Asian Insights

What to watch closely in Asia in 2016

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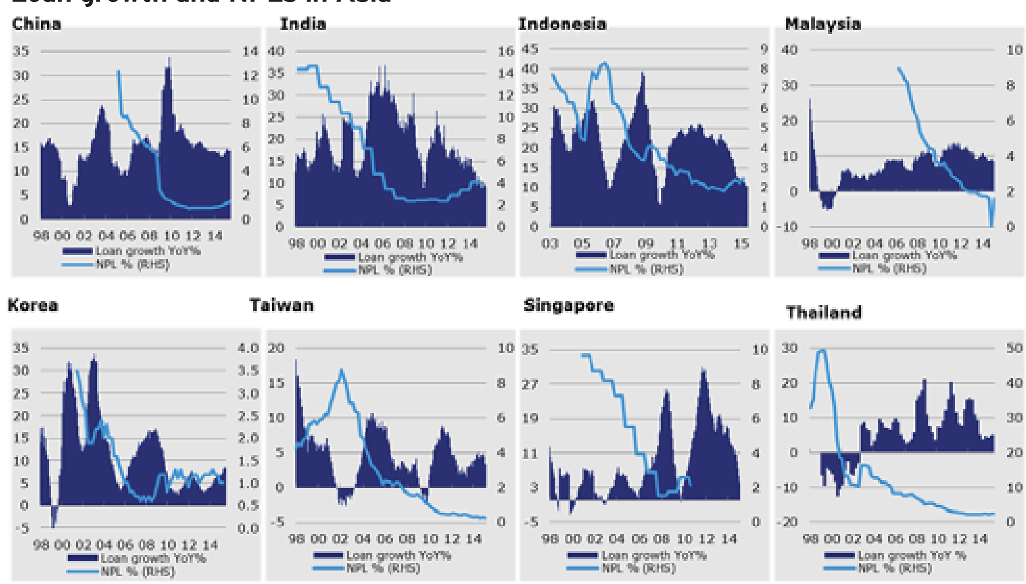
The past year turned out to be a year where one of the oldest investment adages came true: "Sell in May and go away, don't come back until St. Leger's Day."[1] On Jun. 12, the Shanghai Composite Index peaked, hitting a low on Aug. 26 and losing -43.3%[2] in the process. Markets were hit hard globally, while throughout the period, China kept unveiling measures to shore up its market. In light of the global market turmoil, in September the Federal Reserve chose to postpone a much-awaited rate hike, helping to trigger a rally in markets.

After a very volatile year in 2015, we look ahead to 2016, when past policy actions throughout the region should become more evident, while structural reforms move forward to cope with changes in demand on a global scale. In following developments in Asia, these are some of the key areas we will closely monitor in 2016.

Non-performing loans (NPLs)
One trend we will observe closely is the potential rise in NPLs across Asian banks. Since 2009, the Asian region has benefited from ample liquidity provided by the rounds of global quantitative easing (QE). Refinancing of debt via rollovers was relatively easy even for companies with weak balance sheets. As a result, NPLs trended to multi-year lows for most Asian countries. With loan growth gradually decelerating since the US began its tapering in 2013 and with US interest rates having increased for the first time since August 2007 in December, shrinking global liquidity may pose a more challenging environment for some Asian corporations and could potentially lead to an increase in NPLs.

Loan growth and NPLs in Asia



Note: Loan growth in terms of local currencies
Source: UBS AG, CEIC, data as of Sept.7, 2015

[1] Horse race held on the second Saturday in September
[2] Source: Bloomberg

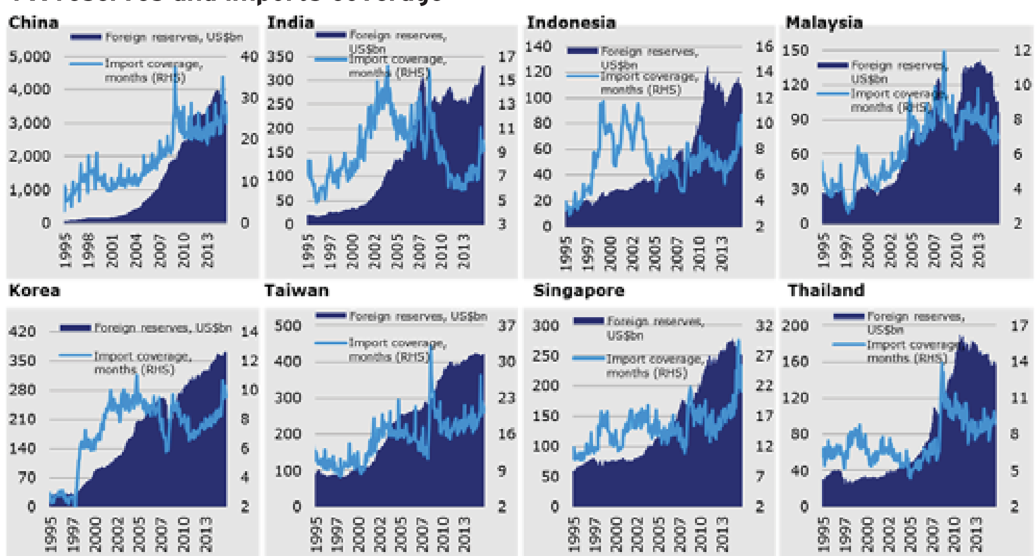
The good news is the pace of interest rate normalization will likely be slow, in our view, as global inflationary pressures are expected to remain subdued. Although banks in general are trading at a meaningful discount to the regional indices (i.e. MSCI AC Asia ex Japan), we maintain a relatively cautious outlook for the sector in Asia as earnings are overshadowed by the potential increase in NPL loan provisions over the next 12 to18 months. The exception to this view is with regard to our selective interest in private banks in India, as both cyclical and structural conditions are improving for the country.

Foreign exchange (FX) reserves and import coverage

Another area we will watch is FX reserves. Countries may hold FX reserves as a precautionary measure for potential external shocks. For countries with flexible exchange rates, as is the case for most countries in Asia, the question is how much is required? One indicator that we choose to observe closely is the import coverage ratio of individual Asian countries. This shows how many months of imports the country can cover with existing FX reserves. Using this measurement, most Asian countries are in good shape, with over 8 to 9 months of import coverage. In particular, China has reserves that cover more than two years' worth of imports. One reason for such a large amount of FX reserves for China is its desire to maintain currency stability. Thailand's import coverage is also sound, with FX reserves now four times the amount held during the Asian financial crisis of 1997.

In fact, most Asian countries, except for Malaysia, have been witnessing FX reserves on the rise the past year as imports declined. For the past four years,

FX reserves and imports coverage



Source: CEIC, Haver, UBS AG, data as of Sept. 1, 2015

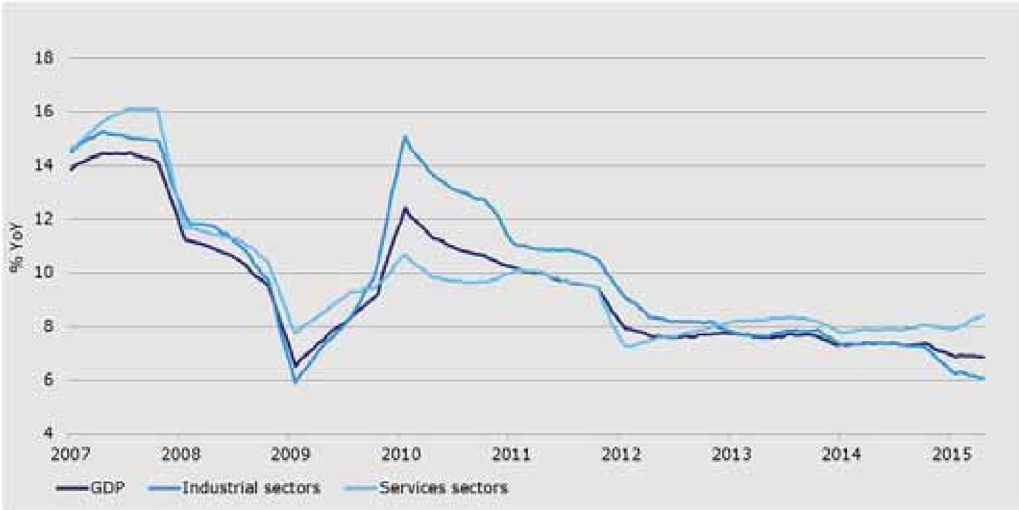
Malaysia's import coverage ratio has been heading lower and currently covers less than eight months. The country has been experiencing domestic political issues and capital outflows. While the government's fiscal deficit is in much better shape than in 2012, the collapse in commodity prices continues to weigh on government revenue, limiting any policy action in the future. Until we see any improvements in fundamentals for Malaysia, we maintain a cautious view of the country.

China's service sector

Looking ahead, the service sector will become the "heart" of China's economy, in our view. Over the past two years, the balance of the Chinese economy has gradually shifted toward a greater weight in services as growth in the industrial sector continues to slow down. The resilience of China's labor market reflects the faster growth in the more labor-intensive services sectors since the manufacturing and investment-related sectors continue downsizing to cope with excess capacity. The National Bureau of Statistics estimates that between 2012 and 2014, 36 million jobs were added in service sector businesses.[3] In fact, service sector jobs require more skills than manufacturing, which can lead to higher value added income for households.

The breakdown of China's GDP growth shows tertiary industries were the key driver behind growth in 2015, recording an 8.4% year-on-year increase in the first three quarters of 2015, compared with 5.9% in manufacturing.[2] The strength of the services sector is one reason why the Chinese consumer has been able to keep spending throughout China's economic transition, which has been evident in the resilience of retail and auto sales, as well as Chinese overseas tourism.

Services expanding at much faster pace than industrials



Source: CEIC, Morgan Stanley Research

Policy pipeline

Policy implementation, both fiscal and monetary, will need to be watched closely in 2016. What is encouraging is most countries in Asia have fiscal balances that are still relatively healthy. Although the pace of fiscal spending in Asia accelerated in 2015, fiscal deficits for most countries remained low. There were some fiscal packages announced in countries, such as China, South Korea, Indonesia and Thailand that included tax cut measures and housing incentives. Governments also stepped up public infrastructure investment. Nevertheless, we believe most Asian governments are in a comfortable position to provide even more fiscal stimulus in 2016.

[3] Source: National Bureau of Statistics China. There were 915.8 million people in the working age population (16 to 59 years old) as of the end of 2014.

Moreover, there is still room for further monetary easing in Asia. The developed world is currently either immersed in or pulling out of an extended period of QE with zero to negative interest rates, while Asia ex Japan still has rates well over 3%, especially in India, China and Indonesia.

As a result of both fiscal and monetary easing to date, we have already started to see signs of stability arising in areas like consumer spending and housing investment. Property sales growth in Asia ex Japan turned positive for the fourth straight month in November due to a favorable base year effect and growth in China. Developments like these are definitely encouraging, and further policy support should ensure the trend continues in 2016.

Conclusion

Looking ahead, NPLs across Asian banks will need to be monitored closely in 2016. What's reassuring, though, is to see that Asia's foreign reserves and import coverage are generally in good shape, serving as a buffer for potential external shocks. With regard to sources of growth in 2016 and beyond, we believe one of the pillars will still be China's service sector, after being the key driver behind China's growth in 2015.

Regardless of the macro outlook, our focus on bottom-up stock selection remains the same. We will continue to seek quality companies that are resilient through any phase of the market cycle and industry leaders with sustainable earnings, compared with more cyclical companies that are highly dependent on top-line growth. Valuations are also quite reasonable in Asia, with the 12-month forward price to earnings ratio at 12.0x for MSCI Asia Pacific ex Japan and the trailing 12-month price to book ratio at 1.2x.[4] Overall, we believe there are plenty of attractive investment opportunities to be found in Asia that are well positioned to benefit from the region's long-term growth prospects.

[4] Source: MSCI, I/B/E/S, JP Morgan, as of Nov. 30, 2015

Market highlights

While we remain selective in Asian equity markets as cyclical headwinds are likely to continue, we are confident policymakers will be able to provide sufficient policy support. Within Asia, growth in India remains on a recovery track despite weakness in external demand. In China, policymakers are providing various measures, which are supporting growth. For Korea, conditions have improved due to the combination of fiscal and monetary easing. In Taiwan, macro conditions are starting to look slightly better. Within the Association of Southeast Asian Nations (ASEAN) region, the outlook differs, given varying policy flexibility. We are slightly more positive on Thailand and the Philippines relative to Indonesia, Malaysia and Singapore.

China: Although growth in China is decelerating, it still remains relatively strong as policymakers continue to provide both fiscal and monetary policy support. The People's Bank of China has cut interest rates six times since November 2014, and further rate cuts are possible as external demand remains sluggish and companies continue to scale back investment. Some recent indicators have suggested growth may be improving slowly, but it is important that structural reform continues for the quality of growth to improve and disinflationary pressures to subside.

Hong Kong: We find that investment opportunities in Hong Kong will in part reflect developments in China. Consumer spending has remained a key driver of growth in Hong Kong, but it may wane as wage growth moderates. Consumer prices slowed further in the third quarter, and this may continue as rates edge higher.

Taiwan: We are turning slightly positive on Taiwan. Although policy options may be limited, the ongoing drop in external demand will lessen as policy efforts globally lend support. Consumer prices have edged higher, but with demand conditions still subdued, the threat remains benign.

Korea: We continue to favor Korea. The impact of past policy easing and a slight improvement in external demand combined with stepped-up domestic investment in property has been supportive of growth. The sustainability of the improvement is dependent on policy action going forward and the durability of demand in developed markets.

India: We are very positive on India, as policy easing has provided support for the economy. The improvement in domestic demand is being driven by capital investment and urban consumption, while rural demand remains lackluster, given slower real wage growth.

Indonesia: We are less positive on Indonesia. Although there are signs of improvement in consumption, there are declines on the capital investment side. Given weak macro conditions, policymakers will likely continue to step up efforts to promote growth.

Malaysia: We continue to have weak expectations for Malaysia. While consumption has improved at the margin, the ongoing weakness in commodities is a drag on growth and Malaysia's fiscal position. While manufactured exports are on the mend, commodity exports remain under pressure.

The Philippines: We turned slightly positive toward the Philippines. Consumption is holding up well as evident in robust car sales growth and imports of capital goods. However, exports continue to struggle.

Singapore: We still have a lower stance toward Singapore as production continues to contract. There are signs that domestic demand is on the mend in retail and property. However, exports remain weak, which will continue to dampen overall growth.

Thailand: We hold a favorable view of Thailand. Domestic demand faces both cyclical and structural headwinds, given high debt, as well as weakness in external demand. However, the government has the ability to provide some support and already started with small packages, with more expected.

Australia: We are cautious toward Australia as weak commodity prices will continue to be a drag on growth. Consumption and residential demand are slowing as unemployment rises. While further policy support is needed, the pace of any provisions is expected to be gradual.

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