Asia Insight

December 2016

CIO Outlook

I start this annual outlook by looking out past the year end. I can't help myself—it's so important for us at Matthews Asia to look beyond the headlines. Over the next five years, according to the IMF, Asia Pacific economic output, measured per citizen and in U.S. dollar terms, will grow by 38.6%, or 6.8% a year. This rate of growth is expected to be higher than that of the U.S. (3.5% per year); South America (4.4%); and Western Europe (2.8%). The IMF is expecting Asia Pacific economies to sustain the gap in economic growth they had enjoyed since before the Global Financial Crisis of 2008. I have no reason to disagree with these estimates. And whereas, this would mark the continuation of a long-term trend that goes back decades, it would be a reversal of much of the last four years, when Asia Pacific's nominal per capita growth (although it was able to outstrip Europe and South America) had not kept pace with the U.S. What might account for this return to past trends and how might it affect the markets?

First, strong growth is rooted in basic dynamics in which Asia Pacific excels: Asia saves about one-third of its GDP compared to only about one-fifth in Europe, Latin America, and the U.S.; and East Asia has about one-quarter of its GDP in manufacturing, compared to one-sixth in Europe and Latin America and one-eighth in the U.S. In South Asia, where levels are more like they are in Europe, that industrial base is being built up. These two factors are important. They show that Asia has the wherewithal to invest in parts of the economy that drive higher rates of productivity growth. Asia is open to new ideas, too: countries such as Hong Kong, Singapore, New Zealand and Australia regularly top indices of economic freedom globally. And Myanmar, India, the Philippines and Vietnam recorded their highest ever scores in the World Economic Freedom Index. You can pick your survey to a certain extent, but it seems that Asia is highly regarded as having open, reformist governments, such as those in India, Indonesia, South Korea, Japan and even to an extent China—a stark contrast to the political trends in the West that focus more on inequalities in income and wealth. The Asian Productivity Organization reports that the 24 countries of Asia achieved the highest total factor productivity growth (growth in utilization of new technologies and creative uses of capital and labor) between 2010–14 of 1.4% per annum. This compares with 0.9% in South Asia, 1.7% in East Asia, and just 0.4% in the U.S. These are the basics of growth—savings, productive investment, openness to new ideas and reformist government. All of this drives productivity, which drives wages, which drives living standards, which drives spending and changes in consumer behavior. All of these look well set in Asia for the medium- to long-term.

Given these impressive track records, it seems churlish to focus on the next 12 months. Churlish, and perhaps even counterproductive! But such is the nature of our industry and the scourge of the annual outlook! So I'll do my best, but will try to put the short-term view in the context of the long-term at every opportunity, and hopefully avoid the worst influences of short-termism.

Matthews Asia

> "Strong future growth is rooted in some basic dynamics in which Asia Pacific excels."

Trump it was!
Who would have thought that Trump would be victorious? Not me—I was a follower of Nate Silver's 538 website, one of the most cautious on Hillary Clinton's chances. Even then, a 70% chance of winning seemed to me significant. It wasn't, as 538 itself pointed out. With the predictions a few percentage points off in the U.S.A.'s rustbelt (Michigan, Wisconsin and Pennsylvania), the election was over for her. This rustbelt is where the GOP and Trump will concentrate their efforts in order to shore up support. And the most likely initiatives are: infrastructure spending, tax cuts, a renegotiation of the North American Free Trade Agreement (NAFTA) to lessen Mexican auto competition, and some kind of initiative to lessen competition from Latin American and Chinese coal. But this is a far cry from some of the panicked reaction to Trump's victory, which seemed to presage trade wars between the U.S. and Asia. The biggest short-term effect is likely to come from increased budget deficits, which have already started to drive up bond yields, and because the Federal Reserve seems likely to offset a portion of the growth generated by stimulus, higher short-term interest rates, too. All of this is causing the U.S. dollar to rally, as I write, as the higher yields in treasuries are attracting money flows away from overseas markets and into the U.S. So, Asia faces portfolio outflows and a liquidity squeeze in the short term, even as longer-term trends seem quite robust. This is an opportunity—and some portfolios have already been taking advantage of the improved prices on offer for Asia's equities.

How to make sense of the recent shifts in political power? Well, the economies in the West still feel like they are depressed and that accentuates the difference between the rich and poor and the manual laborer on the one hand and the financier on the other. Protectionism, government direction of investment (because private enterprise is too bearish to do the job), and suspicion of supply-side reform and the free movement of labor are all logical short-term responses to this environment. They can boost domestic demand and wages today, even as they might be a drag on long-term growth. So, there is little reason, given the profile of Asia's economies I have set out as growth-oriented, for the political trends of the West to take hold in Asia, too. Asia is not isolated from their effects, nor is it fated to follow in their footsteps. But before we get complacent, we do still have a full political calendar in Europe to contend with over 2017 and the issue of the sustainability of the EU will just not disappear! Next year sees German presidential and legislative elections; French presidential and legislative elections; a Dutch general election; and local elections in the U.K. And we still wait to see the outcome of Italy's referendum on constitutional reform in a few weeks' time. There is plenty here to worry markets over the next 12 months. Indeed, fears of a disintegration of the E.U. may increase—surely a deflationary shock to markets.

There is another place we are unlikely to find respite—the continuing debt issues in China. On the one hand, we are not seeing the degree of panic we saw at the beginning of 2016; on the other, this is an issue that will take years to resolve. In the meantime, a gradual depreciation of the renminbi and the continued attempts by the authorities to beat down booms in various asset markets within China, as they reflate the economy behind a closed capital account, all periodically play into alarmist headlines. The Chinese Communist Party seems nervous as it proceeds with these reforms as it knows it risks decimating employment in northeastern parts of the country. It is tightening up on dissent, as it is sensitive to criticism at home. But again—is this a tactical ploy or a long-term shift? I say "tactical" because the ultimate goal is to deal with bad debt and defunct enterprises. China is continuing to grow its services sector and move away

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from traditional industries. But this shift does require patience. And how patient will investors be? Elsewhere, we have better news coming out of India as its reform plan seems to be gaining some momentum and its recent demonetization experiment is surely deflationary over the short term. But India's market is one of the more expensive ones in the region. Japan seems to be losing the reflationary battle at the moment, and there is more it can do, although Governor Kuroda seems to be either losing his nerve or losing a political battle. In ASEAN, we are seeing some improved growth prospects. But here, too, a stronger dollar will take its toll on short-term sentiment.

Indeed, looking across the world, there seems to be the potential for a resurgence of deflationary forces—only China at the moment appears to be moderately inflationary. The Trump "bounce" seems to me more about short-run fiscal stimulus than rising inflation. If all this sounds depressing, don't get too spooked. The good news is that Asia is actually well-placed to weather short-term storms. Government budgets are in good shape, current accounts are generally in surplus (excluding the Indian subcontinent and Indonesia), and structural inflation is low. There should be no need for a severe impact on local nominal demand or unemployment, since either monetary policy or fiscal policy (tax cuts and spending) can be used to offset external shocks. In this regard, Asia is far better placed than Latin America or Eastern Europe.

And we don't exactly suffer from the tyranny of high expectations these days, do we! As I visit clients across the world, my overwhelming impression is that sentiment toward Asia is still very weak. (The contrarian in me thinks this is a good thing!) Allocations to Asia are generally low, too—another counter-indicator. And on my last visit to Europe, there did seem to be a slight improvement in sentiment, as investors there grow wary of their home markets. But the latest rally in the dollar and an expectation of an uptick in U.S. growth has put that change in sentiment on hold. People are still reluctant to make a move. A rebound in earnings, driven by reasonable top-line growth and stabilizing margins may be enough to turn the tide in Asia's favor in 2017, particularly since we go into the year without any lofty expectations in the markets and valuations at a reasonable level in global terms. I do find myself having to look beyond the near-term influences to get more positive on Asia. But that is the point, surely? Markets are always forward-looking—and the long-term drivers of nominal demand growth and corporate earnings are still in place in Asia. We will emerge from the funk of slow profit growth at some point and I believe the more dire predictions of what a Trump presidency implies—at least economically—may also die down. Recent falls in the markets have left Asia at forward price-to-earnings multiples* of 13.8X for the Asia Pacific and 13.4X for Asia ex Japan versus 14X for Europe and 17.5X for the U.S. Okay, that's not bad value. Will 2017 be the turning point? I dare not forecast. Forecasters are having a bad time these days. But I do believe that patience is a virtue in Asian investing and the long-term trends augur well.

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