Market Insights

2014 Asia investment outlook – year of selectivity

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The macro backdrop continues to improve as we are entering 2014. Global purchasing managers' index (PMI) is trending higher and confirming that world economies are well in the expansionary zone. While global economic fundamentals are recovering, investor sentiment has experienced pendulum swings upon the changing expectations of the US Federal Reserve's ("the Fed") asset purchase tapering in 2013. With the retreat of excessively easy liquidity in the global financial system following the commencement of tapering, investors will increasingly focus on the differentiation of economies and be more selective.

In Asia, reform and election dynamics will also be another big theme in 2014, and which will chart the structural growth trajectory of Asian countries for years to come. Looking forward, we are positive on the outlook of Asia but, at the same time, we believe selectivity is the key to portfolio outperformance as divergence among economies and stocks is growing.

Riding the global recovery trade

As developed market economies are recovering from "debt crisis mode" and systemic risk is receding, these economies are likely to experience modest economic growth in 2014. The commencement of the Fed's tapering is proof that the Fed is confident of a broad-based, sustainable economic recovery in the US. We expect the US housing market to continue to pick up, given the still accommodative monetary conditions and much improved bank balance sheets. Though structural growth challenges remain, the eurozone is showing a silver lining with reduced fiscal drag; even peripheral Europe is showing recovery in their current account situations. Japan received a medium-term boost to its economy as it won the bid to host the Tokyo Olympics in 2020.

All these developments are conducive to the export recovery of Asia and export-driven sectors can ride on the recovery of developed markets. In fact, recent trade data from Asia is already showing signs of external demand revival feeding through. For example, China's export growth hit a 7-month high of 12.7%YoY in November, well above market expectations, and Korea posted a record high current account surplus of US$9.5 billion in October. We expect export trends in Asia will continue to gain momentum going into 2014.

Fed's tapering removed a big uncertainty for markets

The Fed took its first step towards unwinding its unprecedented monetary stimulus in December 2013. While the timing of tapering commencement around Christmas might have surprised some investors, the markets had well priced in the imminent move by the Fed, given the strength of recent US data on the employment and housing market fronts. We believe the commencement of tapering and strong Fed guidance about low interest rates[1] gave investors the assurance and comfort that monetary policy will not be reversed any time soon. These factors should help reduce sentiment swings and prevent the volatilities which haunted global markets in 2013. We are confident that Asia as a region, with intact fundamentals, can withstand the impact of an orderly tapering.

Compared to the run-up to the Asian Financial Crisis (AFC) in the late nineties, most Asian countries are now enjoying a much healthier level of foreign exchange reserves and the systematic risk of foreign currency denominated debt is significantly lower than pre-AFC. Also, it is worth noting that the equity correction in selected South Asian markets during mid-2013 had priced in the fear of capital outflows once tapering happened and has brought valuations to more reasonable levels. On the other hand, we do not believe that asset purchase tapering means an abrupt and massive withdrawal of liquidity. It simply means a smaller net addition of assets on the Fed's balance sheet, not an overt sale of assets. We also believe the liquidity within the global financial system should remain ample for emerging market assets. More importantly, Fed Chairman Ben Bernanke commitment to an extended period of a low interest rate environment provides an assurance of stable liquidity costs for Asian corporates, especially relating to short-term USD-denominated debt.

[1] Source: US Federal Reserve, FOMC Statement, 18 December 2013. The FOMC anticipates that it is likely it will maintain the current target range for the federal funds rate well past the time that the unemployment rate declines below 6.5%, especially if projected inflation continues to run below the 2% longer-run goal.

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China reform optimism to carry through, supported by improving macro

We believe China remains the growth engine for the Asian region. The recent mega reform package decided at the Third Plenum offers a structural boost to China's growth trajectory. Since the initial announcement in November, there has been high conviction and dedication shown by the central government in moving forward with such reforms. While it is worth noting that the progress of reforms may take time (up to several years) to bear fruit, we expect to see more implementation about the plans of various reforms to be announced by relevant ministries over the coming months. These details will give more certainties to the market and drive market performance through 2014. Gross domestic product (GDP) forecasts for 2014 by sell-side analysts have been revised up on the back of improved optimism towards reforms and we expect this reform-driven optimism to carry through—although not every sector or company will be a standout beneficiary. After the initial excitement over the aggressiveness of the reform outline subsides, investors will focus on the pace and scale of implementation. Still, we remain optimistic about the commitment and execution of the related reform package and believe a stable macro backdrop, as confirmed by recent releases of data, should provide a solid foundation for reforms to take place.

The reform package sets the stage for China's structural rebalancing from an investment/manufacturing-driven model to a more consumer-driven growth model. As China attempts to move up the production value chain, other Asian countries should also benefit from the emerging opportunities from China, as we have seen in the case of increasing manufacturing relocation from China to the rest of Asia, such as to Indonesia and Vietnam, due to China's rising labor costs.

Elections in Asia to pave way for policy certainties and fuel hopes on structural reforms

National elections in Asia will be one of the highlights in 2014. India, Indonesia and Thailand will have general elections in 2014, which will affect 1.56 billion of people in the region i.e. close to 50% of the Asia Pacific ex Japan population[2]. With the three economies contributing almost 20% of the region's nominal GDP[3], the elections could have significant economic implication for the region over the medium term. India will hold General Elections in May 2014 to determine the lower house of parliament and the next Prime Minister. Indonesia will hold legislative elections in April 2014 and a presidential election in July. Recently, Thai Prime Minister Yingluck Shinawatra dissolved parliament and called for fresh elections to be held in February 2014. All these elections will pave the way for more policy certainties, and fuel hopes on structural reforms that are most needed in the three countries. In particular, there will be more visibility in government spending which removes the existing overhang in corporate capital expenditure. This is especially true for India where new government project announcements have slowed down year-to-date 2013 as the country is approaching the General Elections in May 2014. Political certainty after the election could enhance the progress of solving the country's infrastructure bottleneck situation. Also, the revival of large order books from the government could also help with companies' cashflow and balance sheets, especially for infrastructure-related sectors.

Selectivity is key to outperformance

There is a growing disparity in macroeconomic strength across Asian countries, with North Asia showing stronger signs of economic resilience. We prefer North Asia to South Asia as the former is more geared towards the economic recovery of developed markets on the back of a higher export share to the Western part of the world. Although South Asia is experiencing some macro headwinds, there are also country disparities. India has shown marked improvement in the current account deficit, while Indonesia remains challenged by the same issue.

[2] Source: CEIC, Datastream, Bloomberg, MSCI, World Bank, UNESCO, CIA, US Bureau of Statistics, IMF, J.P. Morgan estimates
[3] Source: ditto. Nominal GDP of various countries in 2012. Region refers to Asia Pacific ex Japan.

Despite the macro headwinds in certain Asian countries, Asia is still full of interesting stock opportunities, but investors need to be selective. There are standout beneficiaries such as export-oriented names which are more leveraged towards developed markets (DM) recovery. Their valuations are also supportable, given the downside risks of DM having been priced in to a large extent over the past two years.

Asia has prided itself as the world's production powerhouse for years, thanks to low production and labor costs. However, we are increasingly finding pure cost advantage is not enough to sustain durable outperformance and matters such as technological innovation can dramatically change industry dynamics in a short period of time. For example, the advent of smartphones and tablets has structurally displaced the demand for personal computers and laptops, and companies which fail to innovate alongside the trend of smart devices will tend to underperform, even with cost advantages. On the other hand, we prefer companies with quality products as they can better weather demand fluctuations. In terms of stock selection, it is also important to select companies with a secular story and industries with low penetration rates, such as the auto industry in Southeast Asia, will continue to present secular growth despite short-term macro headwinds. These opportunities will tend to prevail over the longer term.

Valuations remain attractive, Asia can play catch-up

Asia is expected to deliver earnings growth of 12% in 2014[4]. Valuations remain attractive compared to developed markets, with the MSCI Asia Pacific ex Japan's 2014 price-to-earnings ratio (PER) being 11.8x, compared to MSCI World's 2014 PER of 14.2x[5]. In 2013, the Asian region delivered a return of 3.7% while developed markets rallied around 27.4%[6]. This wide performance gap allows lots of room for Asia to play catch-up as the positive catalysts in the region unfold in 2014.

[4] Source: Invesco, I/B/E/S. Data as of 13 December 2013.
[5] Source: I/B/E/S, MSCI, JPMorgan estimates. Data as of 13 December 2013.
[6] Source: Invesco, Factset. MSCI AC Asia Pacific ex Japan, MSCI World total returns indices, in USD terms.