What Lies Ahead for Asian Equity Markets?

Asian equity markets have been on a tear in 2017. The MSCI AC Asia ex Japan Net index has returned 29.6%[1] in USD terms year-to-date (YTD) as at the end of July, reflecting improving global growth and a recovery in earnings forecasts after a 6-year hiatus.

Macro Backdrop Broadly Conducive for Risk Assets

The global recovery has continued to gather traction this year, led by better growth prospects in the US and the Eurozone, and sustained growth momentum in Asia. Less certain is the timing and pace of the unwinding of quantitative easing (QE) by major developed market central banks, which could pose headwinds for the recovery and risk assets in general.

Inflation indicators in the US remain below the Fed's target inflation rate of 2.0%, suggesting that the Fed may continue to move gradually on rate hikes. That said, the minutes of the July FOMC meeting suggests that the Fed is likely to move ahead with a reduction of its balance sheet, possibly in September this year. Meanwhile, financial conditions in the US have eased despite the rate hikes over the past three quarters, suggesting further room for policy normalisation. On a less positive note though, political tensions in Washington have cast further doubt on the ability of the Trump administration to deliver on its pro-growth agenda.

Elsewhere, Eurozone recovery has grown more robust and broad-based. GDP growth is running at a 2-2.5% pace, supported by healthy domestic demand. While the European Central Bank (ECB) has been deliberating on a decision to scale back its QE programme in response to a stronger economic recovery in the Eurozone, inflationary pressures remain subdued. Furthermore, the timing and pace of the potential QE taper remains uncertain – the minutes of the ECB meeting in July sheds little light on how soon the central bank intends to unwind its massive stimulus programme.

In Asia, growth momentum remains strong. Asian exporters have largely benefitted from the upturn in global demand, despite export growth momentum moderating in 2Q17 on the back of softer electronics exports as the base effects of commodity prices wore off. Nonetheless, Asian purchasing managers' indices have remained buoyant, in line with improving developed market business sentiment.

The inflation backdrop in Asia has however been relatively benign. A sharp decline in food inflation has capped headline consumer price inflation while softer core inflation has indicated a lack of demand-pull inflationary pressures. With inflation staying contained, Asian central banks have the leeway to maintain an accommodative monetary policy stance for longer. Fiscal policy also remains supportive. In China, President Xi is likely to continue to prioritize growth and stability, even amidst the ongoing regulatory tightening and deleveraging of the country's financial sector.

Looking Beyond the Tech Driven Rally

The Asian equities rally YTD has thus far been mainly driven by tech-related names. Contextually, technological changes are causing significant disruption to existing corporate business models. Taking these broader structural changes into consideration, they are a precursor of things to come as companies re-assess their digital strategies and changing consumer patterns. To this end, earnings per share is expected to grow by double digits in both 2017 and 2018, driven by sales growth, margin improvement and rising ROEs. However, the pace of upwards earnings per share revisions in the region has slowed and we see the risk-reward profile being more finely balanced now than it was at the start of the year.

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From a valuations perspective, while equities in the region have experienced some level of upward re-rating, Asia continues to trade at a large discount to global equities. Taking into account falling stock-to-stock correlations, coupled with multiple industrial and economic developments over the medium term, we see the region offering rich opportunities for bottom-up stock picking.

Some key investment themes driving our portfolios include increasing connectivity and artificial intelligence (AI), financial product penetration and changing demographics.

We believe AI and Cloud technology will be pervasive over the medium term, amid the digitalization of our whole social ecosystem. AI is developing at an accelerated pace due to i) massive data growth, ii) faster hardware, and iii) better, more broadly available algorithms. To this end, our portfolios have exposure to AI through the internet and hardware (memory and semiconductors) sectors.

In the area of financial product penetration, countries with huge domestic markets and a growing middle class population, such as India and Indonesia, remain attractive banking markets over the long term.

Lastly, with Asia experiencing a demographic shift towards an ageing population, we see potential opportunities in the healthcare and insurance sectors.

[1]*Source: Bloomberg*

Please do not hesitate to contact us if you require further clarification.

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