LION GLOBAL INVESTORS

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Five Years Later, Hope for Asia

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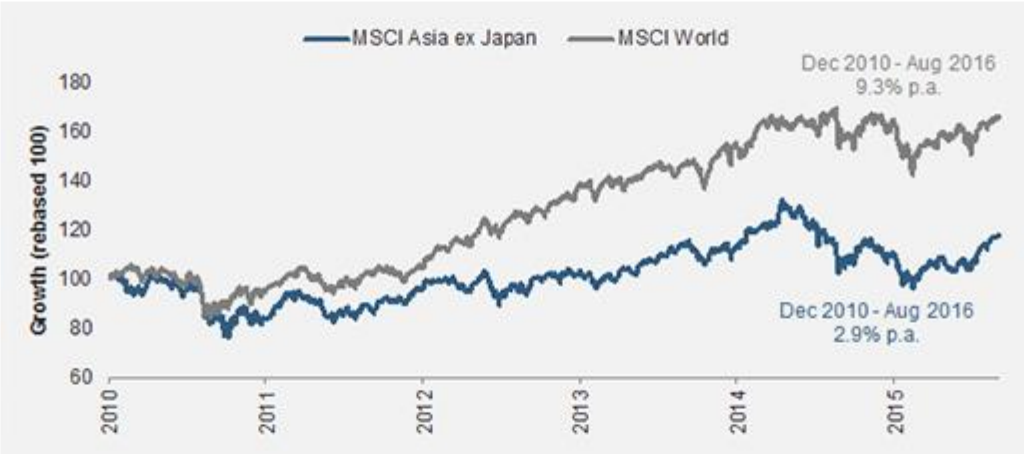
DISAPPOINTING FOR FIVE YEARS

It has been a disappointing ride for Asian investors in the last five to six years. From end-2010 to August 2016, the MSCI Asia ex-Japan index which is a measure of Asian equities has posted a gain of 18 per cent (2.9 per cent per annum (p.a.)) versus 66 per cent (9.3 per cent per annum) for global equities as measured by the MSCI World Index (see Chart 1).

Chart 1: Asia ex-Japan vs World (end-2010 to Aug 2016)



Source: Bloomberg, based on dividends reinvested in SGD terms as at August 2016.

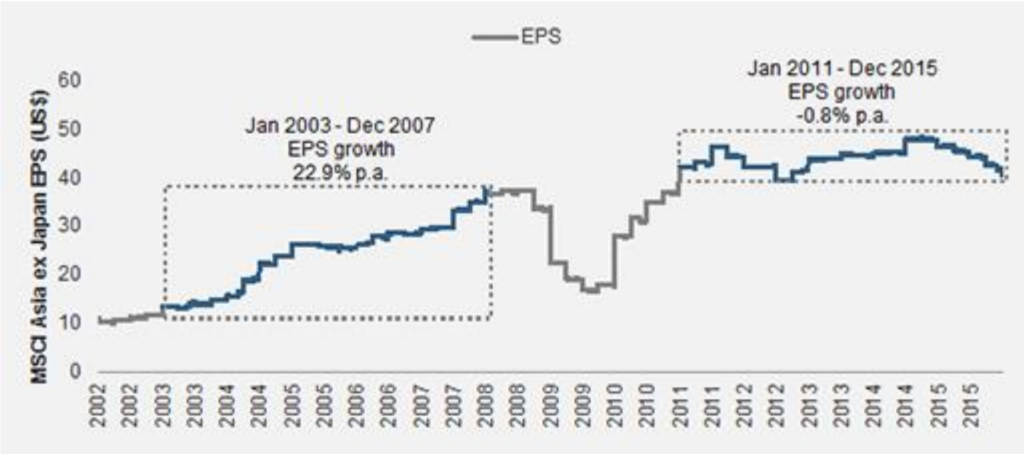
Such uninspiring performance left many investors wondering, “What happened to Asia?”

REASONS FOR DISAPPOINTING PERFORMANCE

The disappointing performance from Asia stemmed from a number of factors. Within Asia, China’s well publicised economic rebalancing resulted in slower growth. Meanwhile, outside of Asia, the economic growth of the United States, while steady, remained a far cry from previous years. Asian exports have correspondingly been affected by the slow grinding global economic recovery.

At the micro level, unbridled capital expenditure expansion led to excess capacity and weak pricing power for companies. This is further compounded by rising labour cost, resulting in pedestrian earnings growth for the past five years (Chart 2).

Chart 2: Asia ex-Japan EPS



Source: Bloomberg, in USD terms, as at Aug 2016. EPS: Earnings per share

Against this backdrop, the Federal Reserve has continued to tease markets with whispers of higher rates, citing employment data and the outlook for the economy and inflation. The stronger US dollar (and weaker Asian currencies) has encouraged funds to flow back to developed markets.

WHAT IS THE OUTLOOK FOR THE NEXT FIVE YEARS

China's on-going transition will continue to restrain growth but the transition to the new economy has gained traction, with strong growth in the services sector offsetting weakness in the manufacturing sector.

While the Li Keqiang index (an indicator comprising of rail freight volume, electricity consumption, and bank lending) continues to slow, the 'new' economy equivalent index of passenger rail traffic and electricity consumption of tertiary industry and households grew at a much faster pace. Outside China, we are hopeful that growth could pick up in India and Indonesia, two large and growing economies within Asia.

With labour costs moderating and excess capacity abating, profits for the next few years will likely be better than the previous five years and we believe high single-digit earnings growth is quite probable. Meanwhile valuation of Asian markets is cheaper than developed markets. In addition, dividend yield of Asian markets is attractive compared to the current low interest rate environment.

Monetary policy divergence will be supportive for the U.S. dollar. However, we think the greenback will remain range bound and we do not expect significant appreciation against Asian currencies.

The combination of global aging, low productivity growth and the slowing pace of globalisation will put a lid on global growth. Interest rates may go up from over-bought level but are not likely to rise substantially. With rates low or even negative, sovereign bonds are not compelling for yield investors. A generation of aging, yield seekers in a low rate environment needs viable alternatives to sovereign bonds.

RISKS REMAIN BUT STAY INVESTED FOR THE MEDIUM TERM

In the near-term, however, Asian markets may remain volatile. Rate hike uncertainty remains, as does persistently weak global economic growth. The Renminbi's weakness could unleash another bout of volatility for Asian markets. Investors should also closely monitor the upcoming U.S. election as a Trump victory is likely to be negative for Asian markets.

Despite this, Asia presents a worthwhile consideration for long-term investors. Asian listed corporates have robust balance sheets, healthy cash reserves and increasing willingness to pay dividends. With commodity prices stabilising and downward earnings revisions bottoming, we could see better earnings next year and eventually this will be reflected in valuations.

On a closing note, after recent years of disappointment, many investors have forgotten that Asian equities have generated strong returns in the earlier years (Chart 3).

Chart 3: Asia ex-Japan vs World (end-2000 to end-2010)

Source: Bloomberg, based on dividends reinvested in SGD terms as at August 2016

In the last decade (end-2000 to end-2010), Asian markets have posted a gain of 159 per cent (10 per cent per annum) while developed markets fell 2 per cent (-0.2 per cent per annum) in Singapore dollar terms.

In a global new ‘normal’ of slower growth, we are not suggesting investors can expect 10 per cent per annum returns as equities are likely to give more muted returns going forward. Instead, we encourage investors to consider whether Asia, with its superior growth and cheaper valuation, is more likely to give not only better returns than developed markets but also good positive returns in the next five years.

Source: This article was first published in the October 2016 edition of OCBC Bank’s “Wealth Insights”.

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