Matthews Asia

Matthews Asia Perspective

The Likely Trade War Fallout in Asia

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The U.S. administration appears to be targeting export-oriented entities out of China. Exports are of little importance, however, to the Chinese economy. The largest and fastest-growing part remains Chinese companies selling goods and services domestically. This means that any impact of a trade war on these companies is likely to be modest. Still, a risk remains that as U.S.-China trade relations further deteriorate, the productivity gains accrued from more efficient manufacturing and global supply chains will start to unwind. In this case the consumer, globally, will have to bear at least part of the pain.

We have seen a partial shift in the financial institutions that exert their influence in Asia. Local regional entities are trying to create lending channels for various countries in the region. But there is not enough depth yet to fully offset traditional Western-backed institutions. If the availability of capital becomes challenging due to global monetary tightening, it may constrain the pace at which Asia's economies can grow.

A dichotomy exists, however, between what Asia's capital markets are telling us—which seem fearful of rising rates in the U.S. and potential trade wars—and what we are being told on the ground by companies and consumers. Not only are businesses across the region looking to invest, but they seem to have a reasonable degree of confidence about their future expectations.

Take India and Indonesia, two Asian countries that appear vulnerable to higher U.S. interest rates. After five years of disappointing economic growth, signs of life are creeping back into their respective investment cycles.

Following the taper tantrum in the U.S. in 2013, policy makers in India and Indonesia focused on the necessary structural reforms to set the stage for better future growth. With both countries reliant on outside capital, they addressed some of the inefficiencies within their economies, such as sticky inflation and wastage of subsidies, as well as long-term challenges to improve the business environment. This may alleviate tail risks of significant dislocations within these economies, but any changes in the availability of capital may constrain the nascent recovery in economic activity.

We believe both economies are starting to recover, albeit gradually. Low Indonesian equity valuations, when set against the backdrop of an improving earnings cycle, may offer opportunities. In India, on the other hand, valuations look more expensive compared with their recent history and will need to be underwritten by a sharp pickup in earnings.

Bull and Bear Cases for Asia's Markets

Bull Case:

- Improved fundamentals in Asia's economies
- Chinese domestic-oriented services sector is insulated from trade war impact
- Indonesian equity valuations appear attractive

Bear Case:

- Global monetary tightening might constrain the pace of growth in Asia
- Ripple effects from potential Chinese trade policy reaction

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