Asia Insight

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Sometimes It's Wiser Not to Follow the Herd

Conventional wisdom is always right—until it isn't. The question is: When is it right to disagree? The investment herd is thinking: Trade wars, tight money, fractious politics and a falling stock market in the U.S. Banking systems in distress in Europe and the splitting of the EU. A weak credit and profit cycle in Asia, slow earnings growth, and a Chinese state determined to assert political control. Roll on 2019, it is likely to be a doozy!

It is easy to get pessimistic at times like this, or overly short term and overly emotional. But it has been an emotional time! As we entered 2018, we were optimistic about Asia's markets. We were right for only a few weeks. Our concerns were more about monetary policy in the U.S. and high U.S. valuations. Asia seemed to be earlier in the monetary cycle (except Japan) and much more reasonably priced. But we got off to a crazy start and soon we worried about Asia's valuations, particularly in some of the high-growth areas of the markets. As 2018 progressed, Asia's markets were battered, beginning with Indonesia, then China and finally even Japan. For a while, the S&P 500 Index remained unperturbed and the Nasdaq marched upward, buoyed by the "last squeeze of the lemon," from U.S. tax cuts. This divergence became extreme and eventually the U.S. market cracked, too, taking Asia down again. In the short run, a one-for-one fall is about what you should expect from Asia. This is what happened, adding misery upon misery and driving Asian valuations as low as 11.3X forward earnings for the MSCI Asia ex Japan Index, a 30% discount to the U.S. That is quite extreme.

What is your greatest risk in markets right now? Well, it might sound trite, but it is probably you. Can you continue to be impartial and thoughtful amid falling equity prices and depressing headlines? Trading is an emotional game; investment is a thoughtful analysis of contradictory evidence. At times like this, the two can conflict. As prices have fallen, my view has become increasingly optimistic. Headlines, sentiment and short-term momentum are overshadowing some important long-term considerations. 2018 is almost gone and thank goodness. While year-end is a somewhat arbitrary time to stop and think about the future, it nevertheless provides an opportunity to pause and reflect on the structural drivers of long-term growth in Asia.

Trade Conflicts Have Been the Headline Writers' Friends

Trade conflicts have taken a severe toll on sentiment, but fears of additional equity market declines stemming from trade impacts have been driven more by sentiment than calculus. I was surprised (and frustrated) by the inability of the U.S. and China to resolve their trade issues. Maybe it is time to jettison my belief that these two administrations can resolve things quickly. I think Chinese policymakers would like to, but the U.S. side remains intransigent. In my view, the U.S. is wrong on the theory and the practical implications of trade with China. What might give the U.S. pause is if the current rumblings of tariffs (both from the U.S. administration themselves and retaliatory ones from China) hit corporate profits and hurt U.S. financial markets. If these rumblings continue to amplify, then the impetus to make a deal will be greater. The irony is trade protectionism, if it ever makes sense in the short run, it is only really useful during times of depressed demand. Today, protectionism is unequivocally damaging, but not to the extent that breathless headlines would have us believe.

Central Banks Have Not Been the Markets' Friends

Nevertheless, I don't think trade tariffs are the major factor behind market declines. Rather, I believe tightening monetary policy has brought the bull market to an end. The U.S. Federal Reserve has been raising rates and looks set to continue. The fact that the market falls in October were accompanied by declines in bond yields suggests that fears were growing over U.S. economic growth. After all, no expansion lasts forever. What surprised me in 2018 were Chinese monetary policymakers. I thought they would be quite happy to see inflation in a range between 2% and 3% and that working through debt and financial system issues would be done within this kind of context. This has proven to be wrong. Whether by design or as an unintended

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consequence, China's core inflation rate peaked at 2.5% in February, as the markets were topping out, and has declined to 1.7% at the end of September. Money is tighter in China than I expected and fiscal policy is too. While trade concerns exacerbated equity price declines in some businesses, I think the woes that befell Chinese stocks were a mixture of domestic policy tightening and some high valuations in certain sectors. Layered on top of this was the fact that domestic Chinese retail investors are by nature skittish and many have pulled their money out of the market due to the slower growth environment. Earnings, while decent, did not post the same kind of growth across the region that was seen in the U.S. or the rest of the world. But global leadership in trade, economic growth and market performance may be on the cusp of change.

As we enter 2019, I am still of the opinion that the U.S. will tighten and that monetary policy in Asia ought to be heading in the opposite direction. I doubt this will cause pressure on Asia's currencies to the extent that many fear. Asia's currencies have already been weak against the dollar (as have all global currencies). What's more, Asia's economies are disinflating when they should be inflating. A bit more robust nominal growth in Asia may even spur better growth and offset some devaluation pressure. The other question is whether costs are out of line. Maybe so. Asia has been favoring the worker over the capitalist for most of the period following the Global Financial Crisis, while the U.S. has been doing the opposite. I suspect, for economic and political reasons, this will flip over. If so, that would be a support for Asia's profits and would suggest more monetary and fiscal loosening in Asia. But I have expected this for two years now and been disappointed. Is it time to change my view?

No, I don't think so. The split between labor and capital in an economy tends to be very stable over long periods of time and there are economic and political forces that work to equilibrate the two. It is simply not possible for a society to perpetually favor corporate profits over labor—at some point the time comes to redress the balance. That can be done smoothly through institutions; or it can be done violently, on the streets. Asia has seen this clearly and has been proactive in emphasizing "stability" of growth over "pace" of growth. This may be to the detriment of profits in the short term, but surely allows for a more stable future.

Valuations Create Opportunity

But sentiment changes only at extremes. Ultimately, for me, that means look at valuations. How panicked investors are in the short run is directly measurable by how cheaply they are prepared to part with equity, representing their long-term claims on Asia's growth. Many of our strategies are taking advantage of low valuations to add to high-quality existing names in their portfolios, laying the groundwork for more durable and sustainable growth when markets recover. As long-term investors, we know that markets move in cycles, not straight lines. And the current cycle among Asian markets indicates that a lot of pain has already been priced in. The way we sleep well at night is by knowing what's in the portfolios and knowing what's likely to hold up well over time, when the dust settles and security prices realize their long-term growth potential.

U.S. equity markets have had a remarkable run over the past nine years. But the market is running on the last drops of gas. With U.S. midterms out of the way, we had a brief "hurrah" from markets. The prospect of gridlock feeds the conventional wisdom that so long as Washington is stymied, the government won't do anything to muck up the stock market party. Perhaps, but U.S. equity investors are unlikely to get any more freebies in the form of corporate-friendly tax cuts. And there is still plenty to weigh on the S&P 500 in the sense of high valuations, slower earnings growth, and tighter money. U.S. earnings, coming off a high base for the 12 months ending September 30, 2018, are likely to moderate (see Figure 1.) Asia ex Japan earnings in 2019, are coming off a very low base, so they clearly have room to grow. And U.S. stock valuations remain near record highs, while Asia ex Japan stock valuations are highly attractive for investors with a long-term view.

Figure 1. **EARNINGS IN ASIA HAVE ROOM FOR POTENTIAL GROWTH**
Earnings per share growth
U.S. dollars annualized to Q3 2018

	1 year	3 years	5 years	10 years	15 years
Japan	17.6%	11.5%	10.0%	4.2%	9.7%
Asia ex Japan	7.3%	3.4%	2.6%	3.4%	7.9%
U.S.	21.5%	9.2%	6.8%	6.3%	7.5%
Latin America	8.3%	8.0%	-4.3%	-3.5%	6.5%
Western Europe	12.5%	7.0%	2.3%	-1.8%	5.0%

Source: FactSet Research Systems. Universe based on FactSet Aggregates
Statistics shown do not represent or predict the performance of any investment.

“At Matthews Asia, we believe in the long-term structural growth of Asia. For patient capital, the present is an exciting time to capture a larger share of the wallet from Asia’s rising middle class. ”

Putting Time on Your Side

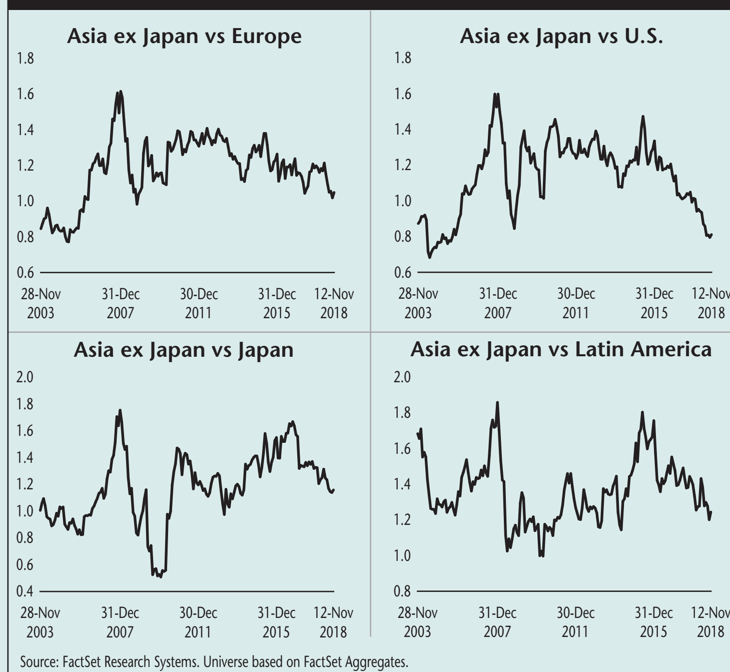
There are powerful reasons to expect the pendulum of market forces to swing back in favor of patient capital. But these are multi-year phenomena and the markets can take a while to get used to short-term interruptions. At Matthews Asia, we stick with a long-term time horizon, striving to make sensible decisions based on generating attractive returns over a full market cycle. I believe that should have our portfolios very well-placed by the time security prices reconnect to the positive underlying drivers of growth in Asia.

Short-term investors are more negative in their outlook, citing tighter monetary policy in China and slowing growth and earnings as reasons to be out of the markets for the near term. I had an interesting conversation with one such short-term investor in Hong Kong. We agreed almost completely about the current macroeconomic trends but we drew opposing lessons from the same data. Why? Time horizon, pure and simple. He was remunerated on a short-term basis, defined as weeks or months at most. I, and my colleagues at Matthews Asia, are incentivized on a multi-year time horizon. And as such, we have to be primarily motivated by our views on quality and valuation—not on where the momentum may be taking the markets over the next few months, but where the value is in the long term and how we can maximize the likelihood of growing sustainably with the economies of the region.

And so, despite all the doom and gloom in the markets and the weakening macroeconomic cycle; or maybe even because of where we are in the cycle, I am turning a little more positive. After all, valuations are much cheaper than they were at the start of the year. If I look at enterprise value (EV) and earnings before interest and taxes(EBIT) multiples in Asia relative to their own history, I see Asia ex Japan looking inexpensive relative to Europe, the U.S., Japan, and Latin America (see Figure 2). Asia’s stock markets seem to be the only ones really factoring in a tough macroeconomic environment in 2019.

All of which makes the contrarian in me a little more comfortable. It makes the value guy in me a lot happier. It leaves the growth optimist in me still optimistic but relying on theory rather more than evidence. That’s OK—I can wait. Investing is about patiently evaluating long-term risks and returns. The dividend yield for equities across the Asia ex Japan region (and including Chinese domestic stocks, known as A-shares) is nearly 2.3%, considering a universe based on FactSet Aggregates. That is higher than it has been for more than 90% of the last 15 years—we are getting paid for our patience.

Figure 2. **ASIA EX JAPAN STOCK VALUATIONS LOOK ATTRACTIVE**
Relative Valuations: EV to EBIT



At Matthews Asia, we believe in the long-term structural growth of Asia. For patient capital, the present is an exciting time to capture a larger share of the wallet from Asia’s rising middle class. Consumer spending could soften a bit over the short term, but over the long term, consumers have behaved with remarkable consistency. As incomes rise, spending usually grows. This trend still appears solidly on track across Asia and should continue to make Asia a key driver of global growth over the coming decade.

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Index definitions

The MSCI Japan Index is a free float–adjusted market capitalization–weighted index of Japanese equities listed in Japan.

The MSCI All Country Asia ex Japan Index is a free float–adjusted market capitalization–weighted index of the stock of markets of China, Hong Kong, India, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan and Thailand.

The S&P 500 Index, or the Standard & Poor's 500, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

The MSCI EM Latin America Index captures large and mid-cap representation across 5 Emerging Markets (EM) countries in Latin America. EM Latin America countries include: Brazil, Chile, Colombia, Mexico, and Peru.

The MSCI Europe Index is captures large and mid-cap representation across 15 Developed Markets (DM) countries in Europe. DM countries in Europe include: Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the UK.

Glossary

Earnings Before Interest and Tax (EBIT): An indicator of a company's profitability, often calculated as revenue minus expenses, excluding tax and interest.

Earnings Per Share: The amount of annual profit (after tax and all other expenses) attributable to each share in a company. EPS is calculated by dividing profit by the average number of shares on issue.

Enterprise Value: A measure of a company's value, often used as an alternative to straightforward market capitalization. Enterprise value is calculated as market cap plus debt, minority interest and preferred shares, minus total cash and cash equivalents

Forward Earnings: A company's forecasted, or estimated, earnings made by analysts or by the company itself. Forward Earnings/Predicted Earnings does not represent or predict the performance of any fund.

Investments involve risk. Past performance is no guarantee of future results. Investing in international and emerging markets may involve additional risks, such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation.

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