Asian Insights

Asian equities: profitability, policy and reflation myth

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Invesco Equity Investment Team in Asia

2017 so far has seen equity markets in Asia off to a positive start, and as a result, global investors are gaining more confidence in their outlooks. Along with global markets, Asian equities have moved forward in parallel led by economic sensitive sectors, while dragged by defensive sectors.

As the year progresses, we believe three key areas may have an impact on Asian equity markets: an improvement in profitability for Asian corporations, spurred by growth in certain sectors; global policy uncertainties impact to Asia will not be as significant and has been exaggerated by the market; and the myth of reflation, at least for the case of Asia.

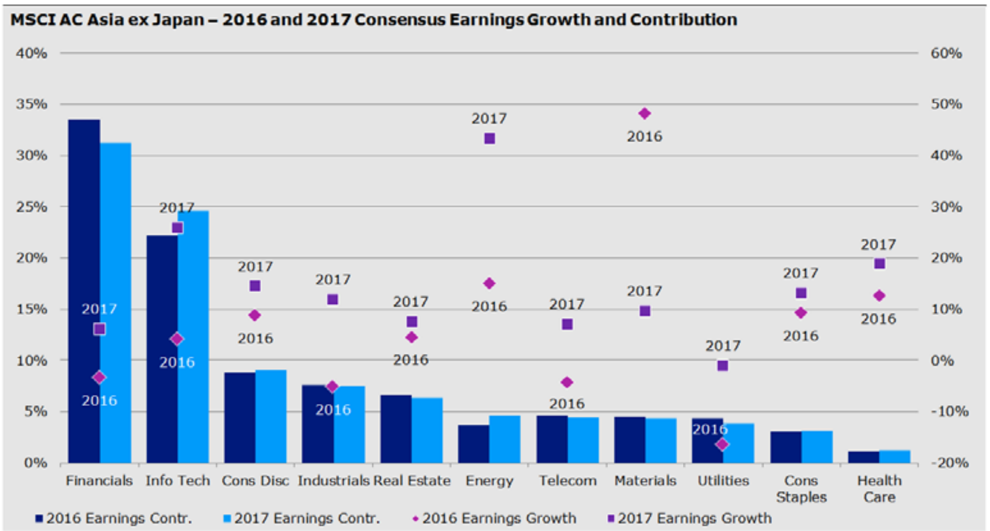
Asian Corporations Improve Profitability

We believe one of the biggest drivers in Asian equities in 2017 will stem from a return of profitability to the region. Compared to 2016, during which Asia ex-Japan earnings were largely flat-lining, the region is expected to see meaningful improvement with a 15% growth in earnings in 2017. We are particularly excited to see an upward revision in earnings already this year, as compared to previous years' ongoing downward revisions from the first quarter.

We predict broad-based earnings growth this year across most sectors, particularly within information technology (IT), the second biggest sector behind financials. This sector accounts for almost 25% of aggregate earnings in MSCI China in absolute terms. It experienced a doubling in earnings growth from 12% (2016) to 24% (2017), driven by the addition of US-listed franchises as American depositary receipts (ADRs) to MSCI indexes via two tranches from late 2015. Most notably in China, several industry leaders are active in their own areas, such as Alibaba, an e-commerce business, and Ctrip.com, an online travel agency. In our view, these franchises will enjoy robust growth in the years ahead as consumer behavior in China shifts to mobile internet. Superior scale, established logistics networks and a high barrier of entry for these industries will leave growth intact.

Asia ex-Japan earnings are further lifted by improvements in the financials sector, which is expected to see a turnaround in earnings from -3% (2016) to +6% (2017). Prior monetary easing and accommodative liquidity across Asia has stabilized overall asset quality and lowered the required provision of non-performing loans (NPLs) expected for 2017. It is worth noting that the financials sector is the largest earnings contributor and may therefore be a swinging factor - any slight downturn in bank earnings growth could have an impact on the market earnings growth result or estimate overall. After the recent Fed rate hike, a rising US interest rate would be positive for Asian banks, such as Hong Kong and Singapore, with expanding net interest margins (NIMs) and high US dollar loan exposure.

Finally, the energy sector has seen the sharpest rise in growth from 18% (2016) to 33% (2017), with crude oil trading at more than $50 compared to approximately $30 a year ago. Unless oil prices correct sharply from their current level, earnings for upstream companies will be relatively secure in 2017 (year-on-year basis). The energy sector stands out with the biggest sequential earnings improvement; however, its contribution to Asia ex-Japan earnings is not as significant at less than 5%.



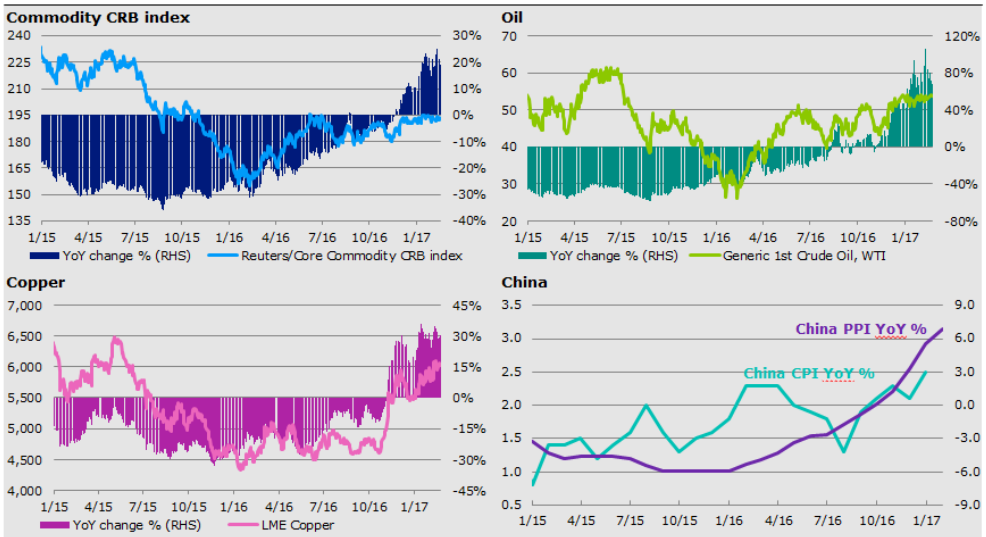
Reduced Impact of Global Policy Uncertainties
2016 saw Asian market trends influenced by events outside the region. The UK's decision to leave the EU, the US presidential election result, and the Fed's shift in monetary policy all resulted in heightened market volatility worldwide, to which Asia was not immune. We believe 2017 will be similar, with politics and policy being the "wildcard" dictating global asset changes. In Europe, upcoming elections in the Netherlands and Germany, as well as ongoing Brexit negotiations, may lead to increased volatility, and a new US administration combined with policy uncertainty may leave investors feeling cautious. In our view, their actual impact on Asia will not be significant and have been exaggerated. In fact, we may even see potential benefits.

- On the trading front, regional trade in Asia is mostly dependent on China as being the biggest trading partner. According to World Trade Organization (WTO) 2014 statistics, 52% of Asia exports are intra-regional, while North American exports account for just 18%. We are also seeing increases in the FDI from China to ASEAN countries, from US$6 billion in 2008 to US$16 billion in 2016. In terms of the US, however, markets have become less concerned about protectionism and policy uncertainty following Trump's inauguration in January as the situation has become clearer. The recent Trump-Xi summit was constructive, with China now encouraged to increase imports to narrow the US deficit, instead of limits being imposed on exports to the US. Furthermore, Trump reversed his stance on April 12 by stating that China was not manipulating its currency to gain a trade advantage, and that this currency trend was the result of a strong US dollar instead, relieving fears of unilateral trade sanctions.
- Market optimism toward a potential deregulation of American banks, creating a surge of US-listed banks, has spilled over into Europe and Asia. However, this would provide little benefit to Asian banks in our opinion, as deregulation is unlikely to expand outside US and the surge in the second half of 2016 was more about a bounce in valuations from depressed levels.
- Lastly, although criticisms surround a potential tax cut campaign in terms of this leading to higher inflation, increased disposable income is poised to become a growing catalyst in boosting consumption. This should directly benefit the Korean and Taiwanese markets in terms of consumer I.T. exports, which have already seen their 2017 earnings revised upward in recent months.

The Reflation Myth

One market trend across the globe is the discussion of economic reflation. This has been exhibited through the resurgence in cyclical-related sectors and lifted by a year-on-year recovery in commodity prices. Reflation is more a myth in our view, at least in Asia. We are yet to be convinced of a sustainable global recovery as suggested by the cyclical rally in recent months, as this reflation was mostly based on a low-base effect, with year-on-year growth lifted by a trough base in early 2016.

Market sentiment in the US is reflationary, with its new administration delivering expectations of pro-business policies, tax cuts to corporate and personal incomes, and industry-specific deregulation. However, US commodity prices have been disguised by this low-base effect - based on index readings, they are still hovering around subdued levels that are significantly below their 2009 peak. In addition, a strong US dollar has traditionally been negative for commodity prices, which further puts a continued commodity rally and reflation into question.



Source: Invesco, as at April 2017.

Within Asia, we believe continued recovery in commodity prices will benefit the Chinese economy, as it allows industries with excess capacity to produce at profitable levels, and this improvement in balance sheets will, in turn, lead to an improvement in banks' asset quality. Concurrently, we maintain that the impact of PPI on the economy overall will decline over time as the Chinese economy transitions increasingly toward service sectors. Outside China, commodity-sensitive economies such as Indonesia and Malaysia have benefited most from recovering prices, and have been able to improve their account balances. Moreover, a multiplier effect applies to these economies, as a significant share of the workforce is engaged in the commodity sector, and improved profitability here can spill over into domestic consumption. While this year-on-year uptrend in prices may continue due to a low-base effect, this trend will be challenged in the second half of 2017, when the base effect fades away to uncover the illusion of reflation.

Conclusion

Looking ahead, the return of profitability in Asia will be a key catalyst driving revised ratings in Asia ex-Japan equities, following consecutive years of downward revisions. We believe earnings over the first half of the year will be relatively secure, with earnings growth building up good momentum since the start of this year. We also acknowledge the potential volatility that may arise from policy uncertainty around the globe, alongside the questionable sustainability of reflation.

As investment managers focusing on fundamental research, we do not make top-down calls on macroeconomics - rather, we consider what impact the global macroeconomic backdrop may have on the companies we invest in. Our investment philosophy and approach focuses on companies with sustainability leadership and competitive advantages, and this emphasis on sustainability has led us to avoid companies which value cyclicality over business cycles.

From a global asset standpoint, despite the year-to-date rally, it is worth noting that returns on Asia ex-Japan equities have lagged behind those of developed markets over the last few years, meaning investors have tended to avoid allocating assets toward emerging markets. A strong US dollar since tapering in 2013 has also driven fund flow toward US dollar assets, and this ongoing flow has led to significant valuation disparity between regions, with the US commanding a meaningful valuation premium over Asia ex-Japan. In our view, macroeconomic stability in the region and earnings growth gaining traction warrant a narrowing gap and fund flow returning to the region, therefore we maintain a positive outlook on Asia ex-Japan equities for 2017.

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Market highlights

China: Domestic macroeconomic data continues to show growth in China strengthening, with fixed asset investment rebounding, while production and retail sales remain resilient. We expect Chinese policymakers to take a balanced approach to ensuring steady growth and progress in reform. Consumption will remain a key growth driver as the Chinese economy continues to transition away from being driven by manufacturing and investment.

Hong Kong: Economic conditions continue to be influenced by developments overseas and in China. Favorable growth developments in China are spilling over to supporting both domestic and external demand in Hong Kong.

India: Confidence in the domestic economy continues to improve as economic indicators show growth exceeding expectations. Structural trends on the ground in India will sustain higher economic growth for India, in areas such as financial services, consumer spending and housing development. Government efforts to stabilize the economy and push structural reforms will continue (e.g. windfall benefits of demonetization in lifting tax revenue and the goods and services tax scheduled to be rolled out in July).

Korea: While expectations are positive for global growth, any recovery will likely be bumpy and uncertain as long as the threat of increased US trade protectionism remains. Government focusing on lifting consumption and tourism as deleveraging proceeds and tourism is under pressure.

Indonesia: Despite the growth possibilities, the risk of geopolitical conflicts and the threat of increased US trade protectionism are likely to influence capital flows to the region. Benefits of accommodative monetary policy and turn in exports helped offset the weakness in growth elsewhere.

Taiwan: The recovery in high tech demand is likely to continue in the short-term but uncertainty over US trade policies risks weighing on growth.
Further policy easing is unlikely after Taiwan's central bank lowered rates four times the past two years given the turnaround in growth.

Thailand: Lower industrial competitiveness compared to other countries in Asia is limiting foreign investment and growth. Thailand is planning to switch to a civilian government in the second half of 2017, which will need to be closely monitored.

Singapore: While political stability and financial resources will help to absorb the economic weakness, cyclical and structural headwinds are likely to persist.

Malaysia: Country is fiscally challenged as government seeks to reduce budget deficit. The debt dynamics remain a concern as it is still highly vulnerable to an external shock given its dependence on external funding.

The Philippines: Despite the uncertainty surrounding the President's controversial headlines, domestic companies continue to make large investments in the economy. With consumer inflation reaching the upper bound of the central bank target range, the Philippines could be the first Asian country to tighten monetary policy.

Australia: Although external demand has been improving, weakness elsewhere has posed a problem for overall growth. The rise in commodity pricies is likely to become more favourable for growth and possibly wages, which could change the course of domestic demand, where the unwinding of an era of strong growth in resources has not been favorable.

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