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Matthews Asia Perspective

Don't Fear the Rally Just Because it's a Rally

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Asia's markets are off to a strong start this year. As of May 17, the MSCI Asia ex Japan Index is up by 19.46% and Japan, though it has lagged behind, also has had a positive start to the year. As I meet with investors these days, common questions are: "Have we missed the rally?" and (for those that haven't missed the rally) "Is it time to take some profits?" I always feel a little uncomfortable trying to answer these questions. I don't have a crystal ball for the markets, and trying to time sentiment is always tricky. But let me enumerate some of the risks and opportunities in the markets at the moment that might help investors make up their own minds.

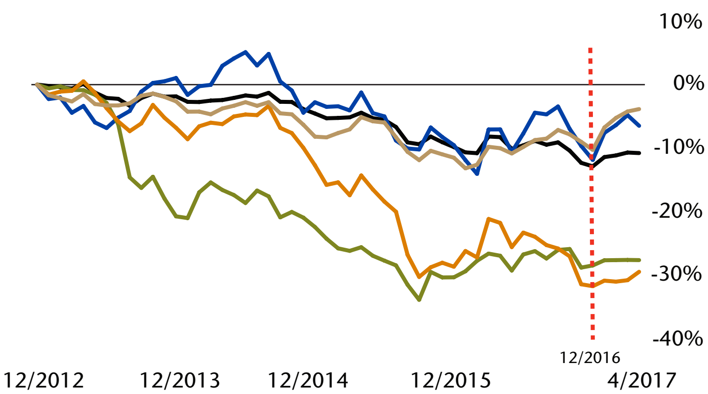
First, the risks: we do have a lot of political uncertainty at the moment. U.S. policy is more volatile than usual. Yes, the threat of tariff hikes that could have driven the U.S. dollar higher have subsided, and yes, it is less likely that the U.S. will implement a large infrastructure and tax cut plan that might have persuaded the Fed to accelerate rate hikes. Nevertheless, the policymaking atmosphere in Washington is unusually hard to guess at the moment. Markets seem to have factored in more of the good news than the potential risks.

The Asia region is not without its homegrown political risks—North Korea poses an ever-present threat to peace and stability. Notwithstanding China's role in trying to rein in North Korea is the potential for a more aggressive U.S. policy under the Trump administration that means the range of potential outcomes varies from the benign to the very serious—with little in between. Once again, the market, unable to factor in one extreme outcome or another, chooses to assume the status quo.

These are all reasons to be concerned. The reason I often hear people give for their market-related concerns, however, is the simple fact that markets have risen a lot. It's as if they fear a force of gravity will pull the markets down. I would be cautious about trading too much on this rationale. First, markets in Asia have been in the doldrums for years now so a rally is not that surprising. Second, valuations, whilst somewhat above average relative to Asia's own history, are still reasonable in global terms. Third, the markets do appear to have the tailwind of better corporate earnings growth than the analyst community had expected, and this growth ought to be sustainable for quite some time as China's economic policymakers have been successful in generating moderate inflation, which is helping corporate profits.

Don't forget—Asia's markets have been somewhat lagging for a few years now, ever since they bounced back from the Global Financial Crisis. Whereas, by IMF estimates, Asia's economies grew by nearly 32% in aggregate in U.S. dollar terms between 2010 and 2016, earnings per share in the region grew by a paltry 5%. Asia has clearly been wringing out of its markets whatever excess was built up to fight off depression in 2009 to 2010. One can see this in the large current account surpluses in places like Singapore, Taiwan, and South Korea. In particular, Thailand, whose current account was in deficit as recently as 2013, now runs one at 10% of GDP. Across the region, inflation rates are low. Core inflation in the 12 major markets of the region averages less than 2%. In India and Indonesia (perennially high inflation countries) prices are rising at just 4.1% and 3.3% respectively.

Asian Currency Rates vs. U.S. Dollar



Source: Bloomberg

Asian currencies, which had weakened as economies entered this period of wringing out the excess, have stabilized and (like the Korean Won and the Taiwan dollar) even strengthened against the US dollar. These are all signs of stability rather than exuberance.

It's always hard to time markets based on second-guessing shifts in sentiment. Unless valuations are ridiculously high (and I don't think they are) and the economic backdrop is worsening, (I actually think there has been moderate improvement) the precise moment and duration and depth of any correction is hard to judge. It's at times like this though that you need to be confident in the underlying quality of the businesses you own. If you are happy to hold onto a business for the long term, it's more comfortable to weather these periods of uncertainty. On the other hand, if you have bought equities on the basis of price movements alone, regardless of the underlying quality of the business, you have a much more fragile basis on which to continue to hold them.

I do think, therefore, that the prospect of a pullback in the markets has risen but that it is likely to be more focused in cyclical areas of the market rather than sectors with long-term secular, if unremarkable, growth characteristics. And should that pullback happen, unless there is a radical change in the economic environment, I still believe the prospect of reasonable earnings growth in domestic sectors of the market is high.

So, beware the risks yes, but try not to be fearful of the rally just because it's a rally. Sentiment in the markets is far from euphoric and economies are not overheating.

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