Figure 4). Also from an employment perspective, Hong Kong is healthier than it appears. True, the unemployment rate is still a high 6.9%. But a significant part of this is structural

unemployment caused by the erection of a welfare state under former Governor Chris Pattern which means that certain sections of the community are better off not working. There are, for example, an estimated 100,000 families living rent free in public housing. A better way to look at the job picture is that a record 3.288m people are now employed in Hong Kong.

Figure 4

Change in number of households by household income

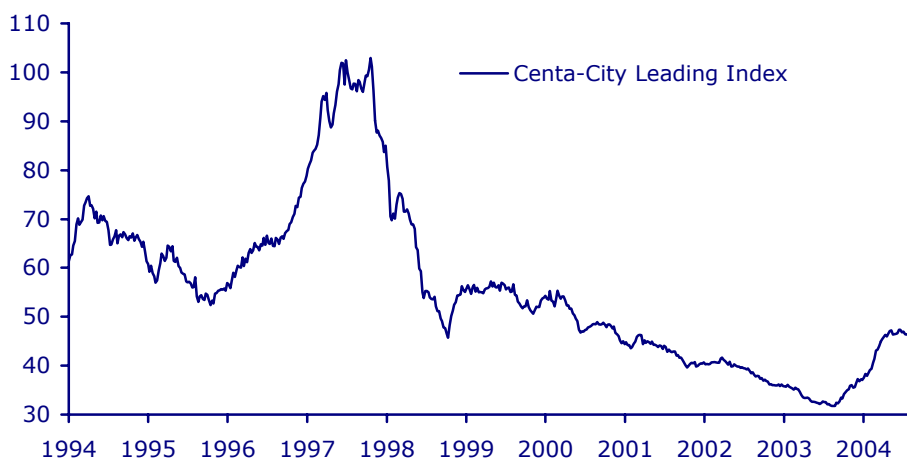


Source: Hong Kong Census and Statistics Department

As for the residential property market, it has been consolidating as expected after the sharp gains seen in 2003 and early 2004. The Centa-City Leading index, which tracks apartment prices in 50 private residential real estates, has fallen by 4.8% since mid-June, after rising 49% from its August 2003 bottom (see Figure 5). *GREED & fear* continues to view this as a healthy pause for breath with a hoped for pick up in the secondary market coming in the fourth quarter. Another point to focus on is the potential for revaluation of Hong Kong property companies' assets when their interim reports are published in coming weeks.

Figure 5

Centa-City Leading Index



Note: Index of 50 residential real estates' prices. Source: Centaline Property Agency

The result is that *GREED & fear* will maintain the overweight on Hong Kong in the relative return portfolio and the holdings in Hong Kong property developers and investors in the thematic absolute-return portfolio. Still, it is important for investors to understand that Fed tightening is a tactical negative for these sectors and indeed Asian asset reflation stocks in general. For such stocks are likely to go nowhere in the short to medium term if the Fed raises

interest rates to the degree still expected by the money markets, however strong the local dynamic. The secular case for Asian asset reflation remains extremely strong. But the tactical view of these stocks must also depend on the view taken on Fed tightening.

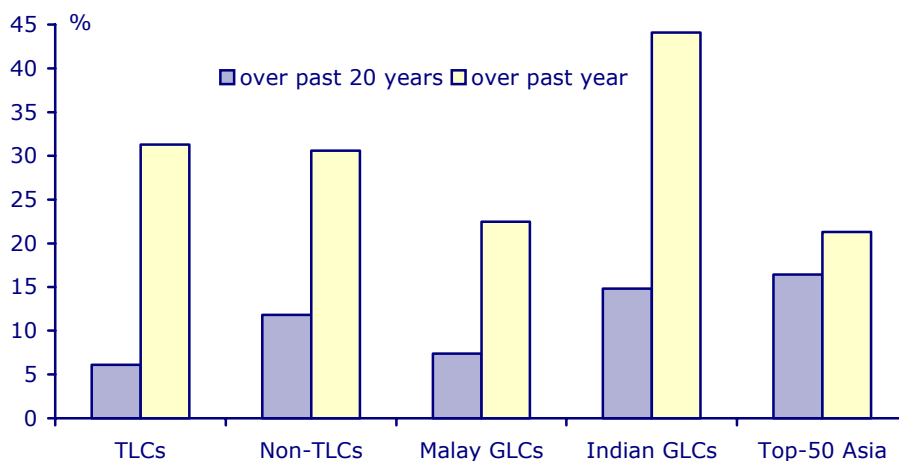
In Singapore briefly this week *GREED & fear* hears that the new prime minister, Lee Hsien Loong, has been doing his best to revive popular sentiment. In his inaugural National Day rally speech made on Sunday, Lee pledged to help low-income households and those hurt by economic restructuring. Thus, one of the new government's main priorities will be job creation and to allow wages and bonuses to rise. There are also practical incentives to procreate, such as longer maternity leave, bigger childcare subsidies and an extension of baby bonuses. To *GREED & fear* all this makes sense. If anyone can move away from some of the more control-freak, authoritarian aspects of the policies of his father, the bizarrely renamed "minister mentor", it is surely his son.

In the meantime, the Singapore stock market continues to offer high dividend yields in a, most likely, appreciating currency and the potential for further ongoing restructuring of the government-linked corporations under the stewardship of Temasek. Many Temasek-linked companies have of late been divesting core assets and distributing special dividends. A new report on this interesting ongoing theme has been published this week by CLSA's Singapore office (*Singapore market – Shareholders return: Focus on TLCs*, August 2004). The key point is that management is now under much greater pressure to focus on shareholder returns. Senior management's pay is now linked to economic value creation with the bonus paid on a rolling three year basis. The result is that the management's interest is linked to a much greater extent than in the past to shareholder interest. This makes it less likely that these companies will in future indulge in value destroying acquisitions. True, both DBS's purchase of Hong Kong's Dao Heng Bank in 2001, and SingTel's purchase of Australia's Optus in 2001, now seem to be working out. But the Singapore companies clearly over paid at the time, probably as a consequence of excessive deference paid to the advice of brand name investment bankers.

The scope for improvement in returns in the TLC sector is clear from the history. The report points out that the share prices of the TLCs have underperformed the top 50 companies in Asia ex-Japan by a very large margin over a long period. The top 50 companies achieved an average annual total shareholder return (TSR) of 16% during the past 20 years whereas TLC companies returned only 6% (see Figure 6). Still the pattern is changing. During the past year the total shareholder returns of the TLCs was 31% compared with a 21% gain for the top 50 Asian companies.

Figure 6

Singapore TLCs' annual total shareholder returns (TSRs)



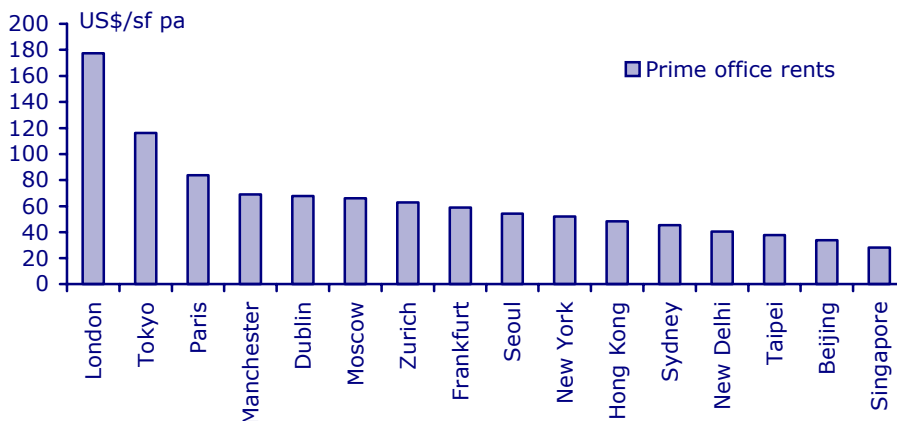
Source: CLSA Asia-Pacific Markets

The other point about these government linked corporations is that many of them are geared into better long term regional growth stories than what is likely to be available in Singapore. That there is a lingering lack of confidence in the island republic is clear from the continuing lack of any recovery in the local residential property market. The problem here remains over supply, compounded by properties being put on the market for sale which had previously been let out. The reason is the lack of any compelling yield. Residential property yields only 3%. Structural concerns remain a high home ownership ratio and the reduced CPF limit in terms of how much a person can borrow from the Central Provident Fund for a property purchase. Indeed the best potential catalyst for the market going forward remains wealthy Indonesians deciding to put to work some of their low yielding US dollar deposits in their offshore accounts.

As for the office market it also remains sluggish. The best story here is that Singapore office space is cheap in absolute terms by global standards. Prime office rent in Singapore is now US\$28/sf per annum, compared with US\$177/sf in London, US\$116/sf in Tokyo, US\$48/sf in Hong Kong and US\$34/sf in Beijing (see Figure 7). But again the upside is limited by pending new supply. *GREED & fear* continues to prefer banks in Singapore where the main driver remains improving asset quality and declining provisions. Still loan growth at 5.8% YoY remains relatively pedestrian, as it does in much of Asia. Asia has a genuine long-term asset reflation story. But it will likely prove a marathon not a sprint.

Figure 7

Prime office rents



Source: CB Richard Ellis - Global Market Rents, August 2004

In Indonesia, the stock market has gone to sleep over the summer amidst depressed trading volumes. Average daily volume is running at only Rp500bn this quarter. If this is in part a regional pattern, it also reflects a certain caution ahead of the second round of the presidential election which is due to be held on 20 September. *GREED & fear* remains of the view that Bambang Yudhoyono is the preferred candidate for the stock market and the economy. Still it has become clear that the race will be closer than previously assumed. President Megawati Sukarnoputri has in recent weeks turned somewhat more pro-active using the power of incumbency to spice up her campaign. An alliance with Golkar has also been formed against Yudhoyono which should help win votes.

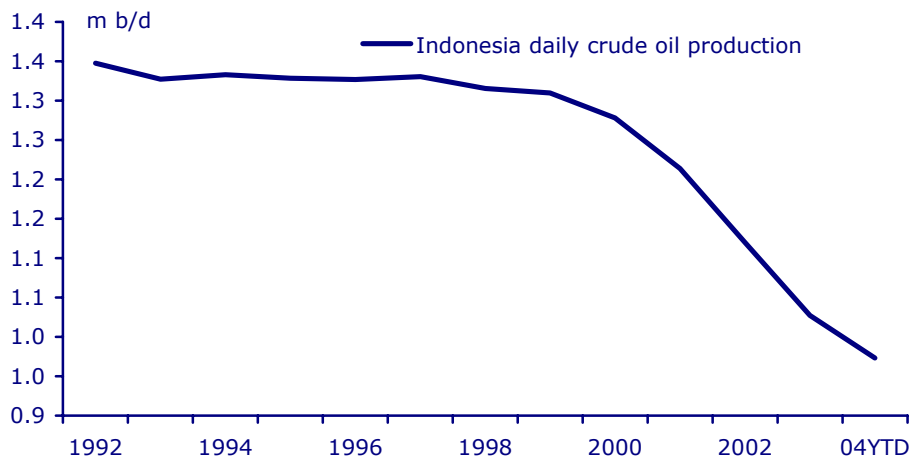
The net result is that the political elite, with a vested interest in business as usual, is seemingly united against Yudhoyono. The potential problem here for Megawati's rival is the power of the Golkar national organization in terms of getting out the vote in Indonesia's rural areas. Still it would seem possible that people could decide to take Golkar's money and still vote for Yudhoyono. For one point is absolutely clear from the first round when Yudhoyono got 33.6% of the vote against Megawati's 26.6% and Golkar's Wiranto 22.2%. That is that Yudhoyono is the preferred choice of the people. This means that if he wins again, with the main political parties

united against him, he will have an overwhelming popular mandate. This, together with the formidable powers of patronage offered by the presidential office, raises at least the potential for much more decisive leadership.

As for Megawati, the silence is golden theme has worked well in recent years when the key pre-requisite was macro-economic stabilization. But that is no longer the case. Interest rates and inflation have stabilised at satisfactory levels and the debt profile of the country has improved dramatically. But Indonesia now badly needs new investment, most particularly in the resource area. For now the most conspicuous form of investment in Jakarta is a boom in apartment buildings, many of them at the luxury end. There has, for example, been almost no oil exploration activity in the country since the Asian Crisis. Average daily crude oil production in Indonesia has fallen from 1.3m barrels in 1997 to 0.97m in the first seven months of this year (see Figure 8). Given the rally in the oil price this year and the potentially alarming fiscal consequences of the fact that Indonesia is on the point of becoming an oil importer; this is a state of affairs that needs urgent attention.

Figure 8

Indonesia daily crude oil production



Source: OPEC

Bidding wars are good for fuelling animal spirits in any market, not least Japan. This must be one way of looking at Sumitomo Mitsui Financial Group's (SMFG) counter bid announced yesterday for UFJ. The government will likely end up siding with Mitsubishi Tokyo Financial Group (MTFG), though MTFG will end up paying more for the privilege of gaining access to UFJ's retail network, which is the strongest in the Kansai region. As for SMFG, it clearly is on the acquisition trial which may imply buying another bank, such as Mizuho. Animal spirits should be bullish. But in this case *GREED & fear* is not so sure. Japanese banks seem to be reverting to their traditional operating procedure, which is to assume that biggest is best. This approach has traditionally not been friendly to shareholders.

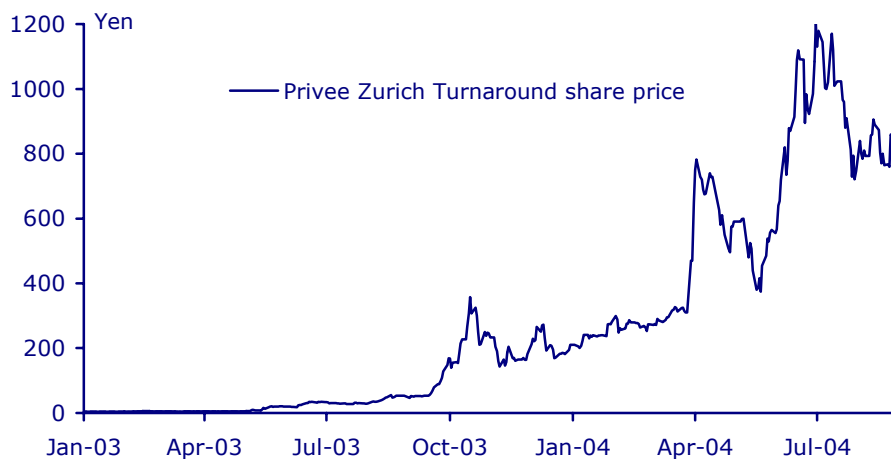
The return of animal spirits to a market also leads to the resurgence of concept stocks. The best example of this in Tokyo during the bull run of the past 18 months has been the splendidly named Privee Zurich Turnaround, a listed company *GREED & fear* only became aware of on a recent trip to Japan. The company's share price has risen a fantastic 213 times since March 2003 and is now trading at a book value of some 250x (see Figure 9). The company has a market capitalisation of US\$2.7bn and is one of the most highly traded stocks in the Japanese market. What is the conceptual appeal? The answer is the application to Japan of a Wall Street concept at a time when "restructuring" is a faddish buzz word in Japan. The proclaimed business model is to acquire troubled Japanese companies, turn them around and eventually realise value through a stock listing.

A recent CLSA research note (*One-on-One – Privee Zurich Turnaround: A bit too clever...*, 19 August 2004) throws, from an analyst's perspective, an understandably sceptical eye on the story. Interestingly Privee Zurich has acquired 35 troubled companies ranging from pet funeral service companies to car deals. But only two of these companies are owned by the listed company with all the others bought by the unlisted parent company. The game plan, according to the report, appears to be to transfer these private companies to the listed entity, thereby allowing an opportunity to "exit at the valuation levels of PZ Turnaround as the 250x book value will be applied to a higher base".

Whatever the end game of this particular venture, such concept stocks thrive on deal flow. This one is no exception. Privee Zurich's share price was ¥771 when the report was published. But it rose to as high as ¥912 this morning with the latest catalyst for the share price yesterday's announcement by the group that it is in talks to buy a 39% stake in Tokyo's venerable Imperial Hotel owned by a company which needs to sell to repay borrowings from UFJ. It is fun times again in Tokyo but it all seems a little premature with the economy, unlike Hong Kong's, still formally in deflation.

Figure 9

Privee Zurich Turnaround share price



Source: Datastream

Additional information is available upon request

©2004 CLSA Asia-Pacific Markets. The information and statistical data herein have been obtained from sources we believe to be reliable but in no way are warranted by us as to accuracy or completeness. We do not undertake to advise you as to any change of our views. This is not a solicitation or any offer to buy or sell. CLSA Asia-Pacific Markets has produced this report for private circulation to professional and institutional clients only. All information and advice is given in good faith but without any warranty. CLSA Asia-Pacific Markets, its affiliates or companies or individuals connected with CLSA Asia-Pacific Markets may have used the information set forth herein before publication and may have positions in, may from time to time purchase or sell or may be materially interested in any of the securities mentioned or related securities. This report is subject to the terms and conditions of use set forth on the www.clsa.com website. MITA (P) No 110/01/2004. V. 040101.

MSCI-sourced information is the exclusive property of Morgan Stanley Capital International Inc. (MSCI). Without prior written permission of reproduced, disseminated or used to create any financial products, including any indices. This information is provided on an "as is" basis. The user assumes the entire risk of any use made of this information. MSCI, its affiliates and any third party involved in, or related to, computing or compiling the information hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to any of this information. Without limiting any of the foregoing, in no event shall MSCI, any of its affiliates or any third party involved in, or related to, computing or compiling the information have any liability for any damages of any kind. MSCI, Morgan Stanley Capital International and the MSCI indexes are services marks of MSCI and its affiliates. The Global Industry Classification Standard (GICS) was developed by and is the exclusive property of Morgan Stanley Capital International Inc. and Standard & Poor's. GICS is a service mark of MSCI and S&P and has been licensed for use by CLSA Asia-Pacific Markets.