

Riding high in Asia

With Asian markets on the rebound, our panellists give their take on how investors can ride this uptrend



ASIAN equities have rebounded this year with double digit returns in some selected markets. How sustainable is this rise? Our experts share their views.

Genevieve Cua: What do you see as the underpinnings of the rebound in Asian markets this year, and how sustainable is it?

Alexis Calla: Asian equities have broadly mirrored the rebound in global equities since their February lows as worries about a sharp slowdown in China and a significant devaluation of the yuan receded. Investors were also reassured by a weaker US dollar (USD) since the start of the year as expectations of a US rate hike got pushed back. As China's outlook stabilised and the USD gave up some of its gains, commodity prices (which had been on a five-year downtrend) bounced back. All these trends encouraged global fund managers to turn more positive towards Emerging Markets (EM).

The rebound in Asian equity markets has been particularly impressive following the UK's decision to leave the European Union (EU). This possibly reflects both the amount of cash waiting for an entry point in the run-up to the Brexit vote and the realisation that the challenges created by the vote are not immediate and will take time to play out.

Asian equity markets have outperformed global markets since the Brexit vote partly due to the region's relatively stronger and improving fundamentals, both in terms of economic and earnings growth prospects, and cheaper valuations compared with Developed Markets (DM).

Easier monetary policies across the region have also helped boost the outlook for domestic demand across the region – several Asian central banks, from India to South Korea and Indonesia, have cut rates this year, encouraged by a weaker USD and subdued inflation.

Of course, there are still risks out there. For instance, we may see a revival of US rate hike expectations in the near term as the US job market continues to tighten. This may result in a temporary bounce in the USD, which is generally not supportive of EM equities.

Meanwhile, we are entering a critical period with regards to the US presidential election, with attendant policy risks. With DM equities generally quite elevated, this suggests an equity market drawdown is a risk in the near term.

However, with the worst of the US corporate earnings recession likely behind us, the downside may be limited to 5-10 per cent. Asia ex-Japan equities could be affected by such a drawdown, although on a relative basis we believe the region is likely to outperform other markets over the medium term. Overall, we remain cautious towards equity markets.

Reginald Tan: At the onset of 2016, investors had totally written off Asian equities due to the steep decline in the Chinese onshore equity market at the start of the year. Two trading halts and "firefighting" measures by policymakers to address the falling markets did little to inspire confidence.

However, markets have a knack of surprising investors. Fast forward seven months – and the Asia ex-Japan markets are up 10.9 per cent in USD terms on a year-to-date (YTD) to August 2016 basis.

The recovery is best understood by examining the painstaking bottoming out process that took place in the Asia ex-Japan markets, particularly in the region's largest economy – China. Subsequent to the inept actions in January, the Chinese policymakers improved their act – with better policy communication and signalling efforts to investors.

The Asia ex-Japan index started to meaningfully register positive YTD returns just after the EU Brexit referendum in late June. "Expensive" US markets with peaking valuations, and uncertainty in Europe emanating from the historical Brexit vote, led to significant portfolio rotational adjustments. Global investors were seen shifting money away from the DM in favour of the EM bloc. The massive inflows account for the firm showing in EM and Asian equity assets since the start of Q3 2016 up to this point.

The billion-dollar question now is whether the re-rating drivers are sustainable, and whether the gains in Asian equities will continue. To some extent, the recovery is merited and has its roots in real fundamental improvement. At the start of 2016, concerns over a "hard landing" scenario in China were very real. This risk factor has since receded, with data point stabilisation emerging in the mainland.

Additionally, fund inflows to the Asean markets were also predicated on real fundamental improvement – investors are convinced of the positive outcome of the fiscal spending efforts in Thailand and Indonesia, and believe that proactive measures by policymakers to induce growth in Indonesia will come to fruition – for example the "Tax Amnesty" programme and the more relaxed Loan-To-Value (LTV) financing guidelines for home purchases.

In short, the positive news flow, along with numerous measures and proactive steps by the various Asean policymakers, garnered the "buy-in" of global money managers, who voted with additional portfolio inflows to the region.

In the Asean space, the overweight positioning by Global EM portfolio managers is in line with, and not excessively above their historical averages, signalling that investors have not got ahead of themselves. We are not in overbought territory, not yet at least.

Moreover, although US Federal Reserve chairman Janet Yellen has signalled that the probability of further US rate hikes has risen, the Fed may still be restrained with regards to the pace of its future tightening actions. A more patient Fed may lead to sustainable inflows, and in turn be supportive of valuations for EM and Asian equities. However, the

"easiest" part (or low hanging fruit) portion of the rally may be behind us, and forward gains may be more measured from here.

Lim Chew Hwee: Post-Brexit, investors discovered that the consequences of the referendum were not as disastrous as some economists had painted. Money lying on the sidelines, earning little or no return, started to flow back into the regional equity markets which were still attractively valued. At the same time, downward earnings revisions bottomed and started to swing higher for a number of countries.

In a nutshell, it was a positive combination of earnings, liquidity, valuation, interest rates and sentiment that propelled the markets higher. Going forward, the sustainability of the rebound depends to a very large extent on whether earnings growth will continue to be revised upwards. Liquidity is still abundant and a positive earnings outlook would be a crucial factor to bring money back to the region.

Sean Quek: When we turned more positive on Asia ex-Japan equities late last year, after maintaining a cautious stance in favour of DM since 2013, global investors were significantly underweight the region. Following sustained downgrades in macro-economic growth outlook, earnings growth expectations have moderated.

Also, given the extended de-rating, valuations were attractive. The region was trading at the low end of its own long-term historical range as well as at a significant discount to developed markets. The subsequent stabilising of the macroeconomic outlook, pick-up in reforms and loosening of policies in key markets, including China, provided the positive catalysts. Also, the extended dovish stance by central banks globally boosted investor risk appetite.

In the current year to Sept 8, the region (MSCI Asia Ex-Japan Index) returned 15 per cent, and significantly outpaced global equities' (MSCI World Index) returns of 6.5 per cent. Although the region continues to trade at a significant PE (price-earnings) valuation discount to global equities, it is now trading near the higher end of its own historical range. The low expectations of a US rate hike suggest that the market could be easily spooked by more hawkish Fed commentary. Coupled with our more cautious view on equities as a whole, we are "neutral" on the region.

Genevieve: What do you see as the major themes to drive Asian equities higher in the short to medium term, and how are you positioning (or advising clients) to take advantage of this?

Alexis: In recent months, we have become more positive on the medium-term outlook for Asia ex-Japan equities given an improving earnings outlook and a pick-up in net inflows to the region. We believe these trends are sustainable given our

THE BUSINESS TIMES' WEALTH ROUNDTABLE

Genevieve Cua, BT Wealth Editor poses questions to wealth experts for their views on Asian equities' rise.



Alexis Calla is Standard Chartered Bank Global Head of Investment Strategy, Advisory & Discretionary. Alexis is responsible for defining and delivering the bank's wealth management advisory proposition. He also oversees the Private Bank investment advisers. He enjoys painting and collecting art, and is an avid supporter of emerging young local artists.



Reginald Tan is Amundi Asset Management Director and Head of Research, Amundi Singapore. He joined Amundi in 2000 as associate director of investments. Previously he was senior portfolio manager at CMG First State Investment where he managed regional, global and balanced portfolios for institutional clients. He likes to travel, particularly self-drive holidays, and also enjoys cooking.



Lim Chew Hwee is ABN AMRO Private Banking Head of Asian Equity Strategy. He has over 20 years' experience in financial services. Prior to joining ABN AMRO, he was chief executive and head of investment solutions at Atlas Asset Management. Chew Hwee is an avid photographer, travel enthusiast and enjoys reading.



Sean Quek is Bank of Singapore Managing Director and Head of Equity Research. He leads the equity research team and spearheads the bank's equity strategy. His team is also responsible for model equity portfolios. He enjoys exploring the growing number of scenic running routes in Singapore.



expectation that the USD will remain relatively stable (as the Fed is likely to pursue a gradual pace of rate hikes). The improved outlook for Asia's corporate earnings – after two to three years of disappointments, a gradual rise in the dividend payout ratio and strong flows into EM assets – should help support potential outperformance in the coming 12 months. Thus, Asia ex-Japan is now our most preferred region from an equity market perspective, followed by the US.

Focusing specifically on equities, we have increased our allocations to EM equities over the past few months (in particular to non-Asia EMs), by reducing our exposure to DM equities. Broadly, five factors have been driving our DM to EM pivot.

i) For the first time since 2011, the outperformance of EM over DM in terms of economic growth is likely to widen in 2016. (Since 1999, EM economies have been growing faster than DM economies. However, this growth differential peaked at around 7 per cent in 2009 and, since a brief pick-up in 2011, it has been on a downtrend.)

ii) Recovery in commodity prices

iii) A pullback in the USD since the start of the year, easing concern about EM currency weakness and contributing to an increase in fund inflows

iv) Attractive EM relative valuations compared with DM

v) Investor positioning – investors are significantly underweight EM and overweight DM (although this trend has been reversing in recent months)

Reginald: With respect to forward looking themes in Asia, we see a few investment opportunities unfolding in the short to medium term. There is a structural shift taking place in the Chinese economy – although headline growth is slowing, we see this as a natural transition from a fast-growing emerging economy to a developed market economy (where the growth rate stabilises and becomes more measured).

In line with this shift, the traditional “old economy” manufacturing-led sectors, which were the key drivers of growth in the past, will take a back seat. In its place, mirroring the US (where consumption accounts for 70 per cent of the economy), consumption spending and services are expected to be the key engines of forward growth. This structural growth is expected to manifest itself strongly in the “new economy” Internet stocks such as the e-commerce names. There is a burgeoning growth trend taking place, where Chinese consumers are taking to and exhibiting firm online spending behaviour. Companies that are levered to this trend by providing the necessary platforms and avenues for the new Chinese consumer to express their newfound spending habits will benefit strongly.

India is another market with strong growth opportunities. The Narendra Modi-led administration with its strong pace of reforms and increased visibility in infrastructure investment spending, where these efforts are being validated with positive GDP (gross domestic product) surprises, is unlocking significant opportunities for the Indian cyclical stocks.

In Asean, there are sound opportunities in the fiscal spending beneficiaries in both Thailand and Indonesia given the strong commitment by both governments to accelerate their respective fiscal spending programmes. Construction-related stocks are poised to benefit from increased demand and rising order book trends. Thai tourism stocks are also appealing as there continues to be strong tourist arrivals and related spending activity, despite the recent bombings in popular tourist destinations.

Additionally, in Indonesia, there is potential for further re-rating in the property developers on the back of the more relaxed LTV financing measures for residential property purchases. The “Tax Amnesty” programme to encourage repatriation of funds may further bolster this trade as offshore monies find a “home” in the form of property asset investments. Thai and Indonesian banks also look appealing at this juncture on improving asset quality profiles. Rising loans growth is an added positive factor.

Elsewhere in Asean, while the longer-term Philippine consumption theme remains intact, and is fundamentally

sound due to its young population demographics and rising disposable incomes, valuations of some of the Philippine consumption names appear stretched, and are vulnerable to intermittent pullbacks in the short term on the slightest sign of disappointment.

Chew Hwee: Some of the secular themes we like include infrastructure development, demographic changes, reforms and tourism.

Increasingly, we are hearing economists and government officials admitting to the limitation of monetary policies and exploring fiscal tools to revive the lacklustre economy. Fiscal spending would favour infrastructure development. In fact, many regional countries need to spend on new infrastructure or upgrade their ageing ones.

Several countries are facing an ageing and shrinking working-age population. To maintain economic growth, it is essential that these countries replace labour with machines, automate their manufacturing processes and increase productivity. Hence, automation is another theme worth exploring.

A number of Asian countries have embarked on reforms. One prominent theme is China's State Owned Enterprise (SOE) reform. To ensure that the Chinese economy sustains an average 6.5 per cent growth over the next few years, reforming the debt-laden and inefficient SOEs is an essential prerequisite.

As for the investment theme of tourism: The propensity to travel tends to rise as the region's middle class grows.

Sean: In the short term, given the relative valuation gap, Asian equities could continue to catch up with developed markets especially as risk appetite expands further. However, following the speedy re-rating in Asia ex-Japan equities with comparably less improvements in fundamentals, we are now highly selective. For example, in China, we are advising investors to take the opportunity to switch from “old economy” into “new economy” stocks. The structural transition of the Chinese economy from a fixed asset investment driven to a consumption-driven one would continue even as the ongoing rebalancing is generating substantial cyclical volatility given the resulting “stop-go” economic performance.

Genevieve: What risks are you most concerned about in terms of Asian equity and what moves would you take to mitigate these?

Alexis: Our positive view on Asia ex-Japan (and US equities) needs to be understood against the backdrop of our cautious stance on the outlook for global equities on a risk-adjusted basis. We remain cautious in the near term given the risk of rising US interest rate expectations (leading to a possible boost to the USD, hurting EM assets). Uncertainty around the US presidential election is another near-term risk. On a medium-to-longer-term view, it remains unclear how successful China will be in managing its deleveraging cycle.

A key medium-term risk remains a US recession. While we continue to believe we are in the late stage of the US economic cycle, our central scenario is that there is still some time left for the current expansion. We estimate that there is around a 30 per cent probability of a recession in the next 12 months.

However, this probability is high enough to be taken seriously when making investment decisions. Indeed, it is one of the reasons that we recommend a below-average allocation to equities, which may still perform reasonably well under our central scenario of continued US economic expansion. (For instance, we believe investors with a moderate risk profile should allocate 33 per cent of assets to equities, compared with 39 per cent at the start of the year. Within that, we believe moderate risk-taking investors should allocate 12 per cent of assets to Asia ex-Japan equities, same as at the start of the year).

How to mitigate these risks? Our favoured approach is a combination of income-generating assets and other strate-

gies that typically have low and potentially negative correlations with equities. Multi-asset macro strategies fit this bill.

Overall, we remain ready to adapt our strategy based on incoming data. With policymakers becoming increasingly data-dependent as they move into uncharted territory, adaptability and agility are likely to be key items in a successful investor's toolkit.

Reginald: In summary, the positive action we have seen in emerging and Asian equities this year is well founded. The outlook ahead is also positive, although the period to reap the low-hanging fruit returns is probably behind. The region is vulnerable to fund-flow direction and by default, policy guidance from the Fed with respect to interest rate direction. Should there be a strong case for sustainable US rate hikes, the region (EM equities) could see material selling pressure. The probability of this happening, however, is small (but it cannot be totally ignored).

As alluded to earlier, the Fed may be restrained with regard to the pace of further monetary tightening as US economic data still paints a mixed picture. Additionally, the other major DM equity blocs – Europe and Japan – are still seeing sub-par growth with the former still not having fully come to terms with the full repercussions of the Brexit vote.

With this backdrop, global funds need to find a “home”, and with fundamentals relatively stronger in Asia ex-Japan, this could keep inflows in the region contained (and valuations well supported). Should there be a massive rise in US rates, we can opt to be well positioned in areas that would benefit from this trend – such as the banks and insurers, or even stocks with strong USD revenue exposure. In a rising US rate environment, it would be prudent to be invested in companies with healthier balance sheet strength (that is, the lowly geared companies), and names with low USD debt exposure.

Chew Hwee: There are three near-term risks and one mid to long-term potential pitfall that I am most concerned about.

A sharp correction on Wall Street, a rally in the USD and finally a soaring interest rate are three near-term risks. The bull run on Wall Street is mature and valuation is lofty. Any sharp correction in the US equity market would have an adverse impact on Asian equities. A rally in USD would depress commodity prices and affect regional commodity exporters. A combination of a soaring USD and interest rate would be a potent concoction for Asian corporates that have leveraged up their balance sheets post-2008 crisis.

The one mid to long-term potential pitfall that I am concerned about is that the present undercurrent of protectionism would spread. Should world growth remain subdued and social inequality intensify, protectionist measures would increase. This would be negative for Asia, a region dominated by trading nations.

To mitigate these risks, one must be nimble and take an active approach to investing. Always be prepared to take profit and do not overstay your welcome. Pay more attention to risk than return. Invest only in quality companies that you understand and do not overpay.

Sean: Investors seem increasingly complacent about a lower-for-longer interest rate environment. Since the Brexit selloff in late June until Sept 8, global equities have rebounded by as much as 11 per cent (and Asian equities by 16 per cent). We continue to expect volatility in the near term amid the political and global growth uncertainties, even as central banks are ready to act further to support growth.

One of the unquantifiable risks is the US presidential election. It is hard to predict what a Trump presidency would look like, but if the polls swing towards Donald Trump's favour in the next few weeks, market volatility could heighten again.

Low expectations of a US rate hike suggest that the investors need to look out for more hawkish Fed commentary as we approach December where we expect the Fed to raise rates. Accordingly, we would focus on quality companies with strong fundamentals especially as increasingly extended valuations are leaving limited margin of safety for investors. **W**