ASIA’S DEEPENING CAPITAL MARKETS

More Resilient, Less Volatile

By Robert Horrocks, PhD

Nearly 20 years ago, the Asian financial crisis (AFC) exposed flaws in Asia’s economies. Fixed exchange rates, underdeveloped bond markets, inefficient banking systems lending to state-backed industry, and a lack of long-term domestic equity capital forced the most vibrant enterprises to borrow in U.S. dollars. When over-inflated asset prices started to fall, the economic reckoning took the form of a vicious downward spiral. Falling demand and depreciating currencies raised the burden of foreign debts, causing companies to cut labor and capital expenditures, further worsening the weak demand.

Asia has had its fair share of problems to face over the past decade, too: the global financial crisis (GFC), slowing Chinese growth, and weak demand in Japan. A strong U.S. dollar and expectations of rising rates, more recently, have depressed investor sentiment. And yet Asia has been much more resilient than it was in 1997. Why? Reforms were put in place after the crisis, including changes in exchange-rate policy and reduced reliance on the U.S. dollar. Also, capital markets have grown in importance in financing Asia’s growth, resulting in the slow demise of the role of state-sponsored banks. A rising middle class also is demanding more sophisticated savings options to prepare for retirement.

Most investors intellectually recognize that the Asia of today is very different from the one that existed during the AFC. Uncertainty about global monetary policy as well as economic and political concerns have meant continued volatility in Asia’s capital markets. The weaker sentiment has led foreign investors to question the Asian growth story. For long-term investors such as Matthews Asia, none of this is particularly new and much of the discussion so far has lacked nuance and a real understanding of the region. The importance of capital markets in financial stability often is overlooked and is one reason why investors should believe a full-scale rerun of the events of 1997 related to the currency crisis is becoming increasingly unlikely.

Some asset managers like to point to more fortified government balance sheets as a key sign that Asia has rectified its woes. Public balance sheets have received much attention, but progress on the private side often is overlooked. We argue that by embracing globalization and free-market systems, Asia has demonstrated itself to be the world’s most dynamic growth region during the past 20 years. By creating a broad base of growth in terms of economics, productivity, wealth generation, and in financial markets, this region was the fastest to recover from the GFC.

We once had a Hong Kong investor liken Asia’s capital markets to “breaking waves”—their rhythms are often violent but ultimately they make a steady progression up the shore. It has often been noted that investors tend to play these short-term rhythms in Asia. But much of this is interim noise and misses the most important element. Inevitably the tide continues to move in.

Momentum Builds in Broad and Deepening Markets

We generalize Asia by using the term “region,” but in doing so, we remind investors that Asia comprises a vast blend of economies, cultures, and financial markets in various stages of development. Hong Kong, Singapore, Japan—and Australia, for that matter—are home to some of the most sophisticated markets in the world, but other markets are in relative infancy. The prevalence of socialism in markets such as Vietnam, India, and China has drastically slowed the pace of private-sector and capital-market development in those countries. In some frontier markets, political unrest has further stalled development. Sri Lanka’s stock exchange was established in 1985 but has drawn investors’ interest only since the resolution of the civil war in 2009. Furthermore, Myanmar anticipates opening its stock exchange in October 2015.

Even in markets that are considered quite sophisticated, certain financial products are new. Korea essentially did not offer open-end mutual funds until banks started to distribute them in the early 2000s. In Japan, where retirement savings vehicles are widely established, variable annuities have been available to investors for barely more than a decade.

Increased demand for insurance products and pension funds indicates the need for securities that combine a healthy return with a measure of security to cover long-term liabilities for institutions. As the region’s middle class grows and personal wealth continues to rise, we expect that individuals with more money in their bank accounts will need additional investment alternatives. Maturation of markets and financial innovation are gathering pace in Asia, particularly for this generation of investors. In a way it is reminiscent of the growth spurt that took place in U.S. financial markets between the late 1970s and the 1990s.
For Asia’s growth to be sustainable, emerging/entrepreneurial companies that drive innovation must have wider access to capital. We already have witnessed an expansion in private equity. The formation of modern, efficient equity and debt markets in Asia is critical to companies seeking capital as well as investors. Financial market integration, trading technologies, and currency internationalization all may serve to deepen the domestic investor base and the markets’ ability to withstand volatility, which may create a virtuous cycle for both domestic and foreign investors (see figure 1).

Much work remains to be done for some of these markets. More transparent, efficient, and free-floating markets may better support the next wave of investors in the short term as well as the next generation with increasingly sophisticated products.

The Old Banking Model Faces Competition
Tradition still co-exists with transformation in Asia and the world of Asian finance is no exception. But Asia no longer is driven by conglomerates that are tied closely to the state. Today, privately run family businesses that wield tremendous power often are considered laggards in efficiency, innovation, and corporate governance. Ironically, as these business practices are being rendered obsolete, banks still tend to favor them.

Generally speaking, banking has been a quasi-governmental operation in Asia, particularly in China where policy has determined which sectors receive capital. In an environment of government-imposed tighter credit measures, smaller, more-entrepreneurial companies have found it challenging to obtain loans through formal channels. Financing alternatives are increasing throughout the region for companies in various stages of development. This should provide new access to capital for smaller firms that have been underserved by the banks.

Massive Influx into Private Equity
Private equity has been an option for new sources of financing for some firms in the early stages of development. After gathering steam in the late 1990s, early dealmakers waded through massive regulatory restrictions as well as cultural/language barriers that often ended in poorly matched deals or failed takeovers. The landscape today looks quite different, particularly in China where hostile takeovers are illegal, and dealmakers seem more tantalized by well-run companies that have the potential for initial public offerings (IPOs). Today’s deals are largely raised in renminbi and increasingly are completed by domestic firms. More deals are being generated domestically in China and the investor base also is growing from within. Insurance companies now can invest as much as 10 percent of their portfolios in private equity (Sheng and Jao 2013). High-net-worth individuals are looking for avenues to invest their increasing wealth. China has a reported 1.05 million millionaires, more than half of whom are between the ages of 31 and 45 (The Chinese Millionaire Wealth Report 2013, 6). Like much of the rest of Asia, China is a funding source for international private equity funds as well as a destination for those investments.

As of December 2013, China’s private equity funds accounted for nearly 15 percent of the US$2 trillion in global private equity funds (Fung Global Institute 2013). This strong demand raises the obvious question as to whether too many funds are chasing too few compelling deals. In today’s expanding equity markets, investors may benefit just as much by taking public-equity

Figure 1: Sequencing toward a Globally Formidable Reserve Currency

Even in the face of great rebalancing, China has become the largest trading nation in the world with US$4 trillion in currency reserves and it is no surprise that there is a growing call for internationalization of the currency. The World Bank expects China will have the world’s largest economy sometime between 2025 and 2030 (Kuijs 2009, 1). But whether or not this actually comes to pass, we can expect the addressability of all of China’s markets to grow exponentially over the coming decade. If the past five years are any indication, we may get there faster than people believe.

<table>
<thead>
<tr>
<th>Interest Rate Liberalization</th>
<th>Currency Internationalization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Managed interest rates have benefited state-run investment projects but penalized savers and private borrowers.</td>
<td>China’s former Premier Wen Jiabao’s call to offset possible dollar devaluations in 2009 appears to have marked the turning point (Lowe 2011).</td>
</tr>
<tr>
<td>Liberalization should lead to a convergence of loan rates across public and private sectors. Increased funding costs likely will mean better risk analysis and tighter lending practices.</td>
<td>Increased coordination with Hong Kong and trading hubs being established there as well as in Singapore, Taipei, and now Europe/United Kingdom are unfolding very quickly.</td>
</tr>
<tr>
<td>Domestically, this highlights the government’s objective to shift the growth drivers away from government-sponsored projects and toward private consumption. This is an important prerequisite toward renminbi (RMB) internationalization, because it will force the banks to become more competitive.</td>
<td>Currency-swap agreements with major trading partners have served to promote the RMB in cross-border trade. Twenty-four agreements have been negotiated since 2009 (Liao and McDowell 2012, 1).</td>
</tr>
<tr>
<td>Would anyone have expected all this movement 10 years ago? We ask, what will the next 10 years bring?</td>
<td>The RMB displaced the euro by October 2013 as the second-most-used world currency for trade finance (SWIFT 2013).</td>
</tr>
<tr>
<td>The recently announced Asian Infrastructure Investment Bank aims to rival lending capabilities of the World Bank, the International Monetary Fund, and the Asian Development Bank (Pesek 2014).</td>
<td></td>
</tr>
</tbody>
</table>
market exposure without being subject to the illiquidity and higher fees associated with private equity.

**Equities: IPOs Indicate Deepening Markets**

Equity markets may be another way to escape overdependence on banks for capital and avoid high funding costs that inadvertently discriminate against smaller companies. They also represent a low-cost, highly liquid diversification opportunity for investors.

The equity markets in Asia-Pacific are valued at US$18.3 trillion. China, Japan, and India make up the world’s second-, third-, and fourth-largest economies, respectively, and they have market capitalizations (of their top exchanges) of more than US$9.4 trillion. In total, Asia represents approximately 29 percent of the world’s free-floating market capitalization, up from 18 percent 15 years ago. Some of this growth has been due to privatization as governments seek to create more-capitalistic markets, but the bulk has been due to corporate IPO activity (see figure 2). New issues comprised a large percentage of market-capitalization increases throughout much of Asia-Pacific over the past decade. In both China and Hong Kong, IPOs have comprised about 45 percent of the growth in market cap. This is notably higher than the U.S. share of IPO activity that has contributed to 15 percent of its market growth over the same time period and is arguably another indication that the pace of recovery in Asia’s stock markets was the world’s fastest emerging from the GFC.

Interest in these markets is rising, both from foreign investors as well as from foreign institutions that seek to list on Asia’s regional exchanges. Larger trading volumes, higher liquidity, and ongoing market liberalization have prompted both regional and foreign firms to seek funding in Asia. Just three years ago, nearly half the investment flows and half the new companies going public in Asia-Pacific were Western-based (Shirakawa 2012). Investors may have been starting to see that they could attain affordable listings without compromising regulatory and accounting standards. Listing activity and foreign investment has cooled somewhat since then, but the infrastructure continues to be developed. We believe that a good litmus test for a vibrant equity market is whether entrepreneurs look to Asia as one of the first, rather than the last, places to raise capital.

**Asian Fixed Income: A Shifting Blend from Sovereigns to Corporates**

The growth of Asia’s local currency (LCY) bond markets is one of the region’s most important and remarkable economic developments over the past decade (see figure 3). At the time of the currency crisis of 1997, Asian countries accounted for only 11 percent of the total corporate bond issuances. By the end of 2013, they accounted for three times that number—36.3 percent of total global (corporate) issuance. The pace of that growth has been very strong, particularly in emerging East Asia where the absolute dollar value in regional local currency bonds has doubled since the GFC to US$7.4 trillion by the end of 2013. In today’s market environment, this kind of
Asia’s development of healthy local bond markets is significant. It means a government can tap into its domestic savings pool and borrow in its own legal tender instead of borrowing in a foreign currency, making it subject to the volatility of that currency. For large corporations, it means an alternative to banks for financing—companies can go directly to the investing public and institutions to obtain capital at more-competitive prices. From an investor’s perspective, bonds provide another investment vehicle for diversification and the opportunity for retail investors to get a better rate on their savings. For large institutions—pension funds, insurers, and banks—the bond market may provide long-dated maturities that enable them to better match assets to liabilities, with diversified investment opportunities that mirror their liabilities. For banks, the issuance of bonds provides an alternative funding source to bank deposits.

One indicator of a bond market’s stage of development is its size as a percentage of GDP. Based on this measure, South Korea (135.2 percent), Malaysia (105.7 percent), Singapore (85 percent), and Thailand (72.6 percent) rank among the world’s more-developed local bond markets. China, on the other hand, maintains a relatively low LCY bond market-to-GDP ratio of 47.4 percent. In terms of absolute size, however, China dominates the region, accounting for about 60 percent or approximately US$4.5 trillion of local currency bonds (including sovereigns and corporates), approximately 31 percent of which is local currency corporate bonds (Asian Bond Monitor, March 2014).

In countries with liberalized capital markets, the percentage of foreign holdings has increased dramatically over the past decade. In fixed income, foreigners continue to place a majority of their holdings in government bonds given the disparity in liquidity and transparency between public and private sector bonds.

About 60 percent of Asia’s local currency bonds are issued by government entities and the remaining 40 percent by large corporations (Asian Bond Monitor, March 2014). Most locally denominated government bonds are more liquid than corporate bonds, which, because of the lack of secondary markets, tend to be more buy-and-hold. We expect technology transparency improvements and increased financial market integration, particularly out of the Association of Southeast Asian Nations (ASEAN), to promote secondary market activity, reinforcing the momentum of growth toward further corporate issues.

Start of a Virtuous Cycle

So what other elements still need to fall into place so that the providers of capital and the seekers of capital can gain comfort, thereby creating a virtuous cycle of liquidity in this most dynamic of regions? In the past, Asia’s stock markets have been small and thus vulnerable to economic or financial shocks. The lack of bond markets exacerbated the problem. When stocks fall into decline, bond markets provide an alternative source of liquidity for investors and companies—but in Asia both markets have been shallow, and thus vulnerable to external shocks.

The informal systems of yesterday are being replaced by formal frameworks, providing for efficiency and fairness in the markets: Law and regulation, consistency of accounting standards, transparency, accountability, and effective governance all contribute to maturation of these markets. Disparities among different countries clearly still exist and much work remains to be done in Asia’s frontier markets, for instance. But we point to various efforts including the ASEAN Economic Community’s plan to promote the free flow of capital across the region and the recently announced “Shanghai-Hong Kong Stock Connect,” which will provide for mutual market access between China and Hong Kong, as evidence that tremendous strides in financial market integration are taking place.

Additionally, the internationalization of China’s currency, the renminbi, is happening at a faster pace than many have expected. The GFC set off a tide of speculation over the need for an additional international reserve currency and it has not taken long for the renminbi to become the world’s second-most-frequently used currency for trade finance. Clearly, this supports the region’s markets.

Asia’s stock markets are infamous for their pronounced volatility, which has been an

Figure 4: Volatility in Asia Falling Relative to Volatility in United States

Note: Represents the difference between volatility on the MSCI AC Asia ex Japan Index and the S&P 500 Index. Volatility is annualized, based on trailing three years of monthly observations of total returns. Volatility for MSCI AC Asia ex Japan index is based on returns specified in USD terms.

Sources: Bloomberg, MICM
impediment to long-term investment in the region. But statistical measurements of volatility suggest that Asia's markets are less prone to sharp fluctuations than they were even two decades ago. In measuring trailing three-year standard deviation differences between the MSCI AC Asia ex Japan and the Standard & Poor's indexes, we have not seen a clear trend downward since the AFC (see figure 4). But the continued trend down since the GFC is a clear indication of the markets' understanding that the cause of the crisis did not stem from Asia. Relative market volatility continues to decline. Now that Asia's capital markets are becoming deeper, more liquid, and more diversified, they very well may become subject to less volatility.

Broad and consistent local participation may provide a flood of capital, leaving markets less vulnerable to the herd mentality of foreign investors. Foreign investors still will be subject to currency and interest-rate shifts, but they should take comfort in the better shock absorbers in these markets. This groundswell is being driven in the better shock absorbers in these markets. This groundswell is being driven in the better shock absorbers in these markets. This groundswell is being driven in the better shock absorbers in these markets. This groundswell is being driven in the better shock absorbers in these markets.

Of course there will always be volatility in stock prices, but we expect the frequency and magnitude of external shocks to decline with the deepening capital markets. And we believe, inevitably, the tide will continue to move in.

Robert Horrocks, PhD, is chief investment officer with Matthews Asia. He earned a PhD in Chinese economic history from Leeds University in the United Kingdom. Contact him at info@matthewsasia.com.

Endnotes
2. Bloomberg, data based on global bond issuance by country of domicile for both government and corporate securities. Compared to bond issuance for Korea, Japan, India, Malaysia, Australia, China, Hong Kong, Taiwan, Singapore, Philips, Indonesia, Sri Lanka, Vietnam, Kazakhstan, Pakistan, Kyrgyzstan, Bangladesh, and Papua New Guinea, by country of domicile for both government and corporate securities. Compared to bond issuance for Korea, Japan, India, Malaysia, Australia, China, Hong Kong, Taiwan, Singapore, Philips, Indonesia, Sri Lanka, Vietnam, Kazakhstan, Pakistan, Kyrgyzstan, Bangladesh, and Papua New Guinea, by country of domicile for both government and corporate securities. Compared to bond issuance for Korea, Japan, India, Malaysia, Australia, China, Hong Kong, Taiwan, Singapore, Philips, Indonesia, Sri Lanka, Vietnam, Kazakhstan, Pakistan, Kyrgyzstan, Bangladesh, and Papua New Guinea, by country of domicile for both government and corporate securities. Compared to bond issuance for Korea, Japan, India, Malaysia, Australia, China, Hong Kong, Taiwan, Singapore, Philips, Indonesia, Sri Lanka, Vietnam, Kazakhstan, Pakistan, Kyrgyzstan, Bangladesh, and Papua New Guinea, by country of domicile for both government and corporate securities. Compared to bond issuance for Korea, Japan, India, Malaysia, Australia, China, Hong Kong, Taiwan, Singapore, Philips, Indonesia, Sri Lanka, Vietnam, Kazakhstan, Pakistan, Kyrgyzstan, Bangladesh, and Papua New Guinea, by country of domicile for both government and corporate securities. Compared to bond issuance for Korea, Japan, India, Malaysia, Australia, China, Hong Kong, Taiwan, Singapore, Philips, Indonesia, Sri Lanka, Vietnam, Kazakhstan, Pakistan, Kyrgyzstan, Bangladesh, and Papua New Guinea, by country of domicile for both government and corporate securities. Compared to bond issuance for Korea, Japan, India, Malaysia, Australia, China, Hong Kong, Taiwan, Singapore, Philips, Indonesia, Sri Lanka, Vietnam, Kazakhstan, Pakistan, Kyrgyzstan, Bangladesh, and Papua New Guinea, by country of domicile for both government and corporate securities. Compared to bond issuance for Korea, Japan, India, Malaysia, Australia, China, Hong Kong, Taiwan, Singapore, Philips, Indonesia, Sri Lanka, Vietnam, Kazakhstan, Pakistan, Kyrgyzstan, Bangladesh, and Papua New Guinea, by country of domicile for both government and corporate securities. Compared to bond issuance for Korea, Japan, India, Malaysia, Australia, China, Hong Kong, Taiwan, Singapore, Philips, Indonesia, Sri Lanka, Vietnam, Kazakhstan, Pakistan, Kyrgyzstan, Bangladesh, and Papua New Guinea, by country of domicile for both government and corporate securities. Compared to bond issuance for Korea, Japan, India, Malaysia, Australia, China, Hong Kong, Taiwan, Singapore, Philips, Indonesia, Sri Lanka, Vietnam, Kazakhstan, Pakistan, Kyrgyzstan, Bangladesh, and Papua New Guinea, by country of domicile for both government and corporate securities. Compared to bond issuance for Korea, Japan, India, Malaysia, Australia, China, Hong Kong, Taiwan, Singapore, Philips, Indonesia, Sri Lanka, Vietnam, Kazakhstan, Pakistan, Kyrgyzstan, Bangladesh, and Papua New Guinea, by country of domicile for both government and corporate securities. Compared to bond issuance for Korea, Japan, India, Malaysia, Australia, China, Hong Kong, Taiwan, Singapore, Philips, Indonesia, Sri Lanka, Vietnam, Kazakhstan, Pakistan, Kyrgyzstan, Bangladesh, and Papua New Guinea, by country of domicile for both government and corporate securities. Compared to bond issuance for Korea, Japan, India, Malaysia, Australia, China, Hong Kong, Taiwan, Singapore, Philips, Indonesia, Sri Lanka, Vietnam, Kazakhstan, Pakistan, Kyrgyzstan, Bangladesh, and Papua New Guinea, by country of domicile for both government and corporate securities. Compared to bond issuance for Korea, Japan, India, Malaysia, Australia, China, Hong Kong, Taiwan, Singapore, Philips, Indonesia, Sri Lanka, Vietnam, Kazakhstan, Pakistan, Kyrgyzstan, Bangladesh, and Papua New Guinea, by country of domicile for both government and corporate securities. Compared to bond issuance for Korea, Japan, India, Malaysia, Australia, China, Hong Kong, Taiwan, Singapore, Philips, Indonesia, Sri Lanka, Vietnam, Kazakhstan, Pakistan, Kyrgyzstan, Bangladesh, and Papua New Guinea, by country of domicile for both government and corporate securities. Compared to bond issuance for Korea, Japan, India, Malaysia, Australia, China, Hong Kong, Taiwan, Singapore, Philips, Indonesia, Sri Lanka, Vietnam, Kazakhstan, Pakistan, Kyrgyzstan, Bangladesh, and Papua New Guinea, by country of domicile for both government and corporate securities. Compared to bond issuance for Korea, Japan, India, Malaysia, Australia, China, Hong Kong, Taiwan, Singapore, Philips, Indonesia, Sri Lanka, Vietnam, Kazakhstan, Pakistan, Kyrgyzstan, Bangladesh, and Papua New Guinea, by country of domicile for both government and corporate securities. Compared to bond issuance for Korea, Japan, India, Malaysia, Australia, China, Hong Kong, Taiwan, Singapore, Philips, Indonesia, Sri Lanka, Vietnam, Kazakhstan, Pakistan, Kyrgyzstan, Bangladesh, and Papua New Guinea, by country of domicile for both government and corporate securities. Compared to bond issuance for Korea, Japan, India, Malaysia, Australia, China, Hong Kong, Taiwan, Singapore, Philips, Indonesia, Sri Lanka, Vietnam, Kazakhstan, Pakistan, Kyrgyzstan, Bangladesh, and Papua New Guinea, by country of domicile for both government and corporate securities. Compared to bond issuance for Korea, Japan, India, Malaysia, Australia, China, Hong Kong, Taiwan, Singapore, Philips, Indonesia, Sri Lanka, Vietnam, Kazakhstan, Pakistan, Kyrgyzstan, Bangladesh, and Papua New Guinea, by country of domicile for both government and corporate securities. Compared to bond issuance for Korea, Japan, India, Malaysia, Australia, China, Hong Kong, Taiwan, Singapore, Philips, Indonesia, Sri Lanka, Vietnam, Kazakhstan, Pakistan, Kyrgyzstan, Bangladesh, and Papua New Guinea, by country of domicile for both government and corporate securities.
3. Emerging East Asia as defined by the Asian Bond Monitor includes China, People's Republic of (PRC); Hong Kong, Indonesia, Korea Republic, Malaysia, Philippines, Singapore, Thailand, and Vietnam.

References

The views and information discussed in this report are as of the date of publication, are subject to change and may not reflect the writer’s current views. The views expressed represent an assessment of market conditions at a specific point in time, are opinions only and should not be relied upon as investment advice regarding a particular investment or markets in general. The subject matter contained herein has been derived from several sources believed to be reliable and accurate at the time of compilation. Matthews International Capital Management, LLC does not accept any liability for losses either direct or consequential caused by the use of this information.