# Asian Insights

## Q2 2016

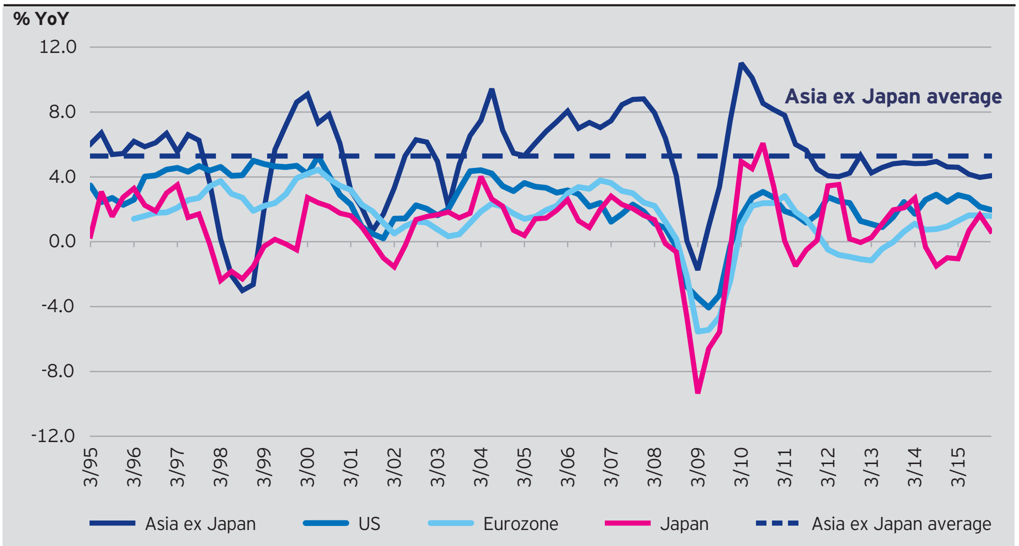
### Reform remains the key for growth in Asia

At the start of the year, the MSCI Asia ex-Japan index lost as much as 12.9%[1] before rebounding to recoup those losses by the end of the first quarter. What drove markets lower were global investors' fears about three issues: 1) the slowdown in China, 2) the potential repercussions of further US policy tightening and 3) rising deflationary pressures driven by weak commodity prices. As it appears investors have overcome these fears, the key question likely now on investors' minds is whether recent signs of an upturn in Asia are sustainable. We would like to point out a number of fundamental drivers falling into place, from government policy to corporate or structural reform, that are essential to supporting growth in the region over the long term.

**Revised expectation of US monetary policy**

Arguably the biggest concern weighing on Asian equity markets at the start of the year, given the fragile state of the global economy, was the impact US interestrate normalization would have on Asian economies. In particular, there were worries that a US Federal Reserve (Fed) rate hike could result in another "taper tantrum"[2] as we saw in the second half of 2013. This concern died down as the Fed turned more cautious in January, leading to Fed rate-hike expectations being toned down from four times this year to maybe only one, at the end of the year. With less Fed tightening on the horizon, Asian currencies quickly appreciated. Some Asian central banks took advantage of the Fed's softer stance and resultant diminished currency risk. Already, since the start of the year, Indonesia's central bank has reduced rates three times, and Taiwan and India have done the same once each. This follows 16 rate cuts in 2015 alone from Asia ex-Japan central banks. History has shown that whenever liquidity expectations turn positive, as we saw toward the end of the first quarter, emerging markets, especially Asia, tend to outperform as investors are willing to take on more risk. However, with global growth expected to remain below par given the structural weights of excess capacity and leverage, it remains imperative that reform and restructuring continue to be pursued in Asia.

**Low growth environment to continue (Real GDP)**




Source: UBS, CEIC, as at December 2015 (latest data available). Asia ex Japan includes China, HK, India, Indonesia, South Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand

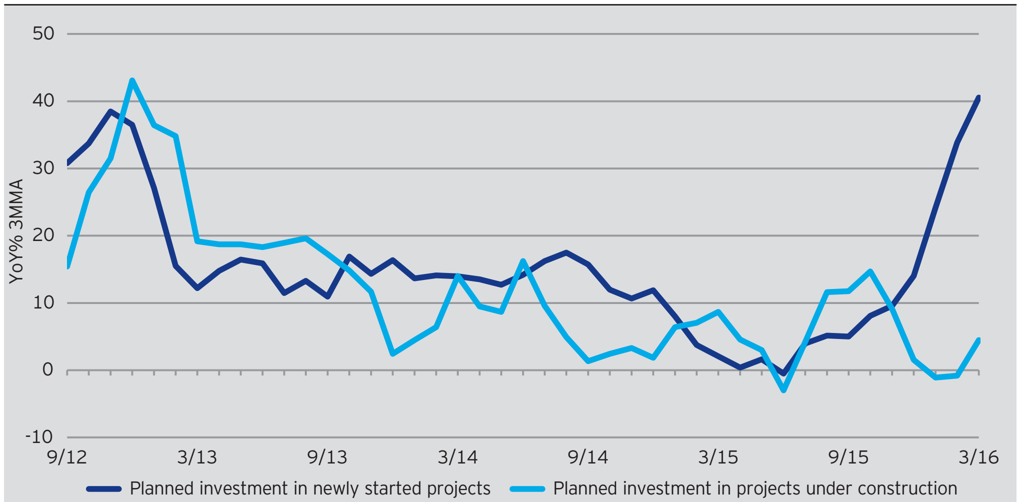
[1] Source: MSCI, Bloomberg in USD terms with the cited index low on Jan 21, 2016.

[2] On May 22, 2013, the Fed ended one of its quantitative easing (QE) programs, triggering panics in bond markets and other risk assets, such as emerging markets.

## China shifts gears on stimulus and reform

At the start of the year, investors seemed to panic over the slowdown in China. However, sentiment quickly shifted as the Chinese renminbi stabilized and capital outflows lessened. Investors were also encouraged by China's policy efforts to jumpstart the property market, as land sales in China's Tier 1 cities started to rise. China's "reflationary" policies, through a combination of lower interest rates, mortgage relaxation measures and fiscal spending to pump up infrastructure investment, have also started to feed through to lifting industrial output and demand for commodities and electricity, to name a few. As the possibility of a turnaround in China continued to gain momentum, foreign exchange reserves also rose in March for the first time since October 2015.

### China spending on new projects surges




Source: CEIC, Morgan Stanley

While policy stimulus alone does not guarantee a sustainable recovery in China, it is essential that demand is robust enough for supply-side reforms to be successfully implemented. China's supply-side reform agenda includes 1) reducing overcapacity, 2) cutting inventories, 3) de-leveraging, 4) reducing costs and 5) shoring up weak businesses. This agenda is expected to target state-owned enterprises, where operations need to be streamlined, excess capacity and leverage reduced, and efficiency raised. For example, in April, China's government halted the construction of new coal-fired power plants in areas where there is surplus power in an effort to curb excess power capacity. The government has also allowed an increasing number of corporate bond defaults among state-owned enterprises suffering from overcapacity in industries like steel, shipbuilding, cement and coal mining, suggesting it is cracking down on inefficient companies undermining growth in the overall economy. If more and more of these types of supply-side reforms are realized, confidence in the sustainability of growth in China should rise.

## India reform spreading

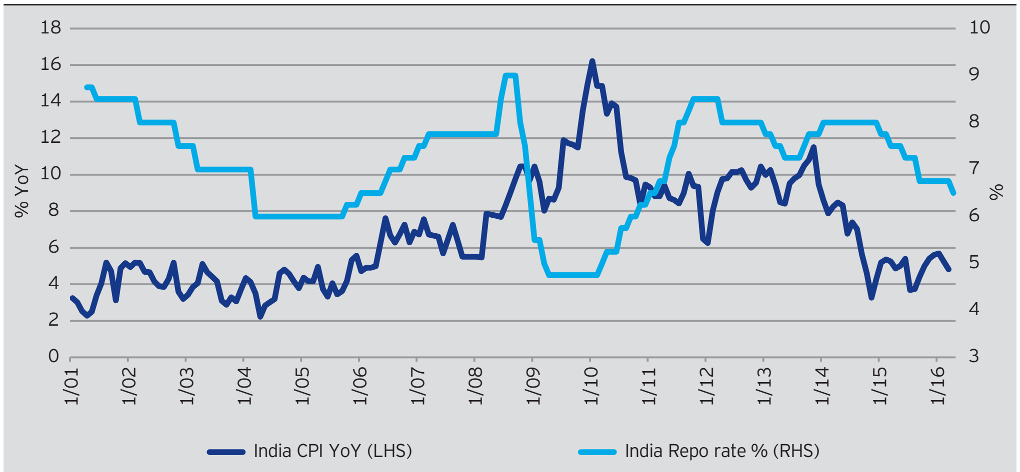
Whether looking at Asia or the world, India is one of the bright spots in a low growth global economy, as it is expected to be one of the fastest-growing countries for some time. However, as progress for reform in India has been gradual instead of anything sweeping, some investors may question whether the high growth can continue. We are confident it will, as micro-level supply-side reforms in India will continue in parallel at a steady pace, with a focus on better governance, ease of doing business and improving the continuity of government policies, etc.

One of the government's major initiatives is to make India a more "businessfriendly" country when it comes to regulations, taxation, etc. The 'Make in India' initiative aims to facilitate investment and foster innovation, thereby transforming India into a manufacturing-and-export hub. However, there are questions over its timing, as the global economy is slowing down. Yet, in the past couple of years, there has been a large increase in foreign direct investment in India, with major global companies announcing plans to set up facilities for electronics, autos, defense, railways and more in India.

At the corporate level, there are also signs of progress. While corporate debt as a percentage of gross domestic product (GDP) in India may be low compared to other countries, the Reserve Bank of India (RBI) conducted an asset-quality review last December and identified 150 top corporate accounts that are stressed. With pressure from the RBI, some big corporate debtors have already started to address these concerns with asset sales and other means. Moreover, Prime Minister Modi's administration introduced a new bankruptcy law in parliament with an aim to strengthen bank leverage over delinquent borrowers, as there currently is no effective national bankruptcy law in place in India.

Investors will be encouraged to see progress on both these fronts: policy reform and improving the asset quality of banks and corporations in India. In an environment where reform is being pursued on various fronts, it is also encouraging to see the Indian government committed to reducing its fiscal deficit (3.5% for fiscal year 2016-2017 from 3.9%) as it helps tame inflationary pressures, keeping the door open for the RBI to ease further in the future to help promote both deleveraging and investment, if necessary. Since the start of 2015, India has already reduced rates five times, to the lowest level in five years.

**Inflation has eased giving the RBI more room to cut rates**




Source: CEIC & UBS as at Apr 25, 2016

## Signs Korean companies are restructuring

With a rapidly aging population, high household debt and the need for corporate restructuring, the Korean economy is standing at a major crossroad. While investors may welcome a cyclical recovery, as exports have been declining since January 2015 and capacity utilization has been on a downtrend since January 2011, they are more interested in seeing the corporate mindset change in Korea.

Korea's economy has been largely controlled by "chaebols,"[3] family-owned conglomerates with a complex web of businesses, many of which are very inefficient and unprofitable. These companies are known to be reluctant to pass on earnings to shareholders. In 2015, the Korean government started pressuring Korean companies to pass on excess cash to shareholders, using tax incentives to raise dividends, offering lower taxes on dividend income and issuing penalties on excessive retained earnings. As a result, Korean companies started to take heed with the dividend payout ratio for KOSPI rising from 13.7% in 2012 to 18.8% in 2015,[4] an improvement but still the second lowest globally, above Argentina. There have also been some signs of positive corporate-governance decisions by major chaebols Samsung and Hyundai from buying back shares to increasing dividend payout ratios to 30% or so. Other companies are following suit with restructuring plans.

With global demand slowing, Korea can no longer rely on only the chaebols, like Samsung and Hyundai, to drive its economy. Korea also needs new growth companies targeting domestic demand in sectors like consumer discretionary, consumer staples and health care. In recent years, more and more non-chaebol companies have been able to make progress in gaining domestic market share. Despite these improvements, however, the 'Korea discount'[5] still applies, where the price-to-book ratio for KOSPI is hovering around 1.0x with the forward priceto-earnings ratio around 10x or less.[4] What investors likely need to see is more independent, non-chaebol-affiliated companies, as well as confirmation that Korean companies are set on changing their ways when it comes to corporate governance. Our strategy has been to look outside the chaebols for quality companies with strong business models and sound corporate governance policies.

## Conclusion

As economic conditions may well continue to improve in the short term, thanks to the benefits of accommodative monetary and fiscal measures throughout the region, progress in structural reform remains important for growth longer-term. What investors will need to see is more active structural reform and policies that help ensure growth in the region is sustainable. As the key engine for growth in the past, Asian exports, is unlikely to be the driver of the future, it is crucial that governments and companies throughout the region continue to tackle reform head on, refusing to turn complacent whenever growth improves.

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3 In 2011, the five largest chaebols made up more than 55% of South Korea's GDP, while the top 20 accounted for an astonishing 85%. (Source: Globe and Mail, Apr 24, 2015).

4 Source: Bloomberg as at Apr 26, 2016

5 A term applied to Korean companies, notably chaebols for their poor record in corporate governance, cash hoarding and questionable tactics amongst family members such that their stock trades below their true value.

## Market highlights

Although we remain selective in Asian equity markets, as structural obstacles such as excess capacity will weigh on growth, we expect most policymakers in Asia to continue to provide policy support in an effort to lift growth in their respective countries. Within Asia, India should remain on a recovery track driven by public investment and consumer demand. In China, policymakers are expected to continue to seek to lift growth, especially in areas of infrastructure and property. Korea needs to see an improvement in external demand. In Taiwan, sluggish global demand will pose a challenge for its economy. Within the Association of Southeast Asian Nations (ASEAN) region, stepped-up government efforts are turning out to be positive for Indonesia, while domestic demand remains strong in the Philippines. Cyclical and structural headwinds, however, persist for Malaysia, Singapore and Thailand.

**China:** Economic indicators show growth momentum is improving as the stronger-than expected fiscal stimulus measures combined with loose monetary policy are helping to support the economy. While external demand remains sluggish, property markets are benefiting from the relaxation in mortgage policy regulations and lower interest rates.

**India:** Domestic consumption continues to be a primary driver for growth. The government is promoting growth via stepped-up public investment, while the central bank provides ample liquidity.

**Hong Kong:** The positive economic developments in China are certain to spillover to supporting growth in Hong Kong. Although macro conditions have recently slowed, investment opportunities remain attractive in Hong Kong.

**Korea:** For economic growth to gain momentum, a recovery in external demand is necessary. However there are still select bright spots in the economy. Consumer demand has been relatively resilient despite the fact that the weakness in external demand continues to suppress manufacturing.

**Indonesia:** With the government placing a high priority on infrastructure spending and the central bank delivering a series of rate cuts since the start of year, near-term economic growth looks encouraging.

**Taiwan:** Lower nominal wages and inflation raise the possibility for further monetary policy easing, especially if external demand remains sluggish. However, there is the possibility the new government will adopt a more-prudent approach to fiscal policy.

**Malaysia:** While consumption has held up, it remains difficult to envision a prolonged cyclical recovery continuing to drive commodity prices higher. In addition, the government is unlikely to provide any policy support.

**The Philippines:** Consumption is reasonably robust and exports are declining by less. While the economy is still prone to being influenced by global developments, its domestic economy is supporting overall growth. Eyes will be on the direction of policy with the new government.

**Singapore:** Cyclical and structural headwinds continue to prove challenging. Despite the weak economy, the government prefers to take a more-conservative approach to fiscal policy, encouraging restructuring and innovation.

**Thailand:** The acceleration in fiscal spending is up against both cyclical and structural headwinds from high debt to weak external demand. Further delay in the country's return to democracy is possible, dampening long-term growth.

**Australia:** The economy is witnessing a slowdown on various fronts. Weaker wage growth with household debt on the rise and weak manufacturing due to lower commodity prices continue to be felt. Further policy action will likely be necessary to support growth.

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