Matthews Asia Perspective
Southeast Asia and India: The Outlook Amid External Headwinds

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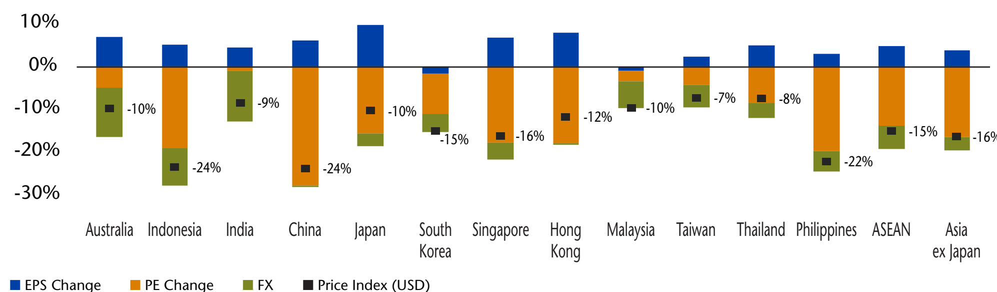
Emerging and frontier markets have weathered a bearish environment since the end of January. High valuations collided with tighter monetary policy in developed markets, a stronger U.S. dollar and U.S.–China trade tensions. Emerging markets in Asia have been hard-hit, and the underperformance appears to have been driven more by an aversion to risk than a deterioration of fundamentals. A valuation de-rating and foreign exchange contributed to negative performance, despite mostly positive earnings momentum.

FIGURE 1. US$ PERFORMANCE BREAKDOWN



Note: Performance from 26 Jan 2018 until 14 Sep 2018. Past performance is no guarantee of future results. Indexes are unmanaged and it is not possible to invest directly in an index. Countries represented by the respective MSCI indexes. Earnings per share (EPS) and price-to-earnings (PE) ratio are 12-month forward figures. There is no guarantee any estimates or projections will be realized.
Source: Thomson Reuters

Investor confidence in Southeast Asian (SE Asia) equities is low given underperformance relative to emerging markets (EM) and Asia ex-Japan over the past five years. Fundamentals have improved over the past five years, however, with many structural developments: India's Goods and Services Tax (GST) and new bankruptcy law; Thailand's friendlier business and operating environment; Vietnam's state-owned enterprise (SOE) rationalization; Malaysia's anti-corruption drive; Indonesia's fiscal reforms; and tax reform in the Philippines. These initiatives should support a domestic-led growth cycle in most of SE Asia as well as in India.

As such, the magnitude of the market decline appears excessive relative to the change in outlook for earnings and risk stemming from external factors. That said, we believe the stars are beginning to align in favor of these markets, as a combination of weaker currencies, cheaper valuation and strong policy responses start to moderate volatility. While these are not necessarily enough to spark a rally in EM, a sufficient push from Chinese reflation could potentially lead to the next upturn. We believe this affords active managers opportunities to position to benefit from the structural attributes of a rapidly urbanizing population and rising middle class, supported by a policy focus on boosting domestic demand.

Here, we explore key factors that will influence the market outlook for SE Asia and India.

Investments involve risk. Past performance is no guarantee of future results. Investing in international and emerging markets may involve additional risks, such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation.

TRADE TENSIONS: RISKS AND OPPORTUNITIES

- Open economies of Singapore, Vietnam, Malaysia and Thailand are more exposed to shocks to global trade.
- Less open economies of the Philippines, Indonesia and India are the least exposed to trade issues.
- Higher U.S. tariffs on Chinese imports open opportunities for countries with similar products exported into the U.S.

The U.S.–China trade dispute will have both negative and positive spillovers in SE Asia and India. Broadly, the overall exposure to trade is depicted by the value of gross exports to GDP–with open economies such as Singapore, Vietnam, Malaysia and Thailand more exposed to shocks to global trade, while relatively less open economies such as the Philippines, Indonesia, and India are least exposed.

The connection of SE Asia countries into the Chinese global value chain (GVC) renders them vulnerable to knock-on effects of lost demand due to higher tariffs imposed on certain Chinese products. SE Asia's indirect exposure to the U.S.–China supply chain, however, is relatively lower than North Asia (South Korea and Taiwan), mainly due to its lack of semiconductor production. The impact would be acutely felt where there is high GVC connectivity and would likely most impact Malaysia and Singapore (as measured relative to their GDP).

On the flip side, such supply chain-related losses could be offset by trade diversion and production relocation. Higher tariffs on Chinese imports by the U.S. open up competitive opportunities for countries with similar products exported into the U.S.

Vietnam, Malaysia and Thailand have significant electronics-related product overlaps with China and could stand to gain market share in the U.S., assuming that tariff restrictions remain between U.S.–China and do not become generalized. Beyond electronics, the most recent US$200 billion product list to face 25% tariffs includes items such as seafood, leather products, furniture, rubber tires and vehicle parts, areas in which Thailand, Vietnam and Malaysia are major and already competitive exporters. The added benefit in potentially gaining increased market share in the U.S. in these products is that the level of domestic value-addition is high, resulting in greater spillover effects in terms of income generation and employment.

Production relocation beneficiaries are likely to be those countries with well-established trade-related supply chains, such as Vietnam, Thailand and Malaysia, as local and multinational firms seek to mitigate higher costs and margin erosion due to the tariffs. Some manufacturers in China are speeding up plans to diversify into SE Asia, with apparel and electronic component manufacturers particularly focusing on Vietnam.

In India's case, the huge scale of its domestic market has always been attractive to investors. The U.S.–China trade dispute could be a further catalyst to attract manufacturing foreign domestic investment (FDI), which would generate employment as well as provide some welcome support to external accounts.

Overall, Singapore appears most vulnerable to the U.S.–China crossfire, while the negative effects of supply chain linkages with China are offset for Vietnam, Malaysia and Thailand by potential benefits from trade diversion and production relocation. India and Indonesia have low supply chain exposure to China, and may well benefit from FDI flows into low-value export industries that overlap with China.

TIGHTER MONETARY POLICY AND GLOBAL LIQUIDITY

- Southeast Asia and India appear to be in a much better positions today than in 2013 and 1997.
- Large current account surpluses in Thailand, Singapore and Vietnam allow greater flexibility in managing domestic policy and help to preserve the longevity of economic cycles.
- Current account deficit countries such as India, Indonesia and the Philippines have had to raise interest rates to attract portfolio inflows to fund a widening deficit.

The U.S. Federal Reserve's pursuit of a soft landing in the face of one of the most concerted expansions in U.S. economic history threatens to stall global growth and liquidity. Not every downturn, however, is likely to end up like the 2013 "taper tantrum" and its predecessor, the 1997 Asian Financial Crisis (AFC). The AFC was a consequence of large current account deficits funded by excessive U.S. dollar debt twinned with pegged exchange rates.

Today, India and SE Asia are in much better positions. The region is now characterized by current accounts either in modest deficit or large surplus funded mainly by long-term FDI flows, reduced reliance on external debt and fewer funding mismatches, stronger foreign exchange reserves and exchange rates that are broadly floating, acting as shock absorbers in capital outflow scenarios.

Policy responses have been very sharp and with real interest rate differentials at high levels, are helping to draw back inflows to fund the deficits. While a price will be paid in the form of modestly slower growth, the pre-emptive impact on inflation also means that the domestic growth cycles, which in most cases are in early stages, will be extended.

U.S. DOLLAR STRENGTH

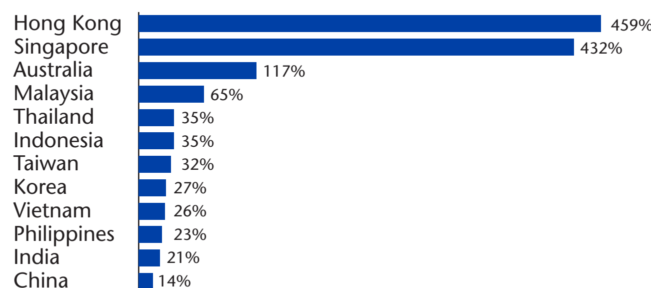
- U.S. dollar momentum could begin to ease, particularly as the impact of trade tariffs materializes.
- The fiscal stimulus from lower tax rates in the U.S. may already have peaked.
- In Southeast Asia and India, external debt/GDP has fallen since the taper tantrum as credit demand moderated.

A stronger U.S. dollar poses a headwind to markets as capital flows reverse and lead to tighter domestic liquidity and higher funding costs, while weaker local currencies increase foreign exchange (FX) debt repayment stress.

We believe the U.S. dollar is stronger due to the extended U.S. growth cycle (amid weakness in other developed markets) and the combination of tighter monetary policy and loose fiscal policy, rather than any domestic imbalances within the region. The fiscal stimulus from lower tax rates may already have peaked, however, and Fed guidance is turning more dovish. U.S. dollar momentum could therefore begin to ease, particularly as the impact of trade tariffs materializes.

In SE Asia and India, external debt/GDP has fallen since the taper tantrum as credit demand moderated, and although credit growth is beginning to accelerate as a new cycle begins, it is fueled mainly by domestic debt. Hence, the potential vulnerability to weaker bilateral exchange rates is lower.

FIGURE 2. GROSS EXTERNAL DEBT TO GDP (%)



Source: CEIC; Data as of 2017

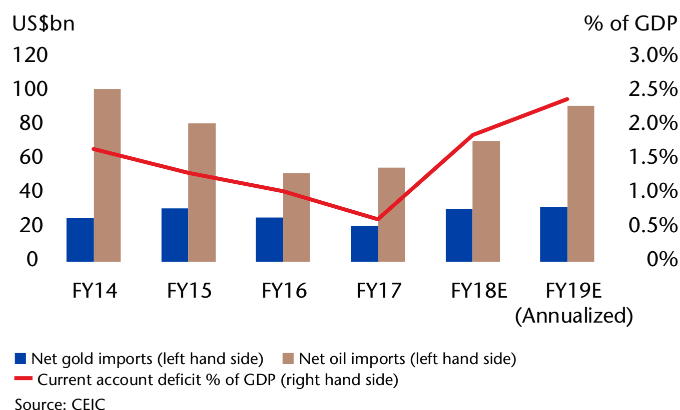
HIGHER OIL PRICES

- There is a risk of a tight oil supply and higher prices.
- India's widening current account deficit has been largely a function of oil, with over 50% of the year-to-date trade deficit in September coming from oil alone.
- Malaysia's current account surplus would widen with higher oil prices, boosting domestic liquidity and helping to insulate local monetary policy from external pressures.

Higher oil prices could be a headwind to growth as most Asian economies are net oil importers. U.S. sanctions on Iran's oil industry start on November 4, taking an estimated 2 million barrels per day of oil out of the global market. The lack of sizable future spare capacity, near-term supply shocks and current demand growth (1.6 million barrels per day) suggest the risk of a tight oil supply and higher prices, unless major producers such as Saudi Arabia step up.

India's widening current account deficit has been largely a function of oil, with over 50% of the year-to-date trade deficit in September coming from oil alone. Significant oil-driven inflation could push bond yields and retail prices higher. Malaysia is the only net oil exporter in Asia (ex-Brunei). The country's current account surplus would widen with higher oil prices, boosting domestic liquidity and helping to insulate local monetary policy from external pressures. Malaysian equities are highly correlated with oil prices, with upside risk if prices rise.

FIGURE 3. INDIA CURRENT ACCOUNT DEFICIT DRIVEN BY OIL



Source: CEIC

CHINA SLOWDOWN AND STIMULUS

- Chinese growth could affect countries with high export exposure to China, particularly Singapore and Vietnam.
- Slower growth in China would likely spell fewer outbound tourists, with a knock-on impact on Thailand where tourism accounts for around 12% of GDP.
- On the exchange-rate front, a weaker Chinese renminbi will also drive regional currencies lower to maintain competitiveness.

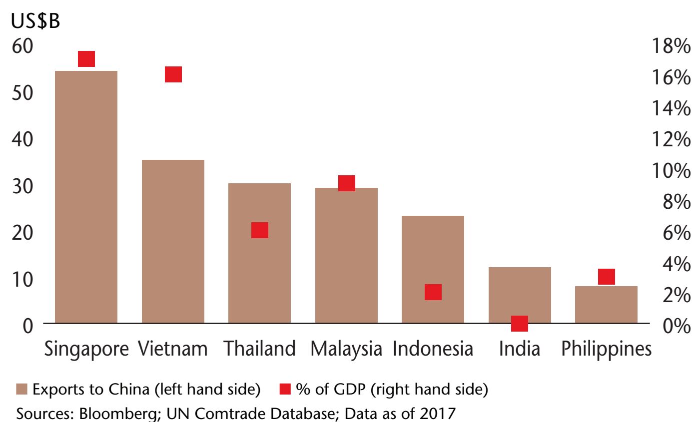
Exposure to China, which now accounts for one-third of global GDP growth, comes via two channels—growth and exchange rate. China's deleveraging has led to slowing growth momentum, while the impact of the trade tariffs has yet to filter through. Slower Chinese growth could affect countries with high export exposure to China, particularly Singapore and Vietnam, while the less open economies of India, Philippines and Indonesia would be moderately affected.

Thailand is a special case: nearly one third of Thailand's tourist arrivals come from China. Slower growth would likely spell fewer outbound tourists, with a knock-on impact on Thailand where tourism accounts for around 12% of GDP.

We believe some policy stimulus by China is likely in the coming months; fiscal policy may take center stage, led by tax cuts. With infrastructure spending having slowed in 1H18, and strong (10% y/y) growth in fiscal revenue, China has the fiscal space to manoeuver. There are early signs of reflation in new construction orders, credit impulse, and rising net bond issuance from Chinese local governments. This would be positive for regional growth, particularly in Indonesia, the Philippines and Malaysia, which benefit from higher commodity demand.

On the exchange-rate front, a weaker Chinese renminbi (RMB) will also drive regional currencies lower to maintain competitiveness. While there are concerns over the possibility of the RMB weakening as a tool to absorb tariff increases, recent RMB weakness appears to have been mostly a function of U.S. dollar strength. Further RMB depreciation risks fueling capital outflows and an adverse reaction from the U.S. with regard to trade competitiveness.

FIGURE 4. EXPORTS TO CHINA FROM ASEAN-6 AND INDIA



Sources: Bloomberg; UN Comtrade Database; Data as of 2017

POLITICAL CYCLES

- A heightened focus on Indonesia's 2019 presidential election may raise risk premiums on assets.
- A weak rural economy in India may prove the biggest challenge to Prime Minister Modi's chances of re-election.
- Thailand's status quo may change little post-election, with the military set to exercise continued influence through parliamentary, legal and constitutional means.

Political cycles in several countries will affect market performance and equity valuations. India, Indonesia and Thailand are all scheduled to hold parliamentary and presidential elections in 2019.

Indonesia's election cycle has already begun with regional elections held in June. There has been a heightened focus on the 2019 presidential election since the unruly November 2017 Jakarta gubernatorial election that centred on race and religious issues. This may raise risk premiums on assets in the lead-up to the presidential/parliamentary elections in April 2019. The orderly regional elections, however, augur well for a more positive presidential campaign and election. President Jokowi's surprise selection of a senior Muslim cleric as his running mate may also help to deflect attempts to bring religious issues to the fore.

India's ruling Bharatiya Janata Party (BJP)'s PM Narendra Modi will be vying for re-election during parliamentary elections in September 2019. While Modi's economic record has been largely positive, marked in particular by the nationwide Goods and Services Tax implementation and passage of a powerful new bankruptcy law, a weak rural economy may prove the biggest challenge to his prospects. Markets are thus wary of potential for populist policies to run rampant ahead of the election, with negative consequences for fiscal stability. A more fundamental concern is the impact of potential election outcomes on the "Modi premium." The sharp expansion in equity market ratings during the current government's term suggests that a change in government to a less stable coalition could, at least initially, deflate Indian valuation premiums.

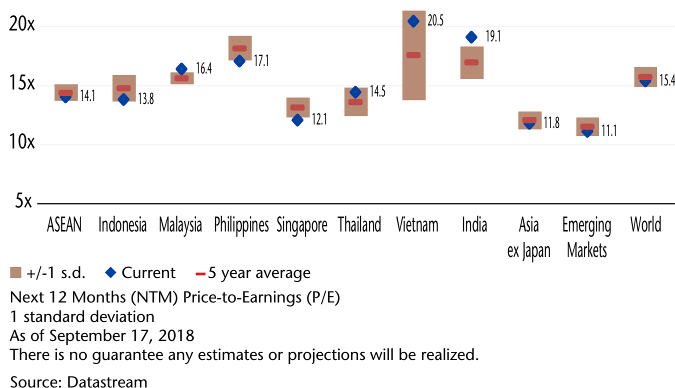
Thailand's parliamentary election, the first democratic poll since the military takeover in May 2014, is scheduled for April-May 2019. There is still potential for delay, however, as various legal and procedural milestones must be passed in order to hold the election. The status quo may change little post-election, with the military set to exercise continued influence through parliamentary, legal and constitutional means.

One important result of passing these milestones will be the resumption of private investment activity which has slowed as perceived uncertainty has risen. We believe this will add further support to domestic growth cycles while also boosting stable external financing via FDI flows.

CONCLUSION

Valuations now look more attractive in both absolute and relative terms. Valuation multiples have fallen to the lower end of the five-year trading range. In relative terms, the premium to Asia ex-Japan (and to frontier markets for Vietnam) has narrowed to near five-year lows.

FIGURE 5. NTM P/E



Next 12 Months (NTM) Price-to-Earnings (P/E)
1 standard deviation
As of September 17, 2018
There is no guarantee any estimates or projections will be realized.

Source: Datastream

The significant decline in valuations suggest that investors already expect various headwinds including trade wars and tighter developed market monetary policy to have a significant impact on growth expectations. Global policy tightening suggests that valuations are unlikely to revert to previous highs, leaving earnings growth to do the heavy lifting. And this is where the nascent recoveries in domestic economies across South and Southeast Asia will come into play.

We believe that market volatility under these circumstances offers opportunities in the emerging and frontier economies of Asia, where fundamentals have improved over the past five years and a new domestic-driven growth cycle is commencing.

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