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Matthews Asia Perspective

What's Driving the Downturn in Asia's Markets?

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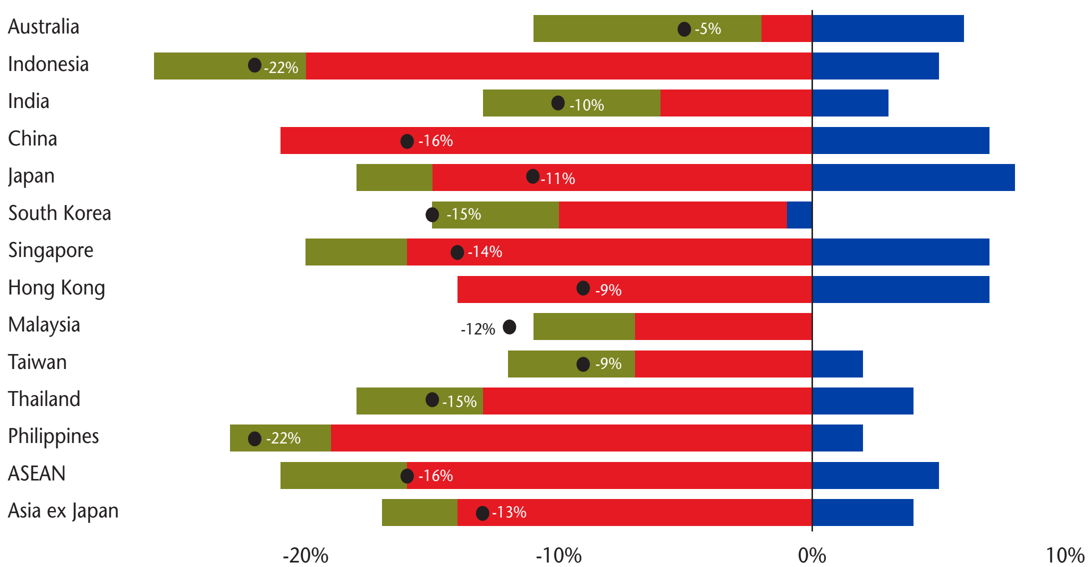
Have markets overreacted in Asia to news of a trade war and tighter money?

Market performance of Asian indices has seen some significant declines since their peak in late January. Indonesia and the Philippines are down over -20%, and even the more protected markets of Hong Kong and Australia are down -9% and -5%, respectively. What is driving this?

It may be surprising but it is not actually fundamentals driving the weakness. Corporate performance has been pretty strong. Earnings growth has averaged about 5% for Association of Southeast Asian Nations (ASEAN) countries and has been higher in China and Japan. That is a decent performance. None of this is surprising—I have mentioned the strong structural forces underpinning long-term nominal GDP growth. Recently, I also have stressed the reacceleration of earnings growth as governments taper off the pro-labor, pro-wage polices of the past few years. And although the conventional wisdom among foreign investors is that Asia is "export-driven," our view is that productivity growth and domestic demand drive the region's growth. So, there seems to be a disconnection between sentiment and reality.

Figure 1. Have Asia's Markets Priced In Too Much Uncertainty?



■ Forward 12-Month Earnings Per Share Change ■ Forward 12-Month Price-to-Earnings Change ■ FX ● Price Index (USD)

Past performance is no guarantee of future results. Countries represented by the respective MSCI Index. Indexes are unmanaged and it is not possible to invest directly in an index.

There is no guarantee any estimates or projections will be realized.

Sources: IBES, MSCI and Bloomberg

Note: Performance from 1/26/18–7/13/18

Both valuations and currencies have declined. But the declining valuations are more noticeable—those falling price-to-earnings ratios that seem to suggest investors expect trade wars and monetary policy to have significant long-term effects. I doubt these worries are realistic—trade effects can be large in a few industries but they are not particularly meaningful for the majority of the economy. And however the U.S. decides to treat international trade, China, Asia and Europe can continue to embrace globalization even without the U.S.'s full participation.

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.

President Trump may think that trade wars are easy to win but they're not. Much of what he wants to do can simply be ignored by Europe and Asia. Of course, many will argue that higher tariffs are yet to have an effect on profits. They are right, but the effect—should it ever come through—is likely to be much less than markets fear. For markets in ASEAN have been de-rated (seen average valuations fall) by -16%, Japan by -15%, Hong Kong and China by -14% and -21%, respectively.

As for the monetary effects—these are real. Perhaps the fall in valuations and the currencies (which have been much less severe) have been exacerbated by a missed opportunity to reflate last year. Perhaps their credit cycles and nominal growth might have been more robust and investors less nervous had governments been more aggressive on fiscal policy. But it does seem to me that markets are factoring in a worse scenario for Asia than the data suggests is likely.

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