Asia ex Japan equities

Will optimism return to Asian equities in 2019?

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Key takeaways

- We believe Asian markets may regain favor from international investors in 2019.
- Regional governments are expected to roll out pro-growth policies to support domestic economies.
- Asian companies are looking for opportunities to expand abroad, which represents an important change in mindset.

Contrary to 2017, when Asia ex Japan equities enjoyed a strong rally with extremely low volatility, 2018 has been a bumpy year. Global events, including rising trade tension and a stronger US dollar and yields, are preoccupying investors, masking solid economic growth from many countries in the region.

Will the tide turn in 2019? We believe there are good reasons that Asian markets will regain favor from international investors given:

- Solid economic growth, supported by strong fundamentals and supportive policies.
- Strong Asian companies, backed by dynamic growth drivers and expansion efforts.
- Compelling valuations, offering an attractive entry point for quality companies.

Healthy economic growth is obscured by near-term headwinds

Economic growth in Asia ex Japan is expected to remain strong despite mild moderation, (6.1% in 2018 and 5.9% in 2019). [1]

In China, we expect economic growth to achieve the government's target of around 6.5% in 2018 and to be between 6.0% and 6.5% in the medium term given the government's rebalancing efforts toward a consumption- and service-led economy. We expect continued innovation in the consumer and information technology sectors to address growing and more sophisticated consumer demand amid rising income and accumulated wealth.

In India, economic growth has been on a positive upward trend, and we expect it to gather further strength in 2019. We believe private consumption, particularly in the rural area, will remain the dominating growth driver, supported by strong expansion in per capital income, which is projected to increase at a compound annual growth rate of 10.2% between 2016 and 2025.[2] Elsewhere in Asia, economic growth is expected to remain steady, predominately driven by robust private consumption.

We believe Asian economies are well-positioned to withstand contagion risk from other emerging markets (in the case of continued strength in US dollar and yields) given their stronger trade balance, higher reserve adequacy and improving external debt profile. Asian countries are not like Argentina and Turkey, which are running current account deficits at around 6% of gross domestic product (GDP), and their overall external debt to foreign exchange reserve level is also much lower. [3]

Supportive policies to ensure stable outlook

We believe regional governments will roll out pro-growth policies to support domestic economies and remain committed to reforms to address structural bottlenecks.

In China, we believe policy responses are data dependent, indicating that targeted easing measures should continue in the near term. That said, we believe structural reforms, including deleveraging and supply-side reform, will remain a top priority given their paramount importance to long-term economic health.

In India, we expect reforms in areas including financial inclusion, housing for all and digitalization to continue, driving further productivity gains. In other parts of Asia, we believe the policy focus will be on sustaining domestic consumption and employment. In the Philippines and Thailand, public infrastructure projects will be another key development area that local governments push for.

1 Source: Bloomberg L.P. 2018 and 2019 GDP growth rates refer to Bloomberg consensus estimate as of Oct. 10, 2018.
2 Source: Deloitte and FICCI, estimate as of Oct, 2018.
3 Source: CEIC, Morgan Stanley Research.

Strength of Asian companies to extend thanks to dynamic growth drivers and expanding efforts

We believe Asian companies will extend strength thanks to the emergence of new and dynamic drivers in the technology and consumer-related sectors on top of existing ones in the traditional sectors that have been benefiting from reforms. We believe it was evidenced by the evolving composition of top Asian companies by market capitalization. Chinese internet giants Tencent and Alibaba have taken over the top two spots that were once occupied by PetroChina and Industrial and Commercial Bank of China. [4]

We believe it also shows that the investment universe of Asian equities is moving closer to the underlying structural drivers of the economy. With consumption and services growth across Asia contributing higher to overall GDP, we believe the underlying investment universe will get broader and deeper and have better quality too.

Besides riding on new growth areas, we also note that Asian companies are looking for opportunities to expand abroad.

We believe it represents an important change in mindset and expansion strategy, and illustrates the rising emergence of Asian corporates that can extend their success outside of their home market to be globally competitive.

Compelling valuation against solid earnings growth

Compared with developed markets, Asia ex Japan equities are trading at a much attractive valuation now. Its 12-month forward price-to-earnings ratio (P/E) stood at 11.1x as of mid-October, which is also one standard deviation below the historical average.[5]
We believe the market might have already priced in most negative events.

We believe earnings growth of Asian equities will remain healthy in both 2018 and 2019.

In China, we expect earnings to be led by sustainable growth sectors including the consumer, internet and health care sectors; while in India, we believe earnings growth will continue to trend up in 2019. In addition to consumer-related sectors and retail-focused private financial institutions, we are also positive toward earnings growth of IT servicing companies. We believe they will benefit from a depreciating rupee and strengthening US economy.

Risks to watch in 2019

Despite a reduction in domestic risks given solid macro fundamentals and prompt policy responses, we believe external risks that were weighing on sentiment in 2018 will likely continue in 2019:

- **Trade tension.** We expect trade conflict to linger for a while, but given its complex nature and connection with US domestic politics, we expect things to turn quickly on either side (not excluding a substantial positive outcome).

  We believe the development on the Korean Peninsula provides a good reference to trade tension. Few expected back in 2017 that North Korea would hold a summit with both South Korea and the US in the following year.

- **Dollar strength and rising yields.** Stronger dollar and rising yields are historically negatively linked with Asian equities, and we believe it is worth continued monitoring, especially for countries running current account deficits.

- **Election.** We believe upcoming elections in India, Thailand and Indonesia in 2019 require close watch given their implications for domestic policies and equity markets. Despite the uncertainty, we believe investors should remember that elections do not always have an unfavorable impact on equity markets. We have seen positive market reactions following elections as well, especially in India.

4 Source: Factset, Invesco.
5 Source: Goldman Sachs Investment Research.

Conclusion

We believe the robust fundamentals of Asia ex Japan equities will likely draw renewed interest from investors in 2019. We believe the current valuation has already priced in most negative events. We believe Asian companies are on solid ground to extend strength given their investment into new growth areas and overseas markets.

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