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Matthews Asia Perspective

Evaluating Portfolios in Unsettling Times

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Key Points

- Matthews Asia Investment Strategist Andy Rothman believes there will be a trade deal between President Trump and President Xi by the end of 2019.
- Even if there is no near-term trade deal between the U.S. and China, we believe this should not jeopardize the liberalization of Chinese financial markets.
- Chinese policymakers have the tools and mostly likely will mitigate an economic slowdown in China if need be.
- Trade deal or no trade deal, China's fundamentals and the earnings outlook should not change significantly.
- Any disruption on the Asian side will, in our opinion, also hit equally on the U.S. side.
- A trade war should not affect long-term trends within the region and may even create unforeseen winners.
- Earnings and even equity prices could recover. As a signpost, look for looser, more accommodative monetary policies.

In this Q&A, Chief Investment Officer Robert J. Horrocks, PhD, Investment Strategist Andy Rothman and Portfolio Strategist David Dali discuss the investment implications if there is no resolution to the U.S.–China trade dispute and share their views on the economic and political environment in China.

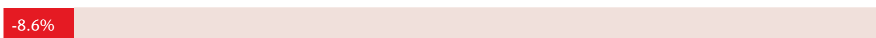
If there is no trade deal between the U.S. and China in the foreseeable future, does that put a stop to the liberalization of Chinese financial markets?

Andy Rothman: First of all, I do think there will be a deal between President Trump and President Xi by the end of the year. Even if there is not, I think that puts more pressure on China to move ahead more rapidly with reforms—not only in the financial sector but also in the rest of the economy. While exports are important to China, they are by far not the most important part of its economy. In order to make sure that the domestic-demand side of its economy continues to thrive, China is going to have to push ahead with reforms even more quickly. We have seen steps toward that already. China has cut tariffs and improved market access for companies from countries other than the U.S.

FIGURE 1. CHINA IS NOT EXPORT-LED, SO A TRADE WAR IS NOT LEVERAGE

NET EXPORTS = 0.8% OF CHINA'S GDP

NET EXPORTS = -8.6% OF CHINA'S GDP GROWTH



U.S. TOOK 19.0% OF TOTAL CHINESE EXPORTS LAST YEAR

DOMESTIC CONSUMPTION = 76.2% OF CHINA'S GDP GROWTH

All data is for 2018.
Source: CEIC

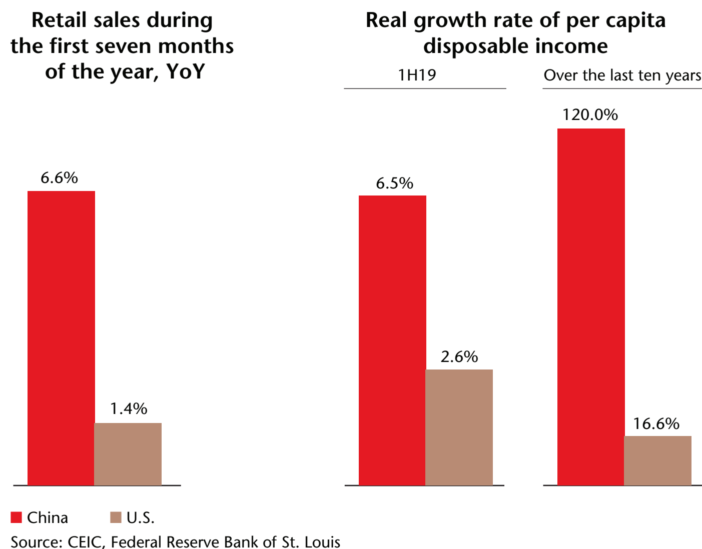
If no trade deal materializes and there is an extended trade war, what would be long-term effects on China's economy?

Andy Rothman: Chinese policymakers and economists in Beijing tell me that they have a backup plan: if the tariff dispute blows up into a full-blown trade war with the U.S., they're prepared to undertake a fiscal stimulus to try and compensate for it. I think they can be successful—we've seen this before—in dealing with these consequences of a full-blown trade war with the U.S. And that will include efforts to soak up unemployment from anybody who loses their job and to rebuild confidence and get investment back up. So I think with our focus on Chinese companies selling goods and services to Chinese consumers, that from an investor's perspective, this is going to be pretty well-insulated from the impact of a full-blown trade war, just like I think the Chinese economy itself will be reasonably insulated.

FIGURE 2. WE SHOULDN'T START A TRADE WAR BASED ON THE MISTAKEN BELIEF WE FACE AN ECONOMICALLY WEAK OPPONENT

Larry Kudlow: "The Chinese economy is crumbling." August 6, 2019

President Trump: "China has had the worst year they've had in 27 years." August 20, 2019



Source: CEIC, Federal Reserve Bank of St. Louis

Is there going to be a long-term effect on China of U.S. businesses moving manufacturing out of China? Do you think it will be a big effect?

Andy Rothman: This process has been underway for a number of years now, as wages have been rising, largely because the Chinese government's been pushing them up with steadily increasing minimum wages, lower value-added assembly and production has been leaving China. But the uncertainty that is caused by the trade dispute has definitely increased the number of companies that are thinking about moving. But I don't think there's been that many changes, because it's really difficult to relocate. And where do you go? Vietnam is going to be a big beneficiary. But Vietnam is the size of one Chinese province.

So I think that yes and no. I don't think you're going to see an abandonment of China because of the large domestic market. And remember that the majority of foreign companies producing in China are producing to sell to the Chinese market or the Asian market, not to export back here. And then the other issue is the uncertainty is going to remain for an extended period of time, and it is going to make the people question not only do they go to China, but where do they go? President Trump has already indicated that now the U.S. is importing more from Vietnam as a result of the tariffs on China, maybe he needs to put tariffs on Vietnam. So where do you go?

Do you see any potential strengthening of the Chinese currency? And could you comment on overall valuation?

Andy Rothman: Over the past several years and I think this continues today, the direction that the Chinese renminbi (RMB) moves against the U.S. dollar is being set over the course of a full calendar year, entirely by the strength or weakness of the U.S. dollar. So if we continue to expect a strong dollar, then we should continue to expect a weak RMB during the calendar year. The Chinese have been intervening in recent years and will continue to do so to prevent the RMB from moving in either direction by I think more than 5% or 6% in any one calendar year. That is the amount that they think is reasonably tolerable for their companies. But beyond that, and there is some short-term movement for political signaling, like we saw recently, but otherwise I think they are going to stick with that pattern.

Robert Horrocks: The Chinese have very strong capital controls. They can control where the dollar goes. If the capital controls weren't there, the RMB would probably weaken, not strengthen. But the irony behind the currency manipulation claim is that if China is manipulating its currency at all, then it is probably keeping it somewhat stronger than it otherwise would be. I don't believe in these scenarios for massive devaluations. But I think the RMB in a free market here would probably be somewhat lower than where it is today.

What about the long-term effect on Asian markets, Asian economies or currencies?

Robert Horrocks: There is no serious implication to Asian sectors that wouldn't also hit the relevant sectors in

the U.S. The biggest potential for disruption here is in the technology sector, where you have the design of the product, the design of the components happening in the West, then getting manufactured in some parts of Asia, getting assembled in China, and then shipped back to the Western world. If you were to have an escalation of the trade war, that's surely the area where you get the biggest impact. But that hits the U.S. consumer pretty directly, and in a very visible way. So it's hard to see a massive escalation that doesn't cause pain on both sides. The major beneficiaries are likely to be the manufacturing economies of Southeast Asia that up to this point have not built the same kind of strength as you've seen in Taiwan, South Korea and China, but where you're starting to see a lot of foreign direct investment from North Asia into building up the capabilities in Vietnam, Indonesia, Malaysia, Thailand, to produce these kind of goods. And so the big beneficiaries are probably Southeast Asia.

The global economy has been slowing. The U.S. economy is slowing. China's economy is in slight long-term decline. How might China respond if the global economy continues to slow?

Andy Rothman: Let's look at the Chinese part first. China's GDP growth rate and the growth rates of other things like retail sales peaked a number of years ago on a year-on-year basis. Part of this is to be expected because the growth rates were in the double digits. Part of it is also the base effect. So that we know that at 6% growth in retail sales now, you're still looking at a much bigger incremental expansion in consumer spending than you were ten years ago at double-digit growth rate. So this is actually a pretty sweet spot for Chinese companies and for investors into that. The second point I'd make is that I don't encounter anybody in the Chinese government who believes that they should be making an effort to try and reaccelerate growth. I think they are all aware of and comfortable with the fact that every year, on average, every part of the Chinese economy on a year-on-year basis is going to continue to decelerate. And within a couple of decades, they'll be comfortable with 2%, 3% growth like we are in OECD-level countries. Now, one thing that they're not going to tolerate is an abrupt, sharp deceleration. And we saw this during the global financial crisis, where they came in with a pretty large fiscal stimulus. So I think if the global economy slows sharply, and that has a sharp impact on the Chinese economy, they will be back with fiscal stimulus appropriate to the size. And I think they have both the political will and the resources to make that work.

Earnings have been depressed in broader Asia for many years. Now, many investors are also witnessing fairly weak equity returns on top of weak earnings. What might turn things around?

Robert Horrocks: Earnings follow economic growth and equity returns follow earnings based on where the valuation starts. Valuation really isn't much of a concern right now, because valuations are relatively reasonable. So the question is, will economic growth continue and will that translate into earnings? Now, what drives economic growth are savings and productivity gains. And all of these things you are seeing in Asia at a far faster rate than in any other large region of the world. The Asian savings rate and the Chinese savings rate are well above those in the U.S. and Latin America. Productivity gains, both the use of capital and labor productivity gains, are far faster in Asia than in the rest of the world. So the underlying growth is there from those big fundamental macroeconomic factors.

Why has this not factored into earnings so far?

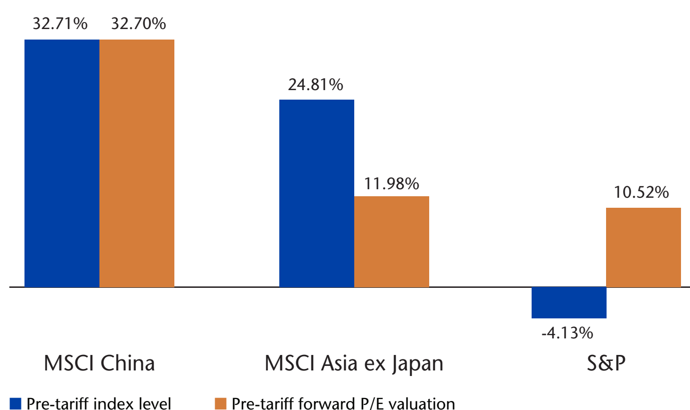
Robert Horrocks: Because China and the rest of Asia has followed this course of very pro-labor policies, trying to get labor's share of income back up to historical averages. It is the exact opposite of policy in much of Europe, and particularly in the U.S., where the governments have been willing to see labor squeezed in order to inflate corporate profit margins and keep the stock market high. Without a buoyant stock market, they lose a way of controlling short-term fluctuations in GDP.

But I would suggest that China and the rest of Asia has prepared society for another decade-long expansion that is more equally shared between labor and capital or might be more conducive to corporate margins. At the same time, the U.S. is squeezing the last drop of juice out of this particular lemon. And at some point, you're going to see a switch, and I think the sign for this happening will be looser monetary policy in Asia and China, and probably looser fiscal policy as well.

What's the upside scenario for investors' portfolios in terms of Asian equity markets and the downside based on history?

David Dali: Let's look at the chart at the top of page 4 and just focus on the blue bars, which are the upside required to get back to the pre-tariff skirmish era. And so if you go back to January of 2018, the index levels of the MSCI China of the MSCI Asia ex-Japan and the U.S. are in blue. So it would take almost 33% upside of the Chinese index to get back to pre-trade levels.

FIGURE 3. RISK/REWARD FRAMEWORK
Index upside to get back to pre-trade war levels



Pre-tariff index level refers to the index return implied by the difference between the index level on January 18, 2019 and August 9, 2019

Pre-tariff forward P/E valuation refers to the index return implied by the forward price to earnings (P/E) valuations on January 18, 2019 and August 9, 2019

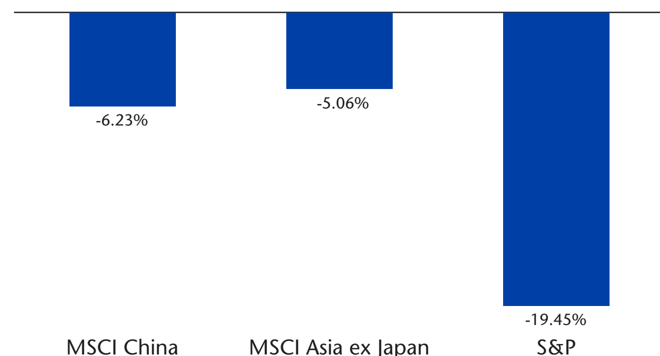
Source: Bloomberg

Almost 25% upside for Asia ex-Japan, and believe it or not, U.S. equities are already above those levels back in January 2018. So to return back to those levels, the U.S. would actually come down. If you don't like index levels type of analysis, the orange bars are valuation purposes. So to get back to a pre-tariff forward PE level in China—that forward PE level, just for reference, was about 14.25—you'd have to go up equally about 33%. In Asia ex-Japan, to return back to the 13.8 times forward PE, you would have to go up about 12. And for the U.S. to return back to those levels of valuation, you have to go back to 11. The moral to the story is that we believe that the upside is skewed very favorably towards China and toward Asia ex-Japan, mostly because a significant amount of uncertainty has been priced in already.

What about the downside capture?

David Dali: In the chart below, this is the downside capture. What is the potential downside? Look at

FIGURE 4. RISK/REWARD FRAMEWORK
How far are we from 2018 lows?



The downside estimates are calculated using the respective index level on August 9, 2019 less the 2018 index low closing level (October 30, 2018 for MSCI China and MSCI Asia ex Japan and December 24, 2018 for S&P 500.

Source: Bloomberg

index levels going back to the lows of 2018. For China and for Asia, that was at the very end of October. We had substantially weak markets, and the lows were hit at the end of October. From index levels today, the Chinese equity market has to fall only 6% to get back to index lows. Asia ex-Japan has to fall only 5%. The point is that a significant amount of uncertainty is already priced in. The U.S., however, were it to get back to December 2018 lows, would fall about 20% to get back to those lows. So I think that the risk skew is favoring China and Asia, primarily because a lot of these risks are priced in already.

Could you summarize some of the risk-reward?

David Dali: I would say the major index levels are within 5% of their 2018 support levels and have taken back about half of their gains of 2017. If I were to add on top of that what could support these major indices and major asset classes, I would point to most Asian major currencies that have already suffered and taken their medicine. A currency like the South Korean won has already fallen about 8% year to date and certainly could be a reasonable buffer for exports--equally so, interest rates. Most of the medicine was taken in 2018 by these Asian central banks, and they created a fairly significant buffer.

How is Matthews Asia approaching the current macroeconomic environment?

Robert Horrocks: We are looking to identify investment opportunities that may arise from short-term market dislocations. Dampened sentiment can lead to buying opportunities. As always we are looking for quality companies with solid management teams that can capture the attractive growth potential of the region. I fully understand that many investors, looking at the disruption, would like to stand on the sidelines, but as long-term Asia investors, we like to buy when sentiment is weak because we are more focused on how companies will perform over a full economic cycle.

Chinese equity valuations relative to the U.S. currently seem to be at the bottom of their historical range. So we find this an exciting time to invest in the region. We continue to monitor risks, including geopolitical risks, while staying focused on the opportunities on the ground. The protests in Hong Kong have been one out of many factors that have been weighing on markets. Other factors seem to be improving a bit and we remain optimistic about China's long-term growth potential.

INDEX DEFINITIONS

The MSCI China Index is a free float-adjusted market capitalization-weighted index of Chinese equities that includes H shares listed on the Hong Kong exchange, B shares listed on the Shanghai and Shenzhen exchanges, Hong Kong-listed securities known as Red chips (issued by entities owned by national or local governments in China) and P Chips (issued by companies controlled by individuals in China and deriving substantial revenues in China), and foreign listings (e.g. ADRs).

The MSCI All Country Asia ex Japan Index is a free float–adjusted market capitalization-weighted index of the stock markets of China, Hong Kong, India, Indonesia, Korea, Malaysia, Pakistan, the Philippines, Singapore, Taiwan and Thailand.

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