Asia Insight

December 2017

CIO Outlook: Bucking the Trends

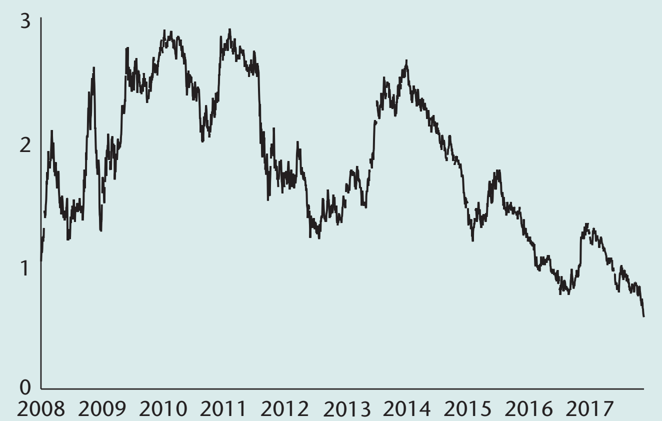
The best first guess about what will happen next year is always "more of the same." That is to say, follow the current trends. So it might be tempting to say that the forecast for 2018 looks like this: The U.S. stock market will continue to power up on expanding margins as wage pressures fail to materialize—even as the U.S. Federal Reserve continues to raise rates; global growth will continue to strengthen; Europe will see strong earnings growth as the European Central Bank (ECB) takes a more cautious course than the U.S. Federal Reserve (Fed), but political woes and secessionism continue; China and Japan will continue their reflationary policies, leading to a continuation of strong earnings growth and the bull markets in their equities—although performance will continue to be focused in just a few mega-cap, high-growth stocks; investor flows into emerging markets will continue to focus on passive ETFs, pushing these mega-cap stocks ever higher; Association of Southeast Asian Nations (ASEAN) governments will continue to flinch on monetary and fiscal stimulus and their economies will underperform as a result; consumer spending across the region will continue to be strong; bitcoin will push on through US$20,000, US$30,000, US$50,000 as pundits find ever more sophisticated ways to conjure up an intrinsic value for it and even as cryptocurrencies proliferate and corporations figure out that they can raise money by issuing a "currency" rather than equity.

Outlook for the U.S, Europe, Japan, China and ASEAN Nations

Perhaps the world will continue like this, but I cannot really believe it will be so. Several parts of this picture are likely but I think some trends will either slow or reverse entirely.

First, I think the U.S. bull market is petering out. It has done well on a mix of low interest rates and strong earnings growth, which in return has relied on moderate wage increases and expanding corporate margins. Well, the era of low interest rates might be coming to an end. A tightening cycle is well underway. In addition, policy proposals by the Trump administration—replacing parts of Obamacare and middle-class tax increases to fund corporate tax cuts—seem like the last attempts to squeeze more money out of the worker and keep corporate margins high and the stock market rolling on. How all this ends, with a bang or a whimper, I just don't know. I suspect, absent any monetary mistakes by the Fed, the U.S. stock market is more likely to flatten out than to fall precipitously—but the change at the helm of the Fed has to be a worry and the bond market, via the two-year to 10-year yield spread, is signaling caution!

TWO-YEAR TO 10-YEAR YIELD SPREAD IN U.S. BOND MARKET



Source: Economic Research Division, Federal Reserve Bank of St. Louis; data as of 11/24/17

Second, I believe Europe could see continued reasonable earnings growth. The ECB is notably more patient in raising interest rates than the Fed. Economies are

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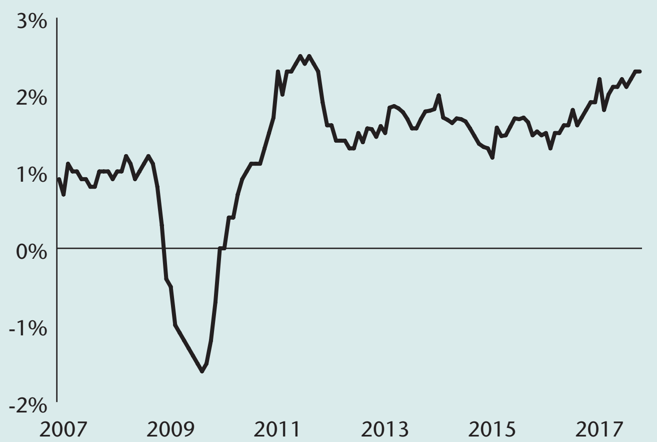
operating below their potential to a much greater degree in Europe and so the "catch up" ought to be able to continue. These underperforming economies, though, have led to political strife and secessionism: first, the question of Scottish independence, then Brexit, now the Catalans. These issues have not been solved and probably stem from inefficient mechanisms by which transfers of money can be made from prosperous parts of the European economy to those parts that are going through harder times. An upturn in Europe's growth should ameliorate the problem, but it still exists—the ECB has to be careful to not squelch the recovery before it takes hold.

Third, I do think Japan and China will continue to reflate their economies. Japan has the ability to be more aggressive on this front. China, however, can also be comfortable with inflation in the 2% to 3% range, in my view. A significant aspect of Asia's economies over the past five or six years has been the extent to which Asia's policymakers, in stark contrast to the West, have been determined to restore labor's share of economic growth by raising minimum wages ahead of the rate of economic growth. China began the trend and many other Asian countries followed suit. This might have squeezed corporate profit margins and left the stock markets lagging behind from a relative perspective. It may have, however, laid the groundwork for a sustained rally from now on. Reflation allows corporations to raise prices and for workers to enjoy nominal wage rises, even if their real wages are rising by a smaller amount. Thus China, which has been reflating since the end of 2016, and Japan, which has been doing it since early 2013, have seen corporate profits rebound and their stock markets surge. There is no reason to think this trend cannot continue. If it does, and if earnings growth broadens across sectors and companies, then these environments, I believe, typically favor small and mid-cap companies trading at more reasonable valuations. Meanwhile, the premium paid by investors for mega-cap, high-growth companies may well shrink.

CHINA CONSUMER PRICE INDEX: A COMFORTABLE RATE OF INFLATION



Source: Economic Research Division, Federal Reserve Bank of St. Louis; data as of 10/31/17

Nor should this trend be limited to North Asia. In many respects the countries of ASEAN are even better-positioned for reflationary policy. Thailand has a large current account surplus and low core inflation. India and Indonesia have brought down their structurally high inflation rates to moderate levels. Policymakers have room to stimulate through both fiscal and monetary policy without severely affecting their currencies. Indonesia was able to implement a surprise rate cut without affecting the rupiah. Elsewhere across Asia, currencies have been strong relative to the dollar and we do not believe that the dollar will be a fundamentally strong currency in 2018. All this means that ASEAN countries can stimulate and in doing so can limit any depreciation of their currencies versus the dollar. There is a good possibility, then, that the rally in Asia will broaden out beyond China and Japan and the big tech companies.

Trends Should Favor Active Management

All of which should attract more investors to choose active managers over the benchmarks. I remember that when Japan started to reflate in 2013, the first wave of money came into ETFs. It took a while before investors started to allocate to active strategies that are better able to invest down the market-cap scale. If I am right

> "We see increased access to China's equity and bond markets for non-domestic investors, access which already seems to be improving governance."

in the way that current trends will evolve, then 2018 might be a year when the style of portfolio flows into Asia's economies starts to change. It may also be that Asia is once again seen as a separate region from the emerging markets—for I believe Asian economies are far better-placed to see higher rates of earnings growth and looser macroeconomic policy than either Russia or Latin America. And I believe that consumer spending in Asia will continue to be strong. For Asia's great strength relative to other so-called emerging markets is high savings rates. Those savings, which in the past have been used to invest in new capital stock and drive the capacity of Asia's manufacturing sectors to produce goods, will increasingly be used as a source for Asia's consumers to raise their spending and buy goods and services. And this is a long-term trend.

Sizing Up Longer-Term Positives for the Region

This commentary so far has focused on the short term. But there are still many longer-term positives for the region. The greatest of these is the continuing structural reform in Asia's economies. We see this across the region. China is increasingly focusing on the quality of growth rather than its pace, including taking seriously issues of social welfare and environmental costs. We also see increased access to China's equity and bond markets for non-domestic investors, access which already seems to be improving governance. In South Korea and Japan, too, corporate governance reforms are gradually influencing management. Southeast Asia, for a long time the region's productivity laggard, is building out its manufacturing base, often with China's help. In Asia's frontier markets, early capitalist reforms are taking root, such as the embrace of a private economy in places like Vietnam.

Perhaps the greatest hope here is still India, where a series of legal and institutional reforms over the years has tried to make the country's bureaucracy more efficient, to recapitalize the banks; to reduce the cash economy and increase the formal economy; to increase the efficacy with which state governments can use land for public infrastructure, and to improve the inflationary tensions and provide non-domestic investors with a more appealing set of macroeconomic conditions. These reforms have been partially successful—and the country remains a work in progress, but India has a chance of setting in motion improvements in standards of living on a scale we have only previously witnessed in China. All of these reforms give us reason to be optimistic for the future.

THE RISE OF BITCOIN

Source: Coindesk

Optimistic, yes, but we must also remain realistic. We must not get carried away. In the midst of all this excitement, we have to retain our discipline–a focus on good businesses, properly managed, at reasonable valuations. All of which brings me to the phenomenon of bitcoin. As far as I am concerned, it is not a currency. No one has convinced me that it has an intrinsic value in the same way the U.S. dollar does. It remains to me a symptom of some irrational, overexcited behavior in certain corners of the world's asset markets. I am quite positive on the outlook for Asia's economies and stock markets. But tread carefully. Don't get caught up in the hype. Keep your eyes on the long term and be sensitive to valuations. I won't be buying any cryptocurrencies—or tulip bulbs for that matter.

Robert Horrocks, PhD
Chief Investment Officer
Matthews Asia

10-Year Yield Data at: https://fred.stlouisfed.org/series/T10Y2Y
Bitcoin data at: https://www.coindesk.com/price/

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Phone: +1 (415) 954-4510
Email: globalfunds@matthewsasia.com
Web: matthewsasia.com

Hong Kong:
Phone: +852-3901-0880
Web: hk.matthewsasia.com