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MARKET INSIGHTS

ASIA PACIFIC[1] EQUITIES: IN FROM THE COLD

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INVESTORS FROZE OUT ASIA PACIFIC[1] EQUITIES

Geo-political concerns, global macro-economic fears and wide-spread corporate health issues have all played their parts. But are these equities coming in from the cold? It looks like it.

A strong case can be made that Asia Pacific equities were unfairly tarred with the global brush concerns just highlighted[2]. Asia Pacific, with its panoply of economies growing and maturing at different rates, has its issues. But if investors avoided the region because of exaggerated local, or global, issues, deep value might result. That seems the message inherent in Fig 1.

Are Asia's economic and profit outlooks so bad they justify crisis low valuations? We doubt it! In fact, we see three strong reasons why today's low valuations offer an opportunity to add attractively valued Asia Pacific (excluding Japan) equities to any portfolio.

Fig.1. Asia Pacific† valuations finally bounce off crisis lows

Source: MSCI from Datastream as at 8 September 2016. †Exc. Japan. Note, about 70% of all values fall within the two outer dotted lines. The middle dotted line is the average.

REASON 1: A 95% RETURN IN FIVE YEARS?

Today's price-to-book ratio for Asian Pacific equities (exc. Japan) is 1.5x. Over the preceding twenty years, valuations have only fallen this low four times – all at crisis points; the Asian crisis, the bursting of the IT bubble, SARS and 2008's financial crisis.

Each time, the bounce-back was strong (Figure 1).

But how strong? "Very", replies Figure 2. When Asia Pacific valuations were this low in the past, the bounce-back averaged 95% over the following five years.

That valuations have remained at these low levels this time for longer than usual looks like a manifestation of the view we expressed initially – global fears are dragging down Asian valuations. This brings us to reason No 2. Many of the fears dragging Asia Pacific were either exaggerated or exposed as having few clothes, we argue. Let's take a quick look.

Fig.2. A deep discount = A strong bounce-back?

Price-to-book MSCI All Country Asia Pacific ex Japan	% of observations	Average returns (%)		
		1 year	3 years	5 years
Less than 1.5x	12	54	63	106
1.5x to 1.75x	32	7	24	95
1.75x to 2x	22	5	43	42
2x to 2.25x	22	(4)	(6)	(0)
2.25x to 2.5x	8	(4)	(15)	3
More than 2.5x	4	(25)	(14)	(13)

Source: MSCI, Bloomberg, Eastspring Investments, as at 31 July 2016.

REASON 2: EXAGGERATED FEARS EXPOSED

Rising Asian debt, a stronger US dollar and the UK's "Brexit" vote were but three issues feeding Asia Pacific woes. How justified were these concerns?

A stronger dollar exaggerated rising debt fears.

Strong dollar fears always seemed anomalous; weaker Asian Pacific currencies should boost exports. But in today's topsy-turvy world of quantitative easing, investors were reluctant to invest in Asia Pacific companies with rising corporate debt[3] fearful that a strong dollar would blow debt servicing costs through the roof (particularly if the US Federal Reserve raised rates). This concern always had its holes.

On the surface, the rise in debt does look alarming (Fig 3); it is only half the story. The net debt/equity ratio rose to just over 35% - not out of line with historical norms. China's rise was more[4], but crisis low valuations suggest significant discounting[5].

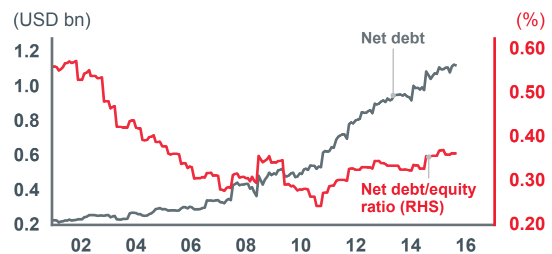
Put plainly, higher Asian company debt (excluding the banks) mostly financed a rise in business activity that resulted in a rise in profits that limited the rise in the debt equity ratio. What is wrong with that? China has yet to show an improved return on capital invested but to reiterate, low valuations discount this

The nail in the stronger dollar coffin fear is that local currencies mostly comprised the rise in debt[3]; dollar debt accounts for only 28% of total debt[6] while accounting for 21% of Asian sales[7]. Companies are generating sufficient dollars to service a large part of their dollar debt. Dollar/debt fears seem unjustified.

The world turns yet again; the dollar's strength is abating and Asia Pacific corporate debt is either stabilising or falling. Asian bonds look more and more attractive in a world of negative interest rates.

So, two major fears that dragged Asia Pacific equity valuations down, are losing their sting. Two legs for the case for not buying Asia Pacific equities, seem to have been kicked away.

Fig.3. Rising debt = More investment = Rising profits. The corporate debt /equity ratio remains low



Source: Worldscope from Datastream as at 8 September 2016.

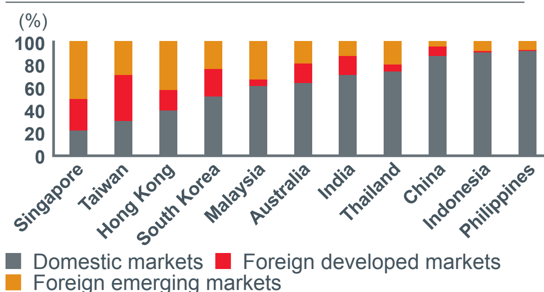
"Brexit" fears inadvertently expose a powerful truth.

Asian Pacific equities were not immune from the contagion that swept markets following the UK's surprising vote to exit the European Union. But, it took a UK share rally to break Asia Pacific's torpor.

Yet, had "sense" prevailed, Asia Pacific equities should hardly have moved – for the simple reason that the bulk of corporate sales are to domestic markets as Figure 4 below illustrates.

It is easy to make the point that the "Brexit" selling, however temporary, was an opportunity. But this episode also inadvertently highlighted the fact that while some Asia Pacific economies (and sectors) are indeed export dependent, the overwhelming bulk of corporate sales are to the local market[8]. With Asia Pacific's economic and profit growth forecasts outstripping the pack, little more need to be said.

Fig.4. Most corporate sales are to the home market

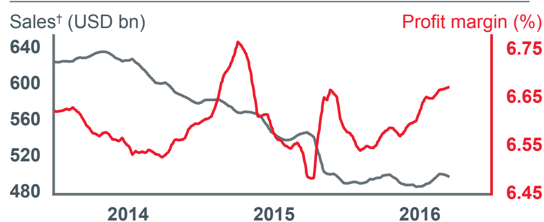


Source: "Global Exposure Guide", Morgan Stanley 22 May 2016. The data is based on 2016 company information. Where this is missing, the analyst's estimate is included.

REASON 3: ASIA PAC COMPANIES ARE STRONG

Having weathered bad sentiment since late 2014, companies have turned a corner, it seems. Falling sales forecasts have stabilized, and margins are nudging higher[9] (Figure 5). Debt levels are lower. Interest coverage is higher. Cash flows are rising.

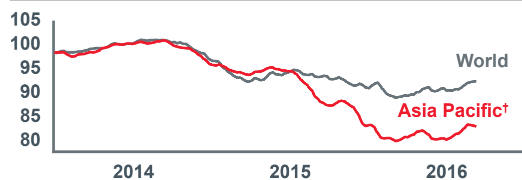
Fig.5. Asian companies are more profitable while the fall in sales has stabilised



Source: Worldscope from Datastream as at 8 September 2016. Both series are smoothed with a 3-week moving average. †Declared sales.

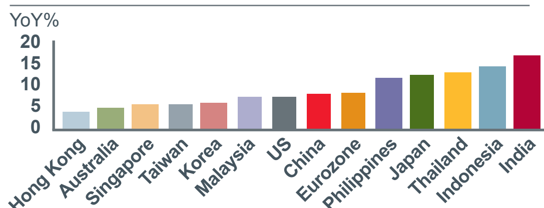
The result? Despite their battering, Asia Pacific profit forecasts lead the pack. Hong Kong's and Singapore's crisis low profit growth forecasts are more than adequately discounted, we think[10].

Fig.6. Asia Pac† profit growth forecasts took a 2015 battering, but …



Source: MSCI and IBES (in local currency terms) from Datastream as at 8 September 2016. †Excluding Japan.

Fig.7. … they still lead the pack

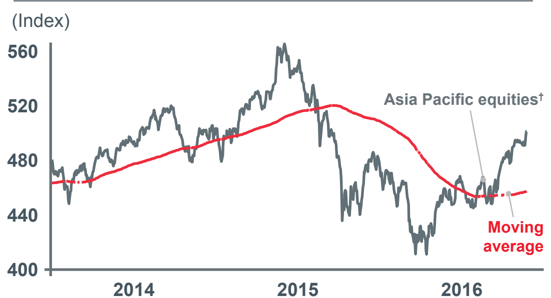


Source: MSCI and IBES (in local currency terms) from Datastream as at 8 September 2016. †Excluding Japan.

INVESTORS "SMELL THE COFFEE"

Investors are reawakening to the value that Asia Pacific equities hold; since early July, the market index has moved convincingly above its trend line (Figure 7).

Fig. 8. Asia Pacific equities† surges on renewed interest



Source: MSCI in local currency terms from Datastream as at 8 September 2016. †Excluding Japan.

THE MESSAGE? ASIA PACIFIC EQUITIES BECKON

The pendulum is swinging in Asia Pacific's favour. Many fears that held the markets back were either exaggerated or are fading, current valuations are attractive and battered profit forecasts still lead the pack (laggards are deeply discounted), while a prospective dividend yield of 3% looks attractive[11]. What is there not to like?

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Sources

[1]For the purposes of this article Asia Pacific, or Asia Pac, means Asia Pacific excluding Japan.

[2]In particular, the Asia Pacific (excluding Japan) equity index in local currency terms, has moved in virtual lockstep with the world index since August 2015 as global fears have dominated sentiment. As of this writing, Asia Pacific equities have not broken free.

[3]Institute of International Finance, EM Debt Monitor March 2016. In 2015, emerging market non-financial debt rose 6½ percentage points to circa 100% of GDP, (which compares with 87% for developed economies). Within Asia, China and Malaysia comprised most of the rise. The bulk of the rise was in local currencies with foreign debt, particularly US debt being repaid. This US debt reduction was pronounced in China (where debt fell by USD70bn in H2, 2015).

[4]While non-financial net debt outstanding rose nearly 2½ times between early 2010 and the late 2015 peak, the debt equity ratio rose from 31% to 53%; as debt has been repaid, it has since fallen to 45%. The rise was mostly in the real estate and construction and materials sectors. It was a reversal in net cash to net debt positions of the banks and insurance companies that spooked investors most which reflects in the banks low valuations.

[5]The “Z” score for Hong Kong’s “H” share index (i.e. China based companies), is below one negative standard deviation i.e. at crisis levels.

[6]Morgan Stanley Research, as at September 2015.

[7]Bank of America-Merrill Lynch, as at January 2016.

[8]“Global Exposure Guide”, Morgan Stanley as at 22 May 2016.

[9]Based on the IBES consensus forecasts from Datastream as at 8 September 2016.

[10]The “Z” score for both markets (i.e. the deviation of both the price to book and prospective price earnings ratios from their 12 year averages) are well below -1 standard deviation, which is at crisis low levels.

[11]IBES 12-month forward prospective dividend yield from Datastream as at 8 September 2016. This is higher than the US (2½%) but lower than the Eurozone (just under 4%).

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