Asia Insight

March 2019

Total Return Shines Late Cycle

Asian economies and markets move in their own cycles, but can also be impacted by the actions of the globally influential U.S. Federal Reserve. Accordingly, late in the U.S. interest rate cycle, global growth sentiment has declined and volatility in asset prices has picked up. Across both fixed income and equities, total return strategies can help investors stay invested late cycle, while capturing Asia's attractive long-term growth potential. Total return strategies attempt to draw on both income and price appreciation as sources of return over the long term, helping to soften the impact of volatility over the short term. In this Asia Insight, four portfolio managers of total return strategies at Matthews Asia share their outlook on the current investment landscape.

Spotlight: Fixed Income

Credit Spreads Look Attractive for Long-Term Investment

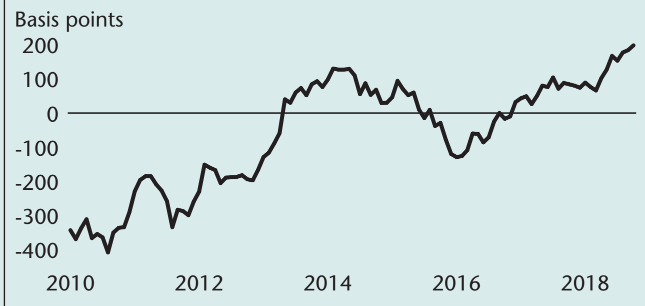
For fixed income investors, current credit spreads in Asia represent attractive total return potential. The volatility in asset prices that we saw in 2018 generated opportunities for active managers, as we believe market participants became too pessimistic and priced in too much risk for Asian corporates.

Credit spreads, currency trends and interest rates are the three key drivers of total return for Asia fixed income. In the near term, all three now look more favorable for Asia fixed income. Credit spreads are near historic highs (see Figure 1), pricing in substantial downside already. Rising U.S. interest rates were a major headwind in 2018 for Asian rates, but now has subsided as the Fed signaled a pause in raising rates. With Fed rate hike expectations priced out of the market, Asian central banks also have more room to stimulate the market through lowering policy rates. In addition, China is providing more support for Asia as Chinese policymakers provide a steady stream of fiscal and monetary stimulus. As tax reform stimulus fades in the U.S. and China recovers from a mild slowdown, we expect Asian currencies to appreciate relative to the U.S. dollar from oversold levels of yesteryear.

While additional volatility could lie ahead, Asia seems to be on stronger footing than in past economic cycles. After all, a lot of negative sentiment has already been priced into both fixed income and equity markets in Asia. When we look at U.S. dollar-denominated bonds issues by Asian companies, we estimate that markets have priced in a default rate of about 7%, while historic averages for default rates tend to be around 3.5% over a full cycle. This means that current prices are already reflecting a substantial rise in defaults from the current run rate of 1.5%. And moreover, investing with proven managers may help to avoid defaults in portfolios through active security selection.

Figure 1. **ASIA HIGH YIELD SPREADS MINUS U.S. HIGH YIELD SPREADS**

The divergence between Asia high yield and U.S. high yield spreads is near record highs



Source: Bloomberg; Merrill Lynch, Pierce, Fenner & Smith Incorporated ("BofAML"), used with permission. Asia High Yield (JACI High Yield Index, which is the high yield portion of J.P. Morgan Asia Credit Index), U.S. High Yield (BofAML High Yield Master II Index). Spreads are represented by option adjusted spreads.

As with so many investment decisions, time horizon is a key component of unlocking Asia's growth. For an investor with a time horizon of three to five years or longer, we believe the current environment provides an attractive entry point for fixed income strategies seeking total return. The 2018 decline in sentiment means that bonds with attractive, long-term intrinsic value can often be purchased at a discount. If we can buy a bond at a 20% discount to its face value and hold it to maturity, it is a tremendous opportunity to lock in return, while also reinvesting and compounding any interest income from the bond's coupon.

Matthews Asia

"Smaller companies are often a rich source of dividends and an attractive source of growth in the price of their underlying stock."

While it may be late in the interest rate cycle in the U.S., we see a favorable environment for Asia fixed income, particularly for investors with a long time perspective.

Teresa Kong, CFA
Portfolio Manager
Matthews Asia

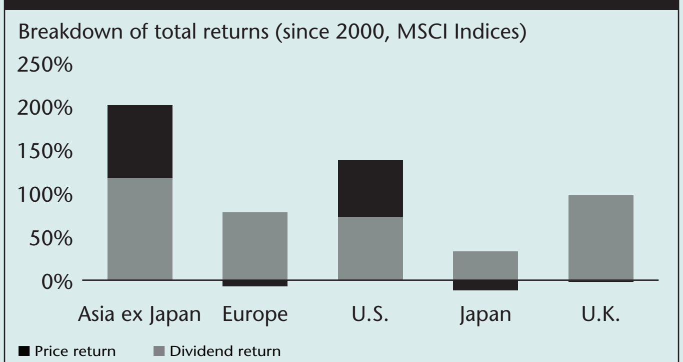
Spotlight: Equity Dividends

Dividend Yields Near Historic Highs

At year-end 2018, the dividend yield on the MSCI All Country Asia ex Japan Index, a widely used regional equity benchmark, was 2.87%—slightly higher than the yield on 10-year U.S. Treasury bonds on the same date. This reflects a distinctive moment in market conditions when valuations for Asia equities are very attractive, increasing the yield on stocks. While yields on Asia equities are near historic highs, healthy dividend payouts represent a long-term secular trend across the region.

The broadening of Asia's capital markets, along with improved liquidity, has contributed to a sharp increase in the number of Asian companies paying attractive dividends. The current state of attractive yields among Asia equities reflects both the growth of Asia's equity markets and increasing expectations among shareholders that profits be paid out. For the past 18 years, looking at the time period spanning 2000 through 2018, dividends made up more than half of the total return attribution for the MSCI Asia Ex Japan Index (see Figure 2).

Figure 2. **DIVIDENDS CONTRIBUTE TO TOTAL RETURN**



Past performance is no guarantee of future results. Indexes are unmanaged and it is not possible to invest directly in an index. All returns measured in U.S. dollars. Time period is December 31, 1999, through December 31, 2018. Sources: MSCI; Matthews Asia.

What's more, dividends in Asia can be paid out by a broad range of companies. We believe many small- and mid-cap companies in Asia have not yet realized their full growth potential and are often overlooked from an income point of view, especially when compared to large-cap peers. Among some small- and mid-cap companies, we see a concentration of ownership among founders, who may be motivated to pay dividends in order to create an income stream for their families. Both majority and minority shareholders can benefit from the resulting dividend stream.

This trend of small- and mid-cap companies paying dividends also means that a dividend approach to Asia does not have to be at the expense of growth. This counters the assumption that investing in the region has to be part of an all-growth strategy because Asia is home to many of the world's fastest-growing companies. Smaller companies are often a rich source of dividends and an attractive source of growth in the price of their underlying stock.

Finally, we observe the potential for an additional benefit for investing in dividend-paying businesses. Companies that generate sufficient cash flow to fund dividend payments and allocate capital prudently tend to have stronger corporate governance than their peers—meaning that investing in Asia from a total return perspective may be a less volatile way of accessing the market.

Yu Zhang, CFA
Portfolio Manager
Matthews Asia

Spotlight: Timeless Appeal of the Growth and Income Style

Protect Against Dips to Stay the Course

As U.S. equities strain to extend a decade-long bull market, Asian markets have experienced a number of "mini cycles" during the same time frame, allowing for healthy market corrections. If you're uncomfortable with drawdowns of more than 10% during market swings, you may want to consider a less volatile approach to capturing Asia's growth. Even seasoned investors can feel nervous when the market dips, so when you look at the emerging markets and Asia components of your portfolio, it is important to understand your personal comfort zone with short-term drops and to

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identify strategies that can help you stay invested during periods of volatility.

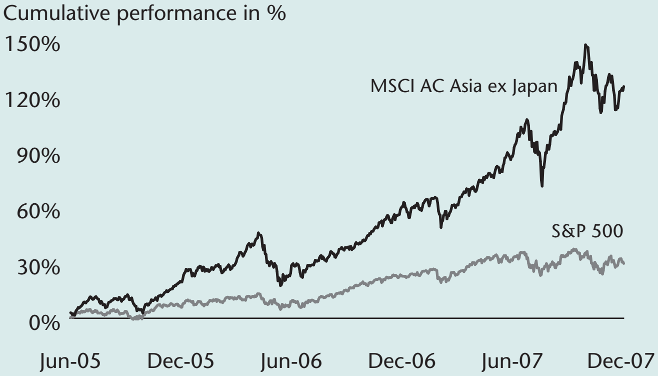
Convertible securities are one way to access the growth potential of fast-growing companies at lower volatility. Simply defined, convertibles are bonds that can be converted into shares of common stock in the future at a higher share price. For our strategies that employ a growth and income approach, we include convertibles within our broader investment mix as a way to capture growth while dialing down volatility. Among convertibles, we tend to look for investment grade convertible bonds of companies that might be a little more cyclical in nature. By owning the convertible, we can still participate in the upside growth potential of a company’s common stock, while seeking to avoid some of the shorter term equity-market volatility and providing some capital preservation.

To further mitigate the impact of market volatility, we tend to look for companies that offer the potential for an attractive combination of growth and income characteristics. We are generally looking for quality companies that offer sustainable income potential compared to the broader market, as well as growth at a reasonable price. We are seeking to capture the market’s upside potential, while also protecting on the downside through this growth and income approach. In the previous Fed rate hiking cycle, which lasted from June 2005 to December 2007, Asia ex-Japan equities experienced bouts of volatility, but generated attractive returns even late in the interest rate cycle (see Figure 3), highlighting the importance of taking a long-term view.

Figure 3. **ASIA EQUITIES HAVE OUTPERFORMED LATE CYCLE, EVEN AMID HIGHER VOLATILITY**

Performance measured during the previous U.S. Federal Reserve rate-hiking cycle (June 30, 2005 through December 31, 2007)

Cumulative performance in %



Past performance is no guarantee of future results. Indexes are unmanaged and it is not possible to invest directly in an index. Index performance does not represent or predict the performance of any fund. Source: Bloomberg.

Defensive equity strategies can lag behind the broader markets during momentum-driven bull markets, but can also provide the potential for attractive long-term returns over a full market cycle due to the compounding benefits of income and superior capital preservation.

Kenneth Lowe, CFA
Portfolio Manager
Matthews Asia

Spotlight: CIO Corner

An Early Adopter’s View on Late-Cycle Investing

Drawing on decades of experience investing in Asia, we believe that time in the market is more important than trying to time the market. When others are pessimistic, we tend to be more optimistic about Asia’s long-term prospects. Economic cycles and sentiment sway global equity prices over the short term, but total return strategies capture Asia’s growth potential over the long term. Indeed, often the behavior of short-term speculators gives rise to long-term opportunities. The key to taking advantage of this behavior is employing a patient, disciplined approach to investing.

Economic growth in Asia is increasingly driven by domestic consumption, meaning Asian consumers buying from Asian businesses. For investors with a multiyear horizon, adding an allocation to Asia can help them meet a broad range of investment goals, while capturing a healthy share of global growth over a full market cycle. The key is matching your investment strategies to your risk tolerance and goals. For investors looking to smooth out some of the bumps in the market, total return strategies can help round out other allocations within a globally diversified portfolio.

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Index Definitions

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.

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. There is no guarantee that a company will continually increase or pay a dividend. Investing in small-cap companies is generally riskier than investing in large-cap companies due to greater volatility and less liquidity.

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