

## Matthews Asia Perspective

### South and Southeast Asia: The Investment Landscape



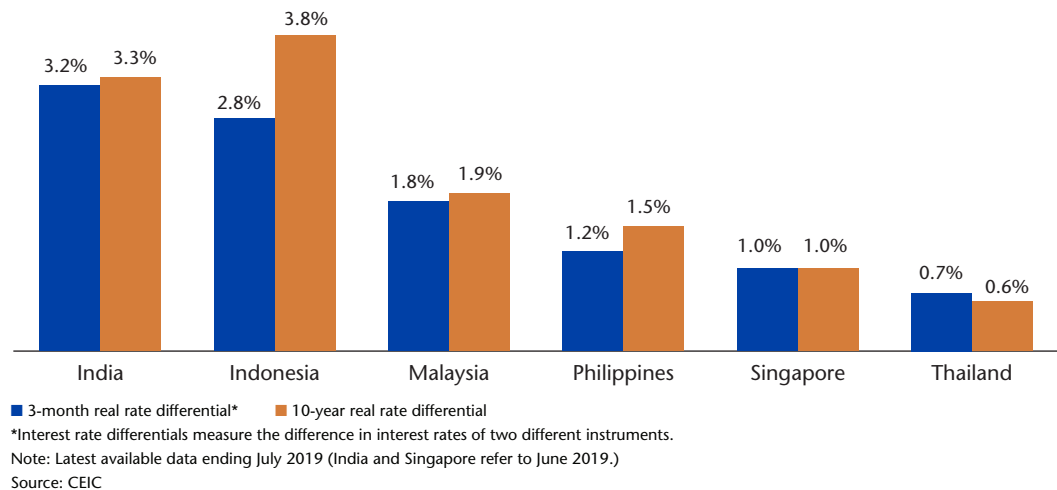
**Sriyan Pietersz**  
Investment Strategist  
Matthews Asia

Why should global investors care about South and Southeast Asia?

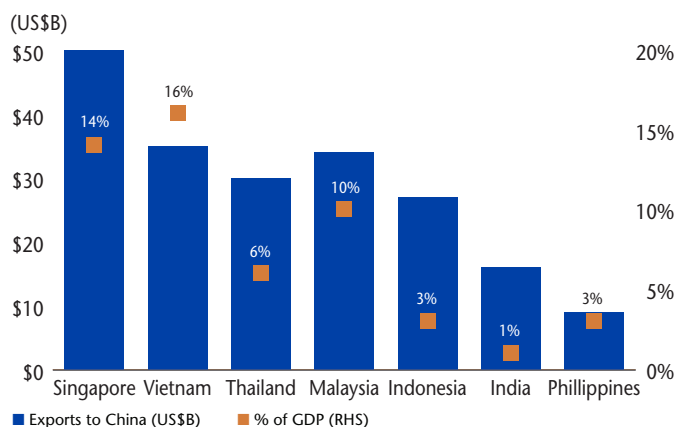
We believe the region offers a compelling proposition given its combination of 1) relative domestic orientation, which confers greater economic stability in a volatile external environment; 2) cyclical positioning as growth bottoms out supported by monetary and, in certain cases, fiscal flexibility; 3) increasing momentum in reforms and infrastructure spending following an election cycle; and 4) an emerging opportunity in the movement of supply chains to the region amid U.S.–China trade tensions.

We think these attributes will allow the region to better balance the opposing forces of trade uncertainty and slowing global growth on one hand and easing financial conditions and light investor positioning on the other. These factors could be a trigger for investor interest in the region, encompassing “safe haven” portfolio flows and new foreign direct investment, in our view.

**FIGURE 1. HIGH REAL INTEREST RATES IN ASEAN AND INDIA PROVIDE ROOM TO EASE**



We expect the region to follow in the footsteps of the U.S. Federal Reserve, and note that the current account-deficit (CAD) countries—India, the Philippines and Indonesia—stand to benefit the most from easing global monetary conditions. Soft global activity indicators such as the Purchasing Managers’ Index (PMI) and the inversion of the U.S. yield curve point to weakening growth conditions. Moreover, the continuing escalation of the tariff war by both China and the U.S. will pose a drag on corporate confidence, investment and global growth. In this environment, we continue to prefer more domestic-oriented economies such as Indonesia, the Philippines and India. Thailand is stuck in a low-growth equilibrium, but the capacity for fiscal stimulus and a strong external surplus provide defensive characteristics that may draw foreign inflows. Singapore and Malaysia are most exposed to global turbulence, although they too have some defensive characteristics that may enable outperformance relative to North Asian economies and markets (fiscal flexibility in Singapore and cheap currency and significant room for policy easing in Malaysia).

**FIGURE 2. TRADE EXPOSURE TO CHINA POSES RISK IF RMB DEPRECIATES**

Note: 2018 annual data except Vietnam, which refers to 2017 (latest available data).

Source: UN Comtrade

Currency headwinds continue to sustain. The narrative around a weaker U.S. dollar as the Fed eases notwithstanding, the trade dispute and slowing global growth are driving flows into the safe haven of the U.S. dollar. While this dynamic may eventually give way, the current depreciation of the Chinese renminbi (RMB) above seven to the U.S. dollar adds to pressure on emerging market (EM) Asian currencies, particularly among manufacturing exporters in EM Asia that are directly linked to the China supply chain—in Southeast Asia, Malaysia, Singapore and Vietnam stand out. Commodity exporters/current account deficit economies such as India, Indonesia and the Philippines, which are less tied to the China supply chain, should face less currency pressure following significant adjustments in 2018 as global financial conditions firmed in the first half of 2018. Overall, EM Asian foreign exchange is likely to have a weakening bias over the rest of 2019, in our view.

Subdued earnings-per-share growth remains a concern for investors. In a late-cycle U.S. growth environment, however, where a dovish Fed's hand is forced by a deteriorating trade environment, together with indications of fresh quantitative easing by the European Central Bank, liquidity may provide an offset to weak growth. While we anticipate a 2020 recovery in earnings on bottoming economic growth and the lagged impact of varying degree of monetary and fiscal easing, valuation expansion is likely to support markets ahead of earnings recovery, in our view.

## VIETNAM

Growth in Vietnam is moderating off a high base as exports slow on a weakening tech cycle and global demand. Solid productivity gains have underpinned wage growth, however, which in turn underpins steady

and sustained consumption growth. Vietnamese authorities have also leveraged the solid growth fundamentals to adopt more prudent fiscal policy (the fiscal deficit has shrunk from recent highs and public debt/GDP has fallen well below the 65% limit). This may have contributed to the moderation in growth. Stability indicators have also improved, with inflation at moderate levels and foreign exchange reserves at historical highs.

Vietnam remains an outlier among open economies as a relative beneficiary of the U.S. –China trade conflict. Trade diversion benefits and medium-term production relocation should support income and domestic demand while buffering against external volatility. A movement in supply chains and manufacturing to Vietnam would boost investment and increase exports over the medium term.

Rising leverage and weaker China growth are risks, but recent de-rating provides a long-term positioning opportunity. Upcoming new legislation on securities could improve the scope for foreign ownership of equities, which could in turn boost the case for Vietnam's promotion to MSCI's Emerging Markets classification in 2020. This could drive upside for valuation of Vietnam equities.

## INDONESIA

The current account deficit has stabilized after a robust policy response, and growth momentum has bottomed. The dovish Fed tilt opens the door for monetary and fiscal policy easing, which should help to lever up growth momentum into 2020 while setting a floor on earnings revisions. With investor positioning light and expectations low, a shift in policy emphasis from stability to growth should provide a positive shock to the market along with prospects of significant reforms, driving a market re-rating.

Indonesian President Joko Widodo (Jokowi) has stated that his intention to carry out reforms and boost foreign investment during his second term. The key reforms include a) cutting the corporate tax rate to 20% from 25%; b) opening up more industries to foreign direct investment; c) investing in infrastructure; and d) easing labor laws. To support domestic demand, the government is planning several tax cuts to encourage consumption and investment. President Jokowi has also issued a regulation that gives companies tax incentives to invest in skills training and research and development, which could spur productivity and innovation in the medium to long term if combined with structural reforms. The process may not be easy, however, as the government depends on a broad coalition for support.

The economy should benefit from accommodative monetary policy given a high real interest rate differential with U.S. dollar rates, although the Bank Indonesia's easing cycle will likely be more cautious as it navigates external risks.

Earnings may have turned a corner in the second quarter of 2019, with consumer stocks delivering above expectations. Portfolio inflows have risen since the presidential and parliamentary elections, suggesting that the market is likely to remain resilient as President Jokowi's re-election bodes well for further reforms, investment spending and potential growth.

## PHILIPPINES

The Philippines' valuation has moved higher from its November 2018 low on peaking inflation and a more stable Philippine peso (PHP). Improved policy credibility, lower oil prices, expectation of significant monetary-policy easing and continuing infrastructure spending, a strong mandate for President Duterte at midterm elections and light investor positioning continue to support equities.

Following 2018's 200 basis point policy-rate increase to combat a sharp rise in inflation, inflationary pressures have eased with CPI growth easing toward the midpoint of the central bank BSP's target range. This was partly facilitated by the introduction of the rice tariffication bill in the fourth quarter of 2018, which liberalized rice imports and thus moderated food price increases. The central bank's pro-growth stance now augurs a sharp reversal of last year's rate hikes, together with a significant multiyear plan to ease the banking system's required reserve ratio (RRR). This will provide a strong growth stimulus from lower funding costs and increased liquidity.

The growth outlook remains benign given the Philippines' domestically oriented economy, and easing inflation/catch up in public spending story will remain in focus. The Philippine peso could depreciate anew on U.S. dollar strength, although the Philippines could also be a beneficiary of supply chain realignment, especially with U.S. and Chinese companies taking more interest in Southeast Asia.

The current account deficit (CAD) remains a risk, but is buffered by rising services inflows and easing global policy rates that are helping to drive portfolio inflows to finance the external deficit.

The equity market de-rating in 2018 has partly reversed on recent portfolio inflows, but Philippine stocks remain attractively valued. The cheap PHP and light investor positioning provide upside, in our view.

## INDIA

Growth has slowed, with private demand hampered by rural distress, tighter liquidity for consumer lenders and an undercapitalized banking system, while fiscal resources are stretched. With a high real interest rate differential to U.S. dollar rates and moderate inflation affording significant room to cut interest rates, the Reserve Bank of India (RBI) could take an aggressive path on monetary policy easing.

The cumulative effects of the 110 basis point rate cuts and liquidity easing already effected should encourage a cyclical growth recovery in 2020, in our view. Some signs of bottoming are emerging with rising capacity utilization and increasing credit growth to the industrial sector, but earnings revisions are likely to remain weak as expectations adjust to current conditions. An escalation of the shadow banking crisis and weak monsoons stifling rural demand are downside growth risks, while further easing of monetary policy is an upside risk.

The market also has underperformed the region since the announcement of the 2020 budget as foreign portfolio flows exited on potential plans to raise taxes on foreign investors. However, with the Indian government's reversal of the higher surcharge on capital gains tax on foreign portfolio investors, the announcement of a host of measures aimed at easing bottlenecks and supporting demand, and the re-escalation of U.S.–China trade tensions, India's domestic-oriented economy may draw in fund flows. Despite pricy valuations and earnings revision pressure, falling rates, expectations of further reforms following Prime Minister Modi's broader-based election win, and India's defensive attributes may provide support for equities.

## THAILAND

Defensive attributes led by a large and persistent current account surplus should shield against EM volatility and valuations have eased from highs. Return of the military in a more 'democratic' guise is positive for policy continuity, with mega infrastructure projects to drive investment in the medium term. But, growth momentum has paused, earnings revisions have turned down and lower oil prices could drag on the performance of large capitalization energy stocks.

Thailand is caught in a low growth equilibrium, with weak external demand and declining competitiveness from a strong Thai baht dragging exports. We believe exports remain vulnerable to escalating US-China trade tensions and the deepening global tech down cycle. The deterioration in external demand will likely

have a negative spillover effect on domestic demand in 2H19 through weakening wage growth in the manufacturing sector and declines in both consumer confidence and business sentiment. The risk of a drought has also intensified, which could weigh on the outlook for agricultural output and household incomes. Domestic demand is also hampered by high household indebtedness, with consistent fiscal stimulus and tourism spending the primary growth levers.

Spending on large infrastructure projects that are expected to provide the backbone of Thailand's next generation manufacturing has been largely delayed into 2020 and beyond. However, the commitment to the government's Eastern Economic Corridor development plan remains strong, and should begin to draw increasing private investment. Board of Investment (BOI) data in 1H19 show a strong increase in new FDI investment applications, suggesting a lagged pickup in investment activity in 2020. In the interim, the recently announced US\$10 billion fiscal stimulus is expected to boost growth by 0.2% to 0.3%, according to the Bank of Thailand.

Low real interest rates mean that monetary policy space is limited, but the central bank cut policy rates at its latest meeting on concerns over weaker growth. We see little further room to cut and expect the current low growth environment to persist, dragging corporate earnings. However, abundant excess liquidity and a resilient Thai Baht may support equity valuations.

## MALAYSIA

Cleanup of the old political economy structure following 2018's surprise general election victory by PM Mahathir Mohamad detracts from growth, although revival of infrastructure projects that were initially canceled will add some impetus going forward. Given heavy external exposure and a weak oil price, the state owned enterprise-heavy index will struggle to outperform. However, potential medium term gains from production relocation, a cheap Malaysian Ringgit, and light investor positioning provide downside support.

Similar to Singapore, Malaysia's high exposure to the global economy is causing a drag on growth. As Asia's only net oil and gas exporter, weak oil prices are a net negative for the country. Weaker external demand manifests itself not only in declining exports but also increasingly in wage growth, business confidence and investment spending. Growth risks are thus skewed to the downside in the event of a sharper downturn in tech exports and increased global trade protectionism.

However, with high real interest rates and inflation likely to remain subdued we believe Malaysia's central bank BNM has ample space to respond to a worse-than-expected growth downturn at a time when fiscal policy is constrained by the large revenue gap left by repeal of the Goods and Services Tax (GST) in 2018.

Following significant depreciation in 2018, the ringgit is among the cheapest currencies in Asia, positioning Malaysia to benefit from both import diversion resulting from the U.S.–China trade conflict and production relocation. Heavy trade exposure to China is a risk for the MYR, in the event of further Chinese renminbi (RMB) depreciation.

## SINGAPORE

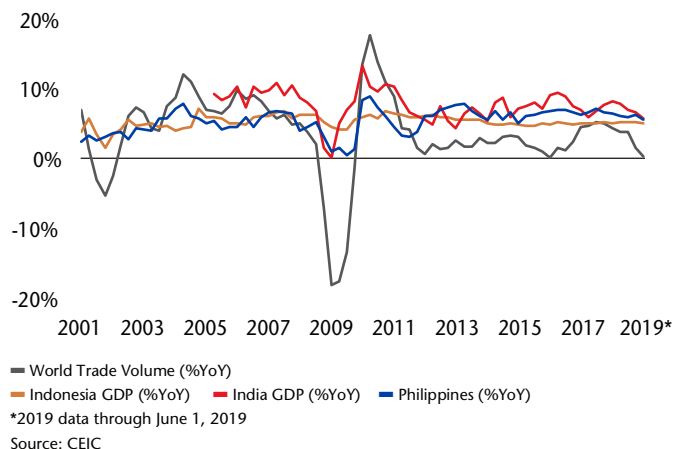
Singapore is most vulnerable to trade disruptions given its trade-centric economy. Singapore continues to be the region's biggest casualty of the trade war and tech slowdown, no surprise given trade/GDP exposure of well over 200%. Intensifying external headwinds will continue to weigh. Despite valuation de-rating and strong household sector fundamentals, equities will struggle to perform. That said, from a listed company perspective, their exposure to the region (ASEAN in particular) provides a growth buffer, notably in the Singapore banks. Trade tensions, China growth and lower oil are key risk factors.

The Monetary Authority of Singapore (MAS: the country's central bank) looks poised to ease monetary policy in light of slower economic growth and softening activity data at its next policy meeting in October. Core inflation has trended lower since the start of the year (1.2% year over year in June), against a backdrop of weakening consumer indicators: consumer loan growth turned negative during 2Q19 (-0.4% year over year and -0.6% year over year in May and June, respectively) while retail sales contracted over the full quarter.

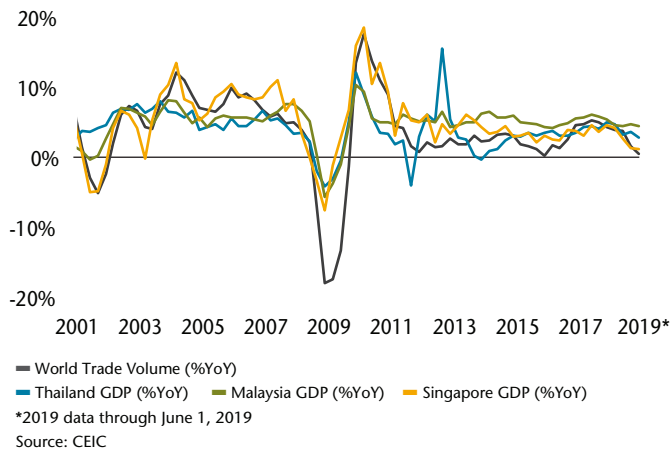
While Singapore authorities expect domestic sectors to continue to do well "given firm demand conditions", prolonged uncertainty and the weak global economic backdrop caused a recent official downgrade of full year 2019 growth estimates from 1.5% to 2.5% to zero to 1.0%. That said, any improvement in global trade conditions would likely see improvements in Singapore as well. Further, it is worth noting that fiscal stimulus is likely to be an option going into 2020, as the war chest of accumulated surpluses now totals over SGD15bn and allows the government significant spending leeway under Singapore's balanced-budget rule.



**FIGURE 3. DOMESTIC-ORIENTED ECONOMIES ARE MORE INSULATED FROM TRADE WEAKNESS**



**FIGURE 4. WHILE EXTERNALLY-ORIENTED ECONOMIES ARE EXPOSED**



**IMPORTANT INFORMATION**

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.

Matthews Asia is the brand for Matthews International Capital Management, LLC and its direct and indirect subsidiaries.

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 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. This document may not be reproduced in any form or transmitted to any person without authorization from the issuer.

In the United States, this document is issued by Matthews International Capital Management, LLC. In Singapore, issued by Matthews Global Investors (Singapore) Pte. Ltd. (Co. Reg. No. 201807631D). 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 (SFC). In the UK, this document is issued by Matthews Global Investors (UK) Limited, which is authorised and regulated by the FCA, FRN 667893. 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. This document has not been reviewed by any regulatory authorities.

