Asia Insight

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CIO Outlook

I think it is fair to say that sentiment toward China, and by extension, Asia, within the U.S. investment community, is quite polarized. Whereas some investors I have met recently see opportunity in the weakness of the second half of the year, doubts over the reality of recent growth rates and anxiety over a slower headline rate of growth has caused many others to be quite fearful of China as a deflationary force in the world economy. I think this caution is mirrored by investors around the world, albeit the degree of discomfort with China and Asia is perhaps less acute in Europe. Whilst those in Asia appear to be much more optimistic about the region's own long-term growth prospects (and less suspicious about the quality of China's historic growth), most investors are still in a "wait-and-see" mode.

It is not hard to see why. Indeed, let us just list the headwinds that Asia faces in the near term: the prospect of further tightening by U.S. monetary policy—this time in the form of rising rates; slowing nominal growth; low margins and disappointing earnings growth; a strong dollar and weak local currencies; increasing credit spreads; and poor momentum in the equity markets. And all of this is happening at a time when valuations, whilst not expensive, cannot be regarded as cheap in absolute terms. It is understandable that people may be waiting for some event or some improvement in valuations before they turn more positive. And it is rational, and almost always your best first guess, to assume that current trends will persist when you are trying to forecast the near-term future.

Now, let me just suggest that we have some data that should allow us to be more confident over Asia's ability to weather the world's deflationary forces. First, current accounts in Asia are generally positive. That means Asia's countries are saving more domestically than they invest domestically. And so, they are relatively less reliant on foreign capital. There are some exceptions—India and Indonesia. But even here, reliance on U.S.-dollar capital markets has reduced dramatically over recent years. Second, inflation rates are low across much of the region (again Indonesia and India are exceptions, even though they have been successful at moderate price rises). These low inflation rates mean that Asia's policymakers have a lot of room to offset deflationary impulses by either monetary policy or even government spending or tax cuts. A return to a more inflationary environment would relieve some pressure on margins, earnings and valuations.

The question is: are we seeing any signs of such a response? I think we are. First, there are the natural responses of markets—prices adjust. Most obviously, in the face of deflationary U.S. pressures, Asia's currencies have taken the strain.

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Acute declines have been limited to commodity-related currencies, such as the Malaysian ringgit and Indonesian rupiah. Elsewhere across the region, moderate currency declines (nowhere near as severe as what Latin America has suffered) have acted as a sort of pressure valve to protect domestic employment and maintain domestic demand. Although this is a drag on U.S. dollar returns and (to a lesser extent) Euro-based investors, the fact that currencies have been able to act as stabilizers of demand shows how far we have progressed in Asia since the late 1990s.

Then, we have the active response of policymakers. In India, we have seen the central bank successfully squeeze down core inflation rates without too severe an impact on industrial profits (perhaps helped by lower commodity prices). Now, India's central bank seems ready to ease. In China, we are seeing authorities raise the growth rate of narrow money, continue to press with financial system reforms, and support the property market. Japan is continuing its policy of reflation and structural reform initiatives. So, in the face of a deflationary U.S. policy, the three Asia giants seem to be leaning in the other direction. The degree of offset is perhaps still small. But talking to clients and investors around the region leaves me to believe that there is no great liquidity crisis. Indeed, if the acutely bearish reaction to the Chinese currency re-pegging in the middle of 2015 taught us anything it is that, in the wake of a fall in equity prices, value was quick to emerge and buyers were quick to enter the markets.

Global Middle Class Spending

In this context, Asia's long-term growth prospects still look good. High savings rates, large manufacturing bases, reformist governments pursuing financial, legal, and corporate reforms mean that Asia should continue to invest and potentially grow at higher rates than the rest of the world. Over time, this investment will continue to raise real wages across the region. This trend should not only support currencies and growth but also may lead to big changes in Asia's households. We have noted before that on current trends, Asia stands to account for two-thirds of global middle class spending by 2050. We believe this is just the beginning of a sustained growth in the kinds of businesses that will help generate profits from facilitating this revolutionary change in lifestyles: consumer brands, restaurants, leisure, media, insurance, property, consumer banking and wealth management. In industry, automation equipment and IT software will help companies offset higher wages. Increased government and private spending on health care, the environment, and general welfare will open up new opportunities for companies to create competitive advantages and raise profits and shareholder returns.

In light of these trends, we should remember the monetary environment that dominates our discourse and the media headlines: when will the Fed raise rates, and by how much? This environment, whilst important in the short-term, is to an extent just a veil that distracts our attention from the real economic changes that are evolving almost undetected before our eyes. With that said, nevertheless, we have to admit that 2016 is likely to be a landmark year in U.S. monetary policy—the first rise in rates in a decade. As I write, it is unclear whether or not the Fed will raise rates in December 2015. I think to do so would be premature, as inflation expectations are still very low in the U.S.—1.5% versus a Fed core inflation target of 2%. However, even at currently uninspiring rates

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of GDP growth in the U.S., the unemployment rate is likely to reach 4% to 4.5% by mid-2016, a level at which we could expect inflation to start rising. So it seems likely that the Fed will be raising rates in 2016 and that always makes it hard to get too enthusiastic about near-term returns. But it is a much more benign scenario for Asia if the Fed is raising rates as inflation and wages are rising in the U.S., compared to what the markets feared might happen in 2015—a rate rise in the U.S. despite the complete absence of inflationary pressure.

Within Asia, our focus remains on the companies that will support the real economic growth trends, across all countries. However, it is true that some countries currently appear to be more fertile grounds for corporate research than others. On valuation grounds, India looks moderately expensive, with disappointing earnings growth and a lot of expectations over the still-unfulfilled reforms by the prime minister. In China, valuations are much more reasonable—parts of the Hong Kong market look cheap. And after a difficult time in 2015, the Association of Southeast Asian Nations once again looks to offer new opportunities, even as stock prices in some parts of the North Asian markets, particularly in Korea, seem to be quite advanced. Japan, at least, offers some value and some hope of better corporate returns, though one should be wary of hyping Abe's third arrow too much.

Overall, I look forward to 2016. Although the headwinds are currently considerable, Asia's businesses seem to be weathering the storm, and so long as we keep our eye on the long term, the investment environment should offer up some good opportunities.

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