In a sweet spot

External and domestic factors, coupled with attractive valuations, may drive Asian equities to outperform global markets in 2015

By Arthur Kwong


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WITH the Standard & Poor's and Nasdaq benchmarks breaching all-time high levels and pushing valuations for the MSCI United States Index to above 18x price-earnings ratio (P/E) – based on Bloomberg 12-month forward earnings estimates – some investors are likely to re-think their portfolios in search of more attractively valued investments.

Given the low growth-expectations and concerns over unresolved debt problems across many eurozone nations, Europe is not exactly a screaming "buy" for some investors at this juncture. Meanwhile, Latin America, the Middle East, Eastern Europe and Africa regions – the darlings in the eyes of many investors in the not-so-distant past – are now plagued by a myriad of obstacles weighing down investors' appetite.

While economies in Asia also face a number of challenges, we believe that the relative attractive valuation for the region, coupled with internal domestic drivers, provides downside risk support, and positions the region in a "sweet spot" in 2015. Additionally, a number of external factors provide a strong tailwind for Asian equities, such as weak energy/commodity prices, an accommodative European Central Bank (ECB) ready to inject abundant liquidity into the financial system, and an expected sustained, albeit moderate US recovery propping up exports for Asia.

Domestic catalysts

It is undeniable that many Asian economies also face a soft patch in terms of growth as they undergo rebalancing to the "new normal" slower global growth trend. However, we believe much progress has been made in recent years, with key notable positive developments in 2014.

What is most encouraging is the determination demonstrated by many Asian governments to drive reform across all facets of the economy, including what were once highly sensitive government-dominated areas. We see this trend especially evident in China, India and Indonesia since the new "reform-minded" political leaders took office. The leaders in Japan and South Korea can also be commended for championing much-needed reform agendas.

We should be mindful that despite slower growth across many Asian economies, Asia ex-Japan countries continue to top the charts for global Gross Domestic Product (GDP) growth. The International Monetary Fund (IMF) and consensus real GDP growth forecast for the Asia ex-Japan region averages around 5 to 6 per cent – much stronger than the 2 to 3 per cent growth estimate for the US, and the one per cent for the eurozone.

Also worth mentioning is that Asian corporates are cash rich. Cash on the balance sheets of Asian companies is approaching US$1 trillion, leaving the door open for possible dividend increases, share buybacks, and opportunities to increase shareholder value through accretive acquisitions – all positives for shareholders.

External catalysts

A sustained US economic recovery cycle should help boost exports for many Asian economies, especially for Japan, South Korea, Taiwan, China, Hong Kong and Singapore. Additionally, quantitative easing from the ECB should inject abundant liquidity into the financial system, which should bode well for global equities. We believe emerging Asian markets will be key beneficiaries of the new flood of liquidity given the region's inherent higher-beta market structure.

As a net importer of commodities and energy products, Asia significantly benefits from the recent weakness in commodity prices. Given the structural demand-supply forces in the global commodity market, coupled with the "new normal" softer global growth trend, we expect commodity prices to remain suppressed for some time. Weak commodity price has been a significant positive for Asia in a number of ways. For one thing, lower input cost for Asian corporates has and will continue to bode well for margins.

The steep decline in commodity prices has been a powerful disinflationary force globally and in Asia. The low inflation environment has paved the way for many economies (that is, Indonesia, India and China) to push through price reforms for energy and resource-based utilities. As a result of recent energy price reform implemented in India and Indonesia, both economies are now benefiting from a much-improved fiscal position, making them less vulnerable to a future US rate normalising cycle.

Furthermore, disinflation pressure has enabled many Asian central banks to trim benchmark rates to support growth. In fact, with inflation easing significantly across the region, all Asian economies are now on an easing-bias (China, India, South Korea, Thailand, Indonesia, Singapore and Australia). And while the central banks in Taiwan, Malaysia and the Philippines have not yet moved to an easing stance, their monetary policies are not positioned to hike anytime soon. On the contrary, if disinflation pressure persists (which we expect it will), these economies could very likely swing to a more dovish policy.

The opportunities

Our outlook on Asian equities remains very constructive. In fact, there may be a high probability that Asian equities will outperform many global equity markets in 2015. Within Asia, we highlight the following opportunities:

Japan remains one of our preferred markets. Given the Bank of Japan's easing monetary policy, the weak yen should continue to benefit Japanese exporters. We see many technology-related opportunities, especially in the healthcare equipment and industrial automation and robotics area, and we are encouraged by the early signs of corporate restructuring plans. It will be a slow process to change decades of ingrained cultural behaviour and norms, but the early signposts are encouraging with Prime Minister Shinzo Abe at the helm.

India is also a preferred market and we expect a re-rating over the medium term. The two recent rate cuts by the Reserve Bank of India are a huge positive to help boost growth. The long-term consumption growth story remains very much intact, and we believe increased household wealth will drive consumption for many low-penetrated areas across the economy. Meanwhile, the Modi government continues to accelerate structural reforms and improve the policy environment.

China offers the benefit of being one of the cheapest markets in Asia-Pacific. The urbanisation and increasing wealth trend in this country provide good support for consumption over the medium term. With the People's Bank of China clearly signalling an easing posture, equities should be supported despite the weak growth trend. Excessive government debt and a weak property market, however, continue to be areas of concern.

Australia continues to face headwinds from weak commodity prices, but the economy is healthier than some may expect. Favourable demographics continue to drive growth in domestic consumption, benefiting the transportation (airport/toll road), healthcare, telecommunication and utilities sectors. Risk remains high in energy and materials except for large diversified miners who continue to generate strong cash flows despite weak commodity prices. We also like a number of the banks as they offer very attractive yields, and operate in an oligopoly structure, which allows them to command strong pricing power.

Within Asean, our outlook for Indonesian equities remains very positive. Ongoing reform to mend the country's balance sheet is very positive for the country over the long term. We favour banks due to the country's low credit penetration and the oligopoly structure of the sector. The acceleration of infrastructure projects is seen as the next most important challenge for President Joko Widodo to overcome. If he succeeds, we expect Indonesian equities will see another strong year. We also have a positive outlook on the Philippines. With inflation risks in the rear-view mirror and growth picking up, this market is expected to continue to outperform.

We are more cautious on the outlook for South Korea and the non-technology sectors in Taiwan. For South Korea, the weak Japanese yen will continue to pose headwinds for Korean exporters. Domestic consumption also remains weak. The Korean government seems committed to pushing forward reform measures, but the market remains unconvinced so far. However, current valuation for the market is favourable. In Taiwan, domestic growth continues to be muted as well, but inflation is no longer a concern. We don't see many positive catalysts for this market in general and prefer to remain invested in selected technology leaders.

Valuations remain attractive for the region. Despite the recent multi-year strong market performance for many of the Asian countries, with a number of markets breaching all-time high levels, valuations remain attractive with both the MSCI Asia ex-Japan Index and the MSCI Asia Pacific Index still trading below their five-year historic average P/E multiple (12-months forward P/E basis).

Asia-Pacific ex-Japan trades at a 22 per cent discount on a price to book value (P/BV) versus return on equity (ROE) valuation model to global equities, making the region the second-most undervalued region after Europe, the Middle East and Africa (EMEA). Investors seem to agree that Asia may be in a "sweet spot" if recent market performance is any indication. W

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