November 2018

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Nikko Asset Management

ASIAN EQUITY OUTLOOK

Summary

- The MSCI AC Asia ex Japan (AxJ) Index fell by 10.85% in USD terms, on the back of concerns about rising interest rates, slower economic growth, and persistent US-China trade tensions. Large technology stocks were particularly hard hit. Separately, the USD broadly strengthened against Asian currencies in October.
- North Asian markets saw double-digit declines and lagged their regional peers. China fell by 11.5% in USD terms, with weakness mainly in the tech and consumer discretionary sectors. The RMB approached a 10-year low against the USD, and the central bank stepped in to restore market confidence, cutting its reserve requirement ratio for the fourth time this year.
- Korea was the worst-performing market in October, posting lower-than-expected 3Q18 GDP growth.
- India was weighed down by continued fears of a liquidity crisis among its non-bank financial companies (NBFCs).
- Elsewhere, ASEAN saw relatively smaller declines as a pullback in oil prices provided relief to net oil importers such as Indonesia and the Philippines. However, weak manufacturing activity pressured industrial stocks in Singapore, while expectations of a wider fiscal deficit weighed on Malaysian stocks.
- October's sell-off has brought valuations in Asia near all-time lows. The strong US dollar, rising oil prices, Chinese deleveraging and the escalating Sino-American trade conflict continued to plague Asian markets despite China starting to ease policy. We have been adding exposure to quality businesses with long-term structural growth, particularly in China and Hong Kong at the expense of India.

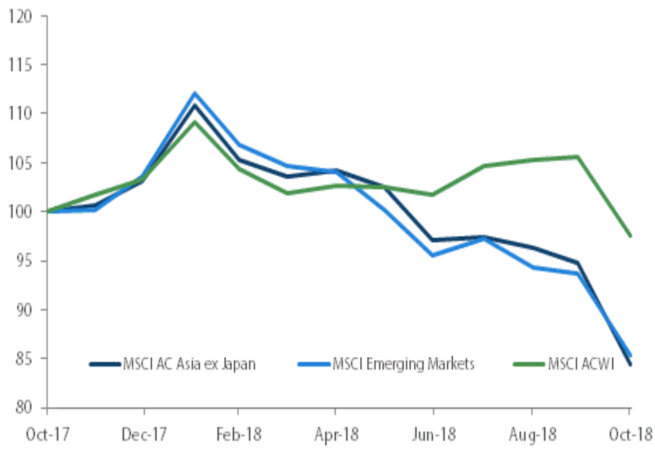
Asian Equity

Market Review

Asian equities fell in October

The MSCI AC Asia ex Japan (AxJ) Index fell by 10.85% in USD terms during October on the back of concerns about rising interest rates, slower economic growth, and persistent US-China trade tensions. The US threatened to impose tariffs on all remaining China imports should talks between presidents Trump and Xi fail in November. Large technology stocks were particularly hard hit, after Amazon and Alphabet reported results that lagged expectations. In Asia, Baidu, Alibaba and Tencent all saw steep declines. The USD broadly strengthened against Asian currencies over the month.

1-Year Market Performance of MSCI AC Asia ex Japan versus Emerging Markets versus All Country World Index



Source: Bloomberg, 31 October 2018. Returns are in USD. Past performance is not necessarily indicative of future performance.

MSCI AC Asia ex Japan versus Emerging Markets versus All Country World Index Price-to-Earnings

Source: Bloomberg, 31 October 2018. Returns are in USD. Past performance is not necessarily indicative of future performance.

North Asia underperformed regional peers

North Asian markets saw double-digit declines and lagged regional peers. China fell by 11.5% in USD terms, with weakness mainly in the tech and consumer discretionary sectors. Its economy expanded by 6.5% year-on-year (YoY) in 3Q18, missing expectations of 6.6% as domestic de-leveraging and the trade war put pressure on growth. The manufacturing PMI slipped to 50.2 from 50.8 in September, while industrial production disappointed. The RMB hit a 10-year low, approaching the psychologically important level of RMB 7 to the dollar. In response, the People's Bank of China stepped in, issuing supportive comments to restore market confidence, and easing monetary policy by cutting its reserve requirement ratio for the fourth time this year. Elsewhere, Hong Kong returned -11.1% as its property and bank sectors were hurt by higher credit costs. Private home prices fell for the second consecutive month in September and the government scrapped the sale of a residential site on The Peak after poor developer response, sparking concerns that the property market could be at the brink of a correction.

South Korea fell by 14.3% in USD terms, and was the worst-performing market over the month. Its 3Q18 growth was lower than expected at 0.6% quarter-on-quarter (QoQ), and the Bank of Korea trimmed its growth forecast for this year to 2.7%, citing weak jobs growth and global trade friction. The government subsequently announced a fresh set of measures offering financial support for smaller companies and a fuel tax cut to spur consumption. Elsewhere, Taiwan declined by 11.8%. Its tech sector continued to be hampered by concerns about slowing Apple demand.

India continued to be weighed down by NBFC concerns

Meanwhile, India returned -7.0% amid continued fears of a liquidity crisis among its non-bank financial companies (NBFCs). Its central bank took steps to infuse liquidity into the system, easing requirements for banks to lend to NBFCs and raising single borrow exposure limits for NBFCs outside the infrastructure segment.

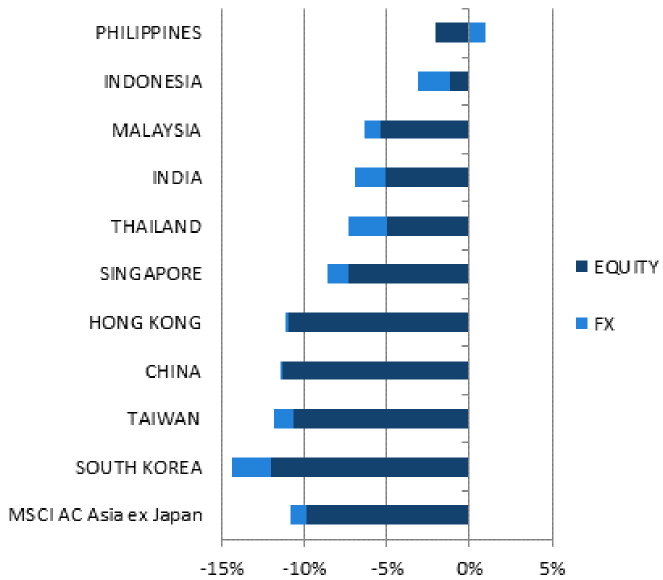
ASEAN saw comparatively smaller declines

While ASEAN markets were not spared the sell-off, they saw relatively smaller declines. Singapore was the exception: it fell by 8.6% as weak manufacturing and construction activity put pressure on industrial stocks. The Monetary Authority of Singapore was the only ASEAN central bank to take action in October, steepening the SGD NEER band in anticipation of higher inflation. Elsewhere, a pullback in oil prices provided relief to the net oil importers, particularly Indonesia and the Philippines which edged lower by 3.1% and 1.0% respectively. Previous efforts by the Indonesian government to address its trade deficit appeared to yield initial results, with the country recording a trade surplus of USD 227m in September against expectations of a USD 500m deficit.

Malaysia returned -6.4% as uncertainty around government policy sparked volatility ahead of its 2019 budget announcement. Authorities forecast a wider fiscal deficit and slower economic growth over the next two years. Cuts to development spending are expected to continue, with the government having already suspended over USD 20bn worth of public infrastructure projects. The telecommunications sector also saw sharp declines, with Telekom Malaysia's shares in particular hit by the government's decision to lower fixed broadband prices.

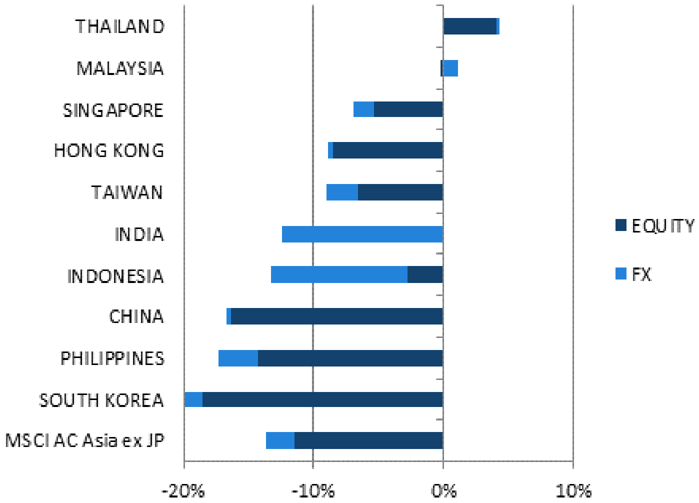
MSCI AC Asia ex Japan Index[1]

For the month ending 31 October 2018



Source: Bloomberg, 31 October 2018

For the period from 31 October 2017 to 31 October 2018



Source: Bloomberg, 31 October 2018

[1]Note: Equity returns refer to MSCI indices quoted in local currencies while FX refers to local currency movement against USD. Returns are based on historical prices. Past performance is not necessarily indicative of future performance.

Market Outlook

Valuations in Asia continue to be attractive

October's sell-off brought valuations in Asia (ex Internet) to within 5-10% above all-time lows at only 1.3x price to book ratio. A strong US dollar, rising oil prices, Chinese deleveraging and an escalating Sino-American trade conflict continued to plague Asian markets despite China starting to ease on the policy front. The prospect of mid-term elections, Xi-Trump face-to-face meetings and China's 4th plenum give ample opportunity for further clues on future policy direction in November. We have been taking the opportunity to add exposure to quality businesses with long term structural growth, particularly in China and Hong Kong at the expense of India.

Focus on China sectors orientated towards domestic consumption, healthcare and software

Despite ongoing uncertainties on trade and investments as well as continued deterioration in macro data, we expect China to remain committed to its long term resolve of financial deleveraging and shifting from quantity of growth to quality of growth. This has been evident in recent policy easing with tax breaks for consumers and infrastructure funds being raised through more formal debt channels than in the past. The recent market pull-back thus provides buying opportunities in quality businesses exposed to these multi-year structural tailwinds and we have recently added software to our other core long-term holdings of insurance, healthcare and select consumer sub-sectors.

Have reduced exposure to India on valuation grounds

In India, while there are some signs of a pick-up in industrial activity, there have been continued dislocations in the financial sector owing to a combination of higher rates, liquidity tightening and a NBFC failure. Political risks are also rising with opposition parties contemplating various alliances to put up a more united stand in the general elections in 2019. This together with rich valuations have led us to reduce positioning here, although we retain our long term core holdings in sectors which stand to structurally benefit from recent reform efforts, notably in real estate.

Remain selective in Korea and Taiwan

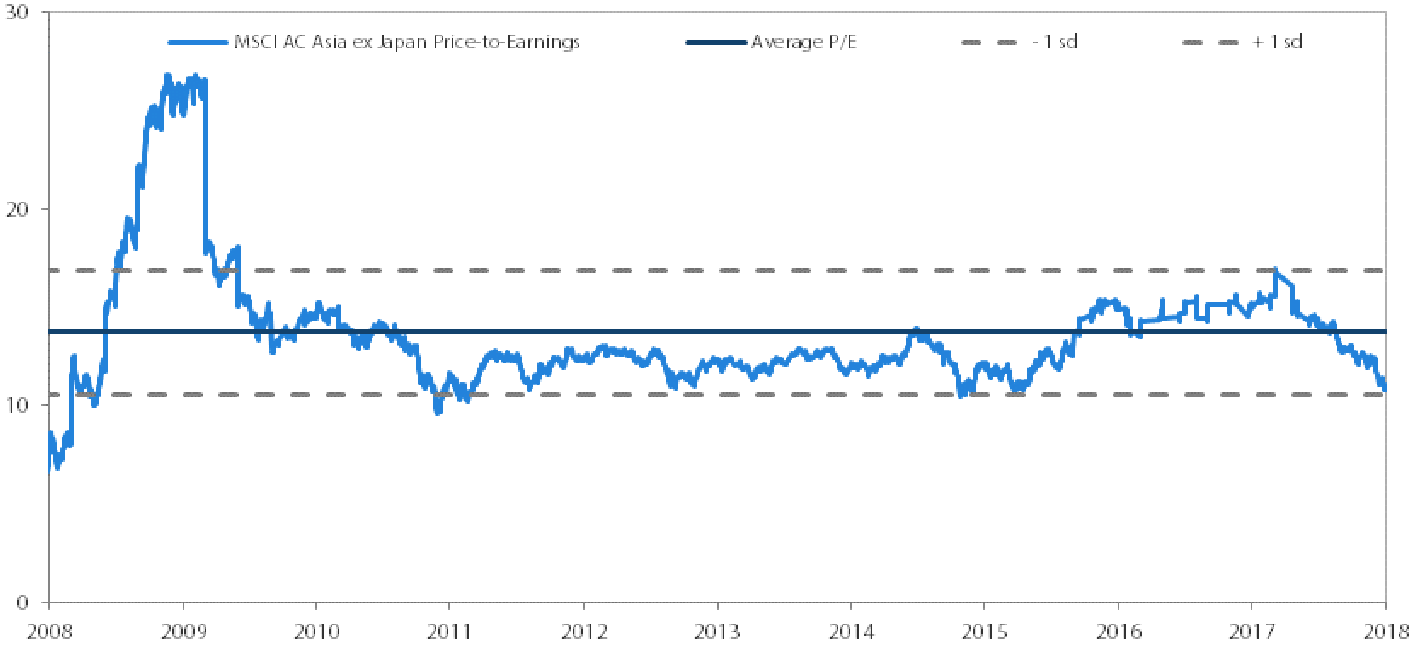
In Korea, despite President Moon's conciliatory moves towards the northern neighbour, the domestic economy remains lacklustre and the breadth of corporate profits is gradually compressing. In the tech sector, memory prices in particular are also moderating as a result of supply pressure. Taiwan too faces pressure on the hardware and semiconductor side from a combination of rising input costs, smartphone demand waning and potential supply chain disruption. We continue to be selective in Korea and Taiwan with investments in structural growth areas of electric vehicles, healthcare and high-speed transmission interface sub-sectors.

Maintain underweight in ASEAN

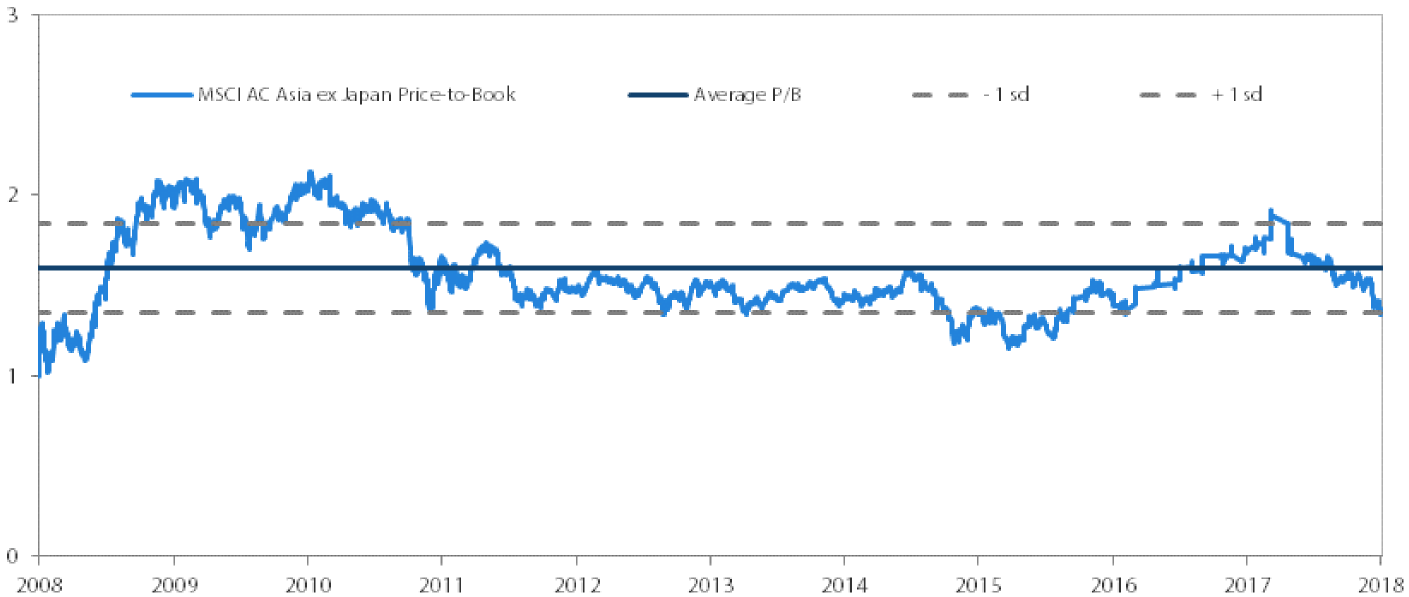
Within ASEAN, a strong US dollar and higher oil prices are responsible for the ongoing market uneasiness. There is, however, greater political clarity in Thailand which augurs well for the country's longer term prospects. Together with its healthy balance of payments, Thailand remains our preferred market in ASEAN owing to some attractive bottom-up stock ideas. There are early signs of a consumption recovery in Indonesia and a significant amount of adjustment has already taken place within the local banking system and from currency weakness. We are reviewing investment opportunities here. Malaysia is interesting in that there could be significant medium- and long-term positives should the new government deliver on its electoral promises; we are content to wait on the side lines pending proof. We remain zero weighted to the Philippines where higher rates and inflation are likely to curtail the high growth rates we have witnessed in recent years.

Appendix

MSCI AC Asia ex Japan Price-to-Earnings



MSCI AC Asia ex Japan Price-to-Book



Source: Bloomberg, 31 October 2018. Ratios are computed in USD. The horizontal lines represent the average (the middle line) and one standard deviation on either side of this average for the period shown. Past performance is not necessarily indicative of future performance.

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