

Equities poised for growth

The correction at the start of the year didn't damage the region's fundamental recovery, but volatility will rise, providing active managers with a good environment to outperform

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The outlook for a multi-year rally in Asian equities is very much intact, with the key drivers unlikely to be troubled by recent market movements or an uptick in inflation. Sustainable growth, driven by policy and political stability, accompanied by firm corporate earnings and resilient consumer confidence, will carry the market forward over the medium term.

While volatility is likely to rise, we believe a severe and permanent market downturn is unlikely in the context of the healthy growth outlook. The likelihood of a moderately more volatile market environment will present abundant opportunities to exploit stock mispricing.

Potential for strong returns

Across much of Asia a new cycle of quality growth has begun and the pace of this growth will be moderately high yet sustainable, leading to a more robust environment for corporate profits to grow steadily and a positive backdrop for Asia's stock markets.

In 2017 the MSCI AC Asia Pacific ex-Japan Index made gains in every quarter, powering to returns of more than 37% in US dollar terms. Such a

rally reflects a definitive turn in risk perceptions towards Asia, which lifted valuations off multi-year lows.

As we stand, consensus earnings forecasts indicate Asia-Pac ex-Japan will generate earnings growth of 10% or more in 2018 and 2019,¹ and in some sectors and countries earnings growth could be significantly higher. On a price-earnings basis, Asia-Pac ex-Japan is trading on 13.7x estimated earnings for this year, going down to 12.5x for 2019 (MSCI AC Asia Pacific ex-Japan Index). This does not look expensive when the US market is trading on 17.5x estimated 2018 earnings, going down to 15.8x for 2019 (S&P 500). Even with a re-rating that takes it to 15.5x for this year, the Asia-Pacific ex-Japan region will still be at more than a 10% discount to the S&P 500.

It is therefore not unreasonable to anticipate total returns of 20% or more from Asia-Pac ex-Japan equities for the rest of the year, coming from a balanced mix of earnings growth and valuation re-rating. In addition, the consensus forecast for dividend yield stands at 2.9% for the coming year, further supporting the upside potential.



Living life: Thai people want a less disruptive environment to get on with their lives

Confidence anchored amid volatility

Events relating to China will remain key to confidence towards the region. Developed Asia, India and globalised sectors such as Taiwan and Korea technology will remain good diversifiers, but China will be key given its sheer size and rising importance in regional indices.

History is important in evaluating the sustainability of China's growth. In the aftermath of the global financial crisis, the Hu Jintao administration injected a massive fiscal stimulus. This was poorly executed in terms of making sure the money went into commercially viable projects, not to mention the leakages due to corruption. The outcome was excess capacity in various sectors, which eventually led to a rapid growth deceleration in 2010-2012.

In March 2013, Xi Jinping assumed office and re-orientated the policy mindset to achieving sustainable, high-quality growth rather than simply a high pace of growth. He was somewhat fortunate in

that the new economy sectors helped soak up employment. This meant China was able to avoid an unemployment issue, even when growth decelerated to below 7%. This allowed the Xi administration to successfully engineer supply-side reforms to reduce excess capacity and raise productivity in parts of the economy. Online ecommerce had also helped to stimulate consumption of goods and services, allowing China to achieve a more balanced economy less dependent on investment demand.

Recent rhetoric suggests Xi Jinping remains committed to his quality growth agenda, backed by a full arsenal of policy options which he has wielded with increasing skill in the past five years. Indeed, the Asia Pacific ex-Japan region is better positioned for stable, high-quality growth compared to five years ago. This means corporates should be able to work towards achieving the sustainable earnings growth trajectories that are needed to anchor multi-year equity upcycles.

Equity volatility versus economic volatility

The Chinese are not alone in the mindset shift towards sustainable strategies. We believe this has been facilitated by a greater appreciation for what stability could bring across the gamut of social, political and economic outcomes. On the political front, for example, Thailand's masses are not demanding a quick return to democracy as they seek a less disruptive environment to get on with their lives. Philippines' President Duterte has chosen to downplay claims to the Scarborough Shoal in exchange for economic cooperation with China.

Globally and in the region, regulatory policies have been tightened to lower the risk of negative financial events. Fiscal, monetary and exchange rate policies have also been careful and gradual in nature, save for India's gambit on demonetisation and the goods and services tax (GST) – although the ramifications for its economy should be positive after the pain of implementation has been taken.

China's debt-to-GDP ratio remains a potential source of economic instability that weighs on market sentiment. However, a high ratio in itself is not necessarily a problem; in fact, developed economies tend to have a higher ratio than emerging economies. It is the speed at which China has reached its current level that is more worrying. That said, a lot of work has been done on tightening financial practices, with banks lending with greater prudence today than they were eight or 10 years ago. China's debt composition is also domestic in nature, with very little borrowing from overseas, giving the government substantial scope to manage the situation.

The positive outlook for sustainable growth in Asia Pacific ex-Japan is occurring in the context of synchronised growth in the US and Japan and Europe. In theory, economic volatility should be declining as such synchronicity kicks in. It is ironic, therefore, that equity market volatility may be about to increase.

Sustained growth means inflation as well as interest rates should continue to normalise – in other words, go up. This is bound to spook some in equity markets, although for the real economy it is something we should expect in the course of a sustained upcycle. We may have to worry more about inflation at some point, but at it is still too early to be a substantial threat to growth.

Until then, the Fed and key central banks across the world should have enough leeway to trade-off inflation and interest rates without them running out of the bounds that could threaten sustainability. Historically, when such trade-offs have been taken to prolong the growth cycle, as I believe was the case in episodes of Fed rate hikes in the past 30 years, they had co-existed with positive performance for global equities (as represented by the MSCI ACWI Index).

Summary

Fears that the current economic growth momentum will be stymied are too premature. Inflation at this stage remains a reflection of the strength of the economy, with global central banks sitting on a full arsenal to manage a sustained upcycle in which Asia Pacific ex-Japan markets have started to participate. I believe there is more upside to be had in Asia Pacific ex-Japan equities as growth is delivered this year, particularly if short-term, benign or technical factors succeed in coaxing attractive entry opportunities out of the trading volatility.

Sources:

1. Bloomberg, as at 19 Feb 2018, for all figures referred to in the paragraph.

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