eastspring investments

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2016 EQUITY OUTLOOK
SURFING THE VALUE WAVE

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ASIAN EQUITY SALE – THE NUMBERS DON'T LIE

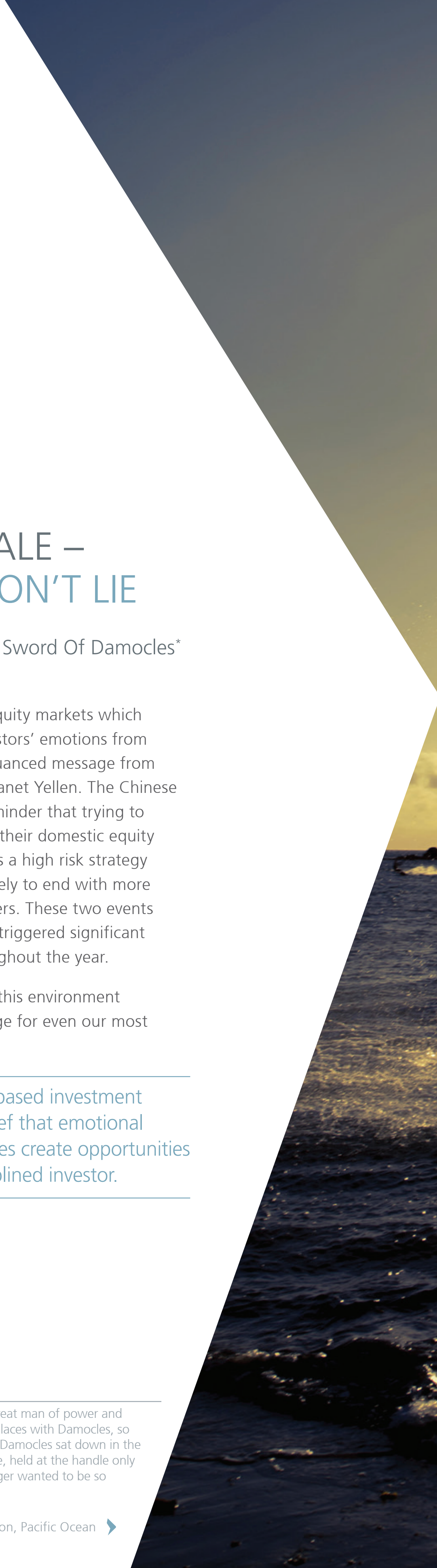
Rising US interest rates were the Sword Of Damocles* for Asian equities in 2015.

An ever present threat hanging over equity markets which had the ability to swing seasoned investors' emotions from greed to fear with little more than a nuanced message from the US Federal Reserve Chairwoman, Janet Yellen. The Chinese authorities also gave us all a gentle reminder that trying to manipulate 'free' market mechanisms (their domestic equity market) to promote domestic growth is a high risk strategy laced with endless complexities and likely to end with more unintended losers than intended winners. These two events coupled with slowing Chinese growth triggered significant volatility in Asian equity markets throughout the year.

Managing our client's money through this environment was a technical and emotional challenge for even our most seasoned investors.

> As always we resort to our value based investment process and the fundamental belief that emotional reactions and drivers of share prices create opportunities over the medium term for a disciplined investor.

*According to the legend 'Sword Of Damocles', pandering to his king, Dionysius, Damocles exclaimed that, as a great man of power and authority surrounded by magnificence, Dionysius was truly extremely fortunate. Dionysius then offered to switch places with Damocles, so that Damocles could taste that very fortune firsthand. Damocles quickly and eagerly accepted the king's proposal. Damocles sat down in the king's throne surrounded by every luxury, but Dionysius arranged that a huge sword should hang above the throne, held at the handle only by a single hair of a horse's tail. Damocles finally begged the king that he be allowed to depart because he no longer wanted to be so fortunate, realising that with great fortune and power comes also great responsibility (and danger).



Kitesurfer action, Pacific Ocean

2016 EQUITY OUTLOOK

US rate hike jitters throws up value opportunities in Asia

Addressing the issue of US interest rates first, it is clear to us that it is all about the timing of a modest increase. We see many commentators taking opposing views. One camp seems to think that increasing rates have a negative impact on US debt holders in Asia and thus puts pressure on growth. The other believes it will be a very moderate rate hike path, reflecting the steady improvement in global economic conditions. Both views have legs; however, the impact of this debate has been to create large valuation dispersions and emotional price reactions. As such we find stocks in the broad "cyclical interest rate sensitive" buckets being sold off regardless of fundamentals, creating very interesting medium term value opportunities.

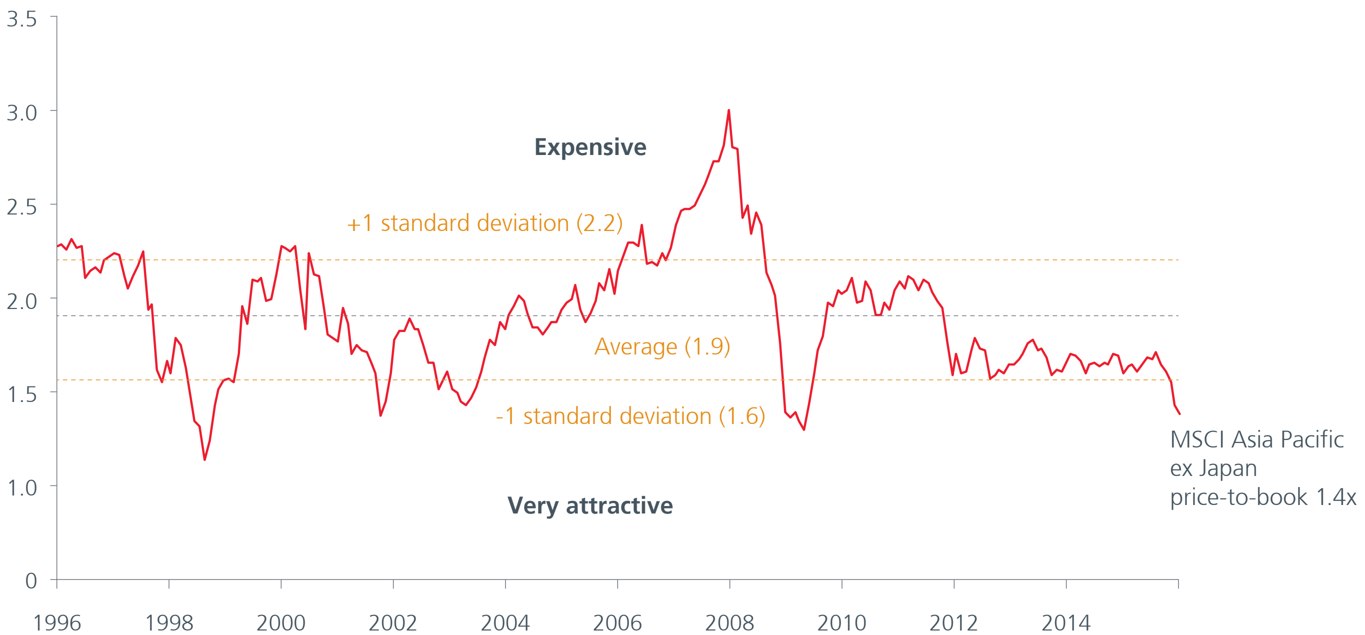
Not only are headline valuations in Asia very attractive on a long term perspective, the valuation dispersion between cyclicals and defensives is also at long term highs. This gives investors an opportunity to get into Asia at levels that have historically led to impressive gains over the medium term.

Selective value in China, supported by policy missteps

China's economic growth moderation dominated Asia's news headlines in 2015 (and is very likely to continue to do so in 2016). In late 2014, against a backdrop of moderating economic growth, the Chinese authorities implemented measures (which they had to reverse soon after) that caused a dramatic but short-lived boom and bust in Chinese equities. Although the primary impact was on the domestic market, the contagion effect was to take the rest of Asia with it; those markets (Hong Kong, Australia and Singapore) with close ties to China fell the most.

Investors have now priced in significant value destruction in China and the authorities have helped to inject fear and volatility into equity prices. This combination has pushed MSCI China to a price-to-book ratio of 1.2x (as at October 2015) and gives us some very interesting stock specific opportunities to take advantage of. We have found such opportunities in Chinese banks, consumer discretionary, property and energy names, where sustainable earnings have been undervalued. We do not take a strong view on macroeconomic conditions but we note that China's government continues to support the transition from an investment driven economy to a consumption driven one. We believe we may see further stimulus, if required, to smooth this transition into 2016.

Fig.1. Asia Pacific ex Japan trailing price-to-book (x)



Source: MSCI, Bloomberg, Eastspring Investments, as at 30 September 2015.

Aussie banks moving into good value territory

Chinese slower growth has impacted other countries; Australia for one has had to manage the consequences of the unwinding of the commodity super-cycle. The mining sector has collapsed leading to a deteriorating employment picture and the Australian dollar has fallen dramatically versus the US dollar. Similar to China, Australia is managing the transition to a consumption / services driven economy rather than one driven by its natural resources.

The medium term outlook for equities is more constructive particularly as valuations have fallen to more attractive levels over the last 12 months. Having been the expensive darlings of Asia we have been underweight the financial sector for some time but we are now finding that Australian banks are beginning to look interesting again. With recent actions to shore up their balance sheets, dividend yields above 6%, attractive valuations and high quality businesses we believe this may be a good opportunity to add some exposure here into 2016.

Lower commodity prices bodes well for Asia, a net commodity importer

Lower commodity prices have an ambiguous effect on Asian economies and its companies. There are winners and losers; companies that tend to benefit include transportation related sectors, utilities and consumer staples while those in the commodity space like coal, oil metals and mining have seen revenue dips. But there appears to be little evidence to write off all commodity producers and to assume the world will stop demanding any commodities. Such an extreme view once again offers opportunities to pick the stocks where valuations have fallen too far and do not reflect their medium term prospects.

A strong US dollar fuels undue concerns over Asia's US dollar debt

The strong US dollar has also taken its toll on Asia. Asian currencies have been universally weak and volatile relative to the US dollar, with the exception of those fixed / managed such as the Hong Kong dollar. This has raised many concerns particularly for those countries and companies laden with US dollar denominated debt. Luckily Asia is not as reliant on US dollar debt nor as heavily geared as was the case in the past. Nonetheless we have been relatively well positioned to avoid those companies heavily laden with US dollar debt. Looking towards 2016 we will continue to closely monitor those companies with US dollar debt exposures, particularly those operating within floating exchange rate regimes.

2015 was a tough year for value investors such as Eastspring

Many investors found solace in the few growth / momentum stocks typically found in defensive sectors which drove their short-term relative outperformance. However, we believe we have taken opportunities to build portfolios of attractively valued investment opportunities, which on a medium term investment horizon will outperform.

What's in store for 2016?

2016 is also set to be a busy year in Asia's political calendar with major elections to be held in Hong Kong, Philippines, South Korea, Taiwan, and Australia. While we have no strong views on the election outcomes, such political events tend to encourage investors to make emotional investment decisions on unrelated political data points and in the process become another driver of opportunities in 2016.

In summary, Asia's headline valuations don't lie – Asia ex Japan equities are on sale right now. But even more exciting to the team at Eastspring is the huge difference we see between Asian stock prices, offering a value oriented stock picker even better opportunities. We strongly believe that investing in Asia at this point can deliver attractive returns for the medium term investor.

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