ASIA EX-JAPAN EQUITY

Market Outlook 2017

Much of 2016 was driven by significant macro events. From monetary and fiscal stimulus in China to the US Federal Reserve (Fed)'s dot-plot and global geopolitical events, stock and bond markets danced to the varied tunes. Asia clawed its way back from a poor start to 2016 as China stabilised and significantly, saw its producer price index turn positive (on a monthly basis) after four years of consecutive declines. This probably set the mood for better trading sentiment through much of the second and third quarters, which culminated in a broad sell-off in November for both Asian stocks and currencies, triggered by the unexpected result of the US presidential elections.

As we look forward to next year, we have global asset markets adjusting to real economic improvements, higher consumer prices and arguably mostly to perceived fiscal stimulus as the new preferred policy tool. We do not doubt that fiscal stimulus will make a meaningful impact in Asia as the likes of Philippines, Thailand, Indonesia, India and China have articulated plans for new infrastructure.

Checking optimism in Asia are the strong USD, higher interest rates and potential trade barriers. Asia has traditionally not performed well in an environment of USD strength, given its export-oriented nature and, more unpredictably, the intensity of fund flows away from Asian assets towards USD assets. However, we would argue that Asian markets can be resilient against a fundamentally improving economic backdrop.

Economically, we expect Asia region GDP growth to be moderate, with the likelihood that a better 2016 print for China will lead to a slightly lower rate in 2017 as both monetary and fiscal stimulus wane slightly. The rest of Asia will see marginal changes, though at the stock level, aggregate corporate earnings will be one of the strongest in several years (c.12-14% growth) with supportive forward valuations of 12x price-to-earnings and 1.25x price-to-book.

Our outlook is mixed for North Asia with Hong Kong, Korea and Taiwan lagging against an incrementally more positive China. Politics in both Korea and Taiwan are headwinds but for different reasons. While a stronger Korean Won versus the Japanese Yen will pose challenges to Korea's exports, Taiwan's dependence on the Apple gravy train is an inherent risk.

Despite the challenges posed by higher US rates and the US dollar, our outlook for Thailand, Philippines and Indonesia is more sanguine with domestic demand and government support readily available. Malaysia remains the black sheep with a continued absence of reforms and political undercurrents while Singapore is far too dependent on externalities to generate its own direction. Despite the massive upheaval caused by India's decision to remove large denomination notes from circulation, we believe the very real anguish suffered will be temporary until old notes are replaced by the new. India remains a favourite alongside China.

At the bottom-up sector level, our preference remains firmly anchored in Healthcare with a mix of hospitals and pharmaceuticals. Earnings will likely be immune (no pun intended) to higher interest rates and a stronger USD. Within Financials, we are even more bullish on Insurance due to recent curve steepening moves in the bond markets and are beginning to favour larger domestic banks across Asia that normally benefit from upward moves in interest rates. Within the Consumer space, we believe consumption patterns will remain supported by stable employment and high savings. Our selective preference is for names in India, China and Korea.

While 2016 can be characterised as a recovery year, when sentiment initially plumbed on a slowing China bleeding reserves, then climbed on the combination of a dovish US Fed and a nascent China recovery, 2017 is likely to be an affirmation of the belief that expansionary policies in the US will spill over to the rest of the world with an attendant rise in consumer prices and increasingly more vigilant central banks. The phrase "lower for longer" could well become unfashionable very quickly after years of central banks combating the forces of deflation and wishing for inflation instead. Therefore, the clear risk is a rapid rise in consumer prices.

As they say, be careful what you wish for.

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