What will Asian equities benefit from in 2017?

Q4 2016

Heading into 2017, the Invesco Equity Investment Team in Asia believes Asia ex Japan equities will benefit from the bottoming-out in earnings, accommodative liquidity, and attractive valuations relative to history, as well as to global peers. Moreover, we see several bright spots that could further spur regional growth, such as robust consumption, ongoing reforms that enhance productivity, and fiscal initiatives that lead to secular infrastructure investments.

Our view: Earnings to bottom out

In 2016, Asia ex Japan earnings growth is expected to be largely flat after downward revisions to consensus earnings throughout the year. With limited top-line growth worldwide, Asian companies are finding ways to enhance earnings. We believe the bottoming-out of earnings will be a key factor in support of Asia ex Japan equities in 2017.

Our view that fiscal year 2017 margins should be relatively resilient is twofold. First, Asian companies should see an improvement in earnings from tighter expense controls. Second, we believe the decline in input prices will provide relief for consumers as well as specific industries that are reliant on raw material inputs, including manufacturers, refiners and transportation companies. Similarly, after rounds of monetary easing, lower financing costs will also provide a better operating environment for corporates, in our view.

An extension of accommodative liquidity

Although the pace of interest rate tightening cycle in the US may end up being faster than earlier expected, liquidity in Asia ex Japan in 2017 should remain relatively abundant as policymakers focus on stability and growth. A number of Asian central banks have already eased further in the second half of 2016, with some central banks taking policy rates to record lows, such as Indonesia and South Korea.[1] We expect most Asian countries will maintain an accommodative stance in light of the low inflation outlook.

In China, government authorities continued to show a strong commitment to financial reform, by increasing accessibility to offshore Chinese equities. When China's insurance funds were granted access to invest in Hong Kong equities via the southbound Shanghai-Hong Kong Stock Connect channel in September, subsequent to the removal of the aggregate quotas, there was a record fund flow into Hong Kong via the Stock Connect, with net Southbound purchases reaching RMB $58.9 billion (compared to the previous high of RMB $52.7 billion in April 2015).[2] Coupled with the recently launched Shenzhen-Hong Kong Stock Connect, Hong Kong-listed Chinese equities will likely continue to benefit from the huge potential for structural flows and improving liquidity.

Valuations remain attractive

With the recent market volatility, Asia ex Japan is now trading at an even more meaningful discount to developed markets in price-to-earnings terms, with a 15% discount to Europe and 30% discount to the US.[3] While earnings are generally more vulnerable to fluctuations in Asia, regional valuations are equally compelling in

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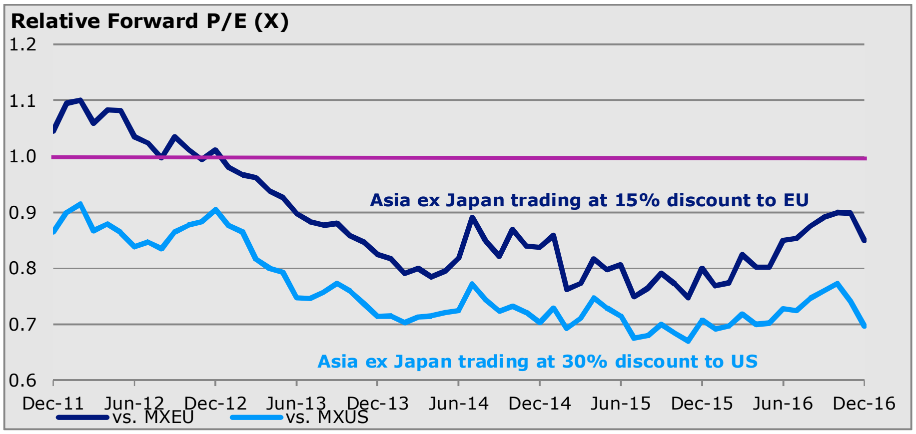
[1] For Indonesia, a record low was reached on Oct. 20, 2016 at 4.75%. For Korea, a record low was made on June 9, 2016 at 1.25%.

[2] Source: Bloomberg L.P. as of Sept. 30, 2016.

[3] MSCI AC Asia ex Japan Index relative to the MSCI US Index and MSCI Europe Index. Sources: MSCI, FactSet, IBES, Bloomberg L.P., Goldman Sachs Global Investment Research, as of Dec. 16, 2016.

price-to-book terms, with MSCI Asia ex Japan trading at 1.3x,[4] which is comparable to levels following the global financial crisis in 2008 and the period after the technology, media and telecommunications bubble in the early 2000s. Although short-term volatility may persist, we believe these valuations offer attractive entry points for long-term investors looking to gain exposure to Asia ex Japan's secular growth trends.



Source: MSCI, FactSet, I/B/E/S, Bloomberg, Goldman Sachs Global Investment Research, 16 Dec. 2016.

Potential Catalysts in 2017

Looking ahead, we believe Asia ex Japan could benefit from a number of structural themes that may act as investment catalysts in 2017:

- **Robust consumption:** Domestic consumption continues to be a key economic growth driver for Asia ex Japan as many economies are transitioning from an export and manufacturing-driven model to one that is consumer-led. The robust growth in private consumption in China, India and Indonesia has mainly stemmed from the solid wage growth in recent years.
- **Ongoing structural reforms**: A number of structural reforms in China, India and Korea designed to enhance productivity and reduce excess capacity may lead to an improvement in return on equity and a potential market re-rating. Reforms in China are broad-based, with supply-side reform seen as key to improving the fundamentals of the less efficient traditional state-owned enterprises. Korea is taking steps to restructure selected troubled industries. In India, 2017 will be a crucial year for reform, as the implementation of the goods and services tax will remove interstate barriers and transform India's economy into a single national market.
- **Fiscal spending and public investment to fuel economies:** The expansion in fiscal spending and infrastructure projects will act as another pillar for economic growth, in addition to the easy monetary conditions and healthy domestic consumption. Demand for infrastructure projects in Emerging Asia is expected to remain strong, as countries in the Association of Southeast Asian Nations, in particular, are in need of increased power and transport infrastructure. Elsewhere, in China, fixed-asset investment remains huge in absolute terms, driven in part by ongoing urbanization.

[4] Sources: Bloomberg L.P., Invesco, as of Dec. 16, 2016.

Conclusion

Overall, we have a relatively constructive outlook for Asia ex Japan in 2017 with the bottoming-out of earnings and continuation of accommodative liquidity, as well as attractive valuations. Meanwhile, we are also aware of the potential risk that may arise from the external macro environment, the foremost being policy developments in the developed world, which could have an adverse impact on regional fund flows and currency trends. That said, we believe it is unlikely that there will be extreme volatility in Asian currencies, as experienced in 2013, when the US began tapering, as the consensus has already priced in a gradual rate-hike scenario. As our investment approach is purely bottom-up and fundamental-driven, the team continues to find many attractive opportunities within the consumer-related areas benefiting from secular growth trends. We continue to rely on our core competence, looking for the best company-specific opportunities and quality franchises trading below their intrinsic value.

Market highlights

China: The focus of attention for the Chinese economy and equity markets will be on growth, debt and liquidity. We expect China's policymakers to focus their efforts on near-term growth stability, with reforms taking a secondary role for now. China's debt problem will linger on, but we see no imminent risk to an economic blowout. Looking at liquidity, the existing Shanghai-Hong Kong Stock Connect and the recently launched Shenzhen-Hong Kong Stock Connect will continue to enhance market accessibility from both north- and southbound channels.

Hong Kong: Economic conditions continue to be influenced by overseas and China developments. Although property markets and consumer demand regained traction, both remain susceptible to fluctuations in China demand. What is positive is China's commitment to financial market reform, which has increased fund flows into Hong Kong.

India: Macro conditions in India remain resilient, where inflation is stable and monetary policy accommodative, backed by the government's strong resolve for economic reform. The government's efforts to stabilise the economy and push structural reforms looks set to produce results. Some recent developments in India that are structurally positive for the economy include the passage of the Goods and Services Tax bill and the demonetization.

Korea: The economy in Korea has been slowly improving. The domestic property market was supported by the completion of various projects and government policies. Consumption has been resilient as consumers benefited from the government's tax easing measures, which recently expired. While there are expectations trade conditions will improve, any recovery will likely be bumpy. Overall growth will likely remain subdued given structural impediments to growth, such as excess stock and leverage.

Indonesia: Following a volatile 2015 and an unstable start to 2016, economic growth has been exceeding expectations. Infrastructure spending was ramped up significantly. Lower inflation allowed the central government to reduce interest rates quite aggressively, which is positive for domestic consumption. The government also opened up to more foreign investment, which should support medium-term growth.

Taiwan: The recovery in economic growth is being driven by a combination of improving consumer spending and a rebound in exports. This has helped to lift earnings. Taiwan's central bank lowered rates four times in the past two years but the bias for further easing is shrinking given the turnaround in growth and recent inflation figures.

Thailand: While there is uncertainty surrounding the King's succession, Thailand is planning to have a civilian government in the second half of 2017 when elections are held. Meanwhile, tourism continues to contribute to growth in consumption while the large government infrastructure projects have been supporting growth.

Singapore: The economy in Singapore is one of the most affected by global developments within the ASEAN region. The services sector has been badly impacted by weak global growth. While political stability and financial resources will help to absorb the economic weakness, cyclical and structural headwinds are likely to persist.

Malaysia: The government has continued to pump-prime the economy with infrastructure spending but consumer confidence remains weak, as past growth has not yet filtered through to consumers. This will continue to constrain consumption, which will also not benefit from the higher living costs as housing price rise.

The Philippines: This country should continue to record strong growth in its economy as it was the only ASEAN country least impacted by the slowdown in trade and weak commodity prices. Despite the uncertainty surrounding the President's controversial headlines, domestic companies continue to make large investments in the economy.

Australia: Domestic demand is struggling as the unwinding of an era of strong growth in resources continues. Although there are signs of external demand improving, weakness elsewhere in the economy continues to pose a problem for overall growth. Policy support appears to be on hold given global developments.

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