Matthews Asia

Matthews Asia Perspective

Investing During a Different Rate Cycle

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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.

Amid a rise in market volatility around the world, the fundamentals for Asia equities look fairly healthy. Investors should not ignore, however, the interconnectedness of today's global markets. The correlation between different asset classes has risen a fair amount, due in part to a distortion from the low-rate environment. Now we are about to enter into a different interest rate cycle. This means the higher correlation could spark a certain level of volatility, and this was reflected during the recent sell-off. Regardless of what types of stocks you owned—whether it was growth, quality or dividend stocks—more or less they all went down in value. As long as you were not going into cash, there was nowhere to hide.

At the start of 2018, the market continued the strong rally we saw in 2017. Without much improvement in earnings or positive news out of Asia, though, what was driving strong performance? Were people getting a bit too excited? The recent volatility caused half of the market to take some profits. That's understandable in the short term. But we believe the outlook for Asia ex Japan still looks very good and macroeconomic conditions in the region also are stable. The volatility could be a sign of things to come—a recalibration of U.S. equities and more rate increases by the U.S. Federal Reserve (Fed) as it combats inflation. But Asia remains attractive from both an earnings and valuation perspective.

What Sparked the Volatility?

The source of the volatility was a market reaction in the U.S. following a more hawkish stance by the Fed toward the current interest rate cycle. The U.S. market has been a strong performer over the past five years. Today, corporate earnings still continue to grow, but the valuation multiples look different. The rerating of U.S. stocks has contributed to the strong market performance. When facing a potential reversal of a low rate environment, if the U.S. economy continues to deliver at its full capacity (relatively speaking), inflation is likely to accelerate and that will cause the Fed to review its rate hike cycle. This may lead it to raise rates further. That could be an argument for a higher risk premium for the equity asset class.

Overall, we think inflationary environments provide interesting investment opportunities. Companies with pricing power, for example, can pass on some of the inflation to their customers. When we talk about inflation returning to Asia, it is primarily the producer price index (PPI)-driven inflation being referred to, i.e., it is happening at the corporate level. In the consumer market, the consumer price index (CPI) indicates that inflation is still quite muted in the region.

Later this year, parts of the consumer market are likely to start seeing price increases across different consumer product categories, and across-the-board price increases probably for the first time in two to three years. For these consumer products, the manufacturers are saying that the input cost is rising and, on the other hand, they have been undergoing a consolidation phase. Some of them are in a better position to charge higher prices. We have been seeing that already, for example, with producers of milk, dairy products and tissue paper—all daily necessity goods. Manufacturers are starting to raise prices. This CPI hike in the region could be quite interesting if we can pick out the business models that will benefit from this inflationary environment.

Blurred Lines in Retailing

Those following the Asia region closely will have noticed that even online e-commerce companies, at this point in their growth phase, need to focus on their omni-channel strategy—that is, how to integrate the online platform with offline distribution. The lines are a bit blurred at the moment between online and offline retailing. We think that both the inflation and industry competitive dynamic could become interesting for traditional supermarket businesses. Supermarkets might be one of those business models that could benefit from passing on the inflationary cost pressure to its customers. Their pricing power tends to look better during an inflationary period.

We also continue adding to discretionary consumer businesses. There is room to grow for these businesses. In large markets, a desire for households to upgrade their goods and premium services could provide interesting investment themes. We see opportunity in hotel businesses based out of China, for example, as Chinese consumers increasingly seek more leisure experiences. There has been strong demand in consumption (and less so in tangible goods), mostly in terms of services and experiences such as international travel.

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