eastspring investments

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MARKET INSIGHTS

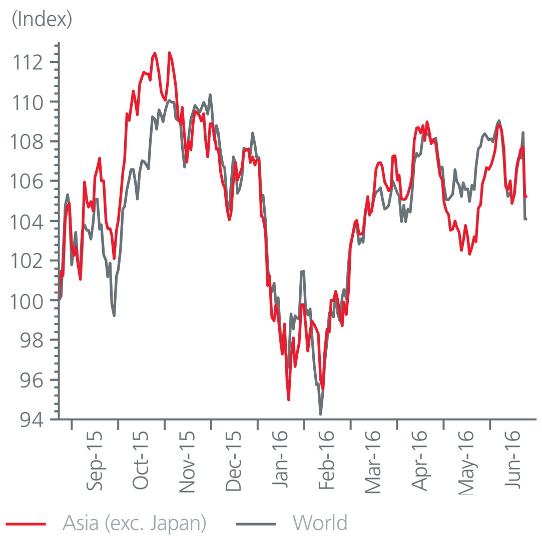
THE OLE' ASIAN TWO-STEP
BREXIT FEARS LEAD THE ASIAN EQUITY DANCE

JULY 2016

If anyone doubts that global concerns are leading the equities dance sheet, take a look below.

GLOBAL EQUITIES LEAD ASIA'S DANCE

Fig.1. Global investor fears are driving global equity markets in nearly identical ways



Source: MSCI World and Asia (exc. Japan) indices from Thomson Reuters Datastream as at 27 June 2016. Both are total return indices and are in local currencies. Both series have been indexed such that 100 = 24 August 2013 (the day markets stopped falling).

Asian equities are dancing in lock-step to the same well-rehearsed global tunes. Global, not Asian, issues have dominated the dance card. For example:

- Newcomer Brexit has magnified uncertainties as investors come to grip with both it and and its unintended repercussions.
- The path of US interest rates is another as recent emerging data points to a slowing US economy.
- Negative interest rate tensions in both the Eurozone and Japan plus related concerns that "helicopter' money will drive rates deeper into negative territory.
- Slower China growth fears (probably magnified) and concerns as to where the RMB is headed.

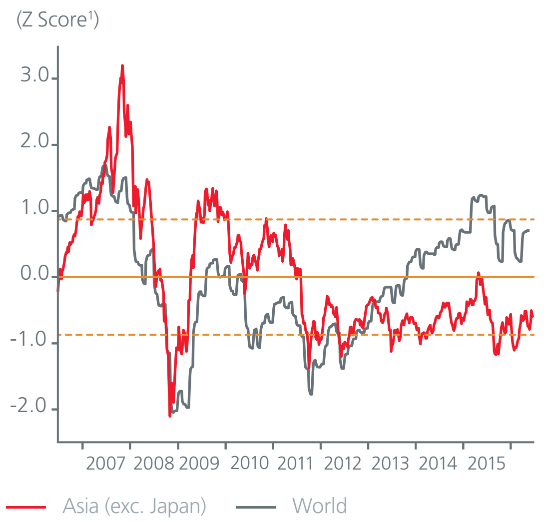
With global tensions poised to continue for the rest of 2016, Asian equities seem unlikely to break free and dance to their own tune any time soon.

Until then, what should the savvy investor do? Should one sit out this dance and wait for the orchestra to strike up for Asian rallies?

The chart below gives a clue.

ASIAN EQUITIES = ATTRACTIVE VALUE

Fig.2. Asia (exc. Japan) equities look attractively valued



Source: Eastspring investments, IBES and MSCI World and Asia (exc. Japan) indices from Thomson Reuters Datastream as at 27 June 2016. [1]The "Z" valuation is a composite measure giving equal weighting to the variation of the historical price to book ratio from its long-term trend and the variation of the prospective price earnings multiple from its long-term trend. The two outer dotted lines represent the limits within which around 70% of all values lie.

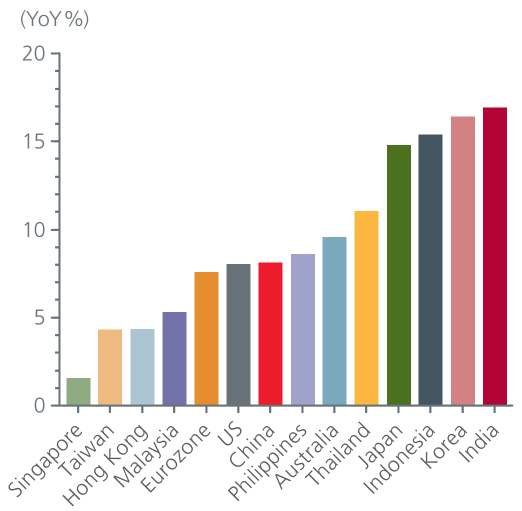
Asian equities look good value, very good value. The risk is that they have looked good value for the last few years; that attractive value may be an illusion. But equally, if it is not an illusion, it is only a matter of time before investors accept the invitation to dance. When they do, we want to be securely positioned.

To help make a decision, the trepid investor needs two bits of critical information. Read on!

ASIA'S LOW VALUE NOT AN ILLUSION

Asia's low valuations seem rooted in reality. Over the past year, a myriad of investor Asian fears reflected in a savage 16¼% cut in the profit forecasts[1] (vis-à-vis around 3% for the world). But not only has the fall in Asian forecasts since stabilised they also remain some of the world's strongest, backed by solid sales growth expectations (9¼% for Asia exc. Japan vs. 6¼% for US[2]).

Fig.3. Asia's profit outlook is mostly good despite some sharp downgrading



Source: IBES 12 month forward consensus EPS forecasts based on each market's representative index from Thomson Reuters Datastream as at 27 June 2016.

INTEREST RATES WILL REMAIN LOW

The view that US rates were headed north were stymied on the publication of May's "disappointing" US jobs numbers[3]. Brexit has probably put US rate cuts[4] on the back burner for the foreseeable future.

Asia's generally higher interest rate structure looks mostly stable (good for income!) with room for cuts in some (India, Indonesia and Korea)[5].

Armed with this information, what are the options?

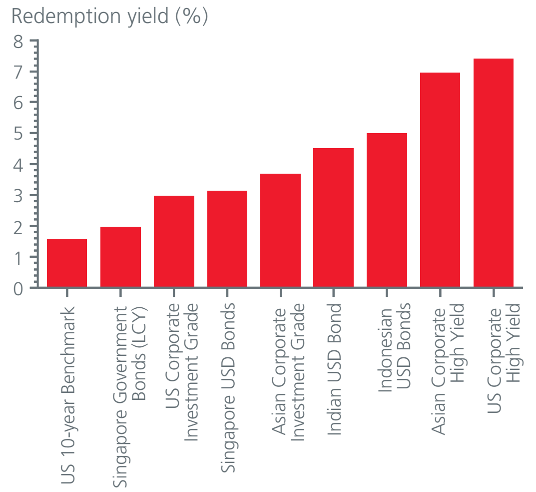
The income story is intact. The only question, in our view, is "Income from bonds, equities or both?"

[1]IBES from Datastream as at 21 June 2016. [2]Sales growth forecasts to the end of 2017. The Eurozone came in at 6¼% while India led the Asian forecasts at 12¾%. [3]To anyone looking at the old-age bias of the jobs numbers, the lack of follow through in final demand will not have come as any surprise. [4]Mrs Yellen in her June statement to the Senate Banking Committee indicates that developments are within Fed expectations. [5]China could possibly cut but the likelihood of this has fallen following May's article from "a person of importance".

A SLOW WALTZ FOR INCOME BONDS

With Japanese and Eurozone 10-year bonds offering negative yields, the yields on Asian bonds and US high yields look tempting.

Fig.4. Asian bonds and US high yields stand out for their attractive yields



Source: Barclays Capital and JP Morgan bond indices from Thomson Reuters Datastream as at 27 June 2016. For indicative purposes only.

This asset class is not without its risks; credit selection is important in China's high yielding real estate sector. US high yields could suffer should oil prices fall again (although 2015's contagion falls seem over).

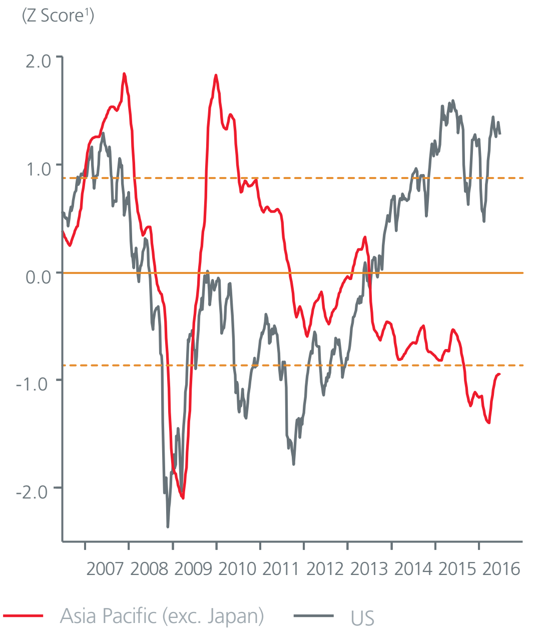
Nevertheless, Asian bonds and US high yields should feature on the dance card. Some (India and Indonesia) have room for capital gains when rates fall.

A FAST WALTZ FOR INCOME EQUITIES

Embraced in the arms of global equities, Asia's high dividend stocks have been dragged towards 2008 crisis lows, lows that look difficult to justify[6]. An opportunity?

An investor in Asian high dividend stocks can pick up a yield of circa 5¼%[7] (vs circa 2¼% for US equities) while waiting for any rally. Now, that sounds attractive!

Fig.5. Many Asian high dividend stocks reside in growth areas. Growth fears have driven these down to very attractive levels



Source: Eastspring investments, IBES and MSCI US and Asia Pacific (exc. Japan) High Dividend indices from Thomson Reuters Datastream as at 27 June 2016. [1]The "Z" valuation definition is as per Fig.2.

THE SAKURA WALLFLOWER – JAPAN

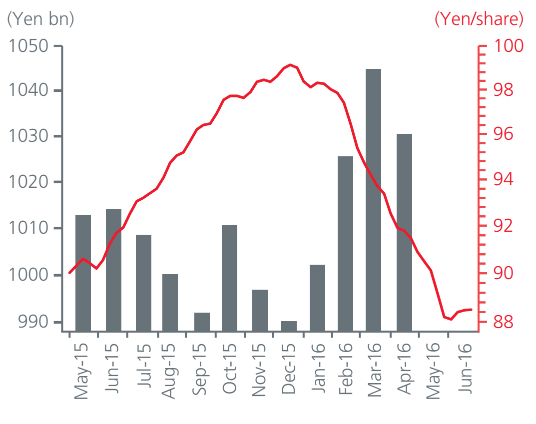
While "Abenomics" concerns linger, the Bank of Japan's negative interest rate policy has badly rattled nerves.

The fear seems grossly overdone – negative rates only apply to excess bank reserves[8]; the impact on bank profits are small. This did not stop government bond yields falling into negative territory and bank shares collapsing 54%[9]. Japan's bank valuations are lower than at the peak of the financial crisis (on reduced profit forecasts) and seemingly ignore the massive restructuring that has taken place.

Many investors have also overlooked a 2016 upswing in new orders largely domestically fed. This is probably why the fall in declared profits has stabilised and why the order backlog is tentatively rising[10].

[6]The low valuation, in our view, is a manifestation of the Asian growth fears that are not reflected in the growth forecasts. [7]On an historical basis. [8]Reserves in excess of required reserves and those backing Japan's reconstruction following the earthquake and tsunami. [9]The TOPIX bank index fall from its August 2015 high to February 2016 low. [10]After falling since mid-2015, the order backlog has jumped over 1½% since February 2016 according to the Cabinet Office, Japan.

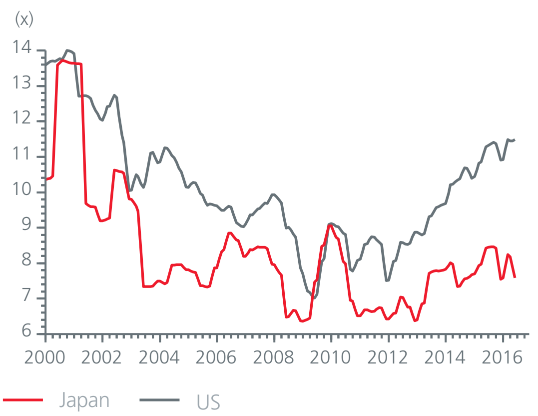
Fig.6. Japan's private sector new orders[1] rise. Declared earnings show signs of following



Source: IBES and Cabinet Office, Japan from Thomson Reuters Datastream as at 27 June 2016. [1]Note that the machinery orders excluding shipping.

Moreover, Japan's companies have delevered; their debt burden has fallen sharply[11]. In contrast, US debt burden has risen. This deleveraging helps explain why Japan valuations remain low despite a 77% rally since January 2012. In contrast, US equity valuations are near historical highs having risen "only" 61%.

Fig.7. Japan's valuations look attractive when both earnings and debt levels are taken into consideration



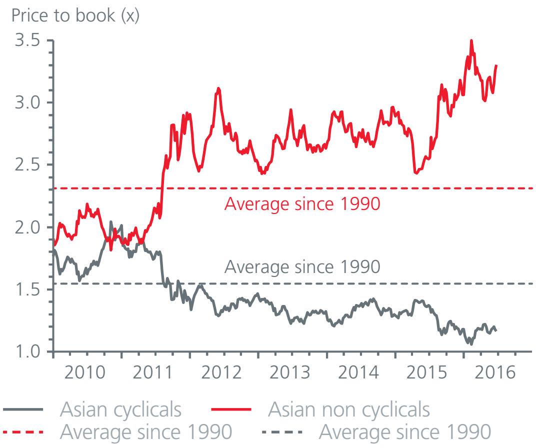
Source: Worldscope and Thomson Reuters Datastream as at 27 June 2016. Valuations are represented by the enterprise value/earnings before interest, tax and depreciation ratio.

When Japan equities are finally asked to dance, it could well be to rock 'n' roll.

THE OLE' TWO-STEP – ASIAN CYCLICALS

Reflecting global growth fears, Asian investors rushed to those sectors deemed "Safe[12]", sectors that not only were less exposed to growth but that also offered higher dividend yields. As these sectors soared, cyclical (or growth related) sectors[13] floundered. That dance is likely coming to an end as the next chart illustrates.

Fig.8. The "flight to safety" has left "safe" stocks looking expensive and "growth" stocks looking attractive



Source: Eastspring Investments and Thomson Reuters Datastream as at 27 June 2016. For indicative purposes only. The non-cyclicals index comprises consumer stables, consumer services and healthcare sectors equally weighted. The cyclicals index comprises base materials, financials, industrials and oil and gas sectors equally weighted.

The valuation gap between "Safe" and "Cyclical" is at its widest since the 1997 Asian crisis. Are Asia's economies so weak that growth related sectors should be valued this low? Asia's higher profit forecasts suggest not.

Moreover, that higher dividend, to which investors were running, no longer lies with the "safe" sectors; higher dividend yields now lie mostly with the much maligned cyclicals[14]. Investors are dancing with a partner who is not only expensive (price to book of 3¼x) but who also offers a low dividend yield (1½%).

[11]Japan's non-financial corporate net debt/equity ratio has fallen from 48% in early 2011 to 38% recently. Similar data for US non-financials has risen from 43% to 66½% according to Worldscope. [12]Consumer staples and services, healthcare, telecoms and utilities. [13]Building materials, financials, industrials and oil and gas. [14]Determined by equally weighting the sectors in 12 and 13 preceding.

Asian cyclicals are waiting. They have a much lower valuation (the price to book ratio is circa 1¼x) and offer a yield of 3¼%[15]. When the ole' Asian two-step starts, watch out.

IN A NUTSHELL

- Asian equities are dancing in tandem with global equities to the same global fear tune.
- Asian opportunities are being exposed as a result. Some valuations are at crisis level lows
- The risk? While global fears dominate, good value could become great value.
- The reward? Asia's attractive valuations could rebound strongly when confidence returns and attention refocuses on the region.

We reiterate our early 2016 mantra:

Buy value (when it appears). Tuck Away. Do Not Chase (the markets).

[15]Based on the consumer staples and services, and healthcare sectors. The similar data for the Telecoms and utilities equally weighted are a book value of 1½x and dividend yield of 3½%.

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