8 May 2009

Equity Strategy
Pan-Asia

HSBC
Global Research

AI – Asia Insights

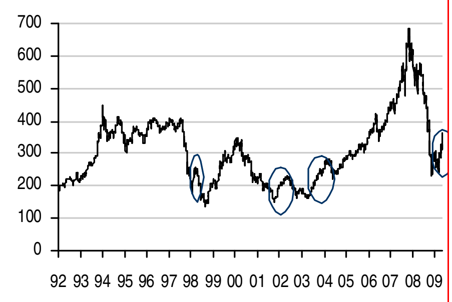
Time for a breather

- **Asia is up 50% from its low in early March**
- **The good news is now largely out and valuations have got a little stretched**
- **We think it likely that the rally is close to petering out**

We have argued since the start of the stock market rally in early March that rebounds in Asia usually take stock prices up about 50% (that is how much they moved in the initial bounces after January 1998, November 2001 and April 2003 – see Chart 1). As of the market close on Wednesday, MSCI Asia ex Japan was up 48.4% from its low on 3 March, and 16% in just the past six days (with Indonesia, Korea and Taiwan up much more than this – see Chart 2). As we write this AI on Thursday afternoon, it seems likely that, after Thursday's action, the index will be up 50% from the low.

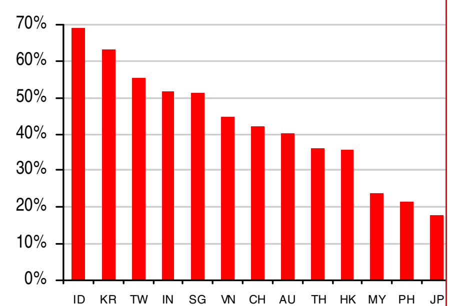
In this AI, we run through a check-list of indicators that can guide investors as to whether the rally is over, for now at least: valuations, analyst behaviour, market leaders and laggards, short-term economic data, investor behaviour. To be honest, we expected to be able to say that it had further to run. But when we look at the data, we have to conclude that most of the good news is now in the price. Valuations are starting to look stretched, foreigners have put USD11bn into Korea, Taiwan and India alone in the past six weeks, analysts have started to revise up their earnings forecasts – and there are the first signs that the rebound in Chinese economic data is running out of steam. We can't see any obvious bad news on the near-term horizon that would cause markets to crash. And, if the newsflow were to continue to improve, they could rise a little further. But the most likely scenario is that markets will drift from here for a few months, before either correcting or picking up momentum again in the autumn (our guess would be the former) depending on how global fundamentals develop.

1. MSCI Asia ex Japan



Source: HSBC, Bloomberg

2. MSCI index changes since 3 March



Source: HSBC, Bloomberg

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HSBC strategy recommendations

Market Recommendations

Market	HSBC recommendation	Last quarter	Rel Perf 3 mnth	End-2009 target	Current index	Change (%)
Japan	Neutral	Neutral	-13.0%	850	847	0.4%
Australia	Neutral	Neutral	10.8%	3,800	3,867	-1.7%
China	Neutral	Over	11.2%	45	50	-9.3%
Korea	Under	Under	9.5%	1,000	1,393	-28.2%
Taiwan	Over	Neutral	34.5%	6,000	6,567	-8.6%
Hong Kong	Neutral	Neutral	14.5%	16,000	16,835	-5.0%
India	Over	Over	15.3%	11,000	11,953	-8.0%
Singapore	Over	Over	17.6%	1,900	2,179	-12.8%
Malaysia	Under	Under	3.1%	800	1,024	-21.9%
Indonesia	Neutral	Neutral	40.6%	1,400	1,798	-22.2%
Thailand	Under	Under	8.3%	400	523	-23.5%
Philippines	Under	Under	-0.1%	1,700	2,206	-22.9%
New Zealand	Under	Under	-9.8%	n.a	1,943	n/a
Pakistan	Under	Under	23.9%	n/a	7,199	n/a
Vietnam	No weight	No weight	11.3%	300	350	-14.3%

Source: HSBC

Sector Recommendations

Sector	HSBC recommendation	Last quarter	Rel Perf 3 mnth	Markets overweight	Markets underweight
Financials	Neutral	Under	4.2%	TW, IN	AU, JP, KR
Industrials	Over	Over	-2.3%	JP	
IT	Neutral	Under	9.3%	TW	
Consumer discretionary	Neutral	Under	7.6%		IN, TW
Materials	Under	Neutral	6.2%		AU, IN, TW
Telecoms	Under	Neutral	-14.4%	KR	CH, IN, TW
Consumer staples	Neutral	Neutral	-10.8%	CH	
Utilities	Under	Neutral	-22.7%	CH	HK, JP
Energy	Over	Over	15.3%	CH, IN	KR, TW
Healthcare	Under	Neutral	-25.1%		IN, JP

Source: HSBC

Asia's Super Ten

Code	Company	Country	Sector	HSBC rating	Upside to target price (%)	Price (local, 5/06/09)	Market cap (USDm)
2409 TT	AU Optronics	Taiwan	Industrials	Overweight (V)	8.0	38 (TWD)	9,748
1800 HK	China Communications Cons	China	Industrials	Overweight (V)	16.2	10.1 (HKD)	17,423
836 HK	China Resources Power	China	Utilities	Overweight (V)	47.2	16.8 (HKD)	9,174
030200 KS	KT Corp	Korea	Telecoms	Overweight	34.8	37450 (KRW)	7,856
2727 HK	Shanghai Electric Group	China	Industrials	Overweight (V)	24.6	3 (HKD)	6,490
SIA SP	Singapore Airlines	Singapore	Industrials	Overweight	17.5	11.7 (SGD)	9,435
386 HK	Sinopec	Hong Kong	Energy	Overweight (V)	8.7	6.4 (HKD)	115,372
SBIN IN	State Bank of India	India	Financials	Overweight (V)	-0.4	1345.2 (INR)	17,323
19 HK	Swire Pacific	Hong Kong	Industrials	Overweight (V)	-7.1	66.8 (HKD)	7,800

Note: Our framework for choosing Asia's Super 10 is detailed in our Asia Insights Quarterly of 6 April. Valuation and risk discussions for these stocks can be found in that report for AU Optronics, China Communications Construction, Shanghai Electric Group, Sinopec, State Bank of India and Swire Pacific; for China Resources Power, KT Corp, Singapore Airlines, please refer to Asia Insights, published 30 April 2009.
Source: HSBC

How to know when it's over

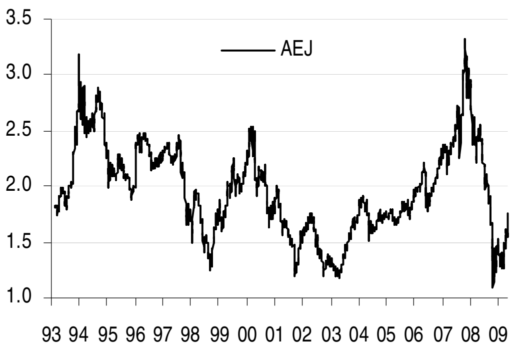
We sat down earlier this week and jotted down the indicators we would look at to tell us the rally was running out of puff. We expected they would tell us that it still had a bit further to go. But on examination – and after the particularly sharp run up in the past few days – many of these signals are now flashing yellow, if not outright red.

Here – in rough descending order of how negative they are for markets – are the indicators we think will help investors decide whether to take profits now, or to keep piling more money into markets for a while longer. We have ticked off those that are pointing to the rally having run too far; a cross means that the indicator suggests it could go further.

Valuations get expensive √√

We have argued for some time that, in this phase of the cycle, price/earnings ratios are not that helpful and that we prefer price/book. (For what it's worth, 12-month forward PE for Asia ex Japan is a rather pricey 15.8x – somewhat above its long-run average of 14.5x.)

3. Price/book ratio, MSCI Asia ex Japan



Source: HSBC, IBES, Datastream

PB for MSCI Asia ex Japan (Chart 3) has risen to 1.8x (after bottoming at 1.1x, a historic low, last October). Is that cheap or expensive? There are three comparisons worth noting: the long-run average PB is 2.0x; the level the market peaked at after the initial rebounds in 2002 and 2004 was 1.7-1.9x; the average PB from 2002-6 (i.e. after the Asia Crisis but before the mini-bubble of 2007) was 1.7x. That suggests to us a fair value level for PB of 1.7-2.0x. At the current level, we are already within that range, and have only 11% upside to hit the top of it.

There are some significant variations between markets. Table 4 shows the current PB and compares it with the long-run average and also the average in 2002-6 (the markets are ranked by the difference between the latter and the current PB). China, Korea and the smaller Asean markets already look more than fully valued compared to history. The markets with the greatest potential upside, such as Japan and Thailand, have significant structural and political concerns that might justify the lower valuation. Australia, Hong Kong, India, Singapore and Malaysia would appear to have further to rise from a valuation viewpoint.

4. Price/book by market

	Current PBR	Long-run average	Diff	2002-6 ave	Diff
Indonesia	3.1	2.9	5%	2.4	29%
Philippines	1.9	1.9	1%	1.6	20%
China	2.2	2.0	6%	1.8	18%
Korea	1.3	1.2	10%	1.3	3%
Taiwan	1.8	2.5	-31%	1.8	-3%
Malaysia	1.7	2.2	-23%	1.8	-9%
Singapore	1.5	1.8	-21%	1.6	-9%
India	2.3	3.0	-23%	2.8	-17%
Hong Kong	1.2	1.6	-26%	1.5	-20%
Australia	1.7	2.5	-31%	2.4	-30%
Japan	1.1	1.7	-37%	1.6	-33%
Thailand	1.4	2.1	-36%	2.2	-37%
Asia Pacific	1.4	1.9	-24%	1.8	-19%
Asia ex Jp	1.8	2.0	-11%	1.7	4%

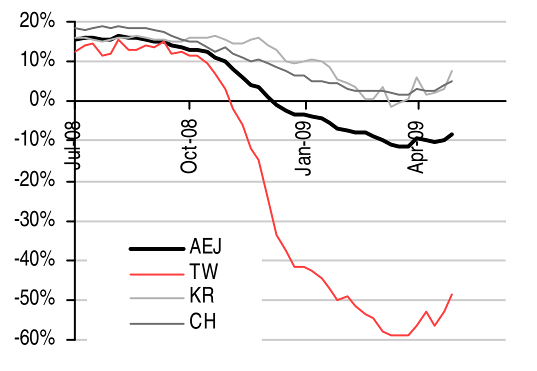
Source: HSBC, IBES, Datastream

Analysts revise up forecasts √

Analysts' forecasts are typically a lagging indicator. We have been arguing for a while that when analysts finally started to get more bullish and revise up their forecasts, it would be a clear sign that all the good news was out. Over the past couple of weeks, they have started to do just that.

Chart 5 shows the IBES consensus forecast for 2009 EPS growth for the MSCI indexes. Having cut the forecast for Asia ex Japan from +15% last October to a low of -11% in mid-March, over the past few weeks analysts have pushed the number back up to -8%. In particular, the forecast for EPS growth in Taiwan has risen to -49% from -59% and in China to +5% from +2%.

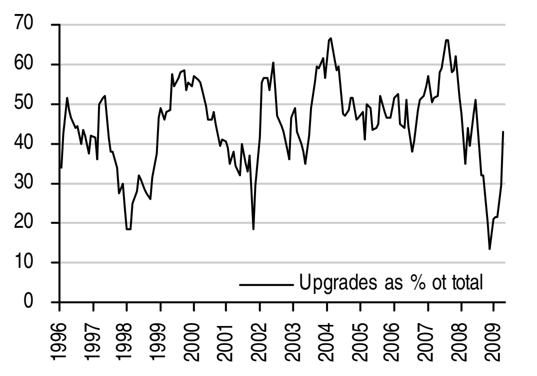
5. Consensus forecast of 2009 EPS growth



Source: HSBC, IBES, Datastream

These are still early days, and there are some markets where the forecasts continue to be cut: in Singapore to -25% from -23% and in India to -1% from +4% over the same period, for instance. But we believe it is significant that the general trend of revisions has turned positive for the first time since summer 2007.

6. Analysts' earnings upgrades as % of all forecast changes

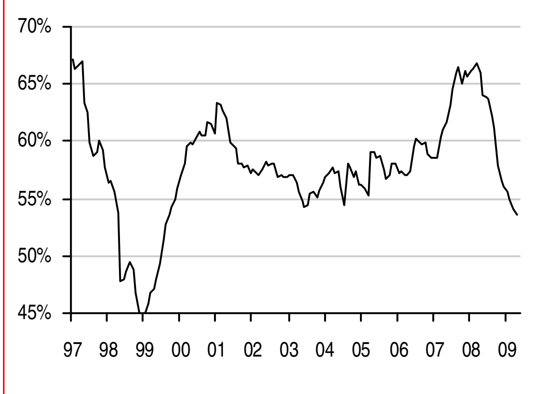


Source: HSBC, IBES, Datastream

We find that the most sensitive indicator of the trend of analysts' forecasts is the ratio of forecast upgrades-to-downgrades (Chart 6). For Asia ex Japan this has jumped from 13:87 in November to 43:57 in April. The precedents from previous market bottoms, for example 1998 or 2001, are that this indicator rapidly rebounds to about 60:40. We would expect that to happen this month or next. When it does, it would suggest that analysts have largely reflected the improvement in economic fundamentals in their numbers.

There is one area where analysts have not yet turned bullish: they have revised up forecasts and raised their target prices, but they have not yet come out with more Buy recommendations. For Asia ex Japan, currently only 54% of analyst ratings are Buys, the lowest level since 1999 (Chart 7). But the evidence of the 2001-4 period is that it took analysts a long time to realise that the bad times were over and that they could use more aggressive assumptions and target multiples for stocks. Only when the market went into a near-bubble phase in 2007 did they rush out a lot more Buys. For the moment, then, a lack of Buy ideas does not necessarily mean that the market has further to rise.

7. Analysts' Buys as % of total ratings



Source: HSBC, Bloomberg, Datastream

Leaders fall, dogs rise √√

Stock market action – in the sense of which sectors and stocks are leading the market up – is harder to generalise about. Typically, as a rally runs out of steam, the blue-chip stocks with compelling valuations that led the early phase of the rally start to sell off as investors take profits in them; the poor-quality, deep-cyclical companies that lagged tend to get bought up as investors get desperate for investment ideas.

That is exactly what has happened over the past few days. The blue-chips which led the rally in late February and March have begun to correct. TSMC (2330 TT, Neutral (V)), for example, rose by 27% between mid-January and mid-March, but has fallen on each of the past three days. Samsung Electronics (005930 KS, n/r) and Hyundai Motor (005380 KS, n/r) rose 26% and 33% respectively in March and early April but have moved sideways since.

By contrast, names that we have proposed as laggards have risen sharply in the past couple of weeks: Shanghai Electric (2727 HK, Overweight (V)) is up 39% and Pacific Basin (2343, Overweight (V)) 36% over the past six days. Even perennial laggard Hutchison (13 HK, Underweight (V)) has risen 20% in those six days.

The other sign that there is perhaps not much further for the market to rise is to look at which stocks remain laggards. We can find only 17 (out of 526) stocks in the MSCI Asia ex Japan universe which have not risen since 3 March (see Table 8). How many of those look like interesting buys now? Except for investors who want to switch back into ultra-defensives, very few in our view. And sectors? The only sectors that have not risen over the past two months are Korean healthcare, Thai telecoms and Philippine telecoms. Any takers there?

8. Stocks that have not risen over past two months

Company	Stock price change since 3 Mar
CHINA HUIYUAN	-38%
HUTCHISON TELECOM	-33%
KT&G CORP	-9%
CLP HLDGS LTD	-6%
HONG KG ELEC	-6%
BHARAT PETROL	-5%
BRIT AMER TOBACC	-4%
PCCW LTD	-3%
HINDUSTAN UNILEV	-3%
CHEUNG KG INFRAS	-3%
CHUNGHWA TELECOM	-2%
UNILEVER IND TBK	-2%
COMFORTDELGRO CO	-1%
LIPPO KARAWACI	-1%
YUHAN CORP	-1%
TOTAL ACCESS COM	-1%
SK TELECOM	-1%

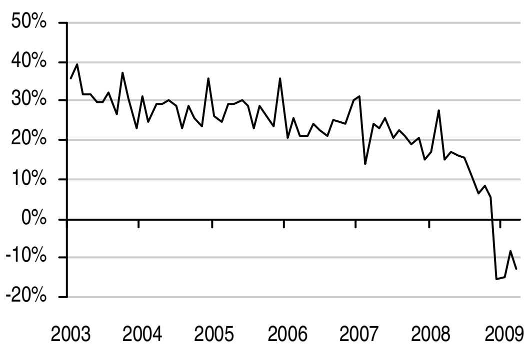
Source: HSBC, MSCI, Bloomberg

Economic numbers start to soften again? √

Since the stock market rally was mainly driven by the "second derivative" of growth – a bottoming-out of economic data such as exports and production, because of inventory rebuilding and fiscal stimulus – we need to be very sensitive to any signs that this is petering out.

China was the first economy to see the numbers pick up, so that is probably the first place to look at to check if they are running out of steam. And indeed, there are the first tiny signs that this is happening.

9. Chinese port throughput (TEUs, y-o-y)

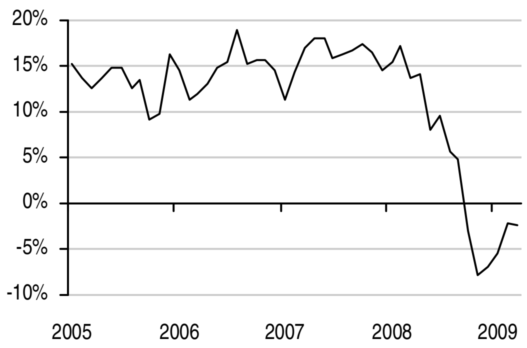


Source: CEIC

Two pieces of data this week showed that y-o-y growth, having picked up in the first quarter, fell back in April. First, our transport team reports that container traffic going through China's ports was down 13% y-o-y in April, worse that the -8% in March (Chart 9).

Second, electricity production, which we have always regarded as a reliable proxy for industrial activity in China, where other data may not be completely reliable. This slowed dramatically during 2008 (Chart 10), but showed signs of bottoming, with the y-o-y growth bottoming at -7.8% in November and recovering to -2.2% in March. But in April, the improvement stopped – although the fall-back, to -2.4%, was not dramatic.

10. Chinese electricity production y-o-y



Source: CEIC

More anecdotally, information from HSBC's trade finance bankers suggests that they, too, saw a decline in demand for letters of credit and other trade finance instruments in April and a pick-up in bad debt risk.

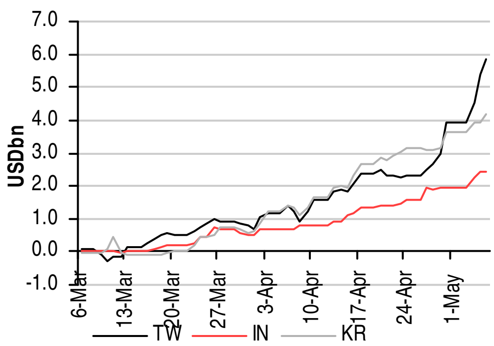
These fragments of data are not enough to say with certitude that the momentum is stuttering, but this is an area to watch carefully.

Everyone is already invested? √

A lot of investors missed the rally, having been very heavily weighted in cash in early March and very overweight defensive sectors. It was not until late March that foreign investors became significant net buyers in Asian stocks (see Chart 11). Indeed, in our view, most of the initial run-up was triggered by domestic institutions in markets such as China, Taiwan and Korea which – from the evidence of our meetings with them in February – turned bullish much earlier than foreigners did.

But over the past few weeks, foreign money has piled back in again: since 20 March, USD5.3bn has gone into Taiwan, USD4.2bn into Korea and USD2.2bn into India. The total inflow into Asia ex Japan (for those markets which report daily flows which, most notably, does not include China or Hong Kong) over that period totals USD12.8bn – in just six weeks. That is not so much when one compares it with the USD91bn that flowed out of Asia between August 2007 and March this year, but in terms of absolute amount it is huge. The USD8.4bn inflow in April, for example, was the second largest month of foreign net buying ever (using data going back to 1996) – the record was USD8.7bn in December 2005. And May – inflow of USD3.1bn in the first six days – is well on track to break the record. Can foreign buying really continue at this pace?

11. Cumulative net foreign buying, past two months



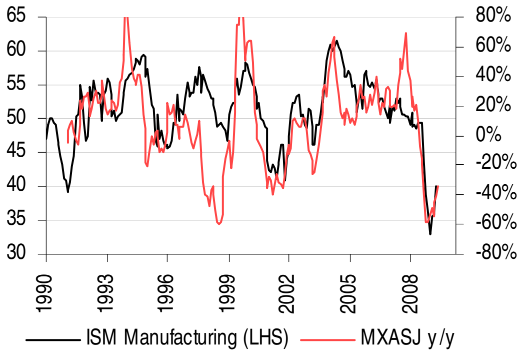
Source: HSBC, Bloomberg

Relationship: equities v economy X

Long-standing readers of AI will know that one of our favourite indicators for forecasting Asian equities is the US manufacturing ISM (Chart 13). The correlation with the y-o-y change in Asia equities has consistently been strong (the only exception was during the Asia Crisis, where other factors drove stock markets in the region). The

May ISM, announced last Friday, showed a modest rebound to 40.1 – still way below the 50 cut-off point, which has generally pointed to Asian equities rising. Has the market, then, overrun the small bottoming out in the indicator?

13. US manufacturing ISM vs MSCI Asia ex Japan (y-o-y)

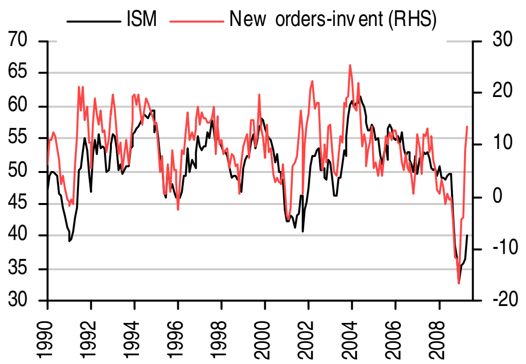


Source: HSBC, Bloomberg

Probably not. Within the ISM, it is well known that dividing the new orders component by inventories gives a good lead indicator of the headline number itself (with a two to three month lead) – see Chart 14. The remarkably strong rebound in new orders over the past couple of months means that this lead indicator is pointing at the headline ISM getting back to around 55 perhaps by the end of the summer.

What does that imply for Asian equities? Judging by the chart, that they will be at +30% y-o-y. Remember, though, that we are comparing not the underlying index but the year-on-year change. That makes it tricky to read: for example, the MSCI Asia ex Japan index will be up 37% y-o-y by November *even if it stays at its current level until then.* What the ISM reaching 55 implies, therefore, is that the index will get back to this level a little more quickly. If the ISM were 55 by September, the index would need to be 20% higher than now – but it would also have to fall back to prevent it from overshooting the ISM.

14. Headline ISM vs. New orders-inventories



Source: HSBC, Bloomberg

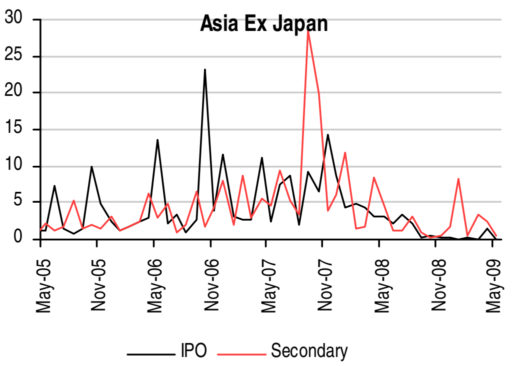
What this says is that the ISM moving above 50 will be in the price by the autumn even if the market doesn't rise any further. But if the ISM rises higher and faster than that, Asian equities could have a further spurt.

New issues suck up liquidity X

It seems that every day there are companies using the better market conditions as a way to raise new equity and lower their gearing. Just this week, there have been issues or placements announced by Li & Fung, Citic Pacific, TCS, Bluescope Steel, China High Speed Transmission and others. Isn't all this issuance – and there is believed to be a lot more in the pipeline, including IPOs postponed over the past couple of years – going to suck up liquidity from the market?

Probably not. Total equity issuance in Asia ex Japan since the start of the year is only USD15bn, compared to about USD24bn in the same period last year (Chart 12). While there is often a lot of new issuance around the time the market peaks – for example in Q4 2007 – there is little evidence that the extra issuance itself causes the market to collapse. There was plenty of issuance, for example, in H2 2006 which the market managed to absorb happily. This is probably not a factor to worry about too much.

12. Total equity issuance (USDbn)



Source: Bloomberg

The newsflow turns negative? X

Markets over the past two months have generally been buoyed by positive newsflow: economic data has improved (Asian export data; US jobs, housing and employment data; PMIs everywhere), US earnings came in better than expected in Q1 (with banks, in particular, turning a profit), and the banking stress-tests were a little tougher than the market expected (but not too tough). More important perhaps has been the lack of bad news: no big bankruptcies, no sovereign defaults, no new banks getting into trouble – even A/H1N1 influenza seems to be turning out less of a concern than initially thought.

For the moment, it is hard to see where the newsflow will turn sharply negative again over the next few months. With the mini-rebound in the economy and the fall in credit spreads, companies and sovereign borrowers in trouble can probably ward off disaster for a little longer. In most countries, data will continue to improve: imagine how easy the year-on-year comparisons for economic series will be by October.

We can imagine a few things that could go wrong.

- Banks are clearly not out of the woods in terms of the write-offs they will have to take (investors who feel themselves getting too bullish are advised to read the IMF's *Global Financial Stability Report*, published last week, which estimates, even taking into account retained earnings over the next two years, that US banks will need to raise between USD275bn and USD500bn in new equity, and European banks, including UK ones, USD600bn-1.2trn). We wonder whether the next earnings season or two (or, rather, the "confession periods" ahead of them, June 10-July 10 or September 10-October 10) might not be vulnerable times if the banks fail to produce the same one-off sources of profits they found in Q1 but still have to make big write-offs.
- Deflation might become a worry, if CPI (and even core CPI) in a number of major economies dips deeply into negative territory. Investors could start to fret about the risk of a debt-deflation spiral. On the other hand, deflation would only add to the pressure on the Fed and other central banks to go through with their commitments to carry out quantitative easing for as long as is necessary, and so might not been seen as entirely negative for equities.

On the whole, though, at least until the end of the summer, it is hard to spot a catalyst that would cause markets to crash again.

We remain of the view, however, that a W-shaped recovery in the global economy is the most likely scenario and that analysts and economists' expectations for growth next year are too high, and that this could cause a correction in Q4 as reality sets in.

The most likely scenario, then, is that markets peak out soon (because of valuations and the good news being price in), have a period of moving sideways, and then fall back towards the end of the year if the economic recovery shows signs of not being sustainable.

HSBC

Disclosure appendix

Analyst certification

The following analyst(s), who is(are) primarily responsible for this report, certifies(y) that the opinion(s) on the subject security(ies) or issuer(s) and any other views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Garry Evans

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For each stock we set a required rate of return calculated from the risk free rate for that stock's domestic, or as appropriate, regional market and the relevant equity risk premium established by our strategy team. The price target for a stock represents the value the analyst expects the stock to reach over our performance horizon. The performance horizon is 12 months. For a stock to be classified as Overweight, the implied return must exceed the required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile*). For a stock to be classified as Underweight, the stock must be expected to underperform its required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile*). Stocks between these bands are classified as Neutral.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

*A stock will be classified as volatile if its historical volatility has exceeded 40%, if the stock has been listed for less than 12 months (unless it is in an industry or sector where volatility is low) or if the analyst expects significant volatility. However, stocks which we do not consider volatile may in fact also behave in such a way. Historical volatility is defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility has to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

Prior to this, from 7 June 2005 HSBC applied a ratings structure which ranked the stocks according to their notional target price vs current market price and then categorised (approximately) the top 40% as Overweight, the next 40% as Neutral and the last 20% as Underweight. The performance horizon is 2 years. The notional target price was defined as the mid-point of the analysts' valuation for a stock.

From 15 November 2004 to 7 June 2005, HSBC carried no ratings and concentrated on long-term thematic reports which identified themes and trends in industries, but did not make a conclusion as to the investment action that potential investors should take.

Prior to 15 November 2004, HSBC's ratings system was based upon a two-stage recommendation structure: a combination of the analysts' view on the stock relative to its sector and the sector call relative to the market, together giving a view on the stock relative to the market. The sector call was the responsibility of the strategy team, set in co-operation with the analysts. For other companies, HSBC showed a recommendation relative to the market. The performance horizon was 6-12 months. The target price was the level the stock should have traded at if the market accepted the analysts' view of the stock.

Rating distribution for long-term investment opportunities

As of 07 May 2009, the distribution of all ratings published is as follows:

Overweight (Buy)	37%	(32% of these provided with Investment Banking Services)
Neutral (Hold)	36%	(31% of these provided with Investment Banking Services)
Underweight (Sell)	27%	(30% of these provided with Investment Banking Services)

Information regarding company share price performance and history of HSBC ratings and price targets in respect of its long-term investment opportunities for the companies the subject of this report,is available from www.hsbcnet.com/research.

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
AU OPTRONICS	2409.TW	38.20	06-May-2009	5, 6, 7
CHINA COMMUNICATIONS CONS	1800.HK	10.36	06-May-2009	4, 6, 7
CHINA RESOURCES POWER	0836.HK	16.78	06-May-2009	4
KT CORP	030200.KS	36750.00	06-May-2009	6, 7
SINGAPORE AIRLINES	SIAL.SI	12.34	06-May-2009	5, 6, 7
SINOPEC	0386.HK	6.44	06-May-2009	2, 4, 5, 6, 7
STATE BANK OF INDIA	SBI.NS	1322.45	06-May-2009	2, 5, 6, 7
SWIRE PACIFIC	0019.HK	67.80	06-May-2009	2, 4, 5, 6, 7, 11

Source: HSBC

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Additional disclosures

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