Matthews Asia

Perspectives Q&A:

Can Asia's Stock Rally Continue?

Robert Horrocks, PhD
Chief Investment Officer
Matthews Asia

Do you see Asia's equity rally continuing into 2018, and why?

We believe the rally will continue. Earnings have been subdued in Asia for a number of years. We suspect a main reason has been a focus by governments on minimum-wage increases. On average, these have been well ahead of economic growth rates. Corporate margins have been squeezed as a result. These policies have reversed, however, meaning that corporate profits ought to be able to grow sustainably at faster rates over the medium term. Asia's companies also have faced relatively tight monetary conditions and a strong U.S. dollar. These have improved recently—the dollar no longer seems to be on a strengthening trend and Japan and China (along with Indonesia) have started to loosen monetary policy. We suspect other economies in the region can follow their lead. There is even plenty of room for fiscal stimulus across Asia, too.

Is there a point at which Asia's equity valuations are just too high? When would investors consider diversifying from heavy allocations in Asian equities to bonds?

Valuations can always become too high. We would argue a couple of points, however, that make current valuations for the market in general seem less aggressive than at first glance. First, earnings have been depressed for six years across most of Asia. That means that the market, although it may be discounting another year of strong profit growth, is not yet discounting multiple years, in our view. Therefore, price-to earnings (P/E) ratios may be less extreme than they appear. Other measures, such as price-to-book ratios, suggest that Asia is much more reasonably valued.

Second, a lot of the extreme valuations have been in growth stocks—in particular, mega-cap growth companies, including software giants and industrial automation, and some health care companies. During years when earnings growth across the region has been subdued, these companies have attracted a high premium for their growth. If profit growth broadens out, that premium may fall. We believe the rest of the market, in particular many small- and mid-cap companies, seems fairly priced.

Diversifying into bonds faces a real challenge at the moment because yields are low and spreads are low almost everywhere around the world. One area where spreads look a little more reasonable is in high-yield corporate bonds in Asia. As for a significant asset allocation switch, we don't think that will happen unless central banks make a big monetary mistake by tightening too much.

As we listen to clients from around the world, we hear that few are overweight Asia. Very few are confident that the rally will continue. Some are looking to "buy on the dip" but most are skeptical. That gives us a little comfort, as we think a lot of the overexuberance in asset markets is in places like cryptocurrency, not necessarily in broad equity markets.

If U.S. interest rates go up two or three times next year as expected (meaning a total increase of 50 to 75 basis points), what effect would that have on P/E ratios in the United States? In Asia?

We think price-to-earnings (P/E) ratios would fall. We also think that growth in the United States would slow significantly, so the economic impact on the United States would likely be far more severe than on domestic demand-driven Asian companies. The yield spread between two-year and 10-year Treasuries is as low now as it was in late 2007. It is only 65 basis points. Three rate increases by the Federal Reserve would threaten to "eat up" that entire spread. That is the prediction the market seems to be making but in our view it is an aggressive prediction. The Fed risks doing too much.

Figure 1. Two-Year to 10-Year Yield Spread in U.S. Bond Market

Source: Economic Research Division, Federal Reserve Bank of St. Louis; data as of 11/24/17

What would be the impact of U.S. tax reforms, if implemented, on equity valuations in the United States? In Asia?

The likely impact of U.S. tax reforms, if implemented as the Republican Party envisages, would largely be on the U.S. dollar. A higher U.S. government deficit would likely raise real interest rates and attract foreign investors to buy U.S. Treasuries. That demand would probably push the dollar higher. In addition, corporate tax breaks, to the extent they would increase investment, likely would also increase the trade deficit. This would be achieved through a rising dollar. The investment impact of tax cuts may not be as strong as Republicans expect, but the overall effect of the plan would be a stronger dollar and that probably would put downward pressure on Asia's P/E ratios.

Will Asian investors be comfortable with P/E ratios higher than they are now?

If Asia's corporations continue to grow profits strongly, we do not think P/E ratios are overly high. Other measures, such as price-to-book ratios, are actually very low. It is not unusual at the beginning of an upturn in markets for P/E ratios to seem quite high, particularly if earnings have been depressed. Over time, however, even if there is strong earnings growth, investors would expect valuation levels to return to historic averages. Those averages can be misleading in Asia, however, because the overall composition of markets has changed quite a bit over the past 10 or 20 years. In a global context, too, we think Asia's valuations, particularly cyclically adjusted valuations, and even P/E ratios look reasonable.

For Institutional/Professional Investor Use Only

This document is not for public distribution and is for institutional and professional investors only and may not be reproduced in any form or transmitted to any person without authorization from the issuer.

The information contained herein has been derived from sources believed to be reliable and accurate at the time of compilation, but no representation or warranty (express or implied) is made as to the accuracy or completeness of any of this information. Matthews International Capital Management, LLC ("Matthews Asia") and its affiliates do not accept any liability for losses either direct or consequential caused by the use of this information. The views and information discussed herein are as of the date of publication, are subject to change and may not reflect current views. The views expressed represent an assessment of market conditions at a specific point in time, are opinions only and should not be relied upon as investment advice regarding a particular investment or markets in general. Such information does not constitute a recommendation to buy or sell specific securities or investment vehicles. This document does not constitute investment advice or an offer to provide investment advisory or investment management services, or the solicitation of an offer to provide investment advisory or investment management services, in any jurisdiction in which an offer or solicitation would be unlawful under the securities law of that jurisdiction.

Matthews Asia is a U.S.-based investment adviser registered with the U.S. Securities and Exchange Commission who has not represented and will not represent that it is otherwise registered with any other regulator or regulatory body.

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.

In Hong Kong, this document is issued by Matthews Global Investors (Hong Kong) Limited and has not been reviewed by the Securities and Futures Commission in Hong Kong.

In Singapore, this document is available to, and intended for Institutional Investors under Section 304 of the Securities and Futures Act ("SFA"), and to Relevant Persons pursuant to section 305 of the SFA, as those terms are used under the relevant law. It should not be circulated or distributed to the retail public in Singapore.

In the UK, this document is only made available to professional clients and eligible counterparties as defined by the Financial Conduct Authority ("FCA"). Under no circumstances should this document be forwarded to anyone in the UK who is not a professional client or eligible counterparty as defined by the FCA. Issued in the UK by Matthews Global Investors (UK) Limited ("Matthews Asia (UK)"), which is authorised and regulated by the FCA, FRN 667893.

©2017 Matthews International Capital Management, LLC

G.BY225_1217

Matthews Asia