Havenport Asset Management

February 2017

ASIAN EQUITIES REVIEW

After starting the year as one of the most out-of-favour regions by global strategists, Asian markets managed to chalk up a second successive month of impressive gains, up 3.4%[1] and bringing the year-to-date tally to 9.8%[1], outperforming its global and emerging market peers thus far. Gains have been led by India, Taiwan and China while Southeast Asia, bar Singapore, continues to lag the rally. The initial list of headwinds for Asia had appeared to be insurmountable, ranging from US interest rate hikes and dollar strength to fears of protectionist trade policies under newly inaugurated US President Donald Trump. Nevertheless, these concerns have been put aside for the moment, overshadowed by better-than-expected economic data from across the region. Ironically, some of these numbers, particular exports, may be partly inflated as corporates attempt to front-run any potential US import tariffs.

India's own concern over demonetisation has been firmly put behind as the outlook for earnings has considerably improved. The impact from demonetisation has been fairly limited with banking asset quality not as badly impacted as feared and credit growth now seeing a recovery, driven by normalisation in the business cycle and aided by higher working capital demand due to stronger commodity prices. The budget announced early in the month contained help for the low-cost housing sector and rural economy. While the demonetisation exercise has not raised any meaningful windfall gain for the government, it has helped promote the movement of cash into the formal banking system, thereby promoting the use of financial assets. This is evident by the surge in deposit growth and a drop in government bond yields.

The MSCI China index has rallied 3.5%[1] month-to-date and 10.6%[1] year-to-date, outperforming even its domestic A-shares counterpart. Cyclicals including materials, consumer discretionary, property and technology stocks have led the rally. Focus has been on the growth in fixed asset investments driven by an acceleration in the implementation of public-private partnerships (PPP). The total size of the government's PPP list has expanded to Rmb13.5 trillion[2] while investment under construction jumped to 16.5%[2] of this enlarged size as at the end of last year. In addition, the average lead time before implementation has visibly shortened to 11 months[2] from greater than 15 months[2] previously. The majority of PPP projects are infrastructure related, benefitting state-owned construction companies and demand for commodities. The trickle down impact on the economy has been clearly visible with robust banking loans growth as well as property sales. Meanwhile, the latest inflation data has seen a further rise in producer price index, which historically has had a positive correlation with GDP and the stock market.

The Taiwan market is one of the most leveraged to the cyclical upswing largely due to its large weighing towards the technology and petrochemical sectors. The upcoming launch of iPhone 8 has led to significant upgrades of component manufacturers while the improving supply and demand balance for Thin-Film transistor (TFT) and Dynamic Random Access Memory (DRAM) has supported semiconductor-related names. Initial concerns about the impact to corporate costs after the implementation of a revised Labour Standard Law has abated after the first month showed a limited increase in costs. The government has now shifted its focus to tax reform with the aim of narrowing the gap between corporate and personal income tax rates.

The inconclusive election for the Jakarta governor has generated some short-term political noise but over the longer-term, investors should be more concerned over the lack of private sector investments to accompany the surge in government spending on infrastructure. Indonesia has had long-held ambitions to be a manufacturing hub but rapidly rising wage cost, combined with onerous labour laws, have not created a favourable environment to invest in Indonesia. Instead, the rally in commodity prices is now the best hope for growth in spending in the rural economy. To its credit, the government has tamed inflation and reined in the fiscal deficit, leading to relative stability in the rupiah.

Macroeconomic conditions for the past two months have provided the perfect sweet spot for Asian markets. In addition, the pickup in inflation has been a welcome relief after several years of deflationary fears. Nevertheless, after such an extended rally, it shouldn't be a surprise if markets were to consolidate recent gains. It remains to be seen whether the attacks on trade policies by US President Trump has just been a negotiating tactic or recent inventory restocking activity has been in response to a genuine increase in demand. Fortunately, market valuations are still reasonable which should provide some support should there be a correction.

Source:
[1] Bloomberg, February 2017
[2] Deutsche Bank, 27 February 2017

Brandywine Global

Clarion Partners

ClearBridge Investments

EnTrustPermal

Martin Currie

QS Investors

RARE Infrastructure

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* As of 31 January 2017.

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IMPORTANT INFORMATION