June 2017

Matthews Asia Perspective
Asia in a Rising Interest Rate Environment

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The fall in interest rates around the world following the global financial crisis sparked investors' interest in dividend producing strategies. A combination of low growth and low interest rates, plus historically low bond yields led swathes of investors to look towards income producing funds.

Well, times are at last changing. After years of ultra-low rates, to date the US Federal Reserve has hiked interest rates three times since December 2015, with more expected to follow this year. Inflation meanwhile is close to the 2% level in many countries, with even Japan seemingly moving out of deflation.

But what are the implications for income investors, both with regards to equities and fixed income? In an environment of rising interest rates globally, both traditional bonds and bond-like equities—so-called 'bond proxies'—appear to carry more risk.

On the other hand, while reflationary environments can be good for growth stocks, we believe there remains enough uncertainty in the world—be it the election cycles taking place in Europe, the protectionist rhetoric in the U.S. or potential global trade wars—to keep investors from rushing to reposition just yet.

So what is the best solution in these conditions? In an uncertain environment where rates are likely to rise, we think investors should focus on total return by investing in companies that offer attractive dividends relative to their share price and can demonstrate the ability to grow their underlying dividends in a sustainable manner. As these companies generate sufficient cash flow to fund dividend payments and allocate capital prudently, they tend to have stronger corporate governance than their peers, and often deliver attractive capital appreciation as well as income. In addition, we think investors in search of yield should look to Asia credit to sustain and diversify their income stream and generate attractive risk-adjusted returns.

The Case for Asia Equity Income

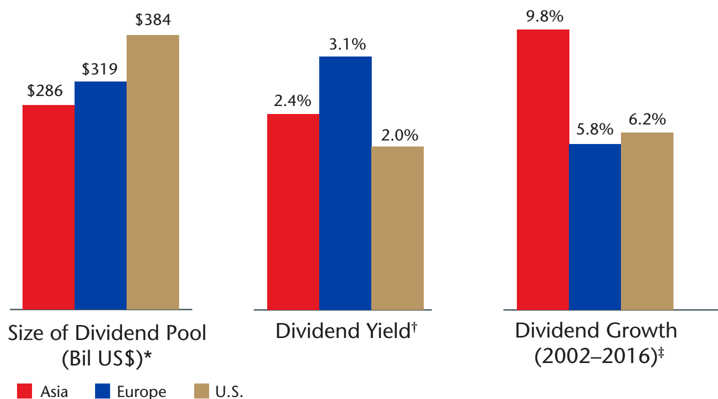
With Asia being home to many of the world's fastest growing economies, it is no surprise that many investors adopt a growth approach to the region. However, despite the dramatic increases in the standards of living in Asia over the past decade or more, the headline equity market has not always met return expectations.

One of the reasons for this is that companies that capitalize on Asia's ongoing growth today are different to those that benefited in the past and benchmarks often fail to keep up with the pace of change in Asia. In addition, we would argue that unless you are aligned with a business that will share this growth with you, you will not see any of the end benefits. That's why we believe a dividend approach to Asia does not have to be at the expense of growth.

Indeed if you look at the underlying growth of the dividend pool in Asia, it has grown almost twice as fast as the U.S. and has been four or five percentage points ahead of Europe over the past decade (see Figure 1). Not only does this explain why dividend investing in Asia has proved popular in recent years, it also goes some way to explain why it should remain the case even if interest rates do rise globally.

Asia is an extraordinarily diverse region. It houses frontier, emerging and developed markets, and there are dividend-paying companies throughout the region. Today the region's equity markets have grown to represent nearly 40% of global stock market capitalization, while dividend payments have grown to about US$286bn, which is approaching the size of the dividend pool in developed Western markets (see Figure 1).

Figure 1. How Asia Compares to the U.S. and Europe



*2015 dividends by index members as of December 2014; Europe (Bloomberg European 500 Index), Asia Pacific (MSCI AC Asia Pacific Index), U.S. (S&P 500 Index).

†Trailing dividend yield estimates for 2016, as of 31/03/17, based on Factset Aggregates.

‡Compound annual growth rate (CAGR) based on index constituents of Europe (Bloomberg European 500 Index), Asia Pacific (MSCI AC Asia Pacific Index), U.S. (S&P 500 Index), as of 31/12/02, excluding those that are no longer in existence as of fiscal year 2015.

Sources: FactSet Research Systems, MSCI, S&P, Bloomberg

The culture of paying dividends is also improving in the region, with countries like Japan and South Korea just beginning to enter the dividend growth area. It is due to this combination of government regulation and investor activism that is increasingly offering opportunities to dividend investors.

In particular the governments of Japan and South Korea have been encouraging companies to better utilize the cash sitting on their balance sheets, which has resulted in a shifting attitude by corporates towards shareholder distributions.

The broadening of capital markets in countries like China, and improved liquidity, has also assisted the dramatic increase in the number of Asian companies paying attractive and growing income. In China, aggregate dividend payments increased from just US$8 billion in 1998 to around US$111 billion in 2016.

We think investors that do not venture beyond established hunting grounds, such as Australia, miss out on opportunities not only in markets such as Indonesia, Vietnam and China, but also within the more developed countries like Japan and South Korea.

While it is possible to find good income generating companies in almost any sector within the countries we invest, at Matthews Asia we see more opportunities in consumer-related businesses, as opposed to those companies which are more export or cyclical in their nature.

On the other hand, stable dividend payers are often large-cap, matured businesses in sectors such as telecoms, public utilities, and infrastructure assets. A total-return dividend portfolio focusing on both dividend yields as well as dividend growth could include names ranging from small- and mid-caps that may be yielding 2% but potentially growing their dividends at a 15% rate to solid businesses that may deliver a stable and recurring dividend yield 4–5%. This balanced approach seeks to create a portfolio that can benefit from an attractive dividend yield without giving up on growth. Generally speaking, compared with large-caps, these small and mid-cap companies have not realized their full growth potential and tend to be overlooked by research analysts.

In addition, we believe it is important to focus on the sustainability of the dividend stream. Many Asian equity income portfolios are built with a lot of emphasis on yield, containing stocks which can have challenging underlying businesses. In our long-term total return approach, we use dividends as an indicator of core earnings growth and strength of the company.

It is important to note however that quality companies, which generate stable and recurring dividends, tend to command a premium which in our view is merited. Still, in certain countries such as South Korea and China we are finding these companies at better valuations than for example in India.

Time for a fixed income rethink?

Just as Asia's equity markets have experienced improvements in liquidity, transparency and diversification over time, so have its bond markets. After significant structural reforms in the past decade, most Asian sovereign credit ratings have been upgraded by international rating agencies and are now among the highest in the emerging market universe.

The region also has a large and liquid local corporate bond market; following rapid growth, the Chinese corporate bond market is now one of the world's largest. Fundamentals in credit in Asia also remain generally sound, as liquidity profiles and levels of leverage are similar to those found in the U.S. and Europe.

However for the income orientated investor who has traditionally held fixed income, the prospect of global rate rises should prompt a rethink in terms of how they will sustain this income in future. In a low interest rate environment, the traditionally risk-free or less risky areas of the market—namely investment grade corporate bonds or government bonds—appear less stable than they were this time two, three or four years ago.

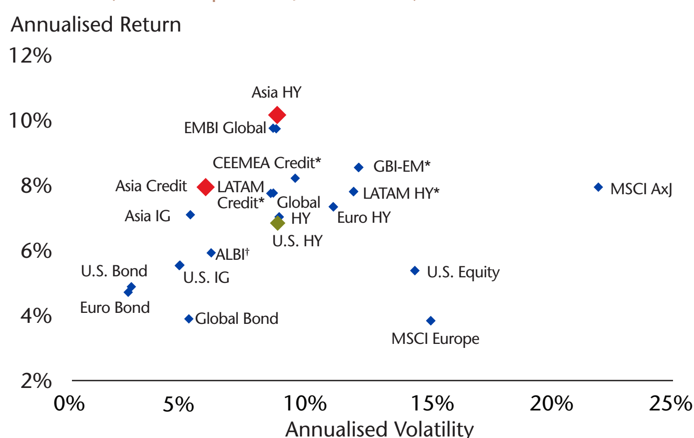
Because of the low level of rates, the sensitivity of bond prices to changes in yield is much higher today than at any time in U.S. history. Likewise, an investor in other low-yielding global government bonds would experience a similar mark-to-market loss in a rising interest rate environment.

Instead fixed income investors should consider a rotation into U.S. dollar-denominated Asia credit as it typically has a lower sensitivity to changes in interest rates than U.S. Treasuries. Asia high yield credit has historically generated attractive returns compared to assets of similar risk: about 10% annualized returns with 10% annualized volatility (see Figure 2).

With U.S. dollar-denominated Asian debt, the interest rate component remains linked directly to the U.S. However, with rates rising in a thriving U.S. economy, improving balance sheets will lead to tighter credit spreads and reduce the difference in yield between higher and lower quality bonds. In such an environment, the prices of dollar denominated Asian bonds will be affected considerably less than that of U.S. dollar bonds like U.S. Treasuries.

Compared to their developed market counterparts, Asia's high yield issuers are often blue chip companies in their countries. This is why Asia high yield spreads are usually tighter than in the U.S. and Europe, signifying potentially lower credit risk and higher corporate quality, while risk-adjusted returns compare favorably with other asset classes.

Figure 2. Asia Bond Looks Attractive Over the Long Run
(Since Inception of JACI in 1999)



Past performance is no guarantee of future results. It is not possible to invest directly in an index. Volatility is the standard deviation of returns.
Data shown from 1999 (or since inception) through December 2016 for Asia Credit (J.P. Morgan Asia Credit Index–JACI), Asia High Yield (high yield portion of J.P. Morgan Asia Credit Index), U.S. High Yield (BofAML High Yield Master II Index), Euro High Yield (Barclays Pan-European High Yield Index), LATAM High Yield (J.P. Morgan CEMBI Broad Latin American High Yield Index), Global High Yield (BofAML Global High Yield Index), U.S. Investment Grade (BofAML U.S. Corporate Master Index), CEEMEA Credit (J.P. Morgan Corporate Broad EMBI CEEMEA Index), Asia Bond (Markit iBoxx Asian Local Bond Index (ALBI), LATAM Credit (J.P. Morgan Corporate Broad EMBI Latin America Index), EMBI Global (JP Morgan Emerging Markets Bond Index Global), GBI-EM (JP Morgan GBI-EM Global Composite) , U.S. Aggregate (Barclays U.S. Aggregate Bond Index), Euro Aggregate (Barclays Euro Aggregate Bond Index), Global Aggregate (Barclays Global Aggregate Bond Index) U.S. Equity (S&P 500 Index), MSCI Europe Index and MSCI All Country Asia ex Japan Index.
Sources: Bloomberg; Merrill Lynch, Pierce, Fenner & Smith Incorporated ("BofAML"), used with permission. See Disclosures for full disclaimer; data period 1999 to December 2016; †2000 to December 2016; *2002 to December 2016.

In addition to providing attractive total returns, Asia's high yield corporate bond market has a low to medium correlation with a variety of asset classes, providing diversification benefits versus the U.S., European, Asian and global asset classes. For investors seeking a higher yield, this can also provide yield diversification, with exposure to an asset class that lives outside of the more traditional fixed income universe investors are more familiar with.

Bond valuations are also less efficient among the emerging and frontier markets, providing alpha opportunities for active managers who seek securities with the potential for credit spread compression due to potential ratings upgrade or underlying fundamental factors.

Over the short term, however, it is important to note that Asia fixed income has the potential to be more volatile than U.S. or global bonds. Therefore investors should have a time horizon of at least three-to-five years when considering Asia fixed income.

Asia credit has continued to provide positive returns even amid volatility in the U.S. interest rate environment. History tells us that Asia credit spreads typically tighten during U.S. rate hike cycles, and indeed, credits spreads globally have tightened past historical averages. Even with spreads now hovering below averages, we believe this positive trend continues.

The preconditions for credit spreads to spike historically have been the combination of expectations of higher defaults and an impending economic recession for the U.S. With commodity prices recovering and no U.S. recession in sight, we expect spreads to tighten even further—reflecting improved credit fundamentals in a growing economy and further adding to total return in portfolios.

Assessing the risks

There is a school of thought among some investors that certain central banks, such as the Federal Reserve, may already be behind the curve and need to hike interest rates even faster than what the markets are predicting. Such a steeper climb in rates would certainly be a larger risk for income investors, whether they hold equities or bonds. Whether or not this is the case can only be mapped out over the next year or two.

We think that central banks in Asia are beginning to be on the same trajectory as the Fed, meaning those banks that were previously dovish or have an easing bias have ceased being so. Consequently income investors that remain invested in 'bond proxies' might face the biggest risk.

Those lower volatility, stable yielding stocks have largely replaced low yielding bonds in income portfolios since the global financial crisis. As a result valuations have

crept up to a point where sectors that can benefit in a rising rate environment, such as financials, appear cheap in comparison. A total return approach that includes a focus on dividend growth, however, can provide exposure to these sectors and thus can offer more shelter from a quickening rate hike bias.

Other risks are more attuned to equities in general. This would be in the form of policy mishaps by the Fed, trade protectionism and retaliation. These are the question marks overhanging the U.S. and the larger Asian economies at present.

Additionally while we maintain a positive stance on Asia as a home for dividends, it should be noted that the past three years have been tough for dividend growth in the region, with margins under pressure and companies struggling to maintain the same levels of growth versus that witnessed in the U.S. Despite this difficult environment, which we believe is set to improve, dividend growth has remained solid.

Conclusion

The question posed at the outset is why investors should not abandon an income strategy and turn to growth stocks in a reflationary environment. We believe that ongoing geopolitical risk continues to overshadow market sentiment. Meanwhile, what if things go the other way, inflation starts to dip and the outlook for the global economy seems less rosy than many predicted?

The slowing down of the world's largest two economies, the U.S. and China, does remain a very real risk, and with the additional concerns that central banks are raising interest rates both prematurely and faster than they should be, we think income investing still makes a lot of sense.

The point is that we cannot predict the future and given the level of uncertainty, we believe a strategy of total return can help income investors weather any upcoming storm. As the contribution of income strategies in Asia has been meaningful over the long term, we believe it can offer a less volatile means to access the faster growing economies in the region while at the same time mitigating risk and providing downside protection.

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