Asian Equities

Why Asia has done well this year?

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Key takeaways

- Our earnings growth outlook for 2018 is largely positive.
- Our regional outlook is based on positive trends in domestic consumption, global economic growth, interest rates and infrastructure spend.
- We see value in the technology and banking sectors as well as in South Korea.

2017 has seen Asian equity markets rally largely due to the strength of corporate earnings. At the start of the year, earnings growth expectations for 2017 were low at approximately 10%, but over the course of the year they have been revised up to 20%. The recovery has been helped by a combination of factors such as: solid global economic expansion, a lack of disruption from President Trump, falling bond yields in some Asian markets and a small earnings re-rating.

What is the outlook for earnings in 2018?

In our view, the outlook for earnings growth in 2018 is broadly positive. Consensus earnings growth expectations for 2018 have been gradually moving up over the course of this year and are now close to 10%. Recently, these expectations were boosted by China's second quarter 2017 results season, in which almost two-thirds of companies beat expectations[1]. Elsewhere, consensus earnings estimates for the Indian market[2] were marginally revised upwards for the full year 2018, post significant downward revisions over the summer months. Going forward, Indian earnings growth should benefit from easier year-on-year comparisons after the government's demonetization of high-value currency (November 2016) and the introduction of the Goods & Services Tax (July 2017) reduced prior year numbers.

These are the main factors which dominate the outlook for 2018 Asian earnings: domestic consumption (particularly in China), global economic growth, the interest rate environment and infrastructure spending. We expect consumption to remain strong in China, with support from wage growth, and to increase in India, driven by a very gradual revival in economic growth. Elsewhere, we believe consumption may continue to be relatively subdued – in particular, the debt overhang in Korea, Malaysia and Thailand renders it difficult for these countries to stimulate consumption significantly. Infrastructure spending, an obvious kicker to growth in much of the developed world, is also a factor that should support growth in Asia. For example, the Belt and Road (OBOR) infrastructure initiative is aimed at increasing cross-border trade within Asia and beyond. The emphasis placed on this program by President Jinping at the recent China Party Congress suggests that 2018 will see increased stimulus as a result of its implementation.

It is also helpful to consider the outlook for earnings growth from a sector perspective, and in particular, to look at the Asian technology and financial sectors, which account for well over 50% of the market. These sectors saw strong earnings growth in 2017, and we expect this trend will probably continue in 2018. For the banks, the main supporting factors will be: some top-line growth as economies pick up; net interest rate margin expansion on the back of higher interest rates; and continuing low bad debt provisioning requirements. In the technology sector, capital discipline and lessening competition is enabling the largest companies, such as Samsung Electronics and Taiwan Semiconductor Manufacturing Company, to capitalize on strong demand growth. Furthermore, select internet companies are taking advantage of increased internet penetration to grow their businesses profitably. So, in aggregate, we expect earnings growth to be reasonably attractive in 2018, but not as powerful as in 2017.

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What are the important themes for the region?

China. China is crucial for the prospects of the whole region, and so far gross domestic product (GDP) growth has remained stable at a respectable level (i.e. third-quarter 2017 real GDP growth of 6.8%[3] year-on-year) , helped by stimulatory government policies and continuing income growth. GDP data showed that consumption growth remained robust with retail sales growing at approximately 10% over the last 12 months. Progress has also been made in rebalancing the economy away from investment–led growth, with consumption as a share of GDP standing above 60% for seven consecutive quarters (as of the third quarter of 2017)[4].

Although the debt mountain has remained high – China's debt-to-GDP ratio is still 270%[5] – the continued liquidity of the banking system, aided by strong domestic saving rates, means that the economy is unlikely to topple over in the short term. Related to this, a further concern in China has been whether pressure on foreign exchange reserves as a result of capital flight could result in currency devaluation. This in turn would lead to the necessity of higher interest rates, which would dampen economic growth. Reserves have now stabilised, mainly as a consequence of government intervention, and the pick-up in global growth has also enabled the Chinese export growth recovery to strengthen foreign exchange reserves.

India. Another important theme within Asia is the progress of reform in India. Over 2017, the Indian equity market performed well in spite of the fact that earnings growth underperformed expectations. Under Prime Minister Modi, India has the best reform momentum amongst the countries we invest in: the implementation of the Goods & Services Tax is progressing well; tax revenue is increasing; the approval of the Bankruptcy Code has been a significant step towards cleaning up banks' balance sheets; the government's demonetisation of high-value currency in 2016 is shrinking the black market; and the Indian government's recent recapitalisation of the state-owned banks should enable the stronger banks to accelerate their loan growth.

Ultimately, investors have remained confident that these reforms are increasing the economy's potential growth rate, which should support higher earnings in the longer term while, at the same time, helping to control inflation and the fiscal and current account deficits. We concur with this view, but if these reforms do not actually produce improved economic growth over 2018, then investors will start to question whether the valuation premium attached to Indian companies is deserved.

> We believe the market valuations of many Asian companies do not reflect their ability to grow earnings, generate strong free cash flow and increase dividends.

Where are we finding value?

In many of our portfolios, technology has been our largest sector overweight relative to the index. Within technology, the Chinese internet companies have been producing stellar earnings growth on the back of consumption-led growth in China, and we expect this to continue in 2018. Consumers have been quick to adopt mobile internet applications, and companies that have been willing to innovate in online services, such as social media, gaming and e-commerce, have become dominant players. We have notable exposure to these companies as we believe the market is too skeptical about their ability to maintain strong long-term growth. Within our technology hardware exposure, we also have a preference for companies that have healthy balance sheets, strong free cash flow generation and growth potential, but remain undervalued. For example, we favor Samsung Electronics which, despite its strong share price performance, remains undervalued relative to the prospects for its main divisions, in our view.

We are also overweight the banking sector. We believe that banking systems with less extreme loan growth in recent years, such as in Korea and Singapore, and those that have been proactive in recognizing bad assets, as in India, will be better-placed. For example, in India we favor the well-capitalized private sector banks, which have seen their valuations fall to attractive levels such as ICICI Bank. Representing only 30% of total lending[6], the private banks still have potential to gain market share from the state banks, which struggle to compete on customer service, efficiency and credit appraisal.

Turning to the energy sector, the near-term outlook for oil prices remains uncertain, but we have been able to find some attractive opportunities that are still profitable even in a low oil price environment. For example, we are positive about the outlook for CNOOC, a Chinese oil business that we anticipate should benefit from management's focus on profitability and asset returns. Furthermore, we believe this company's oil reserves are being underappreciated by the market.

Another source for attractive investment ideas is South Korea, which has long been amongst the cheapest markets in Asia[7]. This discount partly results from the higher representation of cyclical stocks in the market and from the uncertainty caused by periods of aggressive behavior by the North Korean regime. However, Korea's history of poor corporate governance has also been a significant factor in the discount. This is best demonstrated by the low average dividend payout ratio as compared to the average for the Asian region[8]. However, we believe that this is starting to change for the better with positive implications for valuations. Firstly, Samsung Electronics has moved to a capital return policy which outlines that at least 50% of free cash flow will be returned to shareholders in the form of dividends and share buybacks. As Korea's most successful company, Samsung's more shareholder-friendly actions are likely to be copied by other business groups. Secondly, the Korea National Pension Service, a large shareholder in many Korean companies, has begun to be more forceful in demanding better shareholder returns.

What areas of the market are we avoiding?
From a geographic point of view, we remain concerned about Malaysia as we believe that many long-term problems in this country have not been addressed. Until they are tackled, high valuations combined with low growth and political uncertainty means that we will continue to avoid investing in this market.

Elsewhere, some of the defensive sectors are still too expensive, in our view, post a period where investors have been happy to pay a premium for earnings certainty, often on the back of a slightly higher than market average dividend yield. We believe if interest rates do rise gradually, then the rationale for buying such stocks will lessen further, and their overvaluation will become even more apparent.

Conclusion
So, in summary we believe that there is scope for Asian markets to go up in-line with earnings growth in 2018. The consensus earnings per share growth forecasts of 10% for 2018[9] are dependent on a continuation of a benign global backdrop. In our view, such an environment is fertile ground for stock-picking opportunities. We believe the market valuations of many Asian companies do not reflect their ability to grow earnings, generate strong free cash flow and increase dividends.

1 Source: Bloomberg L.P., November 2017.
2 The Indian market is represented by the MSCI India Index.
3 Source: Bloomberg L.P., November 2017.
4 Source: Emerging Advisors Group as at June 30, 2017.
5 Source: People's Republic of China, International Monetary Fund, Country Report No.17/247, August 8, 2017.
6 Source: CLSA, Indian Financials, Sector Outlook, October 25, 2017.
7 Source: Bloomberg L.P. November 2017.
8 Source: Bloomberg L.P. November 2017.
9 Source: Bloomberg L.P. November 2017.

Important Information

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

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