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Asia ex Japan

Can stability in the region extend Asia's outperformance?

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Key takeaways

- We see three positive fundamental structural drivers in Asia.
- Stable politics favors further reform in China and India.
- Bottom-up opportunities are arising from Asia's stable backdrop, in our view.

2017 has been a good year for Asian equities so far, rising 36% and outperforming the rest of the world.[1] The strong performance has been supported by steady economic conditions and robust corporate earnings. Yet still, Asia is trading at its lowest price-to-book ratio relative to the S&P 500 Index in 15 years.[2]

So where do we go from here? Our view is that there are three positive fundamental structural drivers that can help Asian markets remain strong in 2018:

- Stability on various fronts, including economic growth and policy decisions
- Good opportunities driven by earnings, liquidity and valuations
- A reduction in risk

Stable growth is in the forecast

Asia's headline economic growth is expected to steadily adjust from the recent annual growth rate of 6.0% to 5.8% in 2018.[3]

In China specifically, we expect growth to moderate, but to remain on track to deliver the government target of 6.5% growth, which is a decent expansion compared to other major economies.[4] Investments and exports are expected to soften, while domestic consumption will continue to be the key driver in our view. Income growth remains resilient, providing support to consumption.

The macroeconomic environment in India is also favourable, with manageable inflation and a stable growth outlook. The Indian economy has been rebooted under Prime Minister Narendra Modi's bold reforms. As the long-term benefits start kicking in, we expect to see improving fiscal balance, sustainable growth in private consumption, and better corporate earnings.

Elsewhere in Asia, retail sales growth is expected to remain robust in South Korea, while ASEAN economies (Association of Southeast Asian Nations) will likely see ongoing recovery in investments and exports.

Stable politics favors further reform

Asian leadership is stable, in particular within China and India. Chinese President Xi Jinping has smoothly transitioned to his second term after achieving a solid track record of reform in his first term. Supply-side reform has seen good developments, with the coal and steel industries achieving their targets for capacity cuts faster than expected. Looking into 2018, we believe strong leadership under Xi will result in further progress on reforms. In particular, state-owned-enterprise (SOE) reform needs to go hand-in-hand with supply-side reform, as most excess capacities centered around SOEs.

In India, Modi's government has enjoyed a single-party majority since 2014, allowing it to avoid the political paralysis of previous governments. This has given rise to bold reforms. Notably, the demonetization reform has successfully replaced 86% of the currency in circulation in India within a timeframe of just two months.[5] Together with the smooth rollout of the Goods and Services Tax (GST) bill, these successful track records formed a solid foundation for Modi to deepen reforms. Going into 2018, we expect India to see stronger "financial inclusion," i.e., a faster shift of household savings from physical assets (such as gold bars and cash) to financial assets. Banking and financial services should see increasing penetration.

Earnings expected to remain intact

Asia's earnings trend remains positive. Over the medium term, we do not see any particularly strong factors that could reverse the earnings trend. Asian corporate earnings have largely beat expectations in the latest reporting season, leading to upward earnings revisions across countries.

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China's earnings trend remains positive, and we anticipate information technology and consumer-related areas will continue to deliver quality sustainable growth. In India, we expect corporate earnings to gradually normalize after the short-lived impact of the GST bill, and will reap the economic benefits of reform initiatives, which are well underway. Corporate earnings in Korea and Taiwan are expected to benefit from the rising trend of artificial intelligence and big data. The need for faster processing power gives rise to the demand for semiconductors.

Liquidity trends look supportive

US interest rate hikes are likely to be gradual, allowing sufficient liquidity to go around the global financial system. In Asia, southbound flows coming from mainland Chinese investors should continue to provide structural liquidity support for the H-shares and Hong Kong stock market. In India, domestic mutual funds have seen strong inflows, with total assets under management doubling over the past three years. We believe the sticky and structural domestic allocation will continue into 2018.

Valuations remain accommodative

Despite the strong performance in 2017, Asian equities are currently trading on par with their long-term historical average on both a price-to-earnings and a price-to-book basis.[6] Compared to other regions, we are seeing a meaningful discount to developed markets in price-to-earnings terms, with a 12% discount to Europe and a 27% discount to the US.[7] We expect valuations to become even more appealing as further earnings kick in.

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Assessing bottom-up opportunities

We see bottom-up opportunities arising from the stable backdrop in Asia. In the information technology space, we prefer the leaders in China's internet services industry, which enjoy a near-monopoly status and strong competitive edges. In particular, the user ecosystem that these leaders have built spawns many monetization opportunities, ranging from e-commerce to mobile payments.

In India, we favour the financial space, which is benefitting from India's move away from being a cash-dominated economy. Within this space, we prefer companies with high exposure to consumer-related financial needs and private sector banks that are more efficiently run. We also believe that the rising middle class in India creates opportunities across multiple segments ranging from household appliances to consumer finance.

Risks to watch in 2018

Stability on the macroeconomic and political fronts has resulted in a reduction in overall risk in Asia. While we do not see major uncertainty overhangs for 2018, below are the aspects that investors should monitor rather closely:

- **Trajectory of US interest rate hikes.** While the market is expecting gradual interest rate normalization in 2018, volatility could arise if interest rate hikes turn out to be faster or higher than what the market is currently pricing in. An unexpected turn of US Federal Reserve rates could have implications to how Asian central banks should continue with their monetary policies.
- **Geopolitical tension with North Korea.** It remains difficult to predict the interaction between North Korea and the US. Our view is that any major impact triggered by military aggression on either front would not only affect the Asian region, but would influence global economies at large.

Conclusion

Stability in Asia gives potential for the region to extend outperformance. A steady growth backdrop is conducive to bottom-up stock selection, allowing investors to focus on company fundamentals, without the need to worry about major top-down uncertainties.

1 Source: Bloomberg L.P. Based on returns for the MSCI Asia ex Japan Net Total Return Index, expressed in US dollar terms, as of Oct. 25, 2017.
2 Source: Bloomberg L.P. Data as of Oct. 9, 2017.
3 Source: Bloomberg L.P. Recent level of GDP refers to the Asia ex-Japan year-on-year GDP growth rate as of June 30, 2017. 2018 expected GDP growth rate refers to Bloomberg consensus estimate as of Sept. 26, 2017.
4 Source: Xinhuanet. The Chinese government set the 2017 growth target of around 6.5% during the annual National People's Congress (NPC) held on March 5, 2017.
5 Source: The New York Times, as of Nov. 14, 2016
6 Source: Citi research estimates. Long-term historical average refers to the period between Jan. 1, 1975, and June 8, 2017.
7 Source: FactSet Research Systems, I/B/E/S, MSCI, Goldman Sachs Global Investment Research, as of Oct. 20, 2017.

Important information

All data as of October 31, 2017 unless stated otherwise.

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